etfexpress special report
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July 2018

ESG, SRI and impact investing 2018

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Demand surges for ESG, SRI and Impact Investing

By Beverly Chandler

Demand from investors lies at the heart of the current rise in including ESG, SRI and Impact investing filters to investment products. Investors, particularly large institutional investors in the religious or educational sectors, care, and increasingly, they realise that they do not have to lose investment returns in order to invest with ethical considerations.

But the routes to include ESG or SRI factors in investment are less clear. A study earlier this year from American research firm Cerulli Associates, found that alternatives struggle in implementing ESG principles, despite being fully aware that this is what investors want.

Time horizons vary – ESG factors can take a long time to play out, while alternatives tend to invest for a shorter outcome, the firm noted. This piece of research found that reporting, lack of data and transparency were also issues for alternative managers seeking investments that pass the ESG challenge.

However, in the US, 90 per cent of US asset managers reported that ESG integration is a factor in their future product development plans, and some of Asia's major institutions have started awarding ESG mandates, a development that Cerulli believes will prompt others to follow suit.

Using ETFs as a route to including ESG factors has also been studied by State Street

Global Advisors, the asset management arm of State Street Corporation, whose latest research that reveals that 83 per cent of institutional investors and wealth managers expect flows into ESG ETFs to increase between now and 2023. Just over one in five (22.5 per cent) anticipated a dramatic rise.

The largest factor behind this growth was increasing demand from investors, followed by an overall increase in demand for ESG strategies, which accounted for 28 per cent of respondents. One in four (25 per cent) say demand for ESG ETFs will be driven by regulatory changes that make those strategies more appealing.

When asked which exclusions would make investors more likely to invest in an ESG ETF, 61 per cent said weapons manufacturers, followed by 44 per cent who pointed to fossil fuel companies. The same percentage cited organisations that conduct tests on animals.

When asked what inclusions would make investors more likely to select an ESG ETF, 66 per cent cited sustainable energy, followed by 39 per cent who selected habitat protection. More than one in four (26 per cent) said an ESG ETF with a focus on diversity would increase their chances of investing in it.

But that fear of ESG impacting on returns continues. Another study from Cerulli found that, for advisers, one of the biggest hurdles in turning interest into actual investment, both by users of ESG and non-users, is the perceived impact on investment performance.

The firm reports that among ESG users, only 19 per cent state that sustainable investment returns are a major factor driving their demand for ESG. On the opposite side of the fence, 35 per cent of advisers not currently using ESG note that a negative impact on investment performance is a significant factor preventing them from implementing ESG.

Data provider and analyst firm Morningstar published its report on the sector in May. 'Passive Sustainable Funds: The Global Landscape,' reviews trends in asset growth, asset flows, and product development of index-tracking sustainable funds and is designed to illuminate the choices currently available to investors worldwide.

Morningstar writes that as of 31 December 2017, there were nearly 270 sustainable index mutual funds and ETFs worldwide, with collective assets under management of approximately USD102 billion.

Morningstar's figures found that passive sustainable funds' market share has doubled globally from less than 6 per cent five years ago to about 12 per cent, coinciding with the overall trend towards passive investing and the development of more sophisticated indexes on the back of better environmental, social, and governance (ESG) data.

Growth across regions has not been uniform, Morningstar says. Over the past five years, US assets have quadrupled. European funds have dominated inflows over that same span and retain the lion's share of assets–accounting for 85 per cent of the global total.

The firm writes that Europe's dominance is largely supported by institutional investors with sustainable mandates, particularly Scandinavian public pension, sovereign wealth, and insurance funds.

Data based on indices such as the MSCI Emerging Markets Socially Responsible Investment index reveals performance of over 20 percentage points ahead of the MSCI EM index since its launch in mid-2011, based on Bloomberg data from May 31 2011 to April 30 2018.

And MSCI's own research shows that it's not just the G in ESG which makes

ESG factored companies perform. The firm says that when it came to a select group of companies with excellent financial fundamentals, ESG information was more than just a proxy for strong governance.

"Better management of environmental and social risks and opportunities led to higher MSCI ESG Ratings, which, in turn, were associated with higher ROIC and valuation. In short, environmental and social scores provided an overlay investors may use to further differentiate performers, serving as a reminder that ESG is a tale told in three parts," the firm writes.

And environmental concerns are also increasingly important. The UK Sustainable Investment and Finance Association (UKsif) and the Climate Change Collaboration have undertaken its second annual survey of fund managers and reports that the fund management sector is clear that International Oil Companies (IOCs) will be negatively revalued within a few years because of climate change related risks. The Association finds that 90 per cent of fund managers expect at least one risk to impact significantly the valuation of IOCs within two years.

According to this survey, the big risks include reputational damage because of their role in causing climate change; Litigation for losses from climate change; and Regulation to curtail fossil fuel pollution.

The transition of energy also poses risks, the survey says, as the increasing competitiveness of alternative energy technologies leads to a drop in demand for fossil fuels and a shift in market sentiment as investors lose faith in IOCs ability to transition in a financially successful manner.

This study found that 89 per cent of managers agreed that these and other transition risks would impact valuations of the IOCs 'significantly' in the next five years, and that these perceptions of risks have increased dramatically in the last 12 months.

The report found that since last year there is a doubling of investors that see transition risk significantly impacting IOCs in five years with the result that some respondents were planning to divest from IOCs if they didn't see a material change in policy and behaviour.

And, again, investor demand was a significant driver of this change. The report found that 71 per cent of managers reported an increase in client interest in the last 12 months. And 15 of the total 30 managers already offer active funds or bespoke portfolios that have 'Divested from (at least) the 200 coal, oil and gas companies with largest reserves'. Some 13 firms in the study offer active equity funds, and four others could. Three offer passive equity funds with the same criteria, and three more could. Five managers offer or will soon offer bond funds that are divested from the top 200, six others could.

The authors of this report say: "The fund management sector recognises the imminent risks posed to fossil fuel investments from climate change and the transition toward a zero-carbon economy." ■

The robotic route to ESG investment

Interview with Richard Lightbound

2013 saw the launch of index provider ROBO Global, the first firm to launch an index series based on robotics, automation, and artificial intelligence (AI).

Since then, the ROBO Global Robotics & Automation Index has grown to underpin some USD3.7 billion in ETF assets.

ROBO Global European CEO Richard Lightbound says: "The whole robotics and automation theme brings benefits and efficiencies to society. Look at strained healthcare systems and natural resource sources. Look at pollution and safety concerns – robotics and automation impact all of those challenges."

Robotics and automation get a lot of bad press, Lightbound observes, as people take the perspective that developments in the sector will take away their jobs.

"But it's much broader than robots in factories," he says. "Robotics and AI are used in space, underwater, in fields and assisting in surgery. AI is rapidly becoming the best global oncologist with its ability to spot cancer patterns early. This is phenomenally powerful and is going to assist surgeons but never replace them."

Lightbound also notes that most parents want their children to be safe and have better lives. Robotics and AI reduce traffic accident rates, he says.

"Yearly, 1.2 million people are killed in car accidents and 95 per cent of those are caused by human error. So, don't worry about autonomous vehicles – even semi-autonomous vehicles can bring those figures down and the cost of what happens after an accident in terms of hospital bills and insurance and cars themselves is billions of dollars."

Lightbound also believes that robotics and AI can help meet the challenges in agriculture. "There are a lot more mouths to feed as the population is growing and we can't continue to cut down forests to create more land.

Richard Lightbound, CEO EMEA, ROBO Global

"We must improve productivity and we don't want more water, fertilisers and chemicals. Enter precision ag which is a good example of taking the same technology used in the robotics and automation theme and bringing it into real products that can be used by farmers."

One of the index members is tractor maker John Deere which incorporates a great deal of technology in its machines.

"There is a piece of hardware which can be towed behind a tractor with facial recognition type software sensors and a delivery system which is capable of identifying and assessing the water density in plants, giving the exact amount of water needed in the right place."

The index is advised by its advisory boards and has just added its seventh PhD into the team. The index performance last year was up 46 per cent and the median EPS growth went to 30 per cent, with top line sales growth of 11 per cent for the first quarter of this year.

"We are a research driven index provider, and we continue to strengthen our advisory team. We are thrilled with how it's grown – we have managed to attract this talented group of strategic advisers and they like us because as a group they get to interact and help us understand where we want to look for the companies that should be in the index."

The firm formally introduced an ESG policy last year, recognising it was important to investors, and removed two companies from the index as a result.

The principles are: to ensure there is no risk of human rights' violations; there is nothing that could lead to severe environmental damage and to make sure that the companies in the index aren't in breach of any fundamental ethical norms. ■

BNP leads the way in SRI investing

Interview with Isabelle Bourcier

BNP Paribas has been at the forefront of ESG and SRI approaches to running its business, not least with the bank's flagship commitment to becoming carbon neutral.

BNP Paribas Asset Management has continued this initiative with its response to growing investor demand for more responsible SRI approaches.

Isabelle Bourcier, Head of Quantitative and Index-based Management at BNP Paribas Asset Management, explains that investing in a more ethical manner need not necessarily have a negative effect on investment performance.

"The prejudice that a responsible investment approach penalises performance is well entrenched among investors," she says. "However, current analyses of the past performance of indices show that these preconceived ideas are no longer relevant."

Bourcier explains that the outperformance of the SRI index versus the standard index depends far more on the region, period and rules that govern the constitution of the index.

"If we look at the MSCI KLD 400 Social Index, which has the longest statistical history, we see that over the period from 31 May 1994 to 29 June 2018, it slightly outperformed the MSCI USA IMI with an annual return of 10.01 per cent compared to 9.93 per cent*."

Another study from MSCI analysed the relationship between ESG ratings and drops in share prices. Over the period of analysis from January 2007 to May 2017, the 20 per cent of shares with the lowest ESG ratings recorded a drop in their share price of at least 95 per cent – three times more than the best-rated 20 per cent. ESG ratings concern risks that are specific to the shares (business model) as well as systemic risks (change in the market or regulatory environment).

Isabelle Bourcier, Head of Quantitative and Index-based Management at BNP Paribas Asset Management

Investments in funds are subject to market fluctuations and the risks inherent in investing in securities. The value of the investments and the income they generate may go up or down, and investors may not get back the amount they initially invested. The funds described present a risk of loss of capital. For a more detailed definition and description of the risks involved, please refer to the fund's prospectus and KIID. Before subscribing, you must read the most recent version of the prospectus and KIID, available free of charge on our website www.easy.bnpparibas.com

Bourcier also points out that investors have the choice of numerous actively managed funds or ETFs that track the performance of sustainable indices.

"The low total expense ratios, of around 0.25 per cent to 0.60 per cent pa, transparency and the possibility of buying and selling at any time during market opening hours argue in favour of ETFs for certain type of Investors" she says.

BNP Paribas Asset Management offers ETFs that track the SRI indices which cover the major regions and within the BNP Paribas Easy ETF range, there are a number of products that enable investors to reduce the carbon footprint of their portfolio and extend its ethical status.

"BNPP AM has been a pioneer in ESG ETFs since 2008 and we provide since socially responsible investment solutions aimed at institutional and individual investors. We note that investors are increasingly aware of the impact of their investments and would like to invest in financial products aligned with their commitments and beliefs," says Isabelle Bourcier, Head of Quantitative and Index-based Management at BNP Paribas Asset Management.

As a responsible investor, we believe that Environmental, Social and Governance (ESG) issues may impact the value and reputation of entities in which we invest. We are therefore committed to incorporate ESG standards into our voting criteria to act in the long-term interests of our clients. The voting and engagement policy of BNP Paribas Asset Management is applied to all Funds/ETFs when physical replication is concerned. Positions are cumulated to the BNP Paribas ones in order to obtain a more significant impact and the policy is reviewed every year by the board of BNP Paribas Asset Management. ■

**Source: MSCI as of June 2018*