Active ETFs, thematic exposures and ESG innovation needs

In February, Tell Media Group, in co-operation with **JPMorgan Asset Management** and **UBS Asset Management**, invited Finnish investors to discuss trends within the ETF industry at Hotel Kämp in central Helsinki.

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

The discussion started with Niklas Tell asking the investors to highlight some of the main reasons for using ETFs.

CAROLUS REINCKE: "There are some obvious reasons, such as the diverse universe of ETFs, easy access and administration. Also, if you look at actively managed funds versus ETFs, then I view actively managed funds basically as style funds. As an allocator, you need to recognise the style of the individual manager and evaluate how that style works in different market conditions. Alternatively, you can buy style ETFs directly and that's what we typically do."

FLORIAN CISANA: "How would you define a style ETF?"

CAROLUS REINCKE: "I'm talking about style factors such as value, growth and momentum etc."

MIKAEL LÖFBERG: "It's very similar for us. Transparency is key and it makes it very straightforward when you're doing the asset allocation. You can instantly look up the top holdings in your portfolio and that's very helpful. The quick execution is also a plus, even if we're not traders that change our holdings very often. We must of course also mention that ETFs are cost efficient and that's helpful for the overall cost of a mandate because we're also using active funds."

MARKO ALARAATIKKA: "We have a range of internally managed active funds and we use ETFs to fill the gaps when we're building portfolios. We've been using factor ETFs, which Carolus mentioned as well, and during the last couple of years we've also looked at different themes, such as technology, electric vehicles, global water and robotics."

NIKLAS TELL: IS THERE ANYTHING YOU'RE CURRENTLY MISSING FROM THE ETF UNIVERSE?

MIKAEL LÖFBERG: "There are some segments, especially in fixed income and credit. One example would be Nordic corporate bonds, which we do via active managers. Another example would be European leveraged loans. When it comes to equities, our home market of Finland and the Nordic region have been one of the worst performing and we've been staying out of it. However, we started to allocate to Nordic small caps at the end of last year and here we also used active managers."

CAROLUS REINCKE: "If emerging markets would become interesting given that they're very concentrated and heterogeneous markets, it would probably make sense to use an active manager. I agree that the leverage loans space and the whole credit space is dominated by active managers for a reason. I do, however, believe that we will see more innovation in the credit space. I also think it's worth highlighting sustainability, which is linked to what Mikael mentioned regarding transparency. It's easier to implement a sustainable strategy using transparent vehicles such as ETFs rather than a vehicle that has a human layer to it. We've seen this among pension funds in Finland that have been investing in sustainable ETFs."

FLORIAN CISANA: "What you say echoes a lot of what we hear from our clients. Many of the positive features of ETFs are also valid for index funds. I do, however, believe that an ETF is superior to an index fund when it comes to intraday pricing and tradability, regardless of whether it's active or passive. Now, we don't have active ETFs at UBS but we see in particular in the US that the ETF wrapper is used more and more for active funds. I also think that further regulatory changes in Europe, and in particular in the Nordics, will further increase the demand for both active and passive ETFs."

THOMAS STEPHENS: "We very much focus on ETFs as a delivery mechanism of client outcomes, irrespective of the investment focus on emerging markets or different sectors. ETFs are the technology. Indexation and passive investing have been synonymous with ETFs historically but we've moved past that as the active ETF offering is far broader today."

MIKAEL LÖFBERG: "Liquidity is, of course, an important part. With regards to fees, we're only paid by our client for the solution we provide and that will include a mix of cheap ETFs and funds with higher fees such as semi-liquid private equity funds. ETFs are also driving down the fees on active funds. Also, if we're selecting a US small cap growth strategy, there are only a handful ETF providers but we will have some 300 active funds to select from, so it might be more likely that we find the right solution among the 300."

MARKO ALARAATIKKA: "When we're talking about active funds versus ETFs, I think it's clear that it's easier to do tactical asset allocation with an ETF and then liquidity is, of course, important. We believe in active management, so the development of active ETFs is an important and interesting development."

NIKLAS TELL: WE'VE TALKED ABOUT DIFFERENT THEMES AND THEMATIC FUNDS. DO YOU FIND ALL THE STRATEGIES THAT YOU'RE LOOKING FOR OR DO YOU THINK WE NEED TO SEE MORE INNOVATION?

MARKO ALARAATIKKA: "This is, of course, a relatively new area so many of these ETFs are not liquid enough yet."

CAROLUS REINCKE: "One of the main drivers of innovation we see in the ETF space, for example with thematic ETFs, is that it's a way for the ETF providers to keep their fees at a certain level. We've seen a fee erosion, which started on big equity indices and then continued in small caps and sectors, so I think it's natural that we see ETF providers slicing the markets in new ways and launching new ETFs. However, the main problem with thematic ETFs for me is that there is too much noise within the themes. Yes, you can get exposure to for example a theme such as the aging population but it's not clear cut what that risk exposure exactly looks like when you're invested in a couple of hundred underlying companies with diversified revenue streams."

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FLORIAN CISANA: "We have a lot of client conversations about thematic ETFs and we see plenty of new fund launches – consistently in the top three by number over the past three years. However, actual client investments in thematic ETFs are still relatively small so far, being only 2.5 per cent of total ETF assets in Europe."

CAROLUS REINCKE: "Also, if you look at the return contribution for many of best performing thematic ETFs, exposure to the magnificent seven pop up in many of them."

MARKO ALARAATIKKA: "You really need to know what underlying companies you're getting exposure to when investing in thematic ETFs. Also, if you compare to traditional sector ETFs, there are a lot of overlaps."

THOMAS STEPHENS: "I agree with Marko's and Mikael's points – ETFs have the potential to deliver many solutions. However, like with alternatives, the right delivery mechanism for client outcomes could be a mutual fund or another structure."

CAROLUS REINCKE: "One poor performing theme during the last years has been green energy. You might have the right intention for why you're taking a certain allocation but what you essentially end up buying is interest rate exposure. Many of these companies are loss making but are expected to make money in the future and therefore the discount rate becomes very important. It all boils down to the fact that you need to understand what you own and why."

THOMAS STEPHENS: "The low carbon transition is, of course, very important but I agree the macro environment has been challenging with the impact of higher interest rates, inflation, supply chain issues and geopolitics. That said, we still think it's a critical long-term structural investment theme."

FLORIAN CISANA: "Coming back to the size and flows, we see that sector ETFs are a bigger market than themes but it's still only 4.4 per cent of total ETF assets in Europe. Hence, also sectors is not the main asset class for ETF investors. Nevertheless, given the tactical nature of sectors investments, sector ETFs can still be a useful instrument for our clients."

MIKAEL LÖFBERG: "One challenge that cuts across both sector ETFs and theme-based ETFs is that it doesn't take valuations into account. You might be happy with the general exposure you get but as an investor, you must also consider how big of a position you're happy with given the valuation of underlying companies. But this is of course the same if you buy an S&P 500 ETF."

THOMAS STEPHENS: "That's unless you have an active approach that will look at the valuations as part of the investment process. For our active US UCITS ETF, we have exposure to all of the magnificent seven but we have a fundamental view so we can be overweight, neutral or underweight where applicable."

NIKLAS TELL: IF WE TALK ABOUT ACTIVE ETFS IN GENERAL – HOW IMPORTANT HAS THAT DEVELOPMENT BEEN?

THOMAS STEPHENS: "As a provider of active and indexed ETFs, we, of course, think that the best portfolios combine the two. The ability to deliver active capabilities within the ETF wrapper, transparently, with new solutions and outcomes for clients' core asset classes is gaining traction. Not least when it comes to fixed income, given the size of the fixed income investable universe, different capital structures and not necessarily having to invest in the companies and nations that have issued the most debt. Being active is key."

CAROLUS REINCKE: "I absolutely think that we will see more product development in the fixed income space going forward. However, the problem in fixed income compared to equities is that we don't have the same market depth and the same liquidity."

FLORIAN CISANA: "A decade ago, the main concern with fixed income indices and ETFs was a lack of liquidity. Therefore, ETF providers collaborated with index providers and investors to develop more liquid fixed income ETFs. Today, fixed income ETFs are head-to-head with the growth of equity ETFs. Fixed income UCITS ETFs collected USD 70 billion net new assets (NNA) in 2023, which is 42 per cent of the total NNA is ETFs last year. However, if the underlying market liquidity of a sub-asset allocation is not a given, then the ETF can't resolve that problem. Some of the main challenges ETF providers always have to consider when it comes to new ETF launches are a lack of underlying market liquidity, diversification within the index/ETF portfolio and relevance or lack of investor demand."

MARKO ALARAATIKKA: "Coming back to the concentration of equity markets and specifically with the magnificent seven, one solution is, of course, to go with an equal-weighted index."

THOMAS STEPHENS: "Equal weight S&P 500 was a challenging trade last year. We're managing concentration risks by being active through the value add of bottom-up stock selection as the primary driver of excess returns. It's the active insights from our analysts, coupled with strong portfolio construction and risk management, that we feel is important."

MIKAEL LÖFBERG: "We've been looking at the same, but we haven't used equally weighted indices – at least not yet. The concentration has been a friend so far, even if it has been painful for active managers. It's, of course, strange that Microsoft is now the size of the whole equity market of France, even though the French companies are making double the amount of revenues that Microsoft is making. Now, there are ways to get around the exposure if you don't want it. We embraced the concentration during a period but decided to scale back when the price to sales ratio of Nvidia reached twelve times, which of course was too early."

CAROLUS REINCKE: "There's also the possibility that this trend for the magnificent seven just continues. Many of the services we all use daily are produced by Microsoft, Google and Apple – these are in reality the biggest consumer companies of the world. I wouldn't automatically assume that the right strategy is to underweight them. If you look at history, bubbles don't burst by themselves. Valuation has never been a catalyst in itself for bursting a bubble. There must be an alternative because money seeks relative performance. In the 2000 to 2003 period, the relative appeal was in industrial companies because of China. Something needs to happen and the question is what that will be."

NIKLAS TELL: I WOULD LIKE TO MOVE THE DISCUSSION TO

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> – *Carolus Reincke, Forea Family Office*

SUSTAINABILITY, WHICH OF COURSE IS A BIG TOPIC. LAST YEAR WE DISCUSSED PARIS-ALIGNED BENCHMARKS. WHAT'S CURRENTLY HAPPENING IN THE SUSTAINABILITY SPACE?

THOMAS STEPHENS: "ETFs linked to Paris-aligned benchmarks is absolutely a growing area. If we compare to the numbers Florian provided earlier on sectors and themes, assets in PAB ETFs in Europe have already grown past both with assets of EUR 60 billion and we saw EUR 10 billion in net new assets last year."

FLORIAN CISANA: "If I can give a slightly different perspective. I agree that the ESG trend continues but the flows into European ETFs have slowed down. We had USD 167 billion net new assets in ETFs across the industry last year but of that, only USD 47 billion into ESG ETFs. That's a change compared to 2021 and 2022 when ESG took the majority of the flows. Another aspect to consider from an SFDR classifications perspective is that climate transition benchmark (CTB) and PAB ETFs were reclassified from Article 9 to 8 and then back to Article 9. There are also ETFs that were reclassified from Article 8 to Article 9 because the issuer changed the index methodology by adding a PAB or CTB component. So today, it's hard to tell with certainty how much of the AUM in Article 9 ETFs was invested by clients that actively selected CTB/PAB ETFs."

CAROLUS REINCKE: "I think our clients want to understand what the effect is from what we're doing. Is it meaningful work and are we really making a difference if we invest in for example a PAB fund?"

FLORIAN CISANA: "It depends on what we mean by meaningful. With PAB, you facilitate an orderly transition to a lower carbon economy."

CAROLUS REINCKE: "I understand that this is important but for the end client, I think it's more about the impact you can have. It's not about being able to show nice numbers."

THOMAS STEPHENS: "I agree that it's all about the practical implementation – how we use the financial and non-financial analysis to assess companies. It has been challenging but I think as global policy and regulation develops and begins to converge, it should move from an academic discussion to practical implementation."

MIKAEL LÖFBERG: "When we look at sustainability ETFs, it's mostly theme based. In order to move to the next step, I think it would be interesting to find a solution that simply invests broadly in companies that are providing the 'right' products and services and also maybe have that mapped to the SDGs. That could be an interesting product."

CAROLUS REINCKE: "Coming back to ESG and linking that to what you said, Mikael, on finding companies that are providing the 'right' products and services, I think this shows the problem of some ESG data providers. They evaluate how things are done, not what is being done. This might lead to companies with both good and bad impact receiving the same score."

ETF ROUNDTABLE 2024

FLORIAN CISANA: "I think it also depends on the client type. For example, some private investors might be willing to invest in high tracking-error ESG strategies or even philanthropic strategies. However, for example traditional institutional investors, that have followed a market cap index so far, might prefer a lower tracking error in ESG integrated strategies or CTB investments."

NIKLAS TELL: WHAT WOULD YOU SAY ARE SOME OF THE CHALLENGES AND OPPORTUNITIES RELATED TO ETFS THAT WE'RE NOT TALKING ENOUGH ABOUT?

MIKAEL LÖFBERG: "MSCI came out last year with an impact index which maps the SDGs. That would be very interesting to me. There are very few products out there right now and mainly from smaller players. Right now, we're only using active managers in this space."

FLORIAN CISANA: "I also think there are some structural elements that we need to cover. The first is that we now have the regulation in place for sub-funds to have a listed share class (ETF share class) and an un-listed share class (traditional index fund share class). This will allow investors that can't trade ETFs to access the same breath of universe as we have on ETFs. The second point is that ETFs are called exchange traded funds when they're really more like exchange listed funds, at least in Europe. We all know that around 80 per cent of trades are not done on exchange here and that's very different to the US. I don't have an issue with this but I would be interested to hear your opinions whether you think it affects the purpose of an ETF in regards to trading and liquidity."

THOMAS STEPHENS: "I would say that things are starting to change and evolve also in Europe. I'm making it my life's work to put the 'E' back into ETFs. It's very near and dear to my heart. There are a number of technological developments happening. For the cash equity market for example, when you trade single stocks and portfolios, the access is typically algorithmic and that's evolving for the ETF market as well. There are now a number of banks and broker dealers that are offering specific ETF algos. Some have embedded fair value, which helps in managing premium and discount drift. When any of us look at an ETF, we see a bid and offer on an exchange with limited knowledge of the true fair value, which are impossible for clients to assess second by second. These algos are empowering buy-side traders with fair value parameters and I think that's one of the developments that will drive more volume back on the exchange – increasing the visible liquidity. Florian mentioned that some 80 per cent of trades are done off exchange. If we can get to 50/50, I would call that a win."

CAROLUS REINCKE: "If we look back 10 years, a lot has happened and I think we will see a lot of product developments also in the next years. One of the main drivers might be liquification of illiquid assets and with tokenisation, we've seen what might be possible. I think we will see a lot more assets to be traded in this space that now seem to be out of reach for an ETF."

THOMAS STEPHENS: "Yes, I think active ETFs and retail demand for ETFs will serve as key drivers for the continued growth of UCITS ETFs. How ETFs are delivered to retail will be a game changer. Tokenisation is fascinating but nascent and one area to watch in terms of market developments."

FLORIAN CISANA: "Retail, tokenisation and active ETFs are the three main trends we see."