Sustainability, regulation and fixed income in focus

In February, **Tell Media Group**, in co-operation with **Blackrock**, **DWS Xtrackers**, **Invesco**, **JPMorgan Asset Management** and **UBS Asset Management**, invited Finnish investors to discuss trends within the ETF industry at Hotel Kämp in central Helsinki. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the discussion.

By: **Niklas Tell** Photo: **Christer Salling**

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

JONI LESKINEN: "In our multi-asset portfolios, the weight of our own funds are roughly 50 per cent and the rest consists of ETFs. So we use a lot of ETFs and have done so for a long time. The exposure to ETFs has not changed dramatically over the years but how we do it has. Today, we take a more active approach, for example when it comes to index selection and ESG. We're simply more active today in the selection of ETFs we use."

MARKKU LEPPÄLÄ: "My area of expertise is emerging markets within equities and we use ETFs mostly in emerging markets. We need ETFs for both strategical and tactical risk taking. We have a broad exposure to emerging markets via ETFs to track the benchmark and if we want to take a tactical position, for example in Brazil, it's quick and easy to make a switch between ETFs, meaning, selling some of the broad ETF exposure and investing in a Brazil ETF."

MARKO ALARAATIKKA: "In the wealth management at S-Pankki, we manage a lot of customer mandates. We use, of course, a lot of in-house funds but we've seen an increased demand for ETF solutions and we've introduced some model portfolios where we only use ETFs. That has been a change. We´ve been doing this for little over two years now. Markets have been very tactically driven and that's probably one reason for the increased interest."

MIKAEL LÖFBERG: "We haven't seen any big changes more recently. We still have some 30 per cent of assets invested in ETFs across our different strategies. If I look at what we did last year, it clearly reflects what the others have already said in that we were more active in our ETFs, so using them to express our tactical views. We use active managers as our core holdings."

FLORIAN CISANA: "I think that when clients are searching for investment solutions to invest in markets, they first decide if they want to invest in an actively or in a passively managed instrument. Clients choose passive solutions because of market efficiency, tactical need of the investment, costs and/or other reasons. The second decision is on how clients access the passive exposure and here ETFs are besides index funds, discretionary portfolios, futures and swaps, one of many solutions. However, ETFs do offer some unique features to clients, such as secondary market liquidity, iNAV, basket disclosure, easy access and more. That's important to some clients and not least when you want to take tactical positions, meaning trading in and out of a market within a short period. As more and more clients get familiar with these added benefits of the ETF wrapper, which is not about active versus passive, we're seeing more and more clients also interested in getting active exposure in an ETF wrapper."

MIKAEL LÖFBERG: "It's easy to agree with that. I like that I can click into my Bloomberg and buy or sell the ETF. It gives satisfaction seeing the trade being executed straight away."

TOBIAS NILSSON: "The ETF has brought a lot of efficiencies to the market – transparency as you mentioned, execution cost and liquidity but also as a benchmark for active performance over time. Now it's providing even more choices as both passive and active strategies are available in the ETF wrapper. It's up to our fund selectors to evaluate but from a sustainability perspective, we've seen flows favouring active. This year actively-managed ETFs are really taking off and sustainability may be one of the factors, at least in Europe."

NIKLAS TELL: PETER, WHAT ARE YOU SEEING IN TERMS OF PRODUCT DEVELOPMENT WHEN IT COMES TO ETFS?

PETER LIDBLOM: "Let me first go back to the active versus passive discussion and just state that you can be an active investor with passive products. It starts at the asset allocation level so it's not a trade-off between active and passive. Also, what we're seeing is that clients are not only using ETFs for tactical trades but we have a lot of clients running core/satellite portfolios where the core consists of ETFs. There's room for both. When it comes to product development, I think it's difficult to talk about that without talking about ESG. The industry has undergone a lot of change and we're seeing that ESG exposures are becoming more granular. We see more pointed exposure, such as climate transition benchmarks. With an increased supply for investors, we also have a challenge as issuers to educate investors to make sure they fully understand what they're investing in and what they're achieving with regards to ESG. There's more to be done there."

DANIEL ESKILSSON: "I also feel there has been an increased need to rely on a well-diversified product offering during the challenging market conditions we've seen and to be able to offer scale across both equity, fixed income and commodity ETFs. Issuers have realised the necessity to capture and keep the assets within the firm, for example when clients are selling down their liquid ETF equity allocation and moving into commodities, treasuries, or money market funds."

NIKLAS TELL: JONI, YOU SENT ME A CHART BEFORE WE MET HERE OUTLINING THREE DIFFERENT ETFS WITH DIFFERENT AIMS BUT WITH VERY SIMILAR HOLDINGS. COULD YOU TAKE US THROUGH YOUR CONCERNS ON THAT?

PARTICIPANTS

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- **MIKAEL LÖFBERG**
  Chief investment officer at Capman Wealth Services
- **JONI LESKINEN**
  Portfolio manager at Titanium Fund Management Company
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JONI LESKINEN: "I do find it alarming when I find three different ETFs with three different goals – a social fund, a US carbon transition fund and a tech leaders fund – with very similar top holdings. I lose a little bit of confidence when I see things like that. We do a lot of thematic investing and we don't like to see that in our portfolio."

WILHELM SCHAUMAN: "If you think about thematics, and to an extent also ESG strategies, they're typically not standardised. Robotics, for example, could mean a lot of things. You also have to take into account that there are large companies that do a lot of different things and therefore could be found in different strategies. There are also many themes that are interconnected, such as an aging population and health care innovation. I think it's important to not only look at the overlap in the biggest holdings but also the weighting of different holdings and to also look further down in the list of names as these strategies typically would be very diversified."

JONI LESKINEN: "I still think it's crazy to find these overlaps because it's typically always these big tech names that you find. Tesla and Amazon in a social fund has nothing to do with social responsibility. I would like to see product providers doing more independent research to come up with suitable names for these products and not rely too much on big ESG rating houses."

MIKAEL LÖFBERG: "I agree with the points that Joni is making. This is something we've been looking at for a while now as it becomes a portfolio construction issue. If you look at MSCI World and an ESG screened version of that index, you will have a lot of overlaps and you may end up doubling positions. We're looking for research driven indices and we see more of these even if they can be a bit expensive. This challenge is also a reason for why we also to into the active space when it comes to ESG. We need both."

FLORIAN CISANA: "I think it is not uncommon today that the asset management industry construct products for one or two larger investors. As most of the larger investors have different needs and views, there is an increase in the number of slightly different products within the same category, such as light screened ESG investments. I would also like to follow up on what Peter said on product development and ESG. I think it's fair to say that the ETF industry is leading the way when it comes to providing a large variety of ESG strategies and an investor shouldn't disregard ETFs when it comes to ESG investments as ESG ETFs complement the overarching ESG fund offering. The beauty of ESG ETFs is that they replicate indices which are very transparent in the way the ESG methodology is implemented and it makes it simple for investors to understand the investments."

DANIEL ESKILSSON: "What we've seen is that investors are less focused on the absolute level of SFDR classifications due to the uncertainty that has been present lately. In our view, this has changed the perception from some clients on the actual need for specific SFDR classification as long as the product in question fulfils the objective of the client. Specifically, when it comes to the ESG reporting requirements, such as the floor for minimum sustainable investment. If the product still offers an acceptable level, the SFDR classification doesn't play the same role as it did in the past."

TOBIAS NILSSON: "One development is that the market is more mature and can cater to various sustainability needs. If a client wants to achieve meaningful carbon reduction with as little tracking error as possible, there's a strategy for that. It's also fair to say that as a diversified exposure, it will not be a concentrated impact-strategy, but you can find that as well. I think in generally the ETF industry has been beneficial in creating a consensus on defining areas of the market deemed sustainable such as what an ESG-screened benchmark looks like compared to SRI, Paris Aligned to Carbon Transition. Due diligence is however still necessary. What's clear is that 60 per cent of UCITS ETF flows last year went to ESG strategies and they now account for some 25 per cent of the market."

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> – *Markku Leppälä, Elo Mutual Pension Insurance Company*

NIKLAS TELL: IT SOUNDS LIKE YOU NEED BESPOKE INDICES TO MATCH THE ESG NEEDS OF EACH INVESTOR. OR ARE THERE SO MANY PRODUCTS THAT EVERYONE SHOULD BE ABLE TO FIND SOMETHING?

PETER LIDBLOM: "There are a lot of different needs, even across the Nordics, and we need to cater to that. But if you as an investor have very specific needs, maybe you don't need it to be in a fund wrapper – you can do it as a mandate. But as I said, different investors have very specific criteria that they want fulfilled and we need to cater to that."

CAROLINE LIINANKI: SO HOW QUICKLY CAN YOU MAKE ADJUSTMENTS TO AN EXISTING PRODUCT AND WILL YOU DO IT?

TOBIAS NILSSON: "It's a balance. Sustainability will never be static, it will evolve but you need to be confident that there is a demand for it in the broader market. If it's niche, or based on a more subjective framework, it's better as a segregated mandate, even if that means that you miss out on a lot of the benefits of the ETF wrapper."

WILHELM SCHAUMAN: "I disagree a little bit that the ESG needs of investors are so specific that they can't buy standardised products. As Tobias mentioned, we saw that 60 per cent of flows last year went into ESG ETFs and that demand wouldn't be there if these products didn't fit investors' needs. Different investors will obviously have different exclusion lists but I think we have come to a point where many will accept that there are some industry standards when it comes to exclusions."

CAROLINE LIINANKI: MARKKU, WOULD YOU AGREE? ARE YOU ABLE TO FIND WHAT YOU ARE LOOKING FOR IN THE MARKET?

MARKKU LEPPÄLÄ: "If you have an idea and look for that in the market, you will most likely be able to find it. And, as has been mentioned, there's the possibility of doing a bespoke ETF or a mandate if you're unable to find that specific strategy that you're looking for."

ETF ROUNDTABLE 2023

MARKO ALARAATIKKA
Senior portfolio manager at S-Pankki

WILHELM SCHAUMAN
Head of iShares institutional sales in the Nordic Region at Blackrock

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MARKO ALARAATIKKA: "We certainly see that the providers have been launching a lot of new strategies – also with a higher tracking error. So we're able to find what we're looking for."

PETER LIDBLOM: "I would like to come back to standards and product development because we've seen a shift over the last 3 to 4 years. The pendulum is swinging back from pure exclusions and the fact that we now have products that are not as tight when it comes to exclusions allows for engagement. You need to stay invested in order to engage with companies and that's ultimately how you can have an impact. Unless we're talking about fixed income because then you're actually financing something."

FLORIAN CISANA: "We're seeing the same trend with the climate transition where investors are not only focused on having a very low carbon portfolio but instead want to stay invested in companies who transition to lower carbon emissions. I would also like to come back to your question, Caroline, on product development and how quickly we can change a product: I think generally speaking time to market of launching and listing an ETF has increased over the last two years as regulatory requirements have increased and processes to approve a new fund take longer."

NIKLAS TELL: AND HOW LONG WOULD IT TAKE TO SET UP A NEW BESPOKE ETF FOR A CLIENT?

FLORIAN CISANA: "That depends but six to nine months to approve the prospectus, launching and listing the ETF is probably a good indication. The preceding step is to agree with the client, the index provider, the portfolio manager, and many other parties on the exact index methodology."

JONI LESKINEN: "It would be interesting to hear from the product providers regarding the feedback you've received from clients regarding the downgrades on a lot of products from Article 9 to Article 8."

TOBIAS NILSSON: "We've had zero per cent downgrades but would still not jump to the conclusion of greenwashing by providers. We have an SFDR framework settling on what Article 9 actually means. However, there is no obstacle in an ETF itself being Article 9. For our active ETFs, we follow the exact same framework and adhere to our standards and interpretation of what that means."

PETER LIDBLOM: "I agree. It wasn't driven by providers but rather a regulatory change that affected everyone."

FLORIAN CISANA: "Yes, our clients did not have an issue with the reclassification of CTB and PAB. Clients who have invested in UBS PAB or CTB ETFs, looked very closely at the index methodology as the strategy is rather complex. Once investors were convinced by the index, they did not change their minds because of SFDR article classifications change."

TOBIAS NILSSON: "I think we also need to talk about fixed income now that we have higher interest rates again and for a traditional 60/40 portfolio, of course you want to take ESG into account also that side of the portfolio. It's however more complex on the fixed income side, because you can have bonds dedicated to a specific project or revenue stream that is green, while the company as a whole may not be fully green. You can't make that separation on the equity side. Therefore, investors will need to decide if they're happy to own a bond issuance that is green but where the companies at large might not be. Some think that encouragement of transition is really important, others may not. In any case it raises the need for transparency and accountability for solution providers on their underlying investments."

NIKLAS TELL: WOULD YOU SAY THAT FIXED INCOME IS WHERE PRODUCT DEVELOPMENT NEEDS TO HAPPEN WHEN IT COMES TO ESG AND THAT THE COVERAGE IS OK WHEN IT COMES TO ESG ON THE EQUITY SIDE?

MIKAEL LÖFBERG: "There's obviously a need, at least for bigger and more advanced investors. But if we look at retail investors and smaller family offices, I think they're happy with what's available right now. Also, in Finland it's still mostly an equity discussion right now. But with everyone talking about fixed income, it's of course easy to predict that a lot will happen in that area going forward."

WILHELM SCHAUMAN: "Last year was the first time that fixed income ESG ETFs raised more assets than traditional fixed income ETFs, so there's interest out there. We absolutely see a need for more product development on the fixed income side and we're convinced that things will happen. It's a growing market and looking back, fixed income ETFs held some USD 500 billion back in 2015 and today that number is some USD 1.8 trillion. We forecast global fixed income ETF AUM will reach USD 5 trillion by 2030, equivalent to 5 per cent of the fixed income market."

PETER LIDBLOM: "It's a natural progression and you should expect to have the same opportunities for the fixed income portfolio as the equity portfolio. Up until recently, there wasn't a need in the market because we had interest rates around zero. Now that has changed and we will absolutely see development also on the fixed income side."

CAROLINE LIINANKI: 2022 WAS OBVIOUSLY A MORE CHALLENGING INVESTMENT YEAR THEN WE'VE SEEN FOR A WHILE. WHAT ARE SOME OF THE KEY INSIGHTS OR LESSONS LEARNED FROM THESE MORE CHALLENGING CONDITIONS WHEN IT COMES TO ETFS?

WILHELM SCHAUMAN: "On the fixed income side, we saw ETF trading picking up as underlying market liquidity deteriorated. Trading in fixed income UCITS ETFs was up 18 per cent compared to 2021. The record volumes traded over 2022, combined with a more developed ETF options trading, underpin the continued development of fixed income ETFs as financial instruments, against the backdrop of a changing macro regime."

FLORIAN CISANA: "I think what we saw last year in terms of fixed income ETF flow was also due to the positive experience with fixed income ETFs in Q2 2020 when market participants started to appreciate the fact that a fixed income ETFs can provide good price information for the underlying basket. One of the lessons learnt in 2022 was on ESG as ESG indices and strategies didn't perform, in relative terms, as they did the years before. That said, 2022 was still a good year for ETFs with net new inflows of some USD 90 billion."

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Head of ETF distribution Nordic region at JPMorgan AM

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> *– Joni Leskinen, Titanium Fund Management Company*

TOBIAS NILSSON: "I agree that if 2021 was a stress-test for fixed income ETFs, last year reinforced the accessibility and price discovery in illiquid markets. Perhaps hard to draw conclusions on the lack of diversification between equity and fixed income after such a regime shift, but this year may be more relevant to draw lessons from in respect to that."

JONI LESKINEN: "One lesson learnt on the equity side was that you really need to know what's inside an ETF. One example was thematic ETFs where you had very interesting themes if you only read the headline but these were some of the worst performers."

MIKAEL LÖFBERG: "Yes, you need to look at the underlying holdings and understand the exposure you're getting. I think one lesson for many was that you still need diversification."

NIKLAS TELL: MARKO, YOU MENTIONED EARLIER THAT YOU SEE DEMAND FROM CLIENTS THAT ARE LOOKING FOR ETF PORTFOLIOS. IS THAT A MARKET THAT'S PICKING UP OR ARE ETFS STILL VERY MUCH AN INSTITUTIONAL PRODUCT IN THE FINLAND?

MARKO ALARAATIKKA: "It's not a market that's exploding but we're absolutely seeing growth."

JONI LESKINEN: "I think clients in general have a better understanding of costs, which is beneficial for ETFs. That said, there are still a lot of clients that are happy to pay for active management, so I guess there's room for both to grow."

WILHELM SCHAUMAN: "Finland has traditionally been an institutional market for ETFs. You have a lot of large investors that are very sophisticated in how they use ETFs. We are also seeing growth in the distribution and retail space – especially with younger people being more open to use new platforms and apps to find investments."

NIKLAS TELL: LOOKING AHEAD, WHAT DO YOU SEE AS SOME OF THE KEY TRENDS FOR THIS YEAR?

FLORIAN CISANA: "If we look at investor trends over the last years, we've seen a move from non-ESG to ESG and then to decarbonisation. I think the next step is that investors will add more ESG thematic ETFs which are measurable towards SDGs. At the moment, there are a lot of thematic products out there but the question is if you can measure the impact on specific SDGs."

DANIEL ESKILSSON: "The continued growth and developments of digital platforms through new and existing fintech companies is another trend we see. There's a need for providers to expand digital partnerships and offer the right content and storytelling capabilities for this important and growing client segment."