

ESG Unlocked

Is it time to draw the
curtain on ‘ESG’?

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ESG under pressure

What is the future of ESG investing? When addressing this question two years ago, the answer was everything will eventually become ESG as society shifts to a greener economy in the face of increasingly greater climate risks.

Fast forward to 2023 and the narrative around ESG has completely shifted. In the US, ESG has been politicised by the Republican party and the right-wing media to attack ‘woke’ asset management firms. In Europe, the market is having to contend with regulatory confusion due to the impact of ‘level 2’ of the Sustainable Finance Disclosure Regulation (SFDR) which came into effect at the start of the year.

As a result, both proponents and critics of ESG appear frustrated at the direction of travel for the sustainable investment industry with critics going as far as to ban excluding businesses on ESG grounds, as highlighted by the Boycott Act that was implemented by 16 US states in 2022.

Proponents, meanwhile, are also exasperated. Earlier this year, DWS whistleblower Desiree Fixler said the market should retire the term ‘ESG’ after a survey of 300 Bloomberg terminal users warned firms are under increased pressure to stop using ESG in conversations with clients.

“It is about time we retire the term ‘ESG’ and use clear, specific language in terms of risk management and value creation,” Fixler argued. “ESG has been politicised, exploited and phenomenally conflated. The hype and ambiguity of the term conveniently played into and helped fuel a culture war.”

While the vitriol towards ESG has certainly gone too far, especially in the US, where ESG does suffer is around definitions. From broad-based and low carbon to Paris-aligned climate and biodiversity, ESG encompasses such a wide range of issues with many different interpretations that it can cause confusion for investors.

Whether it is time to draw the curtain on ESG and become more focused with the way the market talks about sustainable investing (p.18) is assessed in Chapter 2 of this report, alongside Thomas Kuh of Morningstar Indexes’ evaluation of what artificial intelligence can tell us about the sustainable investing space (p.20).

Elsewhere, the role of biodiversity – which is becoming an increasingly important part of the ESG ETF landscape – within portfolios is also analysed (p.24) as well as what impact regulation has had on the biodiversity craze (p.22). There is also a feature on green bond ETFs (p.26) while ETF Stream’s Jamie Gordon looks at whether any asset class such as commodities or alternatives can be considered ESG (p.6).



Tom Eckett

Editor

ETF Stream

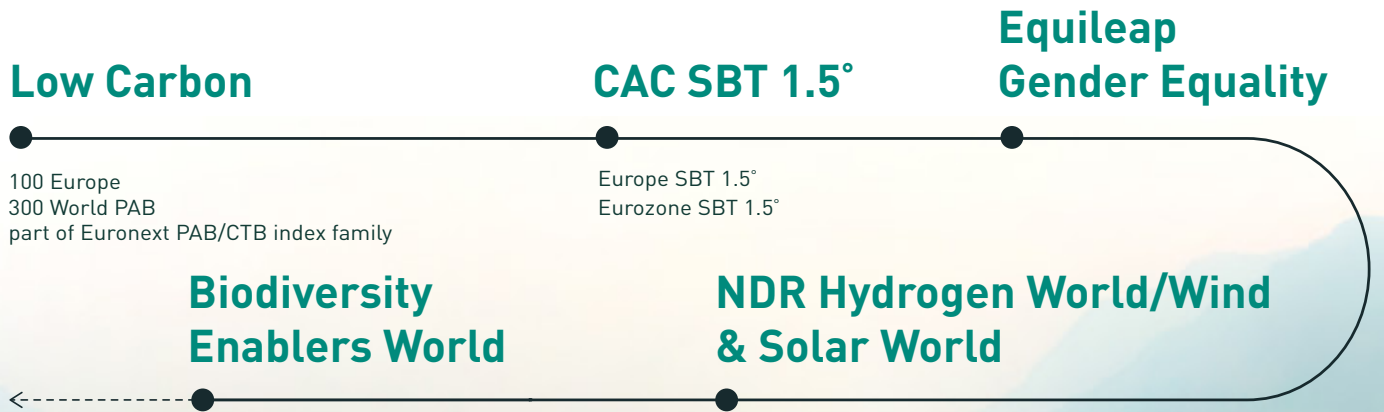
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Can anything be ESG?

A well-established asset class, area of future innovation and a bridge too far

Author: Jamie Gordon

Though applying ESG criteria to conventional equity and bond allocations might pose enough of a challenge, some believe the green hue of sustainable investing can encompass all parts of a portfolio, including alternatives.

Question-marks linger for ESG proponents, from how to categorise funds in regulatory frameworks, to data gaps in Scope 3 emissions and how to rank assets such as sovereign bonds, however, this has not halted demand for sustainable launches in more esoteric exposures.

Greening commodities

Top of mind in recent months have been thematic and ESG commodity baskets, with products capturing transition mining equities including the iShares Copper Miners UCITS ETF (COPM) and underlying commodity trackers such as the UBS ETC CMCI Commodity Transition SF UCITS ETF (RENEW) launching in quick succession.

While offering a thematic basket of transition metals may be a simple enough ask and one undertaken by several issuers in Europe, index providers argue gauging the ESG performance of individual commodities is a tall order. This is especially true for futures-based baskets where it is impossible to trace the provenance of all the physical commodities these derivatives are based on.

This creates potential difficulties for sustainable investors who are unable to see where and how the commodities they are exposed to are extracted.

Hortense Bioy, global director of sustainability research at Morningstar, warned: “Mining is a

very ugly sector, socially. A number of metals are essential to the energy transition but for responsible investors, there may be a conflict between the ‘E’ and the ‘S’ when investing in these strategies.”

However, index providers look to provide ESG insights at an asset if not producer level.

RENEW, for instance, tracks an index based on data from UBS and research firm rfu, which weights each commodity according to social, ecological, production and utilisation risks.

Chris Hackel, head of sustainable index products at Bloomberg, said his team performs lifecycle analyses of individual commodities using external data on physical production processes and corresponding emissions.

“Our thinking was that you need the underlying physical asset to have the future itself and the future reflects the underlying price so there

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That is where the avenue greenwashing arises as removing real-world emissions an accounting treatment

is a clear link.

“You can also think investors who are long these exposures are providing price support to the producers who are looking to hedge their future output. That can provide funding support for productivity improvements and increase the production of the commodities you are overweighting in the benchmark versus others you are underweighting,” Hackel said.

Bioy added outside of conventional commodities, investors are increasingly able to access more nascent sustainability-linked assets including carbon credits via exchange-traded commodities (ETCs).

In traditional precious metal



e for potential
this implies you are
missions, but this is just

investments, products including the Royal Mint Responsibly Sourced Physical Gold ETC (RMAU) are backed by LBMA good delivery bars, exclude Russian gold and are partially made up of recycled metals.

Screening property

An area of future potential are avenues for single and double materiality within listed real estate exposures.

In fixed income, Hackel noted his team is currently working on a solution to risk manage mortgage-backed securities (MBS) by overlaying mortgage pools with geospatial ESG data.

“There is data that we have already



licenced – geospatial coded data which gives you an idea of the emissions profile and physical risk, of various social and demographic characteristics of a certain area – but the challenge is tying that data to mortgage pools is very difficult.”

He said tying ESG data and mortgage pools to postcodes is a puzzle piece Bloomberg is “working on”.

On the equity side, it is simple enough applying ESG criteria to listed real estate companies, as with other ESG sector allocations.

Hackel suggested another route would be to examine mortgage providers and underwriters on criteria such as whether they offer different mortgage rates depending on region or income levels, as well as how they handle delinquencies.

Bioy suggested another area of product innovation would be to target companies focused on sustainable greenfield development or redevelopment of brownfield sites. This could be done through construction sector equities, real estate investment trusts (REITs) or potentially even tokenised property in the future.

Long-short ESG

Finally, a more contentious home for ESG could be hedge fund-style strategies, such as managed futures ETFs or long-short exchange-traded products (ETPs), applying screening criteria and betting against unfavourable exposures.

Taking on short positions likely means relying on futures contracts, which invites immediate structural disadvantages versus traditional equity from an ESG perspective. These include the loss of voting rights and “layers of complexity”, Bioy said, including the collateral being received being potentially unaligned with ESG objectives.

Next comes the challenge of reporting on ESG metrics in a long-short strategy. For emissions, a long-only fund might weighted-

average its holdings’ carbon footprint but in a long-short strategy, gauging performance is more complex.

Rumi Mahmood, director of the MSCI Sustainability Institute, said: “Say you are long Shell and short Exxon, do you net the positions between these two companies? You could end up being net carbon neutral by long and shorting different oil and gas companies.

“That is where the avenue for potential greenwashing arises as this implies you are removing real-world emissions, but this is just an accounting treatment.”

Mahmood suggested segmenting long and short positions’ ESG performance, however, nuances remain such as how to report on instruments including put or call contracts, which may only be temporary allocations.

Most intractable, Mahmood said, is the flawed logic of activist shorting. While some hedge funds effectively use shorts to manage ESG risk, those using shorts to impact companies’ cost of capital may end up shooting themselves in the foot if the company in question changes its ways regarding its conduct on ESG.

“What happens if a company changes its board, applies greener policies and its share price rallies?”, Mahmood continued. “You cannot tell your investors ‘mission accomplished’, your short position would be destroyed, so there is that counter-intuitiveness in the context of using shorts to make the world a better place.”

In conclusion, the debate around what does and does not constitute ESG is just as complex and fluid in alternatives as in conventional asset classes. Product innovation looks set to continue in ESG commodities and property, whereas index providers are more doubtful about the green potential of long-short and crypto exposures.

Jamie Gordon is a senior features reporter at ETF Stream

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ETFs and the state of EU sustainable finance

The state of disclosures, product choices and sustainability preferences will continue to evolve as the regulatory environment in Europe remains in flux

Author: Rumi Mahmood

The state of European sustainable finance has evolved rapidly in recent years. The EU Taxonomy Regulation established criteria for classifying sustainable activities, allowing for fund managers to evaluate the extent to which investments in companies' economic activities are environmentally sustainable. The Sustainable Finance Disclosure Regulation (SFDR) endeavours to bring greater transparency to investors on sustainability factors and how sustainability risks are integrated in fund manager's investment processes. And more recently, requirements to integrate sustainability considerations in investment products through the MiFID II have been implemented. Collectively these regulations have had an impact on the

European ETF market, ranging from product launches, to flows and the levels of transparency they provide to end investors.

We estimated that just under €400bn out of €1.4tn under management in Europe are invested in Article 8 and 9 ETFs, or strategies with some sustainability related focus in portfolio construction. Almost a third of ETF-based capital in Europe is therefore relevant in the context of, and impacted to some degree by the EU taxonomy, SFDR and MiFID. In this piece, we briefly explore how the European funds universe performs across these streams in terms of disclosures and investability.

EU Taxonomy

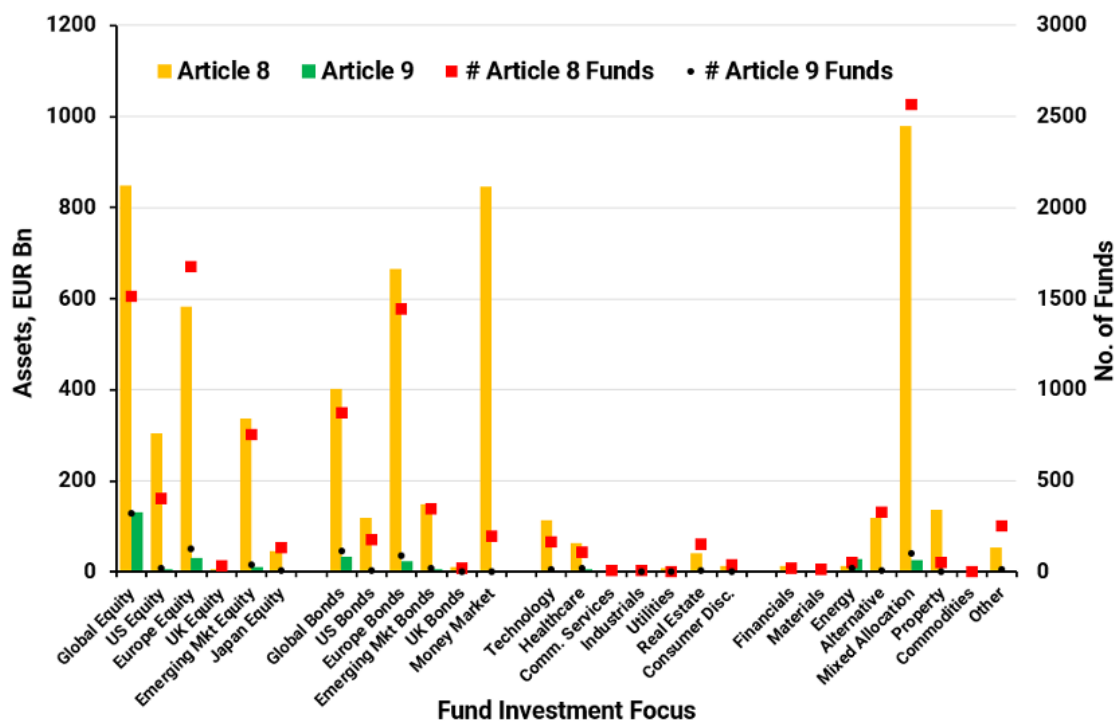
The EU Taxonomy centres upon financial market participants reporting the percentage of environmentally sustainable investments using consistent and comparable definitions. Based on data disclosed by funds in the European ESG Template (EET), as of 30 April, MSCI ESG Research found that the overwhelming majority of Article 8 and Article 9 ETFs stated "no intent" vis-a-vis EU Taxonomy alignment in the EET reporting. Notably, the majority of high taxonomy aligned funds were classified as Article 8 funds under SFDR, with only two being Article 9, which may appear counterintuitive to impact-focused fund selectors.

All of this can be attributed to the 'work-in-progress' nature of the EU Taxonomy or to the level of stringency

Chart 1: (Not) spoiled for choice – only 12 funds with >60% estimated EU Taxonomy aligned revenue

Fund Name	Fund Type	Asset Class	SFDR Article	Estimated % of EU Taxonomy-aligned Revenue
Global X Wind Energy UCITS ETF	ETF	Equity	8	83.3%
Assenagon Funds Green Economy Fund	Mutual Fund	Equity	9	75.5%
Fidelity Clean Energy UCITS ETF Fund	ETF	Equity	8	72.4%
HANetf S&P Global Clean Energy Select HANzero UCITS ETF Fund	ETF	Equity	8	70.5%
Invesco Solar Energy UCITS ETF Fund	ETF	Equity	8	68.5%
Global X Cleantech UCITS ETF Fund	ETF	Equity	8	66.8%
Global X Solar UCITS ETF Fund	ETF	Equity	8	66.7%
Storebrand Renewable Energy	Mutual Fund	Equity	9	64.2%
OCC 21	Mutual Fund	Equity	-	63.6%
iShares Global Clean Energy UCITS ETF	ETF	Equity	8	60.9%
Global X Renewable Energy Producers UCITS ETF Fund	ETF	Equity	8	60.3%
Deka Future Energy ESG UCITS ETF	ETF	Equity	8	60.3%

Source: The EU does not prescribe any specific threshold for funds to be classified as "EU Taxonomy-aligned." In this example, 60% was set as an arbitrary threshold that may be deemed as a minimum standard. Fund classification as of March 2023. Source: MSCI ESG Research

Chart 2: Plenty of choice in Article 8, not so much in Article 9

Source: MSCI ESG Research, as of April. 30, 2023. No. of funds - Article 8: 11,369, Article 9: 973

set for sustainable activities. Although reporting volumes have increased, company disclosure data for EU Taxonomy eligibility and alignment criteria remain low. In either case, it leaves sustainability-minded ETF investors with a limited pool of options, which may be challenging for mandates that require a minimum level of EU taxonomy alignment while balancing diversification needs.

SFDR

SFDR, enacted in 2021, requires financial market participants including wealth managers to disclose how they integrate sustainability risks alongside how they consider the potential adverse impacts of their investments on sustainability factors. SFDR also requires funds to be categorised based on their level of sustainability.

Article 8 and Article 9 funds now collectively account for over €6trn assets (55% of Europe fund assets). As at the end of February 2023, there were 12x more Article 8 funds than Article 9 available for investors and those funds collectively hold 18x the assets. This imbalance may continue, as updates in regulatory guidance have driven reclassifications of funds. Our analysis indicated that approximately 20% of SFDR classifications in European funds changed over the previous year, with a net migration from Articles 6 and Article 9.

On fund types, global equity strategies dominated across both Article 8 and Article 9 funds, however, there was more diversity of choice in asset class, geographic and sectoral focus for Article 8 funds – an important

consideration for wealth managers constructing portfolios from funds, and catering to clients with more ambitious sustainability preferences.

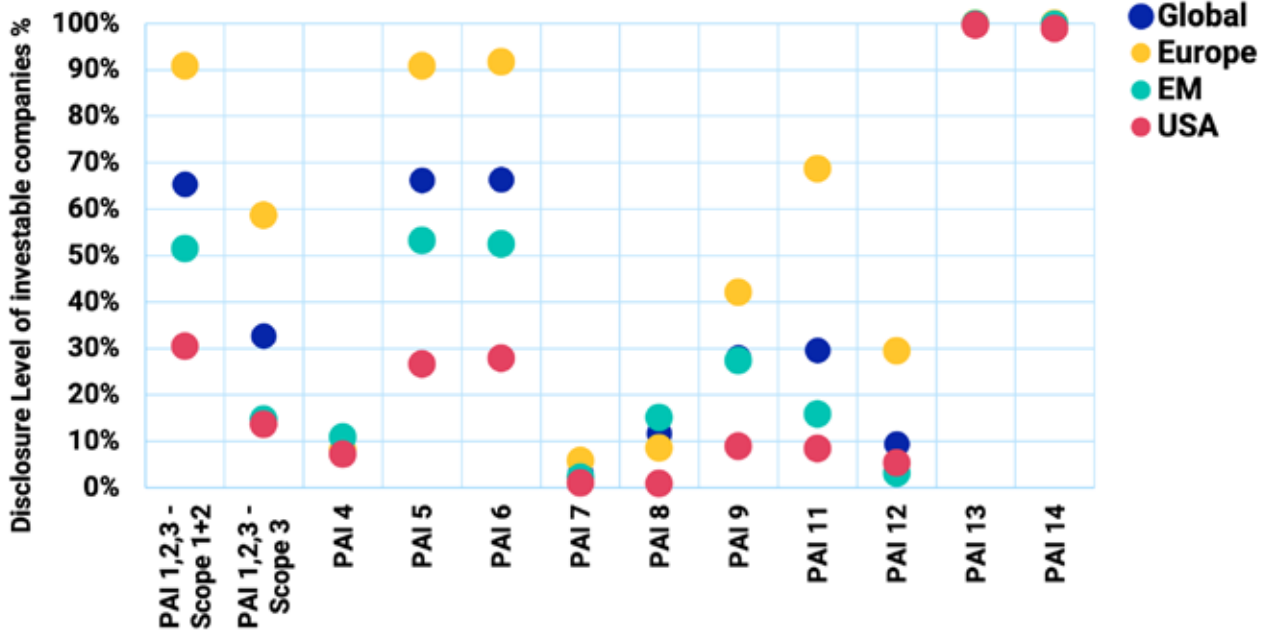
For ETF issuers seeking to create Principle Adverse Indicator (PAI) optimised funds, disclosure levels are a key determinant. Assessing the large and mid-cap investable universe revealed high dispersion on disclosure of environmental PAIs such as emissions-based metrics (Scope 1-3). European companies led the charge with over 90% of firms disclosing Scope 1 and 2 emissions. Notably, emerging markets exhibited higher disclosure levels versus the US, across Scope 1, 2 and 3 emissions, and higher versus Europe on PAI 8 – emissions to water disclosure.

On social PAIs (11-14), gender pay gap reporting was low across the board with 3.1% of companies globally disclosing. Europe had the highest disclosure rates for the social PAIs 30%, and the US marginally disclosed more than the emerging markets. Board gender diversity (PAI 13) disclosure was high across regions, however it is important to note that high disclosure does not necessarily equate to the boards of the companies having higher diversity than peers.

MiFID sustainability preferences

Under MiFID II, investment firms providing investment advice and portfolio management services are required to consider sustainability factors and risks adverse impacts of their investments. Key among the amendments introduced in MiFID II is the requirement that investment

Chart 3: Environmental and social PAI disclosure levels



Source: MSCI ESG Research LLC, as of Aug. 30, 2023. Based on PAI disclosure and MSCI ESG Research assessments of large and mid-cap companies of regions represented by MSCI ACWI, Europe, USA and Emerging Market indexes. No. of companies per region – Global = 2,882, Europe = 424, USA = 625, Emerging Markets = 1,373. PAIs are defined in Annex 1, Table 1 of Commission Delegated Regulation (EU) 2022/1288. Official Journal of the European Union. 2022.

firms inquire about the individual sustainability preferences of their clients. To be able to recommend suitable products to clients, investment firms have to confirm whether a client has sustainability preferences, and if so, whether, and to what extent, one or more of the following criteria should be integrated into their investment:

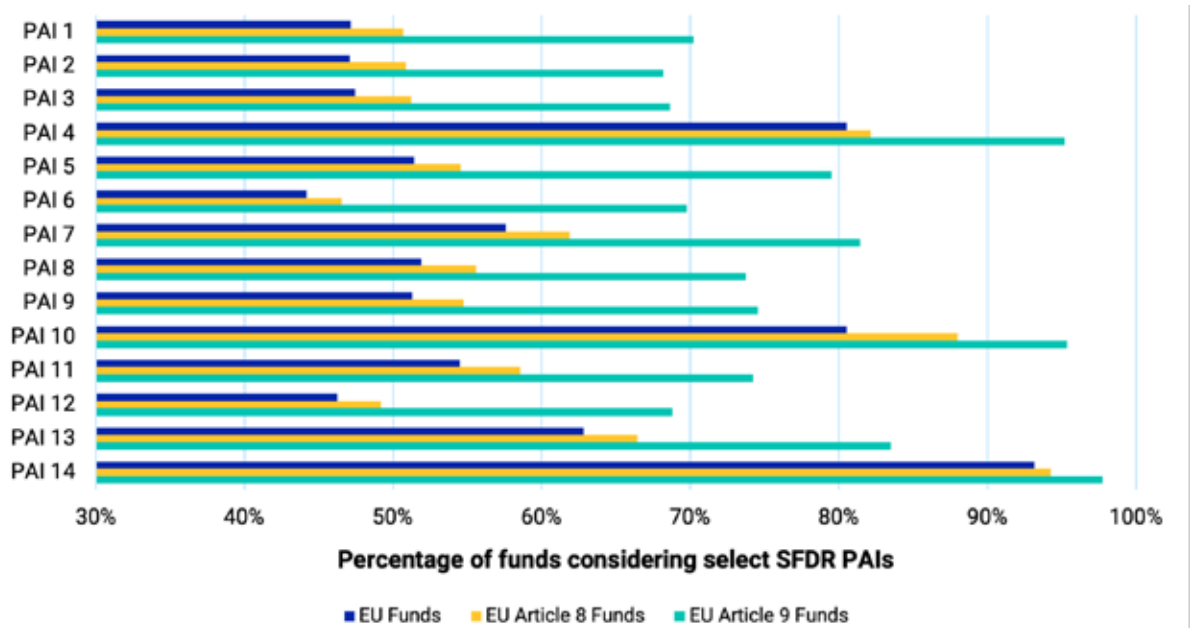
- Financial instruments or products with a minimum proportion of sustainable investments that qualify as environmentally sustainable under the EU Taxonomy

(“Taxonomy-aligned Investments”)

- Financial instruments or products with a minimum proportion of sustainable investments as defined under Article 2(17) of the SFDR (“Sustainable Investments”)
 - Financial products or instruments that consider principal adverse impacts on sustainability factors (“SFDR Principal Adverse Impact Indicators” (PAIs)), where those considerations are determined by the client or potential client



Chart 4: Consideration of select adverse impact indicators among EU funds having disclosed a commitment to reduce or mitigate at least one SFDR PAIs



Source: MSCI ESG Research, EET disclosures as of Aug. 30, 2023. No. of unique EU-domiciled funds: 6,709, No. of Article 8 funds: 5,978, No. of Article 9 funds: 662. PAIs are defined in Annex 1, Table 1 of Commission Delegated Regulation (EU) 2022/1288. Official Journal of the European Union, 2022.

Based on data disclosed in the EET, as of 30 April, MSCI ESG Research found that over half of Europe domiciled funds were considering (committing to reduce or mitigate) at least one SFDR principle adverse impact indicator in their investment strategy.

Consideration of involvement-type adverse impact indicators is more likely than consideration of quantitative indicators for which thresholds are not prescribed by SFDR regulation. Specifically, 80% of funds disclose

considering exposure to companies active in the fossil fuel sector (PAI 4) and 93% consider exposure to controversial weapons (PAI 14).

On the other hand, approximately 47% of funds consider exposure to GHG emissions (PAI 1) and 51% of funds consider exposure to companies with non-renewable energy consumption and production (PAI 5). Across the board, EU-domiciled Article 9 funds have committed to manage or mitigate PAIs more so than funds without sustainable investments as their objective, likely driven by the requirement to assess the portfolio against the principle of “do no significant harm” by considering the PAIs.

The state of disclosures, product choices and sustainability preferences will continue to evolve as the regulatory environment in Europe remains in flux. And while that presents a confluence of challenges for ETF market participants from portfolio construction to sustainability reporting, opportunities may also arise as investors become more attuned to how sustainability risks are integrated in the investment decision process.



Rumi Mahmood is vice president, ESG and climate research, at MSCI

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Synthetic beats physical replication for sustainable commodity exposure

The formula for ESG allocations might not be consistent across asset classes

Author: Jamie Gordon

While the complex mechanics of synthetic ETFs have sparked critiques such as the vehicles being too clandestine to be appropriate for ESG, for sustainable commodity investors avoiding physical replication may be the only viable option.

Last December, French regulator Autorité des Marchés Financiers (AMF) warned synthetic ETFs were too opaque regarding their ESG characteristics. For instance, by not effectively communicating the absence of voting in swaps-based exposures or the fact these ETFs may end up holding the securities of high-polluting companies as collateral within their swap baskets.

However, these concerns may be somewhat less relevant for investors trying to find a sustainable angle to

commodity exposure via exchange-traded commodities (ETCs), for instance, underlying transition metals, given these exposures do not offer voting rights as standard.

For transition metals, some argue synthetic ETCs actually make more sense than physical from a positive impact perspective, given physical replication would mean sequestering copper, lithium, cobalt and other metals – potentially exacerbating existing supply and therefore price pressures.

Aanand Venkatramanan, head of ETFs, EMEA, at Legal and General Investment Management (LGIM) – which does not currently offer an energy transition metals basket – acknowledged this argument: “This is based on the concept of the elasticity

or inelasticity of demand and supply, which is very important for commodities. If you are talking about commodities where it is very difficult to ramp up supply, then yes, holding can create a demand-supply gap and that can have ramifications on price.”

However, while Venkatramanan noted physical gold ETCs have the scale to potentially drive underlying prices, only a small minority of ETCs physically capture transition metals so this argument is more theoretical than practical.

In reality, Venkatramanan said the argument for futures being the better route for transition metals exposure is based on their superior efficiency in this context.

Physical replication might mean avoiding the physical roll yield incurred by rolling swaps or futures contracts but this comes with alternative – and potentially greater – costs.

“If there is enough supply in the market, nobody cares if you hold or not,” Venkatramanan continued. “Physically holding means you are incurring storage costs, with assets that might not necessarily gain asset appreciation during that period.”

He also said physical exposure might be appropriate and even economical for more transferrable investment commodities such as gold, however, futures can help protect against the potential illiquidity and the risk of wider spreads in consumption commodities with less consistent investment demand.

“Imagine you have a few hundred tonnes of a base metal and you decide to liquidate your position – who is going to buy that stock on the other side and what discount will you have to sell at if I really need to redeem? With physical gold, there is not this issue because there are enough buyers and sellers. For harder-to-access commodities, the futures markets are there to facilitate access.”

“

Physically holding means you are incurring storage costs, with assets that might not necessarily gain asset appreciation during that period

Aanand Venkatramanan, head of ETFs, EMEA, at Legal and General Investment Management

Jamie Gordon is senior features reporter at ETF Stream

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The ESG evolution of Research Enhanced Indexing

The REI process is simple but powerful

J.P. Morgan Asset Management’s Research Enhanced Index (REI) investment process has been refined over 30 years, aiming to combine the best qualities of passive – index-like regional, sector and style exposures – with active management. Since launching the first REI strategy in the ETF wrapper in October 2018, the range has grown into one of the biggest active UCITS equity ETF strategies, with eight regional exposures and assets under management of over \$8bn.

Research Enhanced Indexing: The best of both worlds

The REI process is simple but powerful. The objective is to translate our stock specific insights into our REI portfolios while keeping

an index-like structure. We do so by combining best in class fundamental research with robust risk management. We have a large team of career analysts who carry out in-depth research on over 2,500 stocks, leveraging a disciplined valuation framework, which is used across the whole firm. These insights are then packaged into an index-like portfolio by applying small overweight or underweight positions in certain stocks. The end result is a style-neutral, sector-neutral and regionally neutral ETF portfolio, which has the same shape and feel as the index.

The use of ETFs which consider environmental, social and governance (ESG) factors has been growing in popularity among investors, with 60% of total UCITS

ETF flows in 2022 going into ESG focused ETFs, according to Bloomberg, as at 31 December 2022.

Our REI ETFs have also been part of this evolution of ESG investing. The assessment of ESG factors has been part of the REI strategy for decades. We believe that active management has a distinct advantage when investing sustainably. The market also appears to see the benefits of active ESG ETFs, with over 60% of participants from the 2023 Trackinsight survey stating they use solely active or a combination of active and passive approaches to invest in ESG ETFs.

The evolution of ESG

Our established REI ETFs use a robust ESG framework to integrate the insights of our fundamental research analysts who assess companies based on 40 ESG related questions. We then engage with the companies that we invest in on an ongoing basis to discuss ESG issues.

Recently, as part of the evolution of ESG across our ETF offering, we launched a new range of socially responsible investing (SRI) REI ETFs, for investors who want sustainability

MSCI SRI EU PAB Overlay Index: Characteristics

Exclusions



Fossil fuels
(Oil & Gas, Thermal coal mining)



Adult Entertainment



Weapons



Alcohol



Gambling



Tobacco



Power generation



UN Global Compact violators



Genetically Modified Organisms

+

Paris Aligned



7%

minimum reduction of GHG intensity on average (per annum)



50%

lower GHG intensity vs. the investable universe

front and centre of their core investments. This range of ETFs uses the same REI investment process but with one important differentiation. While our traditional REI range uses an ESG framework to take active positions against a traditional benchmarks, like the MSCI World or S&P 500, our new ETFs have bespoke sustainable benchmarks.

From the traditional base index, industries such as fossil fuels, weapons and tobacco are excluded. There is then a further selection of securities to ensure that index constituents' greenhouse gas emissions are at least 50% lower than the wider investable universe and that carbon intensity is reduced by 7% each year. This process enables the index to meet the EU's Paris-Aligned Benchmark (PAB) criteria. The result is an index that

has a smaller, but more sustainable investment universe. For example, the MSCI World index includes approximately 1,500 stocks while the bespoke SRI and PAB version will only have 600-700 stocks.

This is where the portfolio manager's work begins. Using the REI process, we take small overweight and underweight positions against this bespoke index, informed by our fundamental research. The process involves constantly monitoring these positions and engaging with the companies held.

Portfolio allocation considerations

The new sustainable REI ETFs provide clients with core portfolio building blocks in global or US

equities. The objective of these portfolios is to achieve a consistent performance above the benchmark over time, potentially enhancing the performance of a client's portfolio. Diversification is another key aspect, with these ETFs complementing existing investments a client may already have in sustainable ETFs. Finally, given the emphasis of ESG characteristics in the portfolios, they could be used for clients who want to make ESG considerations a central focus of their investments. We believe our sustainable ETFs can offer investors efficient exposure to a portfolio of companies with genuine ESG characteristics, while also aiming to provide an attractive return.

J.P.Morgan ASSET MANAGEMENT

Asset allocation considerations

ESG at the core

Rigorous application of ESG factors on a sustainable investment universe

Enhance performance

Better achieve your performance targets by adding an active ETF with potential for incremental outperformance



Building blocks

Global and US exposures

Diversification

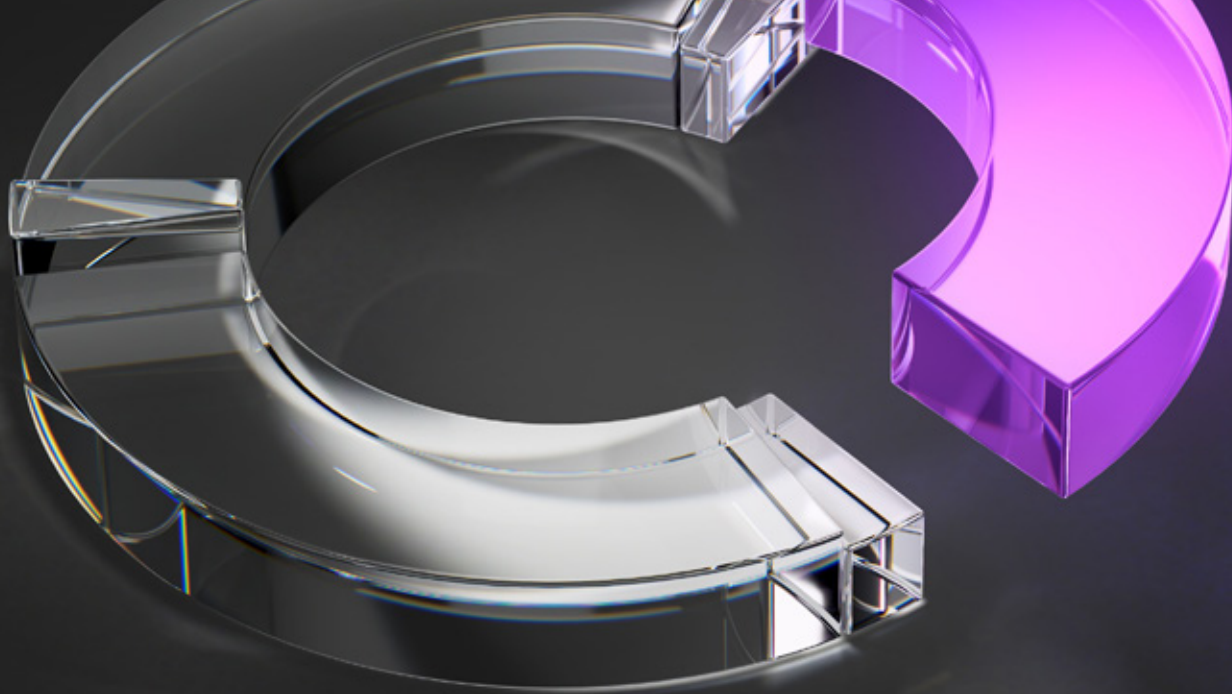
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Enhance your core with active ESG ETFs

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‘It needs to change’: Is it time to draw the curtain on ESG?

Less acronyms and more real talk. Is it time we changed the way we talk about ESG investing?

Author: Theo Andrew

As ESG becomes an increasingly politicised topic in the US, Europe has so far been buffered from the anti-ESG backlash that could well have a major impact on the future of the planet.

Regulators on the continent continue to press ahead with sustainable investing rules that have often tied asset managers and investors in knots while remaining susceptible to greenwashing.

Meanwhile, asset managers in the US are avoiding the term ‘ESG’ completely in a bid to placate clients that might deem the term ‘woke’. A recent survey of 300 Bloomberg terminal users found wealth managers are under increased pressure to ditch the term with clients.

Looking beyond the use of the term as a weapon in the culture war, could the anti-ESG movement in the US provide a learning moment for the continent in its approach to sustainable investing?

Andrew Limberis, investment director at Omba Advisory & Investments, believes the conversation around ESG with clients “has to evolve” from the simplicity of labels such as Article 8 and Article 9 under regulations such as the Sustainable Finance Disclosure Regulation (SFDR).

“[ESG] has to evolve and it is not going to get there overnight,” Limberis said. “It does need to change because an Article 8 or 9 classification might be simple to understand but what does it mean?”

“Something like carbon emissions is a bit more meaningful and understandable, but clients will not just agree with various principles.

They will have their view on how this should be done.”

Last month, former DWS group sustainability officer Desiree Fixler, who is speaking at ETF Stream’s ETF Buyer: London event on 7 November, said it is “time to retire the term ESG”, arguing ditching the term could lead the industry to adopt more specific language in terms of risk management and value creation.

A European backlash?

With various regulatory initiatives so far down the road in Europe, is it conceivable we see a similar backlash to sustainable investing on the continent?

Hortense Bioy, global director of sustainability research at Morningstar, argued this is a primarily US issue but added there has been a clear trend by asset managers to talk less about ESG.

“In slides and presentations, there is less space given to ESG which is being replaced with opportunities arising from the energy transition,” Bioy continued. “We are talking less about the risks and more about opportunities.”

There are signs too some investors have had enough of the term, however, this appears to be a generational view or restricted to certain markets.

Kalinka Dyankova, senior fund analyst at Kleinwort Hambros, said clients often kickback when ESG enters the conversation, particularly when talking about markets such as the UK.

“Of course [we have kickback from clients]. Especially in markets such as the UK where you have companies such as Shell and BP dominating the market,” she said. “I would not say we see the same level of toxicity as in the US. In Europe, it is mainly generational and market driven.”

Limberis agreed, adding many of the firm’s older clients made their money in non-ESG areas.

“On the whole, our client base is a bit older, with many of them made money in areas which today would not be considered ESG such as energy materials so their experience and age leads them to a slightly

“

We would never push ESG onto our clients and we would only hold an ESG fund because we think it is better to hold for non-ESG reasons, but there is certainly a view that it is a bit ‘woke’



different conclusion,” he said.

“We would never push ESG onto our clients and we would only hold an ESG fund because we think it is better to hold for non-ESG reasons, but there is certainly a view that it is a bit ‘woke’.”

While this might be the view of high-net-worth wealth management clients, ESG best practices and the various regulation and reporting standards remain an important consideration in the investment and internal operations of banks and institutional investors.

‘Time to retire’

Earlier this year, the world’s largest asset manager BlackRock went ahead with a de facto retirement of the term ESG, after founder and CEO Larry Fink said the group has stopped using the term, stating it has become too politicised despite still believing and aiming to achieve many of its principles.

Limberis said he could see a point in the future where nothing is

labelled ESG, rather the principles of good governance are incorporated at all levels of investing.

“Several years ago, we spoke about how everything is going to be ESG one day, but rather than everything being ESG, maybe nothing is and we all just try and incorporate the principles of good governance and good corporate citizens,” he said.

Kalinka said she does not believe the term ESG should be retired, noting its evolution from a “nice to have” to a “must have” for wealth managers, but added the differences between markets across Europe.

“I am curious as to what impact the Financial Conduct Authority’s (FCA) Sustainable Disclosure Regulation (SDR) will have as they seem to be more pragmatic,” she said. “On the European side, it has become a bit too strict. The French regulator is completely banning any terms that cannot be justifiable such as ‘sustainable’, which is good to combat greenwashing but is too strict for an asset manager to create

something.”

Despite this, Bioy raised concerns about what else would be ‘cancelled’ if we were to remove the term ESG from investing. “If you get rid of ESG, what is the next word that is going to be vetoed because it is too sensitive or toxic for people?,” she said.

Bioy added the industry has moved on from the greenwashing debacle that has plagued the industry over the past two years, with lessons learnt from the DWS scandal and asset managers now taking a more prudent approach to ESG integration.

“Regulation is taking care of the issue around the lack of clarity around the term ESG, which is going to stay. The industry needs to be clearer about what they mean. Are they talking about ESG data or ESG ratings? It will become more specific but the acronym will remain,” she said.

Theo Andrew is news editor at ETF Stream

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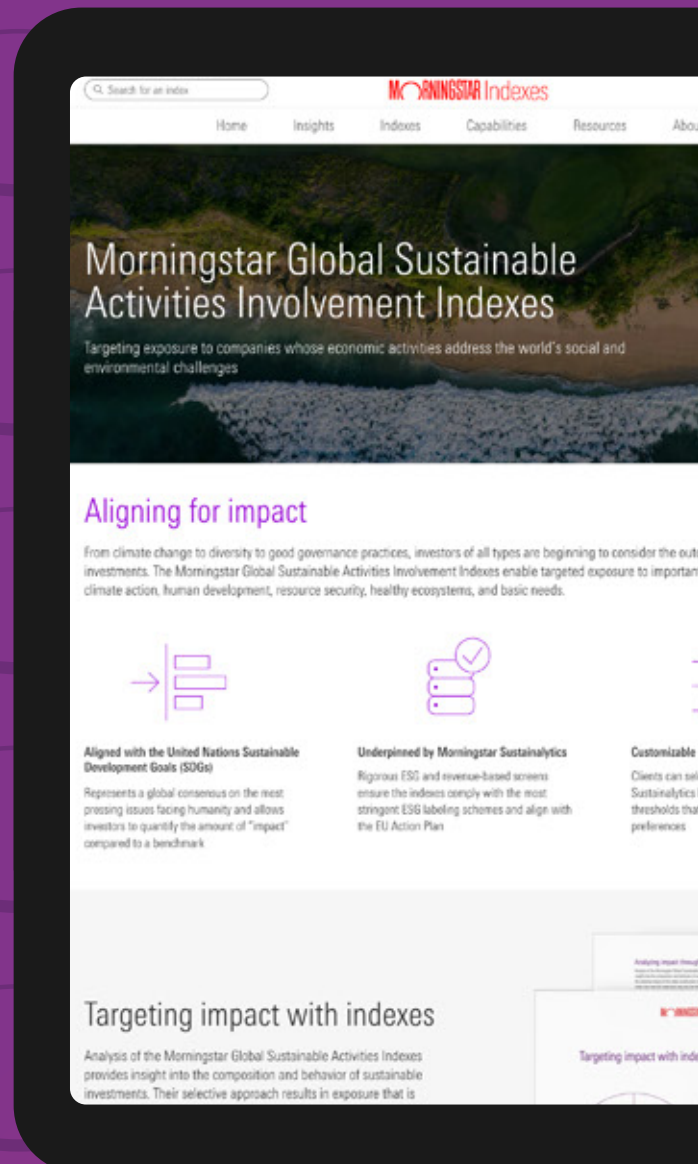
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What generative AI tells us about sustainable investing

Reacting to ESG criticisms

Author: Thomas Kuh

As sustainable investing became mainstream in the past decade, its practices have evolved and its influence has grown. But its purpose remains the same: change investment decision making and corporate behaviour to generate environmentally and socially sustainable outcomes. These are ambitious objectives.

Today, it is *de rigueur* to point out shortcomings of sustainable investing. This phenomenon reflects that the field is maturing – and high expectations as it seeks to address complex challenges like climate change. Sustainable investing alone cannot be expected to solve such problems, however, it can play a catalytic role.

To get an unbiased (by me) view of these criticisms, I asked Claude.ai,

a generative AI, about the “primary criticisms of ESG investing”. The top four are:

1. Performance
2. Subjectivity of rating criteria
3. Greenwashing
4. Lack of standardisation

These criticisms will not be new to practitioners, but I thought it would be instructive to provide insights into these issues.

Performance

For the past 30 years, the performance of sustainable funds relative to their conventional peers has been the subject of hundreds of academic and practitioner studies. Evidence based on fund performance, articles and meta studies show no evidence of systematic

underperformance by sustainable funds and some evidence that they have provided performance benefits.

According to Morningstar research, sustainable funds consistently underperformed for the first time in many years in 2022, primarily due to structural biases favouring technology and underweighting energy in a market where the former strongly underperformed and the latter strongly outperformed. However, three-, five- and 10-year performance favoured investors in sustainable funds over those in conventional peer groups. So, 2022 appears to be the exception that proves the rule.

The good news for ETF issuers and investors is that passive sustainability funds tend to outperform active ones. Yet as evidenced by the AI responses, the perception of underperformance persists. Perhaps it is reinforced by recency bias, but it means investors would benefit from ongoing education explaining that they should be able to at least achieve long-term, risk-adjusted performance in line with the market across a diversified portfolio.

Subjectivity of rating criteria

This concern stems from the qualitative nature of some



sustainability issues and the prevalence of proprietary ESG rating frameworks.

While some sustainability issues lend themselves to quantitative analysis, others are distinctly qualitative. This is unavoidable when analysing ESG issues. The task of rating agencies and analysts is to develop ways to systematically transform qualitative information into quantitative metrics.

In the absence of established standards and data sources, ESG rating agencies developed proprietary frameworks starting in the 1990s. The field evolved organically as there were no accepted models for evaluating sustainability issues at companies. Proprietary analytical approaches solved the need for rating models while also providing competitive differentiation. Without question, the field has benefitted – and will continue to benefit – from a multiplicity of approaches.

As sustainable investing became more popular, investors have appropriately come to expect greater transparency about rating models, their assumptions and the data they use. As this market moves into a more advanced stage, regulators are acting to ensure that expectation is met.



Greenwashing

Greenwashing – intentionally misleading or exaggerated claims about green or sustainable practices – can come from companies or fund managers. We are adjusting to new regulatory regimes, so it is not surprising that high-profile greenwashing cases have surfaced as markets move away from voluntary disclosure and standards.

Selective disclosure of ESG information from companies may overstate positive and underreport negative information. This may skew ratings that use the information. Greenwashing by companies is being addressed by regulatory rules for disclosure. The other type of greenwashing may come from fund managers who exaggerate their how extensively they incorporate ESG analysis into their investment process or use fund names that may mislead investors.

Greenwashing related to funds warrants regulatory guidance to ensure that investors' interests are protected. Now that greenwashing is on the agenda and rules are being established, it is less likely to be a widespread problem going forward. Fund managers are keenly aware of the new regulations as well as the reputational and financial costs of greenwashing.

All key stakeholders have a role to play to ensure greenwashing recedes as a concern, and it is incumbent on industry and regulators to align investor expectations with what can realistically be accomplished through sustainable investments.

Lack of standardisation

Investors need decision-useful, material information to make informed decisions. Since sustainable investing was not widely practiced until recent decades, the field had to develop its own standards and practices. As it has matured and grown in importance, the need for greater standardisation has become a priority.

Investors have recognised the need to establish standards for sustainability-related data reporting since the founding of the Global Reporting Initiative (GRI) more than 25 years ago. Over the ensuing years, other standard-setting organisations like the Sustainable Accounting Standards Board (SASB) have been set up to meet the need for consistent reporting of material climate and sustainability-related data.

Founded in 2021, the International Sustainability Standards Board (ISSB) builds on the work of other initiatives to enable “companies and investors to standardise on a single, global baseline of sustainability disclosures for capital markets”. Its credibility stems from the fact that it was established by the IFRS Foundation, which set up the International Accounting Standards Board (IASB) in 2001.

Defining and implementing sustainability reporting standards will take time, but it is worth remembering that it took almost 70 years to enact global accounting standards. Investors should appreciate that standardisation is being addressed, though it's a work in progress.

So, what can generative AI tell us about ESG investing? The sentiments it reflects define an agenda for fund sponsors, advisers, ESG service providers, regulators and standard setters. These criticisms have led to new oversight and standardisation, signs of a maturing field as it prepares to move forward. Sustainable investing developed without a clear blueprint but it is here to stay. Hopefully, the list is different when we ask the AI again in a few years.



Thomas Kuh is head of ESG strategy at Morningstar Indexes

MORNINGSTAR Indexes

Biodiversity: Regulators drive the latest craze in ESG ETFs

We have had more client conversations about biodiversity since the beginning of this year than all years prior combined.

Author: Jamie Gordon

The ESG movement may be having a moment of self-reflection after widespread scrutiny, but a new theme in ETF launches is gathering steam as regulators turn their gaze to companies' biodiversity footprints.

After years of climate metrics dominating the limelight with everything from Paris-aligned to carbon-offset strategies, nature-related disclosures are taking centre stage in regulatory development at national and international level.

Sylvain Vanston, executive director of Climate Investment Research at MSCI, said: "Demand for biodiversity-related data and solutions has risen rapidly since 2020, and in particular since COP15 last December. We have had more client conversations about biodiversity since the beginning of this year than all years prior combined."

The first time appeared on ETF investors' radar was in December 2020 when French asset manager Ossiam launched a strategy tilting its basket towards companies its team deems to support biodiversity.

However, it is little accident that all but one of the biodiversity ETFs that followed were issued by French asset managers, with the theme being one of a suite of debut products by AXA Investment Managers last year.

This trend has been led by Article 29 of France's 2019 Law on Climate and Energy, which required all financial institutions to disclose the biodiversity-related risks – based on double materiality – their alignment with the 1992 Convention on Biological Diversity and how their investments contribute to reducing biodiversity impacts as underlined by

the Intergovernmental Platform on Biodiversity and Ecosystem Services (IPBES).

With French institutions being asked to disclose on biodiversity from 2022, Lorraine Sereyjol-Garros, global head of sales at BNP Paribas Asset Management – which launched a biodiversity ETF last year – said nature-focused disclosure requirements may be single-country for now, but pension funds and central banks across Europe are now

joining the discussion.

"The interest might not translate into a flood of investments this year – we have to be rational on that – but in the five years to come it will be the big trend. We are just at the start of the biodiversity theme," she said.

ESG's next international movement

Indeed, September marked the end of a two-year development phase for the Taskforce on Nature-related Financial Disclosures – a biodiversity corporate disclosure framework backed by the UN, governments and non-governmental organisations (NGOs) – which was unveiled at Climate Week in New York.

While a voluntary framework prior to being fully unveiled, it is expected the TNFD may follow in the footsteps



of the Taskforce for Climate-related Financials Disclosures (TCFD) in being adopted by national regulators and mandatory reporting being implemented.

Aside from carrying over all 11 TCFD recommended disclosures, the TNFD proposes six general requirements for corporate reporting, carries over TCFD recommendations on governance, strategy, risk management and metrics, as well as incorporating value chain biodiversity impacts – equivalents to Scope 3 emissions reporting.

Vanston said: “We expect the launch of the TNFD guidelines to continue generating strong interest and further questions from investors in this space.

“Demand is strongest in Europe, where interest in sustainability issues tends to emerge first. This is

particularly so in France, but also in the Netherlands, the UK, and increasingly in the USA. Most of this demand is driven by asset managers, as well as insurance companies and, to a lesser extent, banks and asset owners.

“While regulation is always a strong driver of demand for solutions, such as the recent EU ban on “imported deforestation” or its broader 2030 Biodiversity Strategy, other signals matter too. Including ad-hoc coalitions, disclosure frameworks and key events such as COP15, where governments have agreed to step up and inserted the need for investors (and corporates) to measure and report against biodiversity impact drivers in their portfolios.”

The TNFD will join the growing body of sustainability disclosures requiring reporting beyond just climate metrics, including the IFRS Foundation’s International Sustainability Standard Board (ISSB), the European Sustainability Reporting Standards or EU Corporate Sustainability Reporting Directive.

Immovable data dilemma

However, as with everything in the ESG pantheon, scant data availability undermines the breadth and representativeness of company biodiversity performance and in turn investor confidence in resulting products.

Vanston noted there are a host of new metrics required for biodiversity disclosures, ranging from mitigating the impact of company activities to physical risks, reliance on scarce commodities, policy, technology and reputation risks.

“While the climate and biodiversity crises are interconnected, there is nonetheless a lot of new data and knowledge to ingest, such as location-specific ecosystem considerations or how multi-factor pressures interact,” he concluded.

Sereyjol-Garros agreed, noting BNPP AM delayed launching the

BNP Paribas Easy ESG Eurozone Biodiversity Leaders PAB UCITS ETF (BIODV) until last September until the data quality was “sufficient”, however, she suggested “it still needs to be improved”.

“The data sets are still improving but there is plenty of scope to improve further. Not all companies disclose on biodiversity, so the data quality is maybe not as strong as climate for the time being.”

This goes some way to explaining some providers’ reticence when considering biodiversity product launches.

Chris Hackel, head of sustainable index products at Bloomberg, told ETF Stream: “Biodiversity is very much on our client’s radar but in terms of who I have talked to, nobody is ready to move forward on anything yet.

“People are looking for more developments on what makes sense regarding the data required to construct that kind of index. Clients are looking at biodiversity as another potentially significant subset of climate strategies, but it is not there yet.”

This sentiment is also echoed by some of the figures leading the development of new disclosure frameworks.

Guy Williams, foundation member of the TFND, commented in Reuters: “Companies have had 15 years to integrate into their business processes reporting disclosure and mitigation measures relating to greenhouse gas emissions in the fight against climate change.

“It is not possible, nor expected, that doing the same for nature can happen overnight once the TNFD framework lands.”

Be that as it may, regulation looks to force the issue on biodiversity and products are launching to meet newfound demand. Data will once again have to play a game of catch-up.

Jamie Gordon is senior feature reporter at ETF Stream



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Helping investors support biodiversity

Regulators require that financial institutions assess nature-based financial

The need for urgent action

Nature plays a critical role in sustaining life. The ecosystems of the land and ocean give us fresh water, air, food and medicine, and can absorb a significant amount of our harmful emissions. However, they are being destroyed by human activity and climate change. Biodiversity loss is accelerating at an alarming rate: wildlife populations have plummeted by 69% since 1970¹. This poses significant risks to the integrity of natural ecosystems and the sustainability of human societies.

The financial sector is not immune to these risks; it is estimated that over half of global GDP depends on ecosystem services². These ecosystem services include the provision of essential resources such as food, wood or water, for example, but also play a role in regulating biodiversity such as services relating to the climate, water purification, soil fertilisation and pollination. Scientific literature is increasingly documenting the effect of human activities on biodiversity loss, and future works will teach us more, for example about how impacts differ depending on geography.

A strong regulatory focus

Initiatives have multiplied in recent years to raise awareness among decision-makers about biodiversity issues and to better understand their interdependencies with the economy and with the financial sector specifically.

The 15th Conference of the Parties (COP15) on Biological Diversity, held in Montreal in December 2022, led to a first agreement on a global framework for biodiversity conservation. This framework allows, among other things, the setting of initial quantified objectives for ecosystem protection and biodiversity financing. As a result, financial institutions and companies are encouraged to monitor and disclose their risks and negative impacts on biodiversity. Financial regulators require that financial institutions assess nature-based financial risks and their own impacts on nature. Several governments and regulators are already part of the Taskforce on Nature-related Financial Disclosures (TNFD).

The EU has launched a biodiversity strategy for 2030, an ambitious and long-term plan to protect nature and



reverse the degradation of ecosystems. The strategy aims to put Europe's biodiversity on a path to recovery by 2030, and contains specific actions and commitments. The protection and restoration of biodiversity is also one of the main objectives of the EU Green Taxonomy and requirements set up under the Sustainable Finance Disclosures Regulation (SFDR). This principle is also supported by ESG regulations such as SFDR and the MiFID II Sustainability amendment.

Euronext Biodiversity Enablers World index: Measuring double materiality

Tackling the preservation of biodiversity is a key topic at Euronext. After the successful launch of its first biodiversity indices, Euronext has added the **Euronext Biodiversity Enablers World index** to its biodiversity index family, **an innovative index** measuring the **double materiality assessment**.

Designed to support the growing demand for climate oriented solutions, particularly linked to the area of biodiversity, the Euronext Biodiversity Enablers World index is the first world benchmark highlighting the **positive impact that companies can have on biodiversity**, and **measuring the double materiality assessment** of companies worldwide. Constructed in collaboration with Iceberg Data Lab, the methodology leverages on two new innovative metrics:

- **A dependency exposure score** which allows the identification of companies that have revenues which are



highly dependent on biodiverse ecosystems

- **A biodiversity avoided impact** which identifies companies demonstrating best practices in biodiversity and environment impacts.

The index also excludes companies involved in plastics, pesticides and unsustainable palm oil industries. The index is currently composed of 121 companies from world developed countries.

Recognised expertise on biodiversity and ESG

Since 2020, Euronext has offered a full suite of biodiversity indices that are tracked by a number of ETFs and structured products.

Euronext expertise on biodiversity is widely recognised, and in 2023 Euronext was awarded “Biodiversity Index of the Year” at the SRP Europe Awards and the “Excellence Award for Robust Biodiversity Solutions” at the Wealth & Finance Ethical Finance Awards.

Euronext has nearly 40 years of experience designing, calculating and publishing a wide range of indices of all sizes and profiles, making it one of the leading index providers in Europe. In the field of climate indices, Euronext is a pioneer, having launched its first low-carbon index in

2008, one of the first in the world. It now administrates over 350 ESG indices that are widely used as underlyings for innovative ETFs and structured products.

As part of its ESG offer, Euronext provides a range of sustainable index solutions such as the Euronext SBT 1.5° indices, validated by the Science Based Targets initiative (SBTi); indices aligned with EU Climate benchmarks such as the Paris-Aligned Benchmarks (PAB) and Climate Transition Benchmarks (CTB); indices focused on environmental goods and services; positive impact water, hydrogen and wind and solar indices. The new Euronext Biodiversity Enablers World index is the latest innovative climate-focused index to join the Euronext climate index family.

Euronext’s mission is to connect European economies to global capital markets, to accelerate innovation and sustainable growth. Euronext will continue to develop new indices with its customers, for its customers, to shape capital markets for future generations.

Find out more: <https://www.euronext.com/en/news/euronext-biodiversity-indices>

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¹ WWF, 2022

² World Economic Forum, 2020

Euronext NV, as a leading European market infrastructure, exchange operator and index provider, has pledged to align its own greenhouse gas emissions with the 1.5°C global warming limit – the most ambitious climate target set by the Paris Agreement. This commitment was also made through the Science Based Targets initiative (SBTi), which helps companies determine how their operations can stay within the bounds of a sustainable future. By taking these steps, Euronext hopes to demonstrate leadership in combating global warming and encourage other firms to follow suit.

What next for green bond ETFs after ‘double whammy’ year?

Launches have increased in recent years

Author: Anna Fedorova

Last year was somewhat dismal for green bonds. Losses in sustainable assets and the underperformance of the longer end of the yield curve conspired to make 2022 a “double whammy” year for the asset class. Yet amid the gloom, they harbour one important advantage: green bond ETFs are one of the few to have escaped the sweeping downgrades from SFDR Article 9 to Article 8 as issuers grappled with January’s updates to the European Sustainable Finance Disclosure Regulation (SFDR).

In January, data from Bloomberg Intelligence revealed that more than 70% of ‘dark green’ Article 9 ETFs were downgraded to Article 8 ahead of the ‘level 2’ update to the SFDR. Under this update, Article 9 funds were required to invest 100% of their assets in sustainable securities,

leading issuers to fear that their products would not meet this more stringent requirement.

Green bond ETFs did not escape this cull entirely. Yet of the 14 green bond ETFs available in Europe, eight still retain the coveted Article 9 label, according to Morningstar. This could make them an interesting proposition for investors looking to add an “ultra-green” or “impactful green” layer to their portfolios, according to Jose Garcia-Zarate, associate director of passive strategies at Morningstar.

In addition, following a sell-off which saw products in this category fall by between 7.6% and 30.4% in 2022, green bond ETFs are now trading at discounts that could mark an attractive entry point for investors.

Garcia-Zarate said: “In 2022, not only ESG investments suffered but interest rates started to rise. It was a

double whammy for green bonds.”

An ESG gold standard

The advantage of green bond ETFs for ESG investors is that their inherent contractual element makes them particularly well-suited to the Article 9 label, said Charlie Macpherson, managing director of ETFs at Circa5000. This contract “defines the use of proceeds and means that it is easy to demonstrably prove alignment to the sustainable investment objective of an Article 9 fund”.

Unlike Article 8 funds, which are only required to promote environmental or social characteristics in their investment approach, Article 9 products must demonstrate that sustainability is their primary objective. Green bonds simplify this task for the product provider as their issuers must report on the progress of the climate-related or environmental projects the bond is financing.

An ultra-green tilt

However, fund analysts caution that green bond funds are no substitution for traditional fixed

Green Bond ETFs - Europe

Fund Legal Name	Ticker (Oldest Share Class)	Active/Passive	EU SFDR Fund type (Article 8 or Article 9)	Fund Size - comprehensive (Monthly) 2023-08 EUR	KIDD ongoing charge
AMUNDI EURO GOVERNMENT TILTED GREEN BOND UCITS ETF Acc	CB3	Passive	Article 8	1,012,111,320	0.14
Deka iBoxx MSCI ESG EUR Corporates Green Bond UCITS ETF	D6RE	Passive	Article 9	24,986,500	0.25
Franklin Euro Green Bond UCITS ETF	FLRG	Active	Article 9	264,741,333	0.18
Invesco Markets II plc- Invesco EUR Government and Related Green Transition UCITS ETF	EGVA	Active	Article 8	36,521,184	0.15
iShares € Green Bond UCITS ETF	GRON	Passive	Article 9	79,698,026	0.20
JPM Green Social Sust Bd ETF USD Acc	JGRN	Active	Article 9	35,302,701	0.32
Lyxor Corporate Green Bond (DR) UCITS ETF	PLANFP	Passive	Article 8	25,613,749	0.08
Lyxor Euro Government Green Bond (DR) UCITS ETF	EAH	Passive	Article 9	210,239,795	0.10
Lyxor Global Green Bond 1-10Y (DR) UCITS ETF - Acc	XCO2D	Passive	Article 8	160,982,445	0.15
Lyxor Green Bond (DR) UCITS ETF	CLIM	Passive	Article 8	621,881,419	0.25
UBS (Lux) Fund Solutions - Global Green Bond ESG 1-10 UCITS ETF	GREENE	Passive	Article 8	19,059,176	0.15
Xtrackers EUR Corporate Green Bond UCITS ETF	XGBE	Passive	Article 9	168,177,285	0.25
Xtrackers II Eurozone Government Green Bond UCITS ETF	XGEZ GR	Passive	Article 9	4,655,731	0.18
Xtrackers USD Corporate Green Bond UCITS ETF		Passive	Article 9	170,118,497	0.25

Source: Morningstar (as of end Aug 2023)

income exposures. Morningstar's Garcia-Zarate said: "The green bond market still has very substantial biases. Replacing traditional bonds with green bonds would change the nature of the portfolio substantially."

As such, he said these ETFs belong in the satellite portion of a portfolio, providing "ultra-green" exposure for investors looking to increase their overall ESG allocation.

Ryan Hughes, head of investment partnerships at AJ Bell, agreed that investors must be comfortable with the underlying assets in a green bond ETF.

He pointed to the Lyxor Green Bond UCITS ETF (CLIM) as an example. This product holds 30% in Germany and France with only 8.8% allocated to the US, "giving a very different picture to a traditional global bond fund and therefore by default, a quite different performance profile". "This is not a problem but needs to be understood by potential investors," Hughes said.

Long-duration bias

In addition to the corporate credit risk, the higher duration of green bond ETFs is another important risk to consider, since they tend to underperform in a rising interest rate environment. Indeed, this was the primary reason for their dismal performance last year.

However, Santa Zvaigzne-Sproge, head of investment advice department at Conotoxia, said: "On a duration-adjusted basis, green bonds appeared to have similar returns to traditional securities but with lower spread volatility and better downside protection."

As the Federal Reserve and the European Central Bank (ECB) start to phase out their monetary policy tightening programmes, she predicted a turnaround in bond performance. As such, there may be an attractive buying opportunity in green bond ETFs at these depressed levels.

She said: "Once the monetary

“

On a duration-adjusted basis, green bonds appeared to have similar returns to traditional securities but with lower spread volatility and better downside protection.

policy turns more dovish and interest rates start to fall, fixed income securities including green bonds and their ETFs might enjoy a reverse momentum in comparison to 2022."

Future innovation

For investors looking to gain access, however, the choice remains relatively sparse. In addition, according to Morningstar, the majority of Europe's 14 ETFs were launched in 2020 and 2021, while 2023 has seen just three launches so far. However, the Article 9 qualification makes this an attractive option for issuers and could bring more green bond ETFs to the market in the near future.

Lukas Ahnert, senior passive product specialist, Xtrackers, at DWS, also pointed to the growing green bond issuance from both sovereigns and corporates, as well as an increase in the choice of green bond indices. Morningstar counts six different indices including the MSCI Global Green and Bloomberg Global Aggregate Green Bond.

He told ETF Stream: "Given the recent developments in green bonds and the significant funding gaps that need to be covered, we see this as a key area for future fixed income product innovation."

Meanwhile, though some green bond ETFs do charge a slight premium over their traditional counterparts, many TERs are comparable to traditional corporate bond ETFs. Morningstar data shows

that ongoing charges on green bond ETFs range from just 0.08% (Lyxor Corporate Green Bond) to 0.32% (JPM Green Social Sustainable Bond ETF), with the majority in the 0.15% to 0.25% range.

Challenges

However, there are several hurdles when it comes to creating green bond ETFs. One challenge is the famous "greenium" effect, where green bonds deliver lower yields compared to their traditional counterparts.

The good news is that this has "markedly shrank" during the widening of bond yields in 2022, according to Conotoxia's Zvaigzne-Sproge. She has seen this gap reduce "from around 10% of the green bond yield at the beginning of 2022 to around 2% one year later, technically making green bonds more attractive than before".

Another challenge, according to Macpherson, is the general lack of liquidity in bond ETFs, which can make full replication of a green index difficult. Partial index replication has the potential to increase an ETF's tracking error.

Despite these hurdles, though, the steady issuance of new sustainable debt and the anticipation of more favourable economic conditions may well reignite the green bond ETF market in the foreseeable future.

Anna Fedorova is a freelance journalist

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Degrees of climate investing: Decarbonisation on paper and in practice

Different investor goals warrant different strategies

Author: Frederike Bauer

Over the past years, sustainability considerations have permeated the investing space. While traditionally used to reduce risk, ESG investing has evolved to consider not only exclusion-based approaches but also many different areas of sustainability and strategies for translating them into portfolio construction. With almost 90% of global emissions covered by net zero targets, a growing number of investors are also looking to focus their investments specifically on climate. Over the past three years, this trend has been underlined by significant inflows into climate-related ETFs as they received a quarter of total ESG UCITS inflows.

Investors may have many motivations for turning to ESG and climate investing in particular, of which risk, regulation and the rise of investor-specific climate targets may be the most salient. The risk reduction argument has been broadened to include physical or transition risks arising from companies' (poor) management of climate risks.

Regulatory requirements have for the first time provided clarity on specific investments – with the Delegated Act on Paris-aligned (PAB) and Climate Transition Benchmarks (CTB), the European Union has provided a clear framework on what such benchmarks must achieve. In addition, a growing number of institutional investors have set decarbonisation targets for their assets, requiring portfolios to deliver

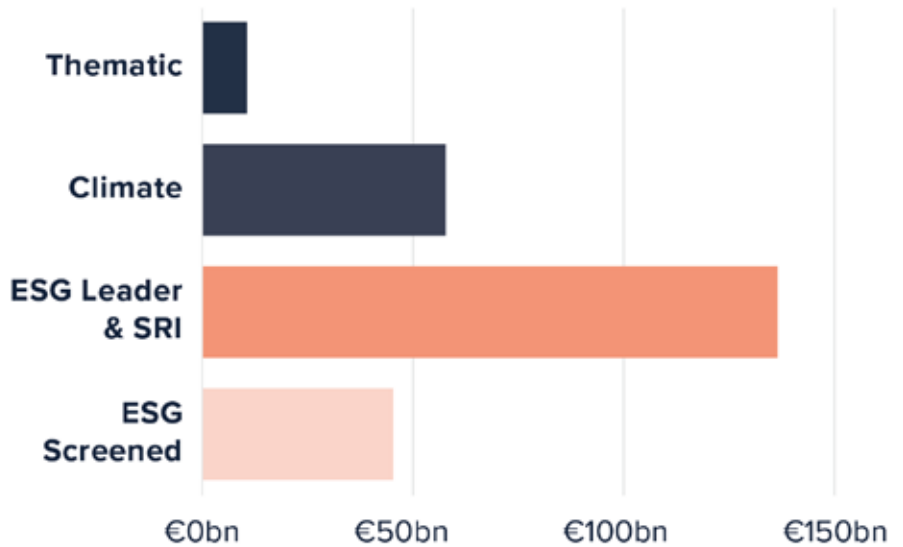
a hard carbon reduction path. Given the different motivations, investors may turn to different investment strategies.

The well-known SRI approach is one way to achieve risk reduction through divestment, while pathway strategies can be more inclusive and green bonds offer the opportunity to directly reallocate capital to projects

influence the real economy and the companies they invest in (or divest from). This is especially true when it comes to climate investments and the associated race to the bottom in portfolio emissions.

We need to ask what role such investments can play in the climate transition – how can reducing carbon emissions at the investment portfolio level (or, to put it bluntly, 'on-paper' decarbonisation) support tangible, real-world decarbonisation outcomes? Reducing portfolio emissions is straightforward. For example, simply excluding around 3% of the weight of the MSCI ACWI IMI can reduce index emissions by 50%. Similarly, strict exclusion-based methodologies, such as the SRI standard, often achieve significant decarbonisation relative to their benchmark, accompanied by notable improvements in other ESG metrics.

Figure 1: ESG UCITS ETF assets under management



Source: DWS International GmbH, as of March 2023. ESG Screened describes exclusion-based strategies with active share around 10%, while ESG Leader & SRI approaches follow stricter exclusions and only invest in companies with the best ESG scores in defined areas. Climate products focus on the climate transition and may replicate a regulated Paris-aligned or Climate Transition Benchmark. Thematic funds often focus on certain societal or economic trends, such as emerging technologies

with an environmental focus such as the provision of renewable energy.

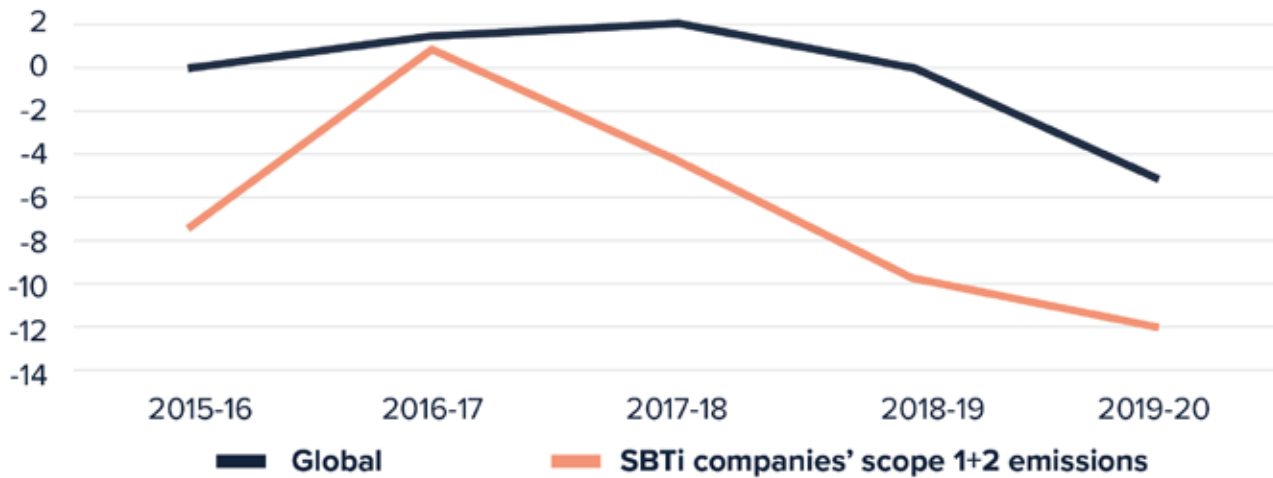
When discussing ESG investing in general, the ethical aspect should of course not be overlooked. After all, many exclusions are based on a consensus that certain activities are controversial and that one should not profit from them. The next step would be to ask how investors can

In this sense, investors can influence asset prices and ultimately the cost of capital for divested companies. From a financial perspective, the "law of large numbers" suggests that a sufficiently large withdrawal of investor funds should increase the true cost of funding because of the resultant reduction of equity values.

Consequently, this should also

Figure 2: Gross scope 1+2 emissions' change rate of companies with approved targets vs the global economy

Annual decarbonisation rate in %



Source: Science-based Targets Initiative (SBTi) Progress Report 2021.

act as an incentive to improve ESG metrics – and may provide an opportunity to link decarbonisation at the portfolio level and in the real world: evidence suggests that companies with approved science-based targets (SBTs) are outperforming the broader economy in their decarbonisation. This provides a compelling case for incorporating SBTs as a variable in portfolio construction. Such an approach can benefit the investor and society at large: The investor has some confidence in the stability of their portfolio and potentially reduced future turnover due to changes in corporate climate metrics.

In addition, from a financial perspective, companies that have validated their 1.5°C target have seen an increase in their economic P/E ratio compared to companies with less ambitious or no targets. From a societal perspective, companies that have set SBTs have an obligation to pursue them and report transparently on their progress in real-world

decarbonisation.

However, the cost of capital effect also reveals a conundrum in ESG investing: The portfolio that looks the most impressive in terms of ESG performance may only make a real difference over a relatively long time horizon. Fortunately, investors have additional levers at their disposal to contribute to positive sustainability outcomes. According to the EU, in order to remain representative of the real economy, an equity PAB portfolio must not reduce its overall exposure to sectors with a particularly high contribution to climate change, the so-called high climate impact sectors. By maintaining exposure to these activities, investors can use stewardship and engagement to drive change.

The most direct way for public-market investors to support the climate transition may however lie in the fixed income space, which is often overlooked due its less clear route of engagement. Green bonds are a

uniquely positioned instrument to help (re-)finance transitional activities and support the development of new technological solutions in the short-term – an immediate lever that is often elusive in the realm of liquid equity markets. Nonetheless, one should not jump to the conclusion that only investments with a direct way of supporting green projects are appropriate climate investments. Different investor goals warrant different strategies and in climate investing, it is important that investors seek dialogue through engagement as well as phase out investments in activities that cannot have a long-term place in a net-zero future.



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State of the market: Active sustainable ETFs in vogue as ESG flows remain resilient

Active ETF tops the flows charts for sustainable strategies this year

Author: Theo Andrew

Investors have turned to active ETFs within their ESG allocations with the strategy topping the flow charts year to date.

The actively managed JPMorgan US Research Enhanced Index Equity ESG UCITS ETF (JREU) has recorded over €1bn net new flows, as of 5 September, the highest of any ESG ETF, according to data from ETFbook.

JREU was followed by two other active ETFs, the Fidelity Sustainable Research Enhanced Emerging Markets Equity UCITS ETF (FEMS) and the JPMorgan Global Research Enhanced Index Equity ESG UCITS ETF (JREG), which saw flows of €872m and

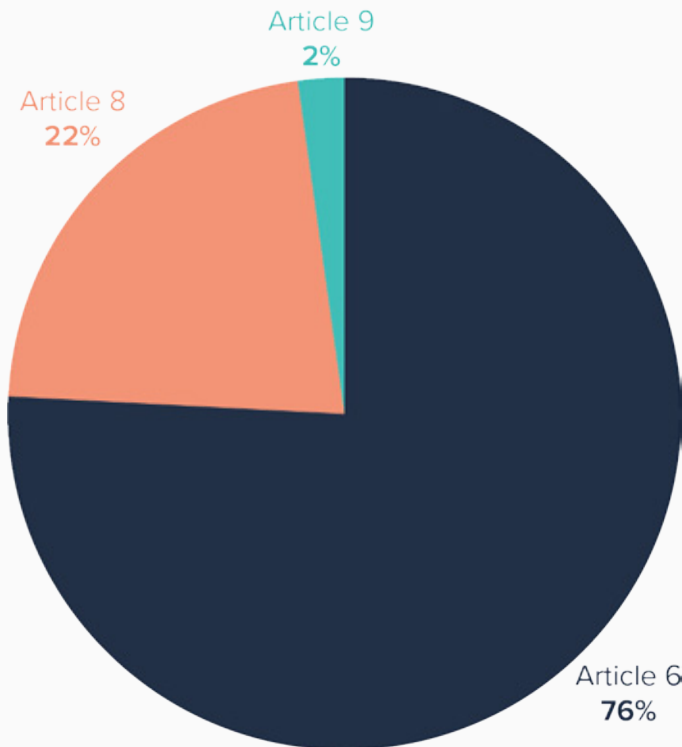
€813m, respectively.

Flows have been resilient into sustainable ETFs so far this year, but have been outpaced by non-ESG Article 6 ETFs.

Combined, Article 8 and 9 ETFs have recorded €31.2m versus €74bn for Article 6 ETFs. ESG ETFs now account for roughly 23% of the entire European ETF landscape, ETFbook data shows.

This has not stopped issuers from continuing to launch ESG ETFs at pace. Over 70 Article 8 ETFs have been launched so far in 2023, compared to 61 Article 6 ETF and just 15 of the more stringent Article 9 ETFs.

AUM BY SFDR



Data provided by etfbook

SFDR Article 8 ETF C

Fund Name

LYXOR MSCI EUROPE ESG LEADERS UCITS

AMUNDI INDEX MSCI EUROPE ESG BROAD UCITS ETF

UBS ETF € MSCI ACWI SOCIALLY RESPONS UCITS ETF

AMUNDI FLOATING RATE USD CORPORATE UCITS ETF

AMUNDI FLOATING RATE EURO CORPORATE ESG UCITS ETF

SFDR Article 9 ETF C

Fund Name

FIDELITY SUSTAINABLE GLOBAL CORPORATE BOND PARIS-ALIGNED MULTIFACTOR UCITS

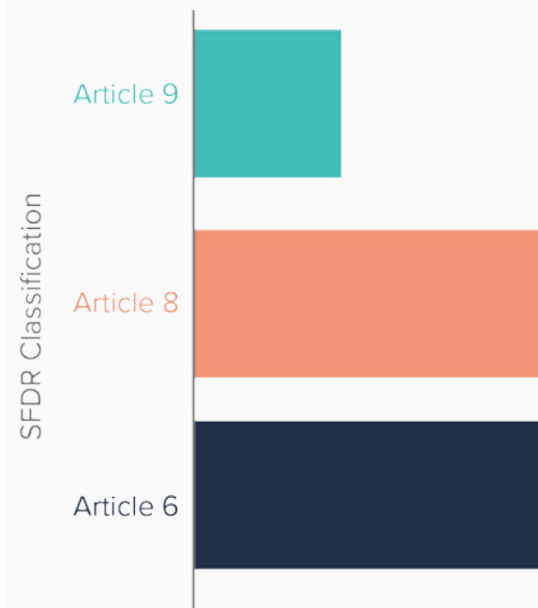
XTRACKERS EUR CORPORATE GREEN BOND UCITS ETF

RIZE SUSTAINABLE FUTURE OF FOOD UCITS

FIDELITY SUSTAINABLE GLOBAL HIGH YIELD BOND PARIS-ALIGNED MULTIFACTOR UCITS

L&G CLEAN ENERGY UCITS ETF

Article 8 ETF launched non-ESG Article 6 E



Outflows YTD (€)

	AUM	Flows
ETF	1.1bn	-678m
CTB	1.6bn	-503m
IBLE	221m	-464m
ESG	282m	-407m
E	1.4bn	-400m

SFDR Article 8 ETF Inflows YTD (€)

Fund Name	AUM	Flows
JPM US RESEARCH ENHANCED INDEX EQUITY ESG UCITS ETF	3.3bn	1.1bn
BNP PARIBAS EASY JPM ESG EMU GOVERNMENT BOND IG UCITS ETF	1.6bn	1.1bn
XTRACKERS MSCI AC WORLD ESG SCREENED UCITS ETF	2.6bn	985m
AMUNDI INDEX MSCI USA SRI PAB UCITS ETF	5.3bn	962m
FIDELITY SUSTAINABLE RESEARCH ENHANCED EMERGING MARKETS EQUITY UCITS ETF ACC-USD	985m	872m

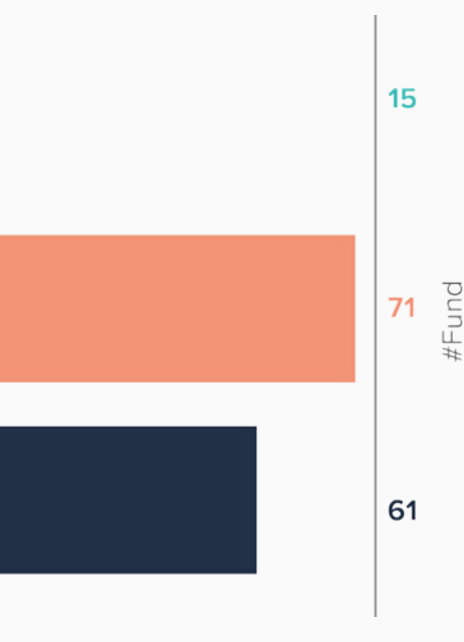
Outflows YTD (€)

	AUM	Flows
TE S ETF	526m	-340m
D	182m	-54m
S ETF	187m	-44m
D S ETF	227m	-39m
	200m	-40m

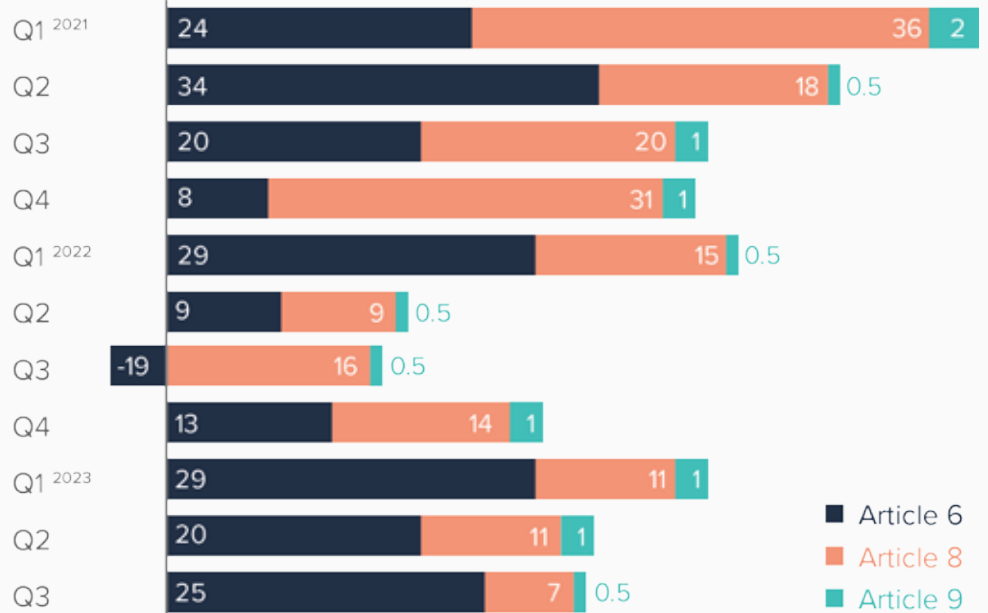
SFRD Article 9 ETF Inflows YTD (€)

Fund Name	AUM	Flows
JPM CARBON TRANSITION GLOBAL EQUITY CTB UCITS ETF	927m	646m
L&G US ESG EXCLUSIONS PARIS ALIGNED UCITS ETF	1.3bn	335m
UBS FUND SOLUTIONS € SUSTAINABLE DEVELOPMENT BANK BONDS UCITS ETF	1bn	302m
L&G EUROPE ESG EXCLUSIONS PARIS ALIGNED UCITS ETF	401m	288m
FIDELITY SUSTAINABLE GLOBAL HIGH YIELD BOND PARIS-ALIGNED MULTIFACTOR UCITS ETF	251m	239m

ETFs have outpaced
ETFs year to date



Quarterly flows into Article 8 and 9 versus Article 6 ETFs (€ billion)





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