SFDR and other ESG challenges for ETF investors

In June, **Tell Media Group**, in co-operation with **Blackrock**, **DWS Xtrackers**, **Invesco**, **JPMorgan Asset Management** and **UBS Asset Management**, invited Finnish ETF investors to discuss trends within the industry at Hotel Kämp in central Helsinki. Tell Media Group founder Niklas Tell and FBNW editor Janina Sibelius moderated the discussion.

By: Niklas Tell Photo: Christer Salling

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

MARKO ALARAATIKKA: "We manage a lot of customer mandates and we mostly use our own in-house managed funds to do that. We do, however, use ETFs as a complement and we've been fairly active when it comes to factor ETFs. We've also seen more and more customers asking us to provide solutions, which would mean building model portfolios with various risk levels only using ETFs."

TONI IIVONEN: "We manage a range of fund-of-funds and we use in-house funds but also a range of ETFs, both within equities and fixed income. We see them as building blocks for the portfolios we construct on behalf of our institutional clients where we follow their investment mandate."

MIKAEL LÖFBERG: "We don't have any in-house solutions so we build portfolios with external providers. Today about a quarter consists of ETFs and that's mostly sector or thematic specific ETFs. The share of ETFs has been growing over the last couple of years and it will likely grow further. We're not trading very frequently but the ability to react quicker with an ETF is a benefit."

HARRI KOJONEN: "We use ETFs in the same way as any other instrument. It's basically an instrument we use in order to fulfil the desired investment profile. At OP, we have a range of in-house products, both active and passive, and for us it's many times cheaper to use our in-house passive funds rather than an external ETF. We have, of course, seen the growth of new products, especially in fixed income, so there's the possibility to gain very specific exposures. However, the AUM of these funds is often too small for us. That said, we've started to use more ETFs at the expense of active external funds, which we previously used for small caps and for exposures outside of Europe, for example. One reason for continuing to use internal funds is that we keep more control, not least when it comes to ESG matters."

NIKLAS TELL: SO YOU HAVE SWITCHED FROM EXTERNAL ACTIVE TO INTERNAL AND ALSO TO ETFS. HAS ESG CONSIDERATIONS BEEN THE MAIN ARGUMENT FOR MAKING THAT MOVE?

HARRI KOJONEN: "I would say that fees have been a bigger driver. Another argument for using ETFs is that our funds have daily liquidity and even if we don't have very big flows as most of our clients are retail, it's still better to trade the ETF rather than having to move in or out of active funds."

FREDRIK NILSSON: "Have you considered US domiciled funds rather than European domiciled ETFs?"

HARRI KOJONEN: "There's regulation that we need to take into account but most of our funds are open to use non-Ucits ETFs to some extent. With the development of ESG and SFDR, it's of course more difficult to find the right article for a US domiciled fund."

TONI IIVONEN: "We have the same problem with regards to SFDR. We do use US domiciled ETFs but they are of course not labelled as SFDR and in order for our fund to be classified as an Article 8 fund, at least 75 per cent of the holdings needs to be Article 8 or higher. That's of course a challenge when the US funds are not labelled."

JANINA SIBELIUS: ARE QUESTIONS RELATED TO ESG SOME OF THE BIGGEST CHALLENGES?

TONI IIVONEN: "Questions related to SFDR is one challenge, as mentioned. But there are, of course, other issues as well, such as companies that we have on our exclusion list and that appear in ETFs."

FREDRIK NILSSON: "That's the issue with the lack of standardisation because everyone wants slightly different things. It becomes even more complicated when you move to the fixed income side as you need to be careful where you draw the line on exclusions in order to keep the universe big enough for diversification and liquidity purposes."

TOBIAS NILSSON: "It's fair to say that lines are becoming increasingly blurred with the development of active ETFs and questions related to ESG differ depending on the strategy. We're now seeing clients coming into ETFs for the first time and one reason for that is the development of ESG. When it comes to the active suite, we see more questions on ESG integration. Quantifying that integration is more of an emphasis compared to our passive range, where it is more a question of understanding the index methodology. ESG has raised the bar for the ETF industry in really understanding what you own and it has increased transparency for investors".

NIKLAS TELL: THERE HAS BEEN SOME CRITICISM ABOUT SFDR AS IT SEEMS TO BE LITTLE STANDARDISATION AS TO HOW DIFFERENT FUNDS ARE CATEGORISED. IS THAT A CONCERN, EITHER AS A PROVIDER OR AS A CLIENT?

FLORIAN CISANA: "At the point the EU taxonomy was communicated, we read some criticism on this framework in the Nordics press. One possible reason for this could have been that investors in the Nordics have come very far when it comes to ESG and decarbonisation and maybe

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the EU taxonomy did not appear to bring added value. Whatever the reason, SFDR Article 8 and 9 is part of almost every client meeting we have today. The various sustainable investment concepts, including ESG, SRI, PAB and CTB, have also brought complexity to investors as well as to the asset management industry. Some investors can implement their required sustainable investment approach by themselves, while others prefer to use external solutions by, for example, building their Article 8 and 9 portfolios based on suitable instruments available in the market."

NIKLAS TELL: I THINK THE CRITICISM I'VE HEARD FROM SELECTORS IS THAT THE RANGE OF WHAT IT MEANS TO BE AN ARTICLE 8 FUND IS TOO BROAD.

FREDRIK NILSSON: "We're seeing that both Nordic and EMEA financial authorities are digging deeper into the SFDR classification aspect of things – looking at the ESG integration in the investment processes. We see that as a good and healthy development for this high-growth segment of the fund industry."

WILHELM SCHAUMAN: "The vast majority of our clients are still considering how to assess sustainable investments under SFDR, Principal Adverse Impact (PAI) and the EU Taxonomy at the portfolio level. We see Mifid II ESG-related suitability requirements as an evolution in market dynamics that will improve choice for investors and we're strongly supportive of its implementation."

TOBIAS NILSSON: "I think we are seeing some standardisation in terms of SFDR. At least basic exclusions are becoming more standardised. As there is plenty of differentiation between ESG strategies and a need for due-diligence, this element of familiarity and convergence on exclusions is welcomed, I think. Then, there can be different viewpoints on what constitutes 'doing good'. When we look deeper, it may not always be intuitive so the evolving market and debate will mean sustainability is not static".

JANINA SIBELIUS: HAS THIS INCREASED CONSENSUS LESSENED THE NEED FOR BESPOKE ETFS? SOME BIG INVESTORS USES TO SAY THERE WAS NOTHING AVAILABLE IN THE MARKET THAT MATCHED THEIR SPECIFIC ESG NEEDS.

WILHELM SCHAUMAN: "There will still be demand for different types of solutions because the ESG landscape is evolving all the time and investors will continue to pursue different types of sustainability strategies. Also, improving data sets, SFDR level 2 implementation and other factors will continue to shake things up."

MARKO ALARAATIKKA: "I think the difficulty is that working in financial markets, we're used to very precise definitions of things whereas this is an area that's still somewhat vague."

FLORIAN CISANA: "We see a wide range of approaches to how different clients tackle their challenges of implementing their ESG requirements. Yes, we see many new ETF clients due to the wide sustainable investment offering the ETF industry provides but we've also seen some few clients who had to temporary move away from ETFs to direct investments as their ESG investment philosophy and engagement process was highly customised."

FREDRIK NILSSON: "I think investors today are more wrapper agnostic and they will engage with the index provider to find a suitable benchmark. Then, the final solution could be an internal fund, an index fund or an ETF. They're simply more flexible."

NIKLAS TELL: IF WE TAKE A STEP BACK AND LOOK AT THE OVERALL DEVELOPMENT OF THE ETF MARKET, WHICH HAS BEEN GROWING, ARE WE NOW WHERE YOU THOUGHT WE WOULD BE, DID YOU THINK WE WOULD BE EVEN FURTHER AHEAD OR HAVE YOU BEEN POSITIVELY SURPRISED?

PETER LIDBLOM: "If you look back maybe five or six years, you probably thought that it would explode and that everyone would use ETFs and that the majority of assets would be in ETFs. In that respect, it has been slower. But at the same time, it's still growing at a phenomenal pace and we still have new investors beginning to use ETFs."

FLORIAN CISANA: "If we look at the US ETF market, it's around USD 6.4 trillion at this point in time and Europe is USD 1.5 trillion and then you have Asia at half a trillion USD. We estimate the Nordic ETF market at approximately USD 60 billion in ETFs, which is 4 per cent of the European ETF market. Looking at those numbers, I think there's great potential for further growth. It's also worth to mention that the Nordics ETF market is highly fragmented by country and segment. I think Finland is overall the largest ETF market in the Nordics and it's very positive to see that Finnish institutional investors are a significant driver for the ETF growth in the Nordics."

PETER LIDBLOM: "I think the number is doubling every five years, so it's still a very significant growth."

MIKAEL LÖFBERG: "If you say that Finland is ahead, why do you think it's so slow elsewhere?"

TOBIAS NILSSON: "That's a good question and I would agree Finland is ahead in adoption. If you look at the wholesale segment in Finland, it's a sophisticated market with a tradition of being good fund selectors. They both understand the benefit of the ETF vehicle but also understand their own value as asset allocators. I think their clients understand that as well. When it comes to Sweden, it has a long tradition with mutual funds and the Swedish banks have a strong position as distributors. They are also sophisticated fund selectors but ETFs are used mostly for more esoteric exposures where there are no alternatives in-house."

FREDRIK NILSSON: "The currency aspect is, of course, also a factor that explain some of the differences across the Nordic region. I would say it's definitely a non-homogenous region in terms of ETF usage across client segments. For example, if I look across the region, I would say Denmark have seen some interesting developments during the last couple of years, driven both by regulation and change of behaviour, specifically on the wealth and retail market. An increased cost consciousness overall. That said, there's probably a reason why we do this roundtable in Helsinki today. Finland is the place to go for ETFs in the Nordics."

PETER LIDBLOM: "If you look at the rest of Europe, the consultants play a role in this as well. They're not as strong in the Nordics as in the rest of Europe, I think they do contribute to the explanation for why the US market is bigger than the European one when it comes to ETFs as consultants are not as likely to recommend ETFs."

HARRI KOJONEN: "And that could have something to do with kick-backs as well?"

PETER LIDBLOM: "Funny you should mention that."

MARKO ALARAATIKKA: "I think we should also say that ETFs are not always better. They're a good tool as a complement in a solution. From our side, we have a lot of in-house managed funds as well and one example when that was a benefit was earlier this year as it became increasingly likely that Russia would invade Ukraine. We sold most Russia

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exposures before the war started and if you held an ETF, you would, of course, have been stuck. So there are some very good reasons to use actively managed funds as well."

FLORIAN CISANA: "I think ETFs have a lower market share in the Nordics than in other European countries but the Nordics ETF market is growing faster than elsewhere. Regulation might have slowed down the ETF growth in the Nordics in the past but the fast adaption of sustainable investment strategies by the ETF industry boosts the growth of the Nordics ETF market today."

TOBIAS NILSSON: "I also think it's a perception issue. In Finland, ETFs are seen more as an institutional solution compared to Sweden where it may more be seen as a leveraged, tactical product when that actually is a small part of the market. Even for Swedish institutions, it comes into the SAA but in Finland and elsewhere, ETFs are a core solution due to the cost and performance profile over time combined with liquidity benefits. In addition, Sweden is a country of mutual fund investors where retail investors select funds themselves. Finland is closer to Europe in that sense and there's still education to be done elsewhere."

NIKLAS TELL: WHEN WE TALK ABOUT RETAIL INVESTORS, IS IT MORE LIKELY THAT THEY WILL ACCESS ETFS THROUGH MANAGED PORTFOLIOS OF ETFS RATHER THAN BUYING FIVE DIFFERENT ETFS?

HARRI KOJONEN: "I think it depends very much on the client. Private investors are still served by the big Nordic banks and then you will mostly be served with the banks' active funds or their in-house passive index funds and in many cases balanced funds. If you have the curiosity, you can, of course, create your own solution and then the solution would be ETFs.

TONI IIVONEN: "No, but you can access ETFs through internet banks."

PETER LIDBLOM: "Historically, if you look at Sweden for example, you have the big internet banks and if you had an account with one of them, it's more likely that you would have traded ETFs than if you had an account with one of the big banks. But this situation is changing with the traditional banks increasingly being able to offer their clients ETF trading capabilities."

MARKO ALARAATIKKA: "If we look at our retail base, they're invested in our own mutual funds but we also provide access to the wider universe of Ucits ETFs. I think that's fair because they will be able to find a broad platform of more exciting stuff, which I think appeals to retail investors. It's tougher when you start to talk about portfolio construction and diversification."

FREDRIK NILSSON: "Storytelling is absolutely important. We see these fintech solutions and robo advisors mostly using ETFs to build portfolios and they typically make investing more exciting for a younger audience."

TOBIAS NILSSON: "In Sweden, you would most likely own ETFs via your managed portfolio but in Finland to a greater extent also tailored from a discretionary perspective. Execution-only platforms have helped give direct access to investors but now the infrastructure within bigger banks is starting to open-up. The brokerage business is today dominated by the platform players. If the retail market develops from single securities to ETFs, as in the US for example, that has a lot of potential for distribution platforms. Then I still think the value of a professionally managed portfolio will be recognised."

FLORIAN CISANA: "What's the percentage of advisory versus discretionary in the retail segment in Finland?"

HARRI KOJONEN: "I don't think there are statistics on that. I think retail clients in Finland access ETFs directly through the platforms, such as OP's, and besides that the banks and companies like us provide solutions and balanced portfolios where we use ETFs. We have only one solution that's purely using ETFs."

MARKO ALARAATIKKA: "I don't think we should treat ETFs as something special or something different compared to any other building block. In this room, it's important but not really when it comes to asset allocation and portfolio construction."

NIKLAS TELL: SO IS IT FAIR TO SAY THAT WEALTH MANAGERS IN FINLAND USE MORE ETFS COMPARED TO THEIR SWEDISH COUNTERPARTS?

PETER LIDBLOM: "I think this picture is also distorted by local listings in Sweden. If you're trying to get a feel for the ETF usage in Sweden and only look at what's listed at Nasdaq, you will not get a representative view of the true ETF appetite and what ETFs can provide investors with. I think that's why you have this scepticism. A lot of people don't really know what it is and the currency aspect should not be underestimated and that's not just for fixed income. In Finland, you have euros so it's no problem. Institutional investors are, of course, used to trade in different currencies but for many retail investors, it's simply another financial acronym and some people can't even get the name right and that's a bit of a challenge."

TOBIAS NILSSON: "Financial acronyms can be a problem. We celebrated a JPMorgan ETF anniversary and ordered a cake from a well-known bakery. We received the cake back saying 'EFNs', so even bakers need education on ETFs."

NIKLAS TELL: WHAT'S THE WAY FORWARD FOR ETFS TO GROW FURTHER – ON THE INSTITUTIONAL SIDE AS WELL AS ON THE WEALTH AND DISTRIBUTION SIDE?

MARKO ALARAATIKKA: "It keeps on growing, even if it might not be growing as fast as providers might hope. As I said earlier, we use them as a complement in our portfolios and a growing number of investors are asking us to provide portfolios only built with ETFs."

TONI IIVONEN: "Of course, one important aspect when it comes to ETFs is the lower fees, or at least the perception of ETFs being cheaper and I think that's still a tailwind that's helping the product. Then one could question how cheap it really is if you consider transaction costs and everything else that comes with trading ETFs. And it's not that cheap when you look for very specific exposures."

FREDRIK NILSSON: "I think this depends on the segment. Some clients have in-house index funds that are as competitive or even more so for core building blocks and for them, it's only interesting to look at ETFs for more granular exposures. When it comes to retail clients, I think ETFs have helped drive fee pressure in the region and you've seen that some banks across the region have had to adjust their fees of both active and index funds, given the fact that ETFs are a potential threat. That's an efficiency gain for the market overall but it doesn't necessarily mean that ETFs are taking market share in every segment."

HARRI KOJONEN: "One observation when it comes to fees is that fixed income ETFs are actually more expensive compared to broad market equity ETFs. We still use fixed income ETFs, partly because of the liquidity."

ETF ROUNDTABLE 2022

HARRI KOJONEN
Strategist & portfolio manager at OP Wealth Management

MARKO ALARAATIKKA
Senior portfolio manager at S-Pankki

MIKAEL LÖFBERG
Chief investment officer of CapMan Wealth Services

JANINA SIBELIUS: WHAT ARE THE SIMILARITIES AND DIFFERENCES WHEN IT COMES TO ESG CHALLENGES IN EQUITIES AND FIXED INCOME?

WILHELM SCHAUMAN: "You can argue it's easier to apply an ESG lens on the fixed income side than on the equity side. You have a bigger universe of bonds and often macro-related themes will be driving returns on the fixed income side, which means that you can run best-in-class ESG strategies and still have a low tracking error relative to standard fixed income indices. If you do the same on the equity side, it will come with a certain tracking error. Tracking error is, of course, not the only aspect investors focus on but so far it has been a key consideration for asset allocators."

MARKO ALARAATIKKA: "But if you use the same benchmark as the one you base your ETF on, you don't have a tracking error. I think a lot of investors are moving to ESG-influenced indices and that solves many problems because many are very bound by the benchmark."

TOBIAS NILSSON: "I think one challenge when it comes to fixed income ETFs and ESG is that you have one issuer and many different bonds. How do you for example look at a green versus a brown bond from an energy company? In the equity space, you only have one instrument to consider."

FREDRIK NILSSON: "Another potential challenge is the lower liquidity and OTC nature of bond trading, along with more complex benchmarks needs that need to be considered to ensure index suitability."

FLORIAN CISANA: "I think there's a huge demand for fixed income ESG ETFs in the market and particularly for Paris-aligned benchmarks. There is a good number of equity PAB ETFs but the fixed income PAB ETF market is at an early stage. All of us ETF providers work with index providers and that cooperation is key, in particular for fixed income indices. The industry is at the point where we need well-constructed fixed income PAB indices."

WILHELM SCHAUMAN: "We are seeing an increased interest in Paris-Aligned Benchmarks, especially on the fixed income side, where index construction has been and still is subject to significant development. This year at iShares, the vast majority of flows into fixed income has been into sustainable strategies such as PAB and we anticipate this trend to continue. There's huge potential for fixed income ETFs. They are newer than equity ETFs and account for less than 2 per cent of the entire global bond market with managed accounts accounting for around 7 per cent. Most of the market is still made up of investors holding individual bonds, which points to a tremendous growth opportunity for fixed income ETFs in particular."

NIKLAS TELL: WHAT THREATS DO YOU SEE WHEN IT COMES TO ETFS IN GENERAL? WE'VE HAD A LONG PERIOD WHERE INVESTORS HAVE BENEFITED SIMPLY BY BEING EXPOSED TO MARKETS AND NOW IT'S TRICKIER TO SAY THE LEAST. WILL THIS BE A TIME WHERE IT'S TIME FOR ACTIVE MANAGERS TO SHINE AT THE EXPENSE OF PASSIVE AND ETFS?

HARRI KOJONEN: "Active managers have actually done well over the last couple of years and mostly due to performance of certain sectors and factors. More recently, you have of course underperformed if you've focused on ESG because of the development for energy and defence industry stocks."

FLORIAN CISANA: "I don't actually see any threat for the ETF industry or passive industry in general. There can, of course, be movements between different wrappers but I think we will still see an increase in passive assets on a global scale, including the Nordics."

PETER LIDBLOM: "I think we need to look at the big picture. It was questioned whether ETFs would survive the financial crisis and they did so brilliantly and here we are today. At the core, ETFs are about tracking an index passively and doing it consistently. That's what they do and they do it cheaply. Then you have active managers that are good at spotting an opportunity and will try to beat the index return and they charge for that potential. I think it's wrong to think that the ETF industry is taking a beating now because the market is turbulent. There's room for both."

WILHELM SCHAUMAN: "I think we only need to look around this table today where we have four active investors and all of them use ETFs. At iShares, we estimate that our fastest growing user base of ETFs is active asset managers using ETFs in different ways such as strategic and tactical asset allocation, managing liquidity and shifting portfolios towards sustainable strategies."

TONI IIVONEN: "One potential risk could be if a small niche provider of ETF for whatever reason find itself in trouble. That could undermine the trust, especially with retail clients. I think professional investors would understand the reasons behind something like that if it should happen."

NIKLAS TELL: WOULD YOU SAY THAT THERE'S A RISK THAT IN THE RACE TO FIND SOMETHING NEW, SOMEONE IN THE INDUSTRY TAKES IT TOO FAR?

TOBIAS NILSSON: "We're working hard to identify threats but perception is important. A risk exists, even if it's small. That could be a strange exposure or replication method that could blow-up and just because it's an ETF, it might create a negative image, particularly for retail. For the professional segment, I think the liquidity, operational and cost-transparency benefit is still immense."

NIKLAS TELL: WHAT ARE YOU LOOKING FORWARD TO IN THE YEAR AHEAD?

FLORIAN CISANA: "Sustainable investing or ESG will certainly continue to be an important topic but I also think there are technological improvements on ETFs that can benefit clients, such as the introduction of a consolidated tape, which would greatly aide investors that are trying to assess the explicit liquidity of an ETF share class. Currency-hedged share classes is another area where technical and methodology improvements can benefit investors."

WILHELM SCHAUMAN: "I think one of the exciting developments that we're working for is to get exchange rules in Europe more harmonised. We think if we can get that done over time, then it will mean more transparency and it will be easier for people to use ETFs. The European Commission is also leading efforts to introduce a real time consolidated tape for EU securities, including ETFs. That will present a more holistic liquidity picture across European listed ETFs. In addition, we're also spending a lot of time and effort specifically on enhancing the ETF trading experience. Together, we expect these initiatives to contribute to improved ETF liquidity, tighter spreads and ultimately make trading more efficient."

FREDRIK NILSSON: "A consolidated tape is still very much a focal point that many in the ecosystem would like to see. Purely because the EMEA ETF space is so fragmented, we could really benefit from having one. It would also help new clients coming into the EMEA ETF market to get a better understanding of the perceived liquidity in less on-exchange traded products."

NIKLAS TELL: ARE MOST OF THE DEVELOPMENTS WHEN IT COMES TO ETFS CURRENTLY IMPROVEMENTS "BEHIND THE SCENES" RATHER THAN A NEW TWEAK ON AN INDEX OR A NEW THEME TO INVEST IN?

TOBIAS NILSSON: "Yes, these in particular are 'behind-the-scenes' but infrastructure is important for ETFs to reach their full potential. The flexibility to trade intraday is a benefit other vehicles don't have and it's particularly utilised by investors in volatile markets. However, much is also done end-of-day, much like mutual funds, and there's always a cost to trade securities. We should not forget that execution costs appear for all vehicles but the ETF is a precise and transparent vehicle in that regard. The potential is that it can be more cost-effective than any other vehicle, as costs and taxes have already occurred in the basket creation and you have an additional layer of liquidity. Inventory match-ups and improvements in exchange connectivity helps that efficiency."

FLORIAN CISANA: "I would have thought that most developments are not 'behind the scenes' as they are driven by things such as regulations or macro economic-based market demand, such as inflation hedging, currency hedging, shorter duration, etc. I also think it's worth to mention that the development of new ETFs is mostly based on client demand and therefore 'what is coming next' can to a certain degree be anticipated by the market."

PETER LIDBLOM: "I agree that it will be increasingly important for providers to listen to clients to know what they want and to have the flexibility to do bespoke solutions. If we look specifically at ESG, most of the focus has been on the 'E' and we have kind of forgotten the 'S' and I think that will change going forward."

NIKLAS TELL: ANY WISH LIST FROM THE INVESTORS?

TONI IIVONEN: "When it comes to ESG, there's very little differentiation between products so even if you buy some five different ETFs, you will end up with the same holdings. We've seen, however, that some smaller providers with more differentiated products are starting to be active in the Nordics. I think the next step would be to provide ETFs that focus on solution companies, so basically Article 9. There are not enough products in this space."