

# Balancing economies of scale with ESG customisation

In late September, **Tell Media Group**, in co-operation with **BlackRock**, **Invesco**, **JPMorgan Asset Management** and **UBS Asset Management**, invited Swedish ETF investors to discuss trends within the ETF industry. The discussion, which was held at Nobis Hotel in central Stockholm, was moderated by Tell Media Group founder Niklas Tell.

By: **Niklas Tell**



The discussion started with Niklas Tell asking the investors at the table how they are currently using ETFs and if this has changed over time.

**JONAS THULIN:** "I would say ETFs make up about 80 per cent of what we use for the entire asset management operation. On top of that, we do some stockpicking and we also use some mutual funds. We use ETFs for active trading and we don't really care much about this active versus passive discussion. We're active and it doesn't really matter to us if the underlying instrument is so-called active or passive. We screen some 58 000 ETFs every day to optimise our portfolios and we hold about 13 ETFs, so it's quite an aggressive approach. We're a small house and that's our strategy to stand out from the crowd. I would trade differently if I was a hedge fund and I would trade differently if I was a big bank."

**KRISTIANS MIKELSONS:** "I run asset allocation portfolios for institutional clients and most of what we use to build our portfolios are ETFs. This is both for long-term strategic holdings and also for more tactical positions."

**NIKLAS TELL:** LOOKING BACK OVER THE LAST 12 MONTHS, WHAT HAVE BEEN THE MOST SIGNIFICANT PRODUCT DEVELOPMENT TRENDS WHEN IT COMES TO ETFS AND HOW WOULD YOU DESCRIBE ETF FLOWS SO FAR IN 2021? IS IT STILL ABOUT FIXED INCOME AND ESG?

**FLORIAN CISANA:** "If I start from a product development perspective, I currently see five topics. Sustainability is, of course, one. We've seen a lot of new products being launched and we've moved from 324 ESG ETFs globally at the end of 2019 to 695 at the end of July 2021. While number of ETFs have doubled, the assets have increased by factor five, so from USD 66 billion at the end of 2019 to USD 309 billion at the end of July 2021. Thematics is another topic, partly connected with sustainability, where we see a lot of new products. Other topics are active ETFs as well as China. The final area is digital assets, even if we from a regulatory point of view are not yet able to launch cryptocurrency ETFs under UCITS and SEC rules."

**FREDRIK NILSSON:** "If I may zoom out a little bit from pure product development trends and add that we are more and more seeing the benefits of competing with a global platform. The last year has been particularly strong for cross-regional flows. We have seen record flows from EMEA-based clients into our US-domiciled ETF range, as well as very strong inflows from Asia-based clients into our UCITS range."

**NIKLAS TELL:** JONAS, HOW IMPORTANT IS PRODUCT DEVELOPMENT IN THIS SPACE TO YOU? YOU SAID YOU SCREEN 58 000 PRODUCTS EVERY DAY, SO DOES IT MATTER IF SOME NEW ETFS ARE BEING LAUNCHED?

**JONAS THULIN:** "Absolutely. The more specific and narrow an ETF, the better for us as we're able to more specifically

express our views. Product providers are not really launching ETFs with broad exposure to a sector but rather to very specific areas. So not exposure to IT broadly but rather to semi-conductors, for examples."

**KRISTIANS MIKELSONS:** "I agree. We incorporate a thematic approach and it's of course a benefit if we can find very specific exposures through ETFs."

**WILHELM SCHAUMAN:** "These are broadly the same themes that we are seeing. If we go a little bit deeper on the sustainability theme, we see that the implementation preferences of investors vary. Some investors prefer to limit their exposure to fossil fuels, some are looking to incorporate more forward-looking ESG measures like physical risk and others would like to take a more targeted approach with sustainable thematic strategies or impact investing. We have built, and continue to evolve, our platform to meet these needs. I agree with what Jonas highlighted on investor interest for more targeted and specific exposures. For equity ETFs, there's a vast offering of specific exposures. However, we also see demand for increasing granularity in fixed income and we have recently launched new strategies that address this."

**NIKLAS TELL:** FLORIAN MENTIONED ACTIVE ETFS AS ONE OF THE TRENDS. DO YOU AGREE WITH THAT, TOBIAS?

**TOBIAS NILSSON:** "Yes I do. We're on track for another record industry year but we also see active ETFs starting to really gain ground. In the US, it constitutes 12 per cent of flows and in UCITS it is starting to resonate with 3 per cent of flows year to date. The introduction and growth of that low tracking-error active-ETF category alongside

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passive, ESG, smart beta, thematic is an important development. That trend is not only for longer term strategic holdings in equity but also in fixed income. In terms of ESG, for that range in particular, we see more client due diligence on integration compared to our passive or quant side, which is more exclusions or active ownership orientated”.

**NIKLAS TELL: IS A LACK OF DATA AND A LACK OF AGREEMENT ON DEFINITIONS WHEN IT COMES TO SUSTAINABILITY AND ESG A PROBLEM WHEN YOU'RE DEVELOPING ETFS IN THIS SPACE?**

**FREDRIK NILSSON:** “I think it's a massive challenge and not only for ETF providers. Data has become crucial for the ESG space. There's an enormous amount of ESG data available today and there's a growing need for better quality and more standardised data sets. We believe the SFDR reporting will accelerate this development, including some of the required regulatory data sets not yet available.”

**WILHELM SCHAUMAN:** “We've seen ESG indices evolve to capture the latest available data sets or to adapt to client interest – a good example being a greater focus on climate. We expect such evolutions to continue as forward-looking data sets become available and overtime these will develop as well.”

**NIKLAS TELL: FROM AN INVESTOR POINT OF VIEW, I ASSUME YOU HAVE INTERNAL FRAMEWORKS WHEN IT COMES TO ESG. DOES THAT MATCH WHAT YOU'RE ABLE TO FIND FROM ETF PROVIDERS?**

**KRISTIAN MIKELSONS:** “It's getting better, I would say. We've moved from a situation where it was a struggle to find suitable products to a situation where we're getting there. Product providers are listening to what we're looking for and the industry is catching up.”

**FLORIAN CISANA:** “Most ETFs we launch are ESG ETFs. We're in a special time right now where a lot of clients are reviewing their current ESG approach with regards to the new EU taxonomy. Therefore, the way we service clients has completely changed. Today, we're discussing with clients what their right approach on ESG is and how we can help clients with off-the-shelf ETFs or alternatively more customised solutions. The challenge for ETF providers is, of course, that we always try to find many clients that have the same needs.”

**WILHELM SCHAUMAN:** “I think we're starting to see some degree of standardisation, for example on what investors want to avoid and screen out of portfolios. The push towards a more robust standard setting will help to eliminate the perceived complexity and counter the perception of greenwashing. Our sustainable investing framework applies to both indexed and alpha-seeking products and it aims to bring much-needed clarity and enable our clients to match their ESG objectives to clear outcomes. From eliminating certain exposures to focusing on the top-rated ESG performers, there are different ways to incorporate sustainable investing into a portfolio.”

**TOBIAS NILSSON:** “I agree that at least exclusions are becoming more standardised. Then it will be about the investment-platform itself: how can we address ESG data issues in coverage or quality? For us, it has been about complementing data by actively coverings stocks or bonds, meeting with management and using that information advantage also for ESG. The framework itself is the most important to provide customised solutions to clients. Then the challenge in the ETFs space is that you need a balance between on the one hand a solution to gain scale and fit many clients due to the low costs of ETFs and on the other satisfy various client approaches to sustainability.”

“We've moved from a situation where it was a struggle to find suitable products to a situation where we're getting there”

– Kristians Mikelsons, Swedbank Robur Fonder

**KRISTIAN MIKELSONS:** “When we talk about sustainability, I think a needed extension would be more products in the small- and mid-cap space. Today it's almost exclusively different versions of S&P 500 or other large cap indices. Another product we would look at would be corporate credit where fossil fuel is excluded.”

**NIKLAS TELL: WHEN IT COMES TO ACTIVE OWNERSHIP, DO INVESTORS NOW UNDERSTAND THAT YOU'RE ACTIVE OWNERS OR IS THAT STILL A CONVERSATION YOU NEED TO HAVE?**

**FLORIAN CISANA:** “I think asset managers have done a good job in explaining that we do stewardship across both active and passive strategies but we still have investors that don't think we're active owners of companies that are held in passive vehicles. That's surprising.”

**JONAS THULIN:** “To me, it's crystal clear and I think this is the one last thing that traditional mutual funds are hanging on to in order to charge the fees they charge. I think that's one reason why some are still arguing that only active managers can be active owners. I was reflecting on another thing that I think must be difficult from a product provider point of view and that's the fact that big institutional investors are constantly raising the bar when it comes to sustainability. It must be a challenge to figure out what will work in the first place but then that can change from one month to the next.”

**FREDRIK NILSSON:** “From that perspective, it's a challenge to be based in the Nordics because we're constantly trying to push our product developers based on the needs and requests from Nordic clients. Our investors are in many ways setting the bar.”

**FLORIAN CISANA:** “Can I ask a question to Fredrik? It's interesting what you're saying that you're raising the bar internally when it comes to meeting the needs of Nordic clients. I agree that Nordic clients in many respects are ahead, for example when it comes to climate. However, if you look at ETF assets in Europe, the Nordic region is some 5 per cent of that. Given the fact that ETFs are about scale, using the Nordic demands to set the agenda for product development will only work if you assume that the rest of Europe will follow. Do you see this the same way?”

**FREDRIK NILSSON:** “I agree and it's therefore not only about bringing ideas from Nordic clients to the product development team but it's also about educating and getting the rest of the sales team on board and making sure they join the journey in order to build scale in these new products.”

**TOBIAS NILSSON:** “I think it's a fair question but I also think it's not only about the Nordic ETF assets today but rather the potential in the Nordic region. It's a big fund market and have a strong outlook when it comes to ETF growth just in the efficiency of the vehicle itself. On the second point, I relate to those observations in that our clients' preference for ESG has meant we've often led that journey internally. At times that can be challenging but the focus has also been correct. The Nordic product agenda is now one that Europe shares, both from a political and financial perspective. Globally, we may be in different stages but the direction of travel is the same.”

**NIKLAS TELL: JONAS, YOU MENTIONED THE FACT THAT INSTITUTIONAL INVESTORS ARE RAISING THE BAR WHEN IT COMES TO SUSTAINABILITY. IS THAT BECAUSE OF GENUINE ESG CONCERNS OR IS IT MORE ABOUT THE HEADLINE RISK - THAT THEY SIMPLY DON'T WANT TO SEE SPECIFIC NAMES IN THEIR PORTFOLIOS?**

**JONAS THULIN:** “It's mainly about headline risk. They don't want anyone knocking on the door and asking difficult questions about specific companies. Another discussion when it comes to sustainability is the fact that Sweden seems to be going against the EU taxonomy, saying it's the wrong way forward. At the same time, we have institutional investors working to ensure they follow this. These are really interesting and complex times as we will have different views on what is sustainable or not and I think it could be a rough couple of years as we work our way through this.”

**KRISTIAN MIKELSONS:** “I don't think asset managers or institutional investors just follow what governments say or do but they should do what they believe is the best way forward. When it comes to SFDR, I don't see that as something that's driving the development but rather something that's coming from behind to provide some structure to the reporting.”

**TOBIAS NILSSON:** “In terms of product development, we saw a major development theme and flows into ESG ETFs



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because we as providers believe it's a positive development and commercially because our clients want that exposure in their portfolios. Then we had taxonomy, so now we have ESG ETFs as well as taxonomy ETFs. If these drivers had happened at the same time, maybe we wouldn't have both types but one that satisfies both. In that sense, I also think it's a moving target."

**NIKLAS TELL: TO WHAT EXTENT CAN YOU CAPTURE THE GREEN TRANSITION THROUGH AN ETF?**

**WILHELM SCHAUMAN:** "For example, a Paris-aligned benchmark (PAB) approach allows investors to manage transition risk by considering company carbon emission profiles and giving preference to those with lower emissions. PAB benchmarks also consider opportunities that arise from this transition towards a lower carbon economy by emphasising companies with revenues from alternative energy, for example. These indices comply with the minimum requirements, as defined by the EU regulation on climate benchmarks. We've also developed a strategy that aims to identify companies we believe are better positioned to take advantage of the transition to a low carbon economy within different sectors."

**FLORIAN CISANA:** "I agree. Since the launch of the UBS ETFs on Paris-aligned and climate transition benchmarks, we're having many dialogues with investors that are reviewing their ESG portfolio with regards to the new EU taxonomy. In these meetings, we don't even talk about products but instead discuss regulations, taxonomy, SFDR and index construction. Then on the other hand, there are some really sophisticated investors and portfolio managers that are really at the forefront of the implementation of these benchmarks."

**NIKLAS TELL: WHAT ABOUT ESG AND FIXED INCOME?**

**TOBIAS NILSSON:** "It's additionally complex when it comes to fixed income as the universe is so large. We have a carbon emission framework where we ask ourselves whether scope 1 to 3 is equally important in a given sector or whether one metric or mix is more relevant than others to measure the carbon-footprint. That materiality framework is crucial so you can achieve the desired outcomes. For ESG scores in fixed income, there are additional complexities. You might have an energy company that can score in a certain way on the equity side but then on the bond side have both brown and green projects."

**NIKLAS TELL: JONAS, DO YOU GET THE SAME TYPE OF QUESTIONS FROM YOUR INSTITUTIONAL CLIENTS WHEN IT COMES TO FIXED INCOME AS YOU DO ON EQUITY HOLDINGS?**

**JONAS THULIN:** "No, not as much and fixed income is lagging in this area. When it comes to fixed income, the discussion is instead on whether you should hold fixed income at all right now. So when it comes to fixed income, it's more about asset allocation rather than ESG. We're looking at other ways to find exposures that does the work of fixed income in a portfolio without having to invest in fixed income."

**KRISTIANS MIKELSONS:** "When it comes to corporate credit, I think it's on the same level as equities and we exclude the same companies from equities as for corporate credit. Then you have this issue of green bonds from heavily polluting utilities and we're currently having a lot of discussions there."

**FLORIAN CISANA:** "I would break down the discussion on fixed income ESG ETFs into data, product development and client adaption in portfolios. ETF and index providers have to take different sets of data when constructing an ESG government bond index versus an ESG corporate bond index. With regards to product development, there are clearly more equity ESG ETFs than fixed income



ESG ETFs in the market. Having said that, fixed income ESG ETFs are actually catching up in numbers and UBS offers in the meantime a full range of corporate and government bond ETFs. I also think clients are more hesitant in adapting fixed income ESG ETFs in their portfolios due to those two reasons: different complexity in the index construction and a smaller ETF offering compared to equities."

**NIKLAS TELL: I WOULD LIKE TO COME BACK TO WHAT FLORIAN MENTIONED ABOUT 5 PER CENT OF ASSETS IN ETFS IN EUROPE COMING FROM THE NORDIC REGION. WHY IS THAT AND WHERE DO YOU SEE GROWTH GOING FORWARD?**

**WILHELM SCHAUMAN:** "We see that fixed income will be one growth driver. Bond ETFs experienced and passed a major stress test last year when liquidity in some underlying markets, such as corporates, dried up. As the bond market was partially frozen, investors turned to ETFs as they traded more frequently than underlying bonds and offered price discovery as index prices of individual bonds were slower to react to market moves. In EMEA, we saw some 100 new professional fixed income ETF investors last year and another 50 this year and we expect adoption of fixed income ETFs to continue."

**FREDRIK NILSSON:** "I think sustainability in general as well as thematic ETFs will continue to be important drivers of ETF growth going forward. I also agree on a continued interest in fixed income, which will be another driver of growth. On our platform, we've seen an increased interest in alternative fixed income this year, compared to the broad fixed income exposure people were looking for last year."

**NIKLAS TELL: SHOULD WE ASSUME THAT ANY MEANINGFUL ETF GROWTH WILL COME FROM INSTITUTIONAL CLIENTS RATHER THAN THE WHOLESALE MARKET?**

**TOBIAS NILSSON:** "In short yes, but there is scope to grow in many channels. There are also some cultural nuances

between the Nordic countries. The efficiency of ETFs compared to index funds, for example, is well understood in some places. Sometimes rebates or internal capabilities can explain differences but I think some regions are just more experienced in having quantified costs between different vehicles. Wholesale continues to be important as they are diligent fund selectors and are increasingly focusing on exposures and asset allocation. Institutional clients are perhaps more outcome orientated and particularly fixed income ETFs are growth areas there. Thirdly, the retail market is growing, which has been a significant contributor elsewhere to ETF growth."

**FREDRIK NILSSON:** "We mustn't forget about the Nordic trading platforms that are competing and taking market share from traditional banks. Here, the dialogue is very different from the ones we're having with institutional clients. On the platforms, it's much more about storytelling capabilities relating to thematic products and about building solutions for the end client."

**JONAS THULIN:** "I'm surprised that we're not talking about the elephant in the room. At the end of the day, it's about greed as no Swedish bank in their right mind lets anything else happen. As long as regulators are soft and as long as we're not fully implementing Mifid II, we can make all the value proposition we like and still not get anywhere. Some countries have taken Mifid II more seriously where they now have true open architectures. We have funds that we can't put on platforms because they're too cheap. The banks can't cut enough between us and the client, so they say no. Wilhelm, at BlackRock you have a US equity ETF that costs 4 basis points but you will never be able to distribute that via a Swedish bank. They will not touch it. That's the elephant in the room."

**NIKLAS TELL: SO IT'S ABOUT DISTRIBUTION?**

**JONAS THULIN:** "It's about regulation." ●