POORLY SPREAD, SURPRISINGLY INVESTED AND WITH DISAPPOINTING RETURNS

Sustainable ETFs put most of investors' money into tech companies

Sustainable investment is a fast-growing business, but turning that into off-the-shelf investment products is not quite so easy. A European Investors study of all sustainable ETFs worldwide showed investments made in the automotive industry, oil companies and a great many technology businesses.

Sustainable investment is more popular than ever. The number of investment funds that specifically state that they put investors' money into the shares of companies that focus on good corporate governance and the environment has never been higher and is continuing to grow rapidly, along with the capital that investors are entrusting to these funds.

In Europe alone there are more than 2000 investment funds on offer in which sustainability is an important principle. What that means precisely, the fund providers largely decide for themselves. The lack of rules and standards has led to a proliferation of these types of products.

What do these sustainable funds have to offer investors? To answer that question, European Investors analysed the sustainable funds available on the market. Over the next few months we will be reporting on the findings. We will start with an investigation of sustainable ETFs, index funds – also known as trackers – that are much favoured because of their wide spread and low cost.

THE OFFERING

ETFs are always publicly-listed which means that in principle all ETFs worldwide should be open to European investors. At the time of writing (late July 2019) 222 trackers were listed worldwide that are described as sustainable.

European Investors

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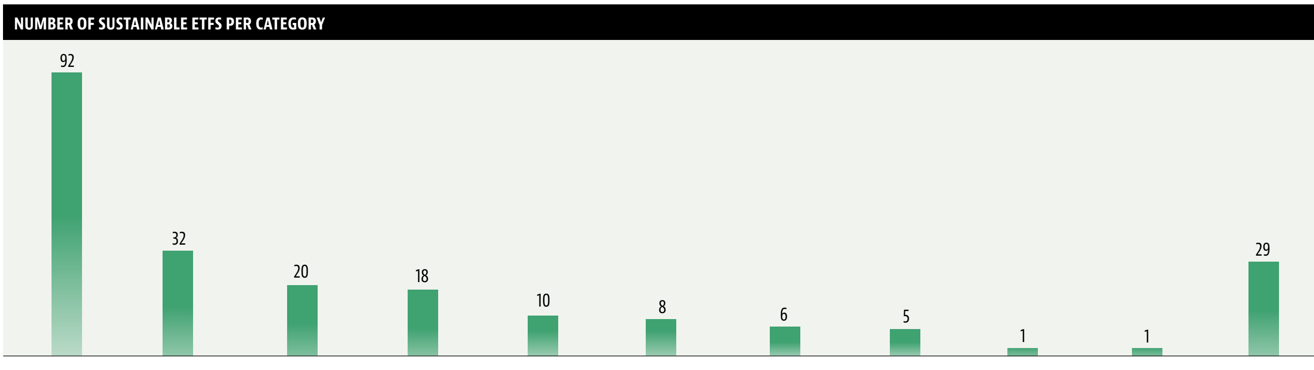
NUMBER OF SUSTAINABLE ETFS PER CATEGORY



THE 5 BIGGEST SUSTAINABLE ETFS — **Source:** Bloomberg, Morningstar

#	Name	Fund capital (in EUR m)	Sustainability score
1	iShares Trust - iShares MSCI KLD 400 Social ETF	1,352	50.1
2	iShares ESG MSCI USA Leaders ETF	1,298	49.6
3	UBS ETF-MSCI World Socially Responsible UCITS ETF	1,227	53.8
4	Xtrackers MSCI USA ESG Leaders Equity ETF	1,100	49.6
5	iShares MSCI USA ESG Select ETF	1,028	52.6

Altogether they represent a capital investment of around EUR 50 billion. In comparison with the total of roughly USD 5200 billion in ETFs on offer, this is still a modest amount.

Sustainable trackers follow baskets of shares - indexes - which have often been specially put together for the ETF market. These are generally variations of the well-known S&P or MSCI indexes which have been adjusted on the basis of a number of sustainability rules. In this way certain shares can be excluded from an existing index, selected on the basis of a best-in-class approach or businesses may be chosen that favour a strategy which is clearly sustainable.

This subdivision results in a mixed bag of sustainable ETFs. There are ESG, Sustainability, SRI, Green, Water, Clean Energy, Efficient Carbon, Social impact and Ethical ETFs, for example.

ESG ETFs are the largest category. Forty-percent of the sustainability trackers bear this label which indicates that the environment, good corporate governance and social impact are aspects which play a role in the companies invested in. These are ETFs which have mostly been set up in the last two years and already hold EUR 11bn in investor funds. Sustainability ETFs are the second category with 32 active trackers. These ETFs have generally been around for a while longer and focus on countries and companies using a sustainable growth model, often linked to or associated with the UN sustainability goals. Following these are the SRI and Social Impact ETFs. These include trackers which look at companies' impact and social justice aims. More specifically, these aspects could be about respecting human rights, combatting gender inequality and accepting diversity, for example.

The precise scope however is rapidly starting to dissipate as ESG ETFs have gained in popularity. Sometimes trackers simply continue as they were under a new name that includes ESG.

SUSTAINABLE CONCENTRATIONS

Investing in ETFs is a cheap way of investing in a large number of companies simultaneously. The spread, together with their low cost and easy tradability, make ETFs highly attractive.

Our analysis showed however that the benefit of a good spread is to some extent lost by sustainable ETFs.

On average, sustainable ETFs are poorly spread. As demonstrated by the large proportion in the total volume of the fund taken up by the ten largest investments. In some cases more than 30 percent of the fund volume was allocated to just three companies. An example of such a concentrated ETF is the VanEck Vectors Low Carbon ETF. More than half of investors money is put into just five shares.

Series of studies

Fraud risks and corruption, climate change and social injustice. These factors are also gaining more attention, including from major investors such as pension funds.

This growing level of interest has also been prompted by forthcoming legislation which expects that factors should be taken into account which as yet are not fully reflected in company P&L accounts. It is clear that the financial markets are on the threshold of major change.

How should investors respond to these developments? In a series of articles over the coming period European Investors will examine the products on offer which focus on good governance, sustainability and the climate. This research on ETFs is the first in this series.

TOP 10 LEAST SPREAD SUSTAINABLE ETFS

#	Name	Share of top 10 investments (%)	# investments
1	VanEck Vectors Low Carbon Energy ETF	70.1	30
2	iShares Índice Carbono Eficiente (ICO2) Brasil	69.0	29
3	iShares Jantzi Social Index ETF	64.3	50
4	UBS IQ MSCI Asia APEX 50 Ethical ETF	62.6	55
5	Invesco Solar ETF	61.7	23
6	Invesco Water Resources ETF	59.5	36
7	Tortoise Global Water ESG Fund	58.2	39
8	Impact Shares Sustainable Development Goals Global Equity ETF	56.6	136
9	Desjardins RI Canada - Low CO_2 Index ETF	56.5	62
10	Invesco Global Water ETF	56.4	44

Invesco Solar ETF invests almost 62 percent of the fund volume in ten companies. The return on this ETF has bounced back and forth over the last few years from minus 42 percent in 2016, to plus 36 percent in 2017, with minus 22 percent for 2018. This year the price of the ETF has so far risen by more than 60 percent. The limited spread will have certainly played a part in this.

The ETFs in question are clear about the limited spread. The prospectuses for similarly concentrated ETFs state that spread is not one of the fund's goals. This is a warning that should not be ignored.

MUCH THE SAME

Apart from their limited spread, ETFs also appear to invest remarkably often in the same companies. Technology companies are very popular. Almost 20 percent of all sustainable ETFs invest in Alphabet, Google's parent company, a third invest in Microsoft, while Amazon and Facebook are among the largest interests held by a great many ETFs.

It is not immediately clear why sustainable ETFs so often choose to invest in Alphabet. On all ESG fronts the company performs worse than its peers. Even on the sustainable rating provider Sustainalytics, Google's score is modest with a ranking of 82.7 (max. 100) which can be interpreted as (only) above average.

POPULAR SHARES AMONG PROVIDERS OF SUSTAINABLE ETFS

#	Company	# trackers	% trackers
1	Microsoft	69	31
2	Procter & Gamble	47	21
3	Alphabet	45	20
4	Apple	44	20
5	TOTAL	41	18
6	SAP	40	18
7	Amazon	39	18
8	Visa	37	17
9	Facebook	36	16
10	Johnson & Johnson	35	16

This essentially lies in Google's huge CO_2 emissions relative to its turnover. These 'turnover weighted' emissions are higher than those of other same sector companies such as Tencent and Facebook. However, given that many internet businesses (e.g. Twitter, LinkedIn and Baidu) never report on their emissions, the comparison may be skewed.

The only reason why Google might be interesting to sustainable investors is that the company has adopted a strategy to become more sustainable. It reports that at present 30 percent of the energy consumed by its data centres is sustainable. The aim is to increase that share. Funds appreciate this strategy and therefore include the share anyway in their sustainable portfolio.

IT IS NOT IMMEDIATELY CLEAR WHY SUSTAINABLE ETFs SO OFTEN CHOOSE TO INVEST IN ALPHABET

Also noteworthy is the popularity of the French energy company Total. This is largely because the company is seen as a 'best-in-class' which always manages to do slightly better than its competitors. As a result Total has a high Sustainalytics ranking of 97.6, but it is still an energy company active mostly in the field of fossil fuels.

DIFFICULT CONCEPT

The differences in approach make it difficult to determine which ETFs really do invest in sustainability.

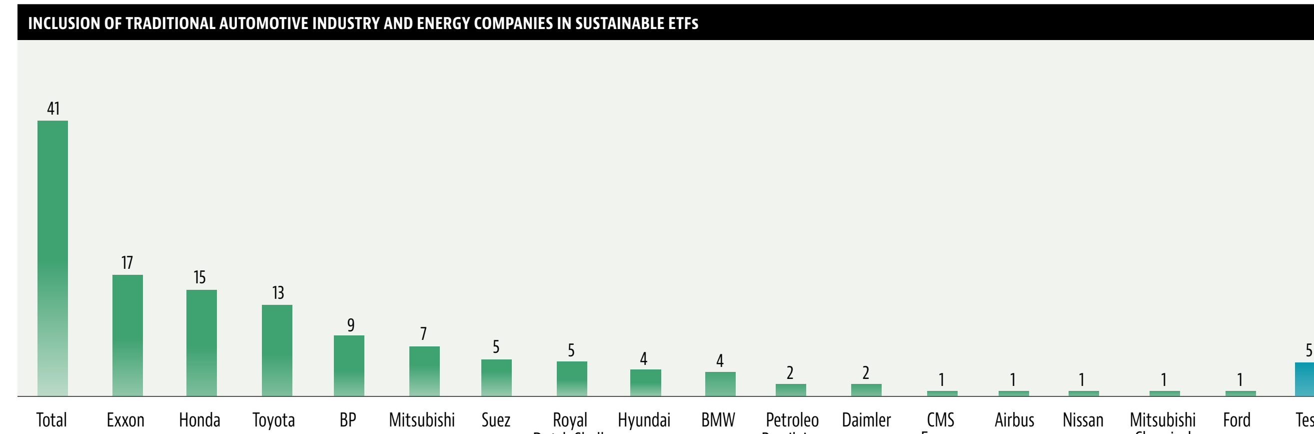
To gain some insight into the sustainable nature of ETFs we looked at the extent to which investments are made in a couple of sectors that on balance cannot be described as sustainable: the traditional automotive industry and the energy sector.

It is unlikely that these should be included in sustainable funds to any great extent, and even then only as a best-in-class investment.

Sustainable ETFs still invest on a large scale in unsustainable energy companies. Besides Total, companies such as Exxon, BP and Shell are found as allocations to sustainable businesses.

In the automotive industry it are mainly Japanese manufacturers that appear more often, along with German brands such as BMW and Daimler. Tesla, considered to be the greenest

INCLUSION OF TRADITIONAL AUTOMOTIVE INDUSTRY AND ENERGY COMPANIES IN SUSTAINABLE ETFs

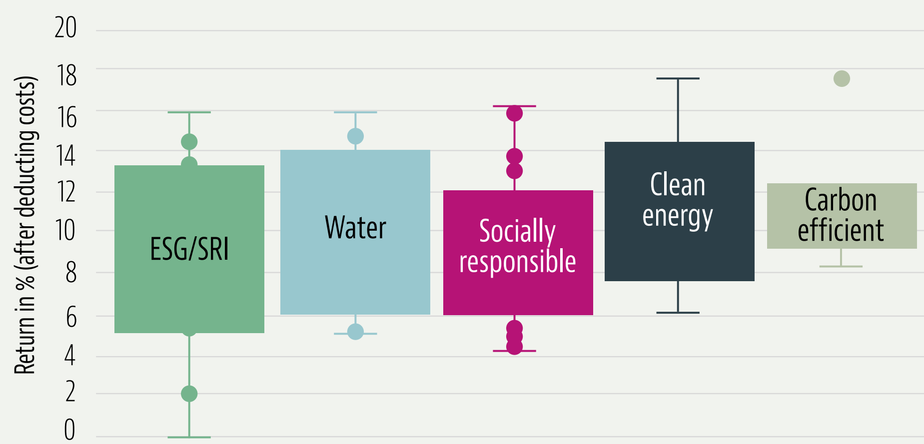


SUSTAINABLE ETFs STILL INVEST ON A LARGE SCALE IN UNSUSTAINABLE ENERGY COMPANIES

carmaker, is clearly less popular than you would expect. This company is included in only five trackers.

Clearly there is a difference between how ETF providers and investors regard sustainability. It is up to providers to offer a better explanation.

BEST RETURNS FROM CO_2 TRACKERS



The return on the various categories of sustainable ETFs. The larger the box and the more dots on the lines, the greater the difference in return in that category.

RETURNS UNSATISFACTORY (SO FAR)

The success of sustainable investment is partly based on the idea that sustainability does not have to be at the expense of yield. The market for sustainable ETFs is still too young to judge whether or not this assertion is correct. Most of the funds have existed for less than three years during a period with a good market climate.

However, it is clear that in terms of yield, sustainable ETFs somewhat lag behind non-sustainable ones. We compared the returns with broadly spread ETFs which are not necessarily sustainability oriented, like the standard SPDR S&P 500 ETF Trust. The average return for all the 56 sustainable ETFs with at least a three-year history works out at 9.8 percent. This is 3.8 percent less than the S&P 500 alternative.

The yield disparities between the various ETFs - both plus and minus – are considerable. There are even wide differences in performance between the various categories of sustainable ETFs.

Over a period of three years the carbon-efficient ETFs showed the highest return on average. The returns also differed relatively little from one another. The group was led by the iShares Indice Carbono Eficiente ETF with a yield of 17.5 percent per year. The investments of this ETF are restricted to Brazil and mostly concentrated (53 percent) around Brazilian banks. The ETF therefore bears a highly concentrated country and sector risk which is not necessarily related to the low carbon mandate. The lesson for investors therefore is always to look further than the label.

OVER A PERIOD OF THREE YEARS THE CARBON-EFFICIENT ETFs ACHIEVED THE HIGHEST RETURN

Clean energy ETFs also do well, with more winners than losers. However here it is important to choose the right ETF. The sustainability trackers which follow an ESG framework do least well on average. The average return here is around 7.6 percent, although the range is wide and there are outliers both above and below this figure.

If we look more closely at a one year period it is noticeable that the rapidly growing category of ESG ETFs, with an average yield of 4 percent, again lag behind that of the SPDR S&P 500 ETF Trust (9.6 percent).

Based on these historic results it would therefore appear that sustainable ETFs have so far been unable to deliver on their promise in terms of yield.

THE 5 BEST PERFORMING (3 YEARS, AFTER COSTS, ANNUALIZED) **Source:** Bloomberg, Morningstar

#	Name	Yield (in %)	Sustainability score
1	iShares Índice Carbono Eficiente (ICO2) Brasil	17.5	49.7
2	Invesco WilderHill Clean Energy	17.5	41.2
3	UBS IQ MSCI Asia APEX 50 Ethic	16.8	45.4
4	UBS IQ MSCI USA Ethical ETF	16.7	46.6
5	iShares MSCI USA SRI UCITS ETF	15.7	51.7

Yield annualized and after costs