Irish ETFs: Supporting Sustainable Finance

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Executive summary

Sustainable investing and environmental, social and governance (“ESG”) integration are key priorities for investors. In line with this investor demand, efforts are underway to transition to a more sustainable economy.

Exchange Traded Funds ("ETFs") are uniquely positioned to assist issuers bringing ESG products to market thereby enabling investors to meet their respective sustainable investment requirements.

The Growth of ETFs

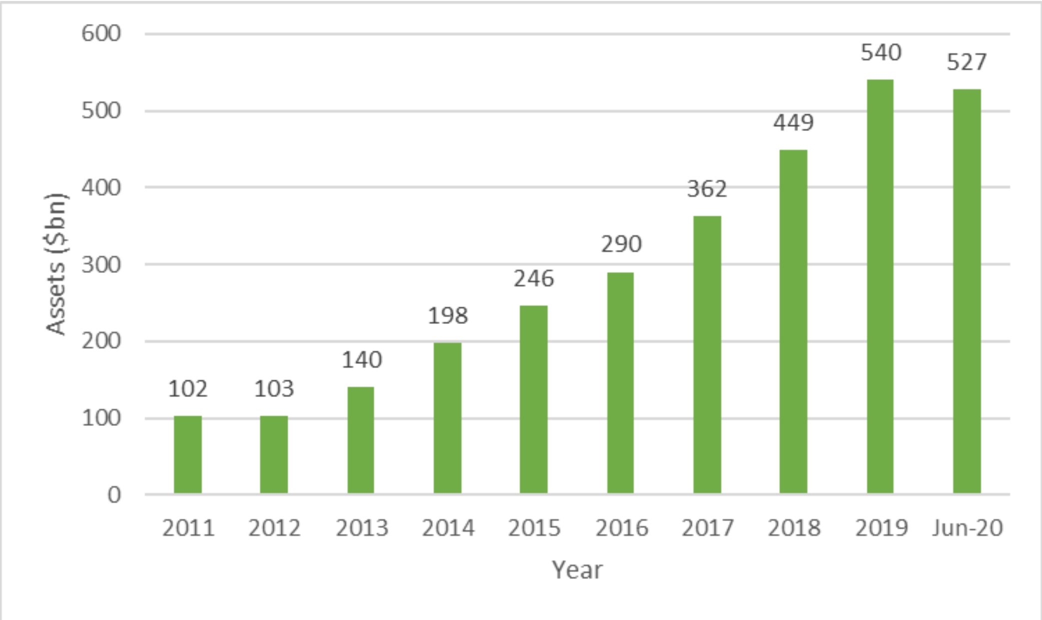
ETFs have grown consistently since their inception over 25 years ago and are now a well-established investment vehicle globally. ETFs' global assets under management ("AUM") currently exceeds US$6.6 trillion, representing approximately 12% of total global investment fund AUM.

Investors' increasing focus on fees and value for money, growing scrutiny of the performance of active managers and the desire of investors for greater liquidity and transparency are the key drivers for the continued growth of the ETF industry in Europe. In addition, despite the impact of the COVID-19 pandemic on markets globally, ETFs have proven to be resilient and their AUM levels have shown strong recovery.

In late 2019, the AUM of European ETFs surpassed US$1 trillion having doubled in size over the last 4 years. ETFs in Europe are fast becoming an established core investment product for both retail and institutional investors.

Ireland continues to lead the way for ETFs in Europe as the domicile of choice for a broad range of asset managers and the centre of excellence for supporting ETFs. Ireland accounts for 62% of the total AUM in European ETFs.

Growth of Irish ETFs AUM



Ireland is unrivalled in Europe for its ETF experience and expertise. The maturity of the Irish model ensures that ETF issuers have access to service providers who can provide market leading, highly automated and scalable global solutions and who are ably supported by Ireland's booming fintech industry.

Ireland's professional services infrastructure is equally well developed, with specialist legal, tax and accounting skills and expertise. This combination ensures that ETF issuers benefit from an exceptional support framework from which to launch and grow their product range in line with the evolving market, regulatory and distribution landscape.

As Ireland's financial services ecosystem evolves from a predominantly asset servicing focus to being the European headquarters for many asset managers following the UK's departure from the EU, Ireland's role in capital markets, product development, innovation and the distribution of funds globally is fundamentally changing the footprints of international asset managers in Ireland. ETF issuers setting up operations in Ireland know that they can tap into a deep pool of talent with ETF knowledge and expertise that will support the growth and continued success of their businesses.

Access to this level of expertise and support means that Ireland has long been at the forefront of ETF innovation, being the first market in Europe to:

- approve active ETFs
- launch a Chinese RQFII ETF
- have a Swiss listed UCITS ETFs
- approve master limited partnership investments in an ETF structure

The successful delivery of these products reflects the ability of the local service providers in Ireland to understand both product sets and also how to build robust systems to ensure delivery of innovative products. It also reflects the deep, technical ETF knowledge of the Central Bank of Ireland which enables it to engage constructively in product delivery. This expertise has expanded the ETF ecosystem in Ireland with leading market makers and others market participants choosing to base themselves in Ireland providing an excellent platform of the next wave of innovation in the ETF sector.

Recent Trends in ETFs

2020 has already seen a number of key developments for the ETF industry, including:

- **COVID-19**: The COVID-19 crisis continues to provide the largest ever stress-test for investment funds, including ETFs. Initial analysis indicates that the ETF markets continue to function effectively since March 2020 further underscoring the robustness of the ETF product. In many instances ETFs have been seen to have performed as a price discovery mechanism due to the heightened trading volumes.

- **Thematic ETFs:** Exchange trading volumes of thematic ETFs (i.e. those tracking investing themes like marijuana, robotics and AI) have doubled this year from same period in 2019 according to Bloomberg. In Europe more than US$10bn of ETFs track innovative content. Increased volumes of trading in thematic funds is considered a tell-tale sign of engagement with retail investors demonstrating the depth of the ETF market. This trend is likely to broaden with thematic investment satisfying increasing ESG thematic demand also.

- **Increased share class offerings:** There has been a significant increase in the number of share classes being offered by European ETFs, to facilitate global distribution and growing investor demand; and

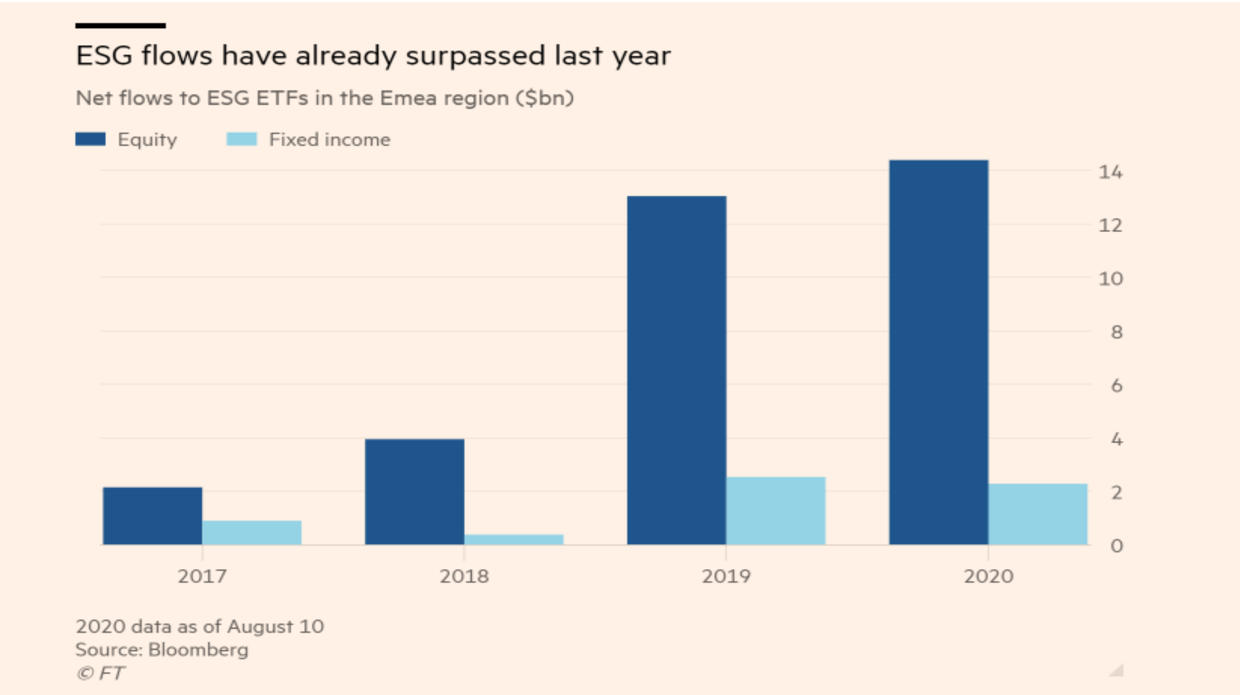
- **Positive Policy Shifts:** Recent policy changes by the Central Bank of Ireland to permit the co-mingling of listed and unlisted share classes within ETFs has opened the door to a wide range of new products which will provide access to new distribution channels and new investors.

However, there is no question that the biggest development in the ETF space in 2020 has been the continuing rise of sustainable finance and ESG investing. The first Irish ETFs offering exposure to companies undertaking carbon transition and indices aligned with the Paris Accord have already reached the market.

According to a 2020 Global ETF Investor Survey by BBH and ETF.com, European ETF investors are sending a clear message that ESG is fundamental, and of increasing importance, to their portfolio construction. 73% of those surveyed plan to increase their allocation to ESG investments and ESG is the asset class which they most want to see more of in the market. A recent PwC report confirmed this sentiment and identified that investors ranked ESG as a top priority, outranking even fee considerations.

ETFs for ESG

ESG ETFs globally attracted an unprecedented US$15bn inflows during the first half of 2020 according to estimates from analysts ETF Flows. Furthermore, according to Bloomberg data, in the first seven months of 2020 in EMEA, equity ESG ETFs attracted net inflows of US$13.9bn while traditional non ESG equity ETFs saw net outflows of US$7.7bn.



There are various reasons for this development:

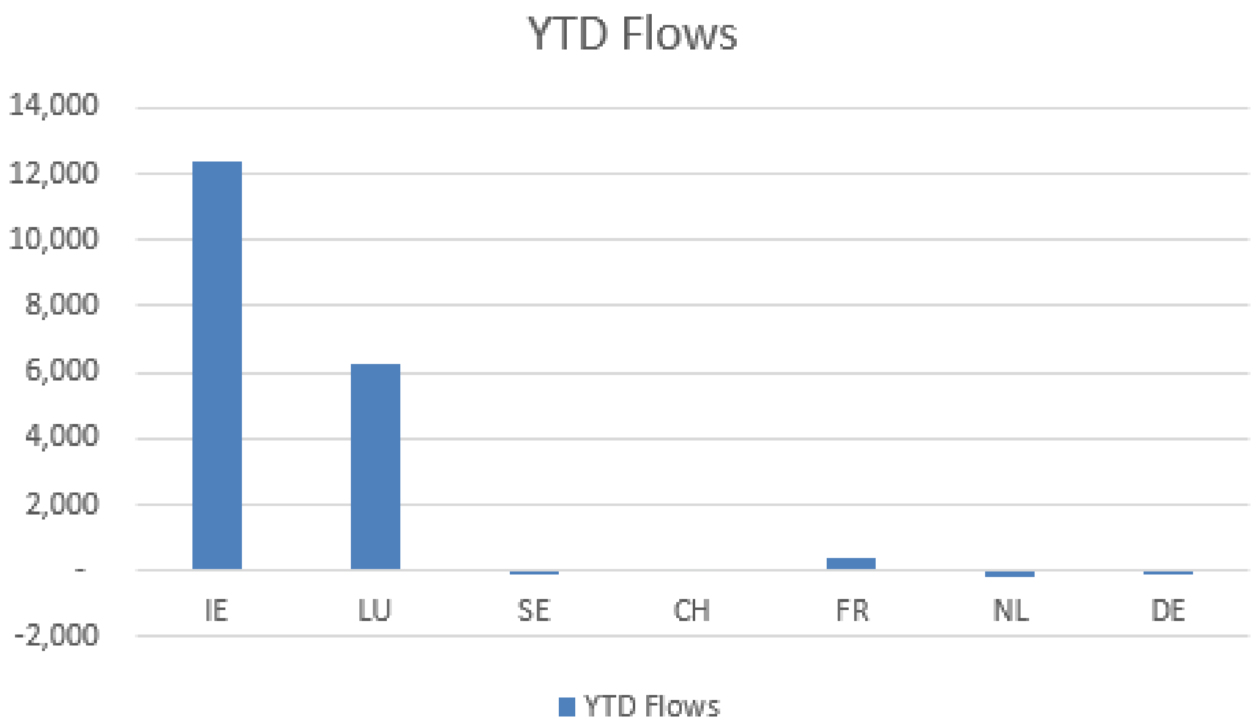
- **Inherent transparency**: The ETF wrapper is uniquely well suited for meeting investors' needs in the ESG space - the inherent transparency and comparability of information that ETFs offer means that investors will be able to satisfy themselves of the ESG credentials of the underlying products, alleviating concerns about greenwashing.

- **Advantages of actively managed ETFs**: The rise of actively managed ETFs enables investment managers to offer products which can combine all of the positive features of ETFs with individual investment/asset selection that will facilitate any ESG focused investment strategy. Actively managed ETFs have the added advantage of offering more direct engagement with and stewardship of underlying businesses.

- **Increasing prevalence of ESG indices and green bonds**: In addition, the recent advances in ESG fixed income indices and the increased issuance of green bonds are providing sustainable building blocks for low cost strategies and deepening the toolkit and level of choice in the market for multi asset investors.

- **Outperforming other funds**: There has been a strong indication that ESG ETFs have shown a real resilience during the COVID-19 crisis in outperforming their conventional fund counterparties.

Flows into Irish domiciled ETF ESG products far outstripped flows into ESG ETFs domiciled in other European locations and Irish domiciled ESG ETFs assets were in excess of US$22bn as at end of July this year, clearly ahead of the rest of Europe combined and increasing its existing market share.



Conclusion

As the leading European domicile for ETFs, Ireland is both facilitating and benefitting from a fundamental shift in investor preference towards ESG products. Investor-led demand allied with the embedded expertise and experience of the local ETF market providers means that Ireland in uniquely positioned to continue to support the surge in demand and innovation in ESG ETF products.

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