Asset management. Sustainable portfolios

ETFs set to usurp active funds in ethical investing universe

Shift to passive vehicles would be body blow to traditional ESG investment approach

STEVE JOHNSON

Exchange traded funds and other passive vehicles are set to usurp active managers as the dominant ethical investing approach, research suggests.

The shift would be a body blow to active investment houses hoping their potentially greater ability to engage with investee companies would allow them to hang on to assets being allocated according to good environmental, social and governance principles.

At present, pension funds, mutual funds and insurance companies with ESG exposure in their portfolios allocate just 21 per cent of this money to passive funds, according to a survey of 101 European institutional investors by Invesco, a fund manager.

However, 45 per cent of the respondents said they planned to increase the amount they invest in ESG ETFs in the next two years while just 5 per cent said they planned to cut passive exposure.

As a result, more than half of the investors believe the majority of their ESG investments will be managed passively within the next five years.

At present, just $2tn-$3tn of the $32tn invested in "sustainable" strategies is done so passively, according to estimates by Amin Rajan, chief executive of Create Research, a consultancy, based in part on figures from the Global Sustainable Investment Alliance.

"For the growing number of investors looking for funds with ESG considerations, it is clear that ETFs are playing an increasingly central role in helping them gain exposure," said Gary Buxton, head of Emea ETFs and indexed strategies at Invesco.

He said that, while investors were first attracted to ETFs due to their low costs and simplicity, "as we have seen so far this year, ESG ETFs have also been able to deliver on performance objectives".

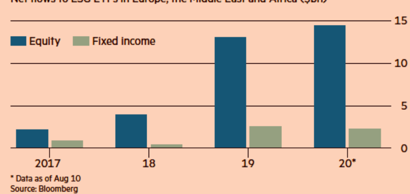
The S&P 500 ESG index, for example, has risen 6.6 per cent this year as of August 13, comfortably better than the 4.4 per cent return of its traditional underlying index.

Few serious investors would read too much into such short-term performance measures, however, given that they may largely be driven by cyclical sectoral swings — after stripping out energy stocks, for example, a sector largely shunned by ESG funds, the S&P is up 6.3 per cent.

Mr Buxton argued that the expanding range of ESG ETFs, encompassing funds that exclude companies in undesirable industries or with poor ESG scores, as well as those that actively favour businesses perceived to be ESG leaders, was a further attraction.

ESG ETFs and exchange traded products saw net inflows of $32bn globally in the first six months of 2020, according to data from ETFGI, more than triple the $10bn in inflows witnessed during the same period last year. This took overall assets to a record $88bn.

ESG flows have already surpassed last year
Net flows to ESG ETFs in Europe, the Middle East and Africa ($bn)



* Data as of Aug 10
Source: Bloomberg

Mr Rajan said he had "no doubt" that ESG investment would be increasingly funnelled into passive vehicles because passive investing was cheaper than active approaches.

But he also cited the influence of defined benefit pension schemes. These schemes, often closed to new money, "have their liabilities maturing at an exponential rate".

This means they want to remain invested for a shorter period of time than would have been the case 10 years ago and have less need for active managers.

Mr Rajan said he expected the shift even though many investors were suspicious of "dubious" data being used to select some of the ESG index constituent companies and were concerned that passive funds did not engage sufficiently with the companies they invested in.

The Invesco research also found that two-thirds of institutional investors believed the Covid-19 pandemic would accelerate the push into ESG in the next two years, with just 4 per cent disagreeing.

A growing number of investors are looking for funds with ESG considerations
Getty/FT montage

Mr Buxton said many institutional investors had already made a decision to increase their allocation to ESG in the past 18 months but, "for a number of reasons, had not done so", in part because they did not want to trigger gains on the investments they already had for tax reasons.

However, given the sell-off at the start of the year, "as people have come back into the market, there is a natural point to re-evaluate how they come back", he added. "ESG was at the front of the queue."

As evidence, he cited Bloomberg data showing that, in the first seven months of 2020 in the Emea region, equity ESG ETFs attracted net inflows of $13.9bn while traditional equity ETFs had seen net outflows of $7.7bn.

"There is a belief that companies in ESG are capable of long-term investment outperformance, that they are well run companies that have adapted to the future," added Mr Buxton.

Invesco modelling forecasts that the assets of ESG equity ETFs will surge from $50bn to $300bn in Europe by the end of 2024 with corporate bond ESG ETFs also seeing rapid growth from a lower base.

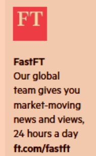
'It has made investors more keen on ESG because of the extreme fragility of the planet'

Mr Rajan agreed that the pandemic was likely to accelerate the trend. "It has made investors more keen on ESG because they realised the extreme fragility of the planet," he said.

Not everyone may be quite so high minded, however.

Mr Rajan said some investors were simply looking for a "bandwagon premium" as they jumped on the ESG trend.

"The March market rout opened up lucrative entry points," he added.



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Cross asset

Managers' survey reveals overvaluation fear after rally

ADAM SAMSON

Investors are worried that the sharp rally across asset classes since the darkest days of the coronavirus crisis has left them "overvalued", a key survey has shown.

Fund managers now see a portfolio with equal holdings of stocks, bonds and gold as the most expensive since 2008, according to the latest monthly Bank of America poll of investors managing almost $500bn of assets.

Unease over valuations comes as unprecedented stimulus measures by central banks, from the US Federal Reserve to the European Central Bank and Bank of Japan, has helped to lift many assets that had endured intense strain during the early days of the crisis this spring. Extra spending by governments has provided a further boost.

Nearly 80 per cent of investors polled by BofA expect stronger economic growth ahead — the highest proportion since December 2009 — while 57 per cent predict higher profits.

Cash balances reported by fund managers in the survey have slipped, indicating more money has been put to work in riskier markets.

But cash still represents 4.6 per cent of portfolios, comfortably above the 4 per cent level that BofA analysts think signals the emergence of "greed" in market behaviour. "We do not think positioning is dangerously bullish," they said.

'We do not think positioning is dangerously bullish'
Bank of America analysts

Developed and emerging market stocks tracked by MSCI's broad All-World index have shot higher by more than 50 per cent since the lows in March to shed nearly all of the losses recorded during the pandemic.

Wall Street stocks have been among the top performers. A rally in America's technology titans propelled the benchmark S&P 500 index into record territory in early trading yesterday, higher than its previous peak in February.

The strong price gains have come even as the global economy has entered a deep recession, putting heavy pressure on corporate profits.

Earnings per share of companies listed on the S&P 500 are forecast to fall by about a fifth this year before rebounding 26 per cent in 2021, according to FactSet data tracking analysts' expectations.

The index is priced at 22.6 times expected profits over the next year — a level not seen since the dotcom bubble burst at the turn of the millennium.

Many other assets have posted big gains. Global bond markets have generated returns including price rises and coupon payments of 5.5 per cent so far this year, after recording total returns of 7 per cent last year, according to the Barclays Multiverse index that tracks both high-grade and junk bonds.

Gold is up by a third in 2020 after gaining 18 per cent in 2019.

Currencies

Positive bets on euro reach all-time high but caution over further gains

EVA SZALAY

Positive bets on the euro have hit an all-time high, prompting some caution over whether the currency's rapid rally could soon run out of fuel.

The latest data released by the US Commodity Futures Trading Commission show that, in the week to August 11, investors as a whole accumulated the largest net long position in euro futures since records began in 1999 with more than $30bn of bets outstanding.

Within that, hedge funds turned net positive on the euro against the US dollar for the first time since May 2018, analysts at Goldman Sachs noted.

The shift illustrates the outsized role that positive bets on the euro are playing in the broad decline of the dollar.

But after an 11.6 per cent rise in the euro against the US currency since mid-March, some believe that gains will be harder to come by.

"The CFTC positioning data suggests that the move in the euro is overstretched," said Jane Foley, head of currency strategy at Rabobank in London.

The currencies market has no centralised trading venue, which makes it tricky to determine which types of market participants are, in aggregate, buying or selling at any time.

The CFTC data capture only a small slice of that market but they still offer what many analysts consider to be a valuable insight into how certain investors, particularly hedge funds, are behaving.

Robin Brooks, chief economist at the Institute of International Finance, said the figures displayed a "deep infatuation" with the idea that the dollar would keep sliding and the euro would keep climbing. "Positioning data went from 'extremely' to 'stupendously' bonkers in this week's data," he said.

The euro is up nearly 12 per cent against the dollar since mid-March

The euro is trading at a more than two-year high against the dollar at $1.19 after last month staging its strongest performance in a decade, in part reflecting investors' expectations that Europe will emerge faster from lockdowns than the US.

The EU's plans to offer a joint financial response to the virus, including through a huge increase in bond issuance, are also seen as a long-term support for the single currency.

Signs of continuing demand for the euro, even after its rally so far this year, suggest that investors have not finished the process of switching out of dollar-denominated portfolios and buying euros instead, said JPMorgan analysts.

On Friday, JPMorgan raised its year-end forecast for the euro to $1.20 from a previous forecast of $1.13.

"In hindsight, we have clearly underappreciated the joint FX impact of [lower US growth and interest rates and the EU Recovery Fund]," said Paul Meggyesi, the bank's global head of currency strategy, in a note.

Fixed Income

Carnival's 'very strange' bond threatens to leave lenders adrift and unsecured

JOE RENNISON

Investors who bought new bonds last week from Carnival Corporation backed by a claim on its fleet of ships may soon find that some of that collateral has floated away.

The world's largest cruise operator raised $900m through the junk bond market on Friday, paying a coupon of nearly 10 per cent for seven-year debt, said people familiar with the deal.

The issuance marked the third time Carnival has tapped bond investors since the onset of the pandemic as it seeks to steady itself.

On each of those deals, the company used its fleet of more than 80 ships as security — helping to give investors a measure of confidence. In the process, the company's total secured debt has soared to $10.6bn, according to documents seen by the Financial Times.

But investors that bought the latest bond may see their claim on those assets come under threat due to an unusual provision that could turn some of that secured debt into unsecured debt.

Carnival's previous bond documents included a requirement that the company's secured debt should not exceed 25 per cent of its total tangible assets. As of July this year, that equates to a threshold of some $12.4bn, according to the bond documents.

But the total asset value could fall as the company continues to take impairments due to the pandemic, said Ross Hallock, an analyst at Covenant Review, a research firm. The company is also in the middle of an asset disposal programme to raise cash, having sold five ships and agreed to sell five more.

'If investors are buying secured paper and it could potentially become unsecured, that matters'

The bond issued on Friday is first in line to lose the security of the collateral backing it, should falling asset values exceed the 25 per cent threshold.

"If investors are buying secured paper and it could potentially become unsecured, then that matters," said Mr Hallock. "It's a risk. Everyone who is buying these bonds should be aware that Carnival has this very strange provision in there."

Carnival did not immediately respond to a request for comment.

Carnival has come under severe strain during the coronavirus-induced downturn. On a call with analysts last month, the company said the money that it had raised up to that point would allow it to continue running without any revenues at all for 12 months.

The requirement to cap secured debt at a maximum of 25 per cent of assets came into effect after the group lost its investment grade credit rating in June.

"These companies didn't think that the parameters in the covenants that they agreed to would constrain them because historically they could issue unsecured bonds," said Mr Hallock. "Now they have to do secured paper at a much higher cost."

Other companies have also included similar clauses in their bond deals.

Royal Caribbean, the cruise line, issued $3.32bn of secured bonds in May but capped the amount backed by the group's collateral at $1.66bn, due to a covenant that limited the amount of secured debt that it could take on.