UNDER THE SPOTLIGHT:

The rise of ESG ETFs

Sustainable investing: Europe in focus

iShares by BlackRock

ESG ETF boom to continue but data challenges linger

Tom Eckett, Editor of ETF Stream

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ETF STREAM

Sustainable investing: Europe in focus

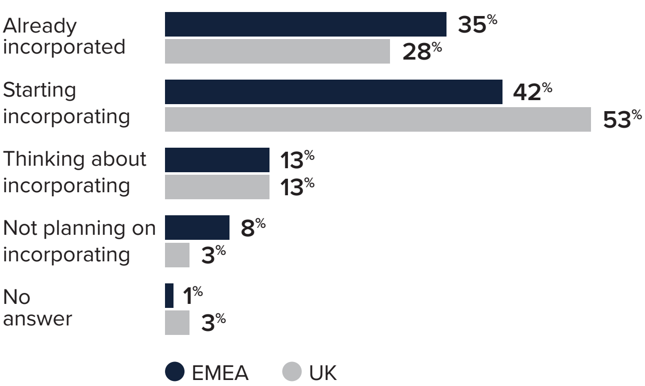
Between March and June 2020, Censuswide surveyed 400 professional portfolio builders across the UK, Italy, Germany and Switzerland to uncover attitudes towards sustainable investing and the role of sustainable indexing.

Sustainable is the new standard

Climate change, wildfires, and the COVID-19 pandemic have shown an increasing impact on European investors. Climate risk is now widely embraced as an investment risk and transitioning from traditional investments to sustainable ones is quickly becoming imperative, especially for those investing for the long-term.

As a result, an unstoppable transition to sustainable investing is now in progress with **78%** of European and **81%** of UK investors already integrating sustainability into their portfolios.

Level of sustainable integration



Source: Censuswide, iShares Sustainable Investing Research, June 2020. For illustrative purposes only.

It's time to act

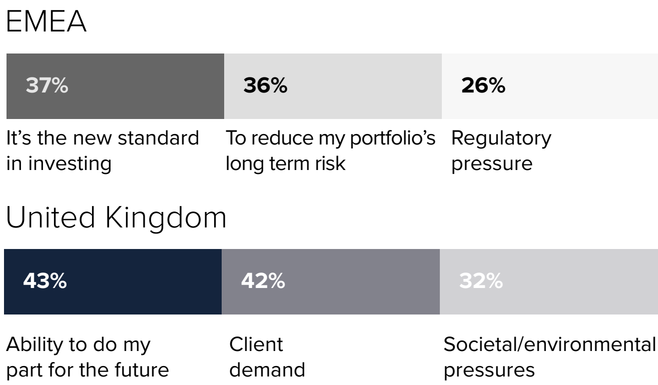
Many of our clients are under pressure to transition their portfolios to be more sustainable and this was confirmed in our survey with **80%** of European investors placing the incorporation of sustainability into their portfolio construction strategies as either urgent or very urgent.

84%	Investors in the UK
85%	Investors in Italy
78%	Investors in Germany
72%	Investors in Switzerland

Future first

We asked investors what the driving forces are behind this urgency to transition portfolios.

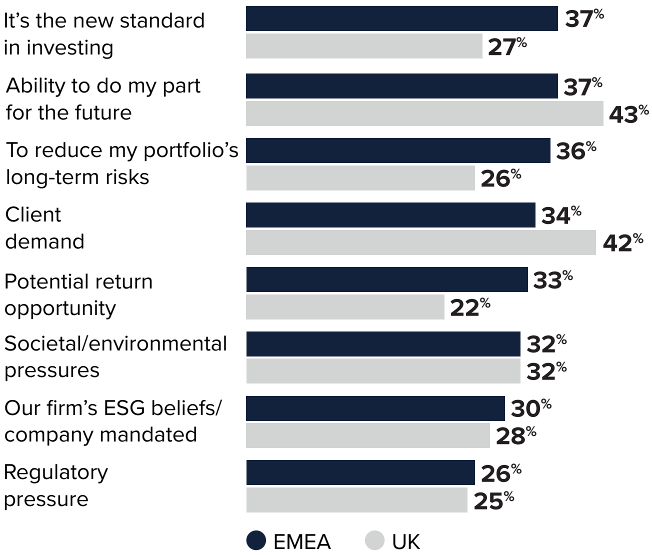
Top reasons for sustainable investing



Source: Censuswide, iShares Sustainable Investing Research, June 2020. For illustrative purposes only. Note: Total may not add up to 100%, as respondents could pick more than one factor.

Whether it's due to ethical considerations, corporate beliefs, client demand or potential return opportunities, sustainable investing is reshaping portfolio models.

What is influencing your transition to sustainable investing?



Source: Censuswide, iShares Sustainable Investing Research, June 2020. For illustrative purposes only. Note: Total may not add up to 100%, as respondents could pick more than one factor.

Challenges to change

Transitioning to sustainable investing is not without its roadblocks. We identified 3 main challenges professional investors are facing today:

1. Lack of confidence in ESG data and ESG scores
2. Choosing the right sustainable investment vehicle
3. Choosing which fund provider to work with

A crucial role

As investors seek more sustainable investment avenues, indexing has naturally come to the forefront and **80%** of the investors surveyed believe indexing is crucial to achieving a more sustainable portfolio.

> ESG integration is increasingly central to the investment process for many in our industry. We view this as a major structural shift and are proud to deliver transparent, high quality and reliable ESG data, indexes and tools to power better investment decisions.

Baer Pettit
President and Chief Operating Officer, MSCI

To uncover why investors believe indexing will play such a crucial role in helping them achieve more sustainable portfolios we asked them why they currently choose indexing.

Top reasons

	EMEA	UK
I like the benefits of traditional index funds/ETFs	27%	22%
I prefer the simplicity and transparency that indexing provides	26%	22%
I like the ability to select specific ESG outcomes	24%	24%
I like the compatibility and standardisation of their sustainability metrics	21%	24%
The transparency of holdings and sustainability characteristics	17%	14%

Source: Censuswide, iShares Sustainable Investing Research, June 2020. For illustrative purposes only. Note: Total may not add up to 100%, as respondents could pick more than one factor.

Indexing: Sustainable, simplified

Our research tells us that as investors transition into sustainable investments, navigating the choice, terminology and data interpretations can be challenging. We believe an important reason why so many investors are turning to indexing, is because indexing can help provide the clarity and simplicity investors need to pursue their specific financial and sustainability goals.

> iShares believes index products such as ETFs and index mutual funds will play a pivotal role in the transition to sustainable aware portfolios, by providing choice, value and access to all investors.

Manuela Sperandeo
EMEA Head of Sustainable Indexing

The sustainable indexing investment revolution has started.

Visit iShares.com to download the full research report and learn why we believe indexing provides investors with the clarity they need to build more sustainable portfolios.

Capital at risk.

ESG ETF boom to continue but data challenges linger

Tom Eckett, Editor at ETF Stream, examines the benefits of an indexing strategy when ESG investing and why ESG data is so critical to the rapidly developing ESG ETF space.

The environmental, social and governance (ESG) boom is well and truly underway with ETFs set to play a major role in the shift to sustainable investments, however, challenges remain for an industry still in early stages of rapid growth.

Last year proved to be a watershed year for ESG ETFs. According to data from BlackRock, EMEA ETF industry cumulative flows in 2020 were $127bn with sustainable ETFs closing at $52bn. Sustainable ETFs made up 41% of the total compared to only 14% in 2019.

Somewhat interestingly, ESG ETFs have proven much stickier assets than their non-ESG ETF counterparts. Highlighting this, the segment saw €730m inflows during the extreme volatility in March, according to Morningstar, while European ETFs overall suffered their worst monthly outflows on record with €22bn pulled from the market.

The significant surge in demand this side of the pond was driven by an increasingly conscious investor set, regulatory tailwinds, performance opportunities and the recognition ETFs provide the perfect tool for investors to express their sustainable views.

	Sustainalytics	MSCI	RobecoSAM	Bloomberg ESG
Sustainalytics	1	0.53	0.76	0.66
MSCI		1	0.48	0.47
RobecoSAM			1	0.68
Bloomberg ESG				1

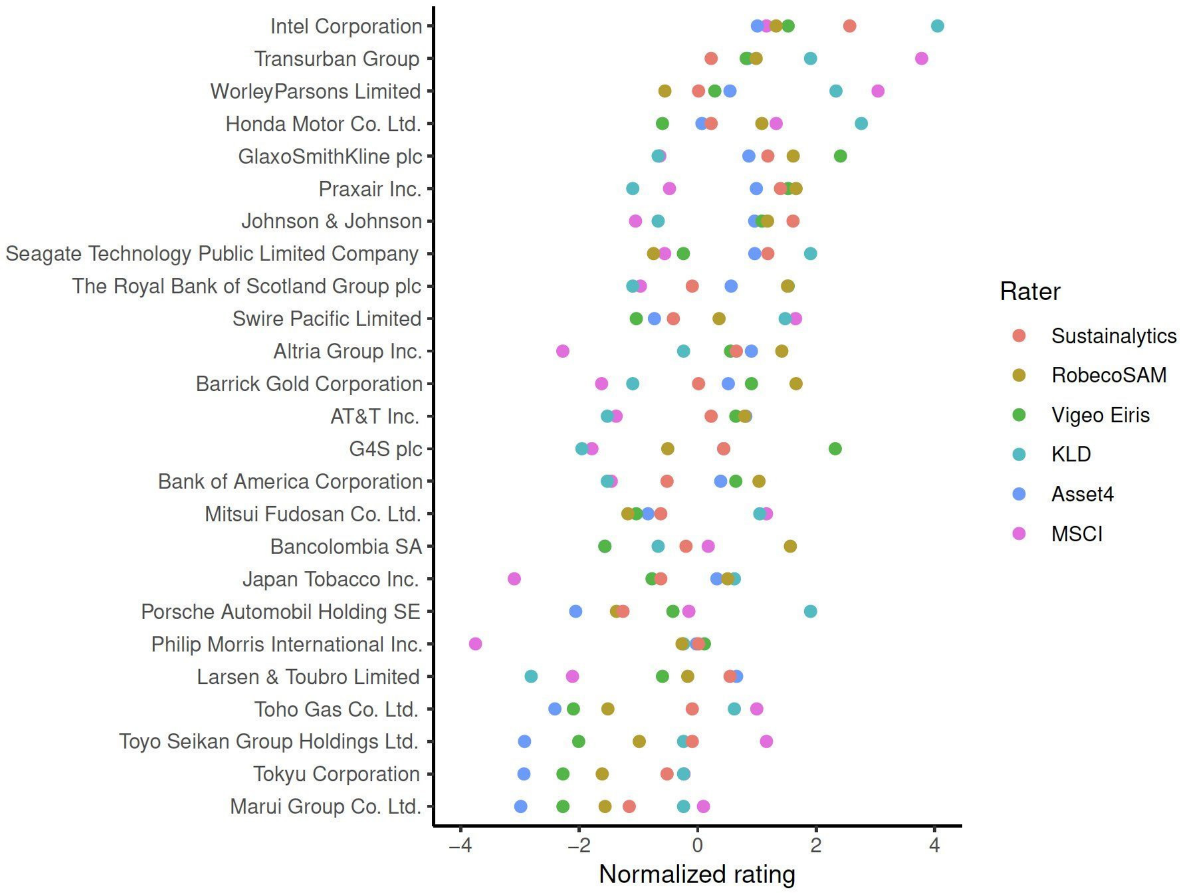
Highlighting this, a survey of 400 professional European investors conducted by Censuswide studied the reasons why respondents used ESG ETFs. Some 27% of respondents said they liked the benefits of traditional ETFs – the most cited answer – while 26% said they like the transparency and simplicity ETFs offer and 24% said they like the ability to select specific ESG outcomes.

As Andrew Limberis, investment manager at Omba Advisory & Investment, told ETF Stream: “Where the relationship between ESG and indexing works well is in the transparency provided by ETFs. It is clear to investors exactly what they own and having a rules-based methodology provides clear reasons for holding a security and in determining its weight.

“Having this clarity is important to ESG investors who want to know what companies they are invested in and may have an opinion on that company. As obvious as it sounds, ETFs are also dynamic in the sense that as the underlying data changes, the composition of the ETF will change.”

Despite the rapid development of the ESG ETF space, one area that continues to be a challenge is around ESG data. As highlighted in the section above, the world’s largest asset manager has said the “lack of confidence in ESG data and ESG scores” is the single biggest challenge facing investors at this moment.

One problem is the number of ESG data providers. According to Gianfranco Gianfrate, Professor of Finance at EDHEC Business School, there are around 200 providers of ESG scores which can lead to greenwashing issues.



Source: MIT Sloan School of Management

"Because there are so many data providers, investors are able to find one that rates the sustainability of a company even if the others do not," Gianfrate continued. "It is like having no ESG ratings at all."

One way investors are solving this challenge in portfolios is by selecting trusted ESG ratings providers with thorough and industry-recognised processes. Using a consistent ESG ratings provider can also help investors take a consistent approach to sustainability across a portfolio's exposures.

While the 200 or more providers certainly opens the door to potential issues, where investors and the European Union are most focused is around the disclosure standards for individual companies.

Firms are not required to submit ESG data to providers which can lead to big holes when being assessed from a sustainability perspective. For example, MSCI – one of the largest players in the space – takes an industry average score when there are holes in its data meaning companies can, in effect, play the system by not submitting data for metrics they know they will score poorly.

"The obvious issue here relates to quality of data which has spurred the number of acquisitions of ESG data providers," Limberis added. "ESG data is without a doubt improving but it is still lagging in some areas like Scope 3 emissions and emerging markets.

"Consistency of ratings between data providers is still an issue which does impact the fungibility of switching between ESG ETFs that use different index providers."

Regulation to improve company reporting standards would be a huge step as it would enable ESG ETFs to be created with more accuracy and provide investors with even more transparency when selecting which strategy to include in their portfolios.

Tom Eckett
Editor
ETF Stream