

Switching to ESG ETFs: Associated Costs and Tracking Error

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While ESG adoption has accelerated dramatically in recent years, there are still some investors who are hesitant to switch their holdings. The most common reasons are worries over increased tracking error from their selected benchmark and the costs of transitioning into an ESG product. In this paper, which follows from an earlier study by Flow Traders in 2021, we show that some of these fears can often be overstated.

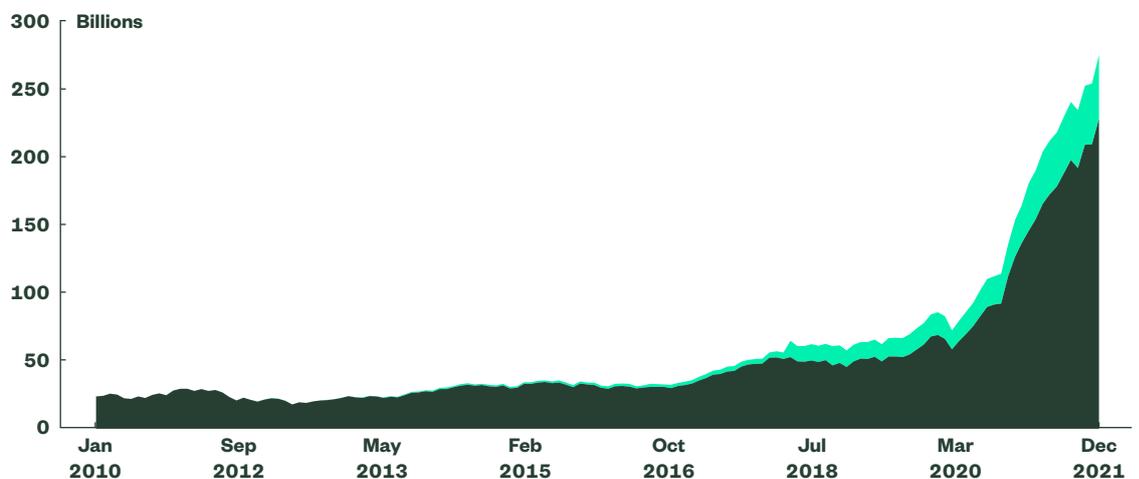
ESG Investing: Demand is Surging

Over the last few years, demand for ESG investments has accelerated massively. While ETFs were initially slower to see this demand boom, the last three years have completely changed that. Assets in ESG ETFs in Europe now stand at \$275 billion, almost double the size they were at the start of 2021 and more than four times as large as three years ago. Indeed, just in 2021, European ESG ETFs took in nearly \$100 billion, accounting for almost half of total industry flows.

A range of drivers has led this surge in demand for ESG. The first is an increased scrutiny of companies' ESG characteristics by governments and regulators. Second, the growing recognition of the climate emergency, and the immediate impact felt around the world, has raised awareness for investors and consumers of the need to act and invest sustainably. Furthermore, conversations around climate have intensified, as highlighted by the coverage of the recent COP 26 meeting, and thus we believe the demand for ESG investments is likely to continue growing during the next few years.

Figure 1
Assets in European ESG ETFs

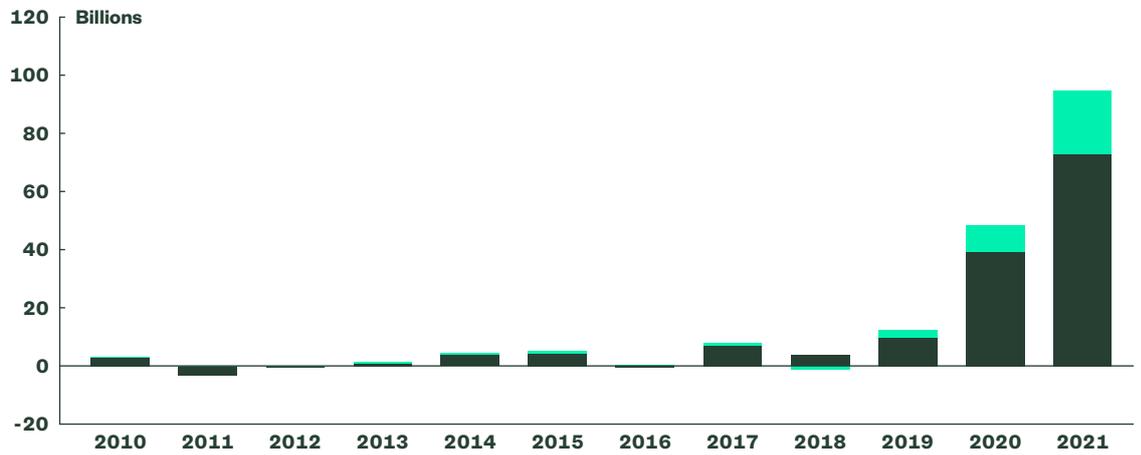
■ Equity
■ Fixed Income



Source: State Street Global Advisors, Morningstar Direct, as of 31 December 2021. All figures expressed in USD.

Figure 2
**Yearly Flows in
 European ESG ETFs**

■ Equity
 ■ Fixed Income



Source: State Street Global Advisors, Morningstar Direct, as of 31 December 2021. All figures expressed in USD.

Switching from Traditional ETFs to ESG ETFs

Common concerns for many institutional investors — who are keen to switch aspects of their core holdings into ESG equivalent funds — centre around tracking error and execution cost impacts that are associated with transitioning to an ESG index.

Tracking Error

In Figure 3 (next page), we look at several ESG indices and compare their total return and tracking error over different time periods. The table demonstrates that some of these tracking error concerns are overdone. Tracking error for most exposures is relatively low, and therefore tracking difference between the two products also comes in close. This is because these indices have been designed to target the same risk-return characteristics while maintaining an ESG investment approach.

Despite the attempts at minimising tracking error, the data in Figure 3 show that these indices still offer a fairly significant uplift in terms of ESG score relative to the parent index, as measured by the R-Factor® score. R-Factor is our proprietary ESG scoring system, measuring the performance of a company’s business operations and governance as they relate to financially material and industry-specific ESG risk factors, as defined by the Sustainability Accounting Standards Board (SASB).

The fixed income indices under analysis apply a best-in-class exclusionary approach to remove companies that have poor ESG scores. However, they then use an optimisation approach to bring the index characteristics back in line with the parent index, so that the duration and yield profiles are comparable to the parent index. This helps to ensure that the risk-return characteristics of the ESG index remain similar to the parent index.

Ultimately, investors need to weigh the internal and external drivers of switching to an ESG-focused product against the potential differentials of varying performance indicators, including tracking error. In general, indices that seek to maximise ESG scores, through weighting constituents by a best-in-class ESG approach, are likely to have a greater level of tracking error. Meanwhile, indices that apply screening approaches (which remove companies that fail certain ESG involvement tests), but continue to weight the constituents by the same approach as the parent index, are likely to have similar performance to the parent.

Figure 3

Return and Tracking Comparison of ESG vs. Parent Indices

Index	Total Return (%)			Tracking Error (%)			ESG Score
	1 Yr	3 Yr	5 Yr	1Yr	3Yr	5Yr	R-Factor Score
S&P 500 ESG Exclusions II Index	28.45	26.42	18.45	0.45	0.49	0.54	69.51
S&P 500 Index	28.16	25.41	17.82	—	—	—	69.33
STOXX Europe 600 SRI Index	26.29	16.12	8.82	2.08	2.44	2.37	79.09
STOXX Europe 600 Index	24.91	15.79	8.90	—	—	—	74.18
Bloomberg SASB US Corporate ESG Ex-Controversies Select Index	-0.97	7.96	5.50	0.80	1.40	1.21	78.67
Bloomberg USD Corporate Bond Index	-1.43	8.80	5.88	—	—	—	67.55
Bloomberg SASB Euro Corporate ESG Ex-Controversies Select Index	-0.90	2.62	1.85	0.12	0.39	0.32	83.43
Bloomberg Euro Corporate Bond Index	-0.97	2.64	1.80	—	—	—	74.57
S&P Euro ESG High Yield Dividend Aristocrats Index	25.61	17.96	13.47	1.14	2.15	2.05	76.17
S&P Euro High Yield Dividend Aristocrats Index	24.74	15.66	11.56	—	—	—	76.09
S&P ESG High Yield Dividend Aristocrats Index	19.87	11.65	7.89	3.29	4.03	3.47	64.38
S&P High Yield Dividend Aristocrats Index	14.59	6.84	4.30	—	—	—	61.57
S&P Global ESG Dividend Aristocrats Quality Income Index	22.96	13.34	9.42	3.18	2.92	2.61	66.57
S&P Global Dividend Aristocrats Quality Income Index	15.41	7.29	5.76	—	—	—	63.03
Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	6.62	9.12	—	0.58	0.91	—	65.03
Bloomberg US Corporate High Yield Index	5.28	8.83	—	—	—	—	55.62

Source: State Street Global Advisors, Bloomberg Finance L.P., FactSet, as of 31 December 2021. Past performance is no guarantee of future results. It is not possible to invest directly into an index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

ETF Trading Costs

ETFs provide investors with efficient access to a broad set of benchmarks, across asset classes, with transactional costs at or around the underlying constituent levels. The unique structure of ETFs can also deliver investors an efficient platform to re-allocate strategies between ETF variants.

When considering switching from a core exposure to an ESG equivalent, investors can leverage the similarities in constituent make-up between the ESG index and the parent index, and transact based on an “all-in switch price” rather than trading the two legs in isolation. Using an all-in switch price can often create pricing efficiency as Authorised Participants are able to manage both legs of the transaction, leveraging the constituent overlap and their unique ability to access the products in primary markets to help minimise execution costs for investors.

In addition, investors can also now benefit from recent developments seen across third-party Request for Quote (RFQ) platforms, which have developed a “switch” quote type mechanism to stand alongside the traditional NAV and risk price trading benchmarks, thus helping automate the switch order flow process. This represents a positive development for investors, and provides an additional trading option within their execution toolkit.

The below table provides indications of the all-in switch pricing achievable when looking to move between our SPDR core strategies and their ESG equivalents.¹ These indicative switch costs were provided by FlowTraders, a global market maker and Authorised Participant in multiple SPDR ETFs across a wide range of asset classes. These switch costs were provided at a specific point in time and therefore are liable to change based on market conditions; however, they provide a helpful estimation of the expected cost to switch from one product to the other.

You will notice that, for our equity ETFs, the market switch indication levels quoted below reduce as notional values increase. But for the fixed income ETFs, the opposite is true: as notional values increase, so do the market switch indications. Why is this? Unlike equity baskets, which tend to see broad constituent overlaps, certain fixed income baskets may see smaller overlaps in terms of sector exposure and duration. As basket sizes increase, the market maker will be forced to begin sampling from even smaller bonds, amplifying these variances, which may increase the overall net risk being managed by the market maker and result in higher costs as the switch notional increases.

Figure 4
**Indicative Switch Costs
for ESG ETFs from
Equivalent ETFs**

ETF	Ticker	Indicative Switch Costs (bps)		
		\$5mn	\$10mn	\$50mn
SPDR S&P 500 ESG Screened UCITS ETF	500X IM	6.00	3.40	1.60
SPDR® S&P 500 ETF	SPY5 IM			
SPDR STOXX Europe 600 SRI UCITS ETF	600X IM	19.86	18.81	18.49
Weighted Average Competitor Products	N/A			
SPDR® Bloomberg SASB U.S. Corporate ESG UCITS ETF	USCR LN	15.45	16.04	18.21
Weighted Average Competitor Products	N/A			
SPDR® Bloomberg SASB Euro Corporate ESG UCITS ETF	EUCR IM	8.00	9.00	12.00
SPDR® Blmbrg Bcly EUR Corp Bd ETF	SYBC GY			
SPDR Bloomberg U.S. High Yield Corporate ESG UCITS ETF	SJNK LN	17.44	19.44	22.44
Weighted Average Competitor Products	N/A			
SPDR S&P Euro Dividend Aristocrats ESG UCITS ETF	EEDV NA	14.80	14.50	14.30
SPDR S&P Euro Dividend Aristocrats UCITS ETF	SPYW GY			
SPDR S&P U.S. Dividend Aristocrats ESG UCITS ETF	UEDV LN	4.00	2.00	2.00
SPDR S&P U.S. Dividend Aristocrats UCITS ETF	UDVD LN			
SPDR S&P Global Dividend Aristocrats ESG UCITS ETF	GEDV LN	15.00	12.00	11.00
SPDR S&P Global Dividend Aristocrats UCITS ETF	GLDV LN			

Source: SPDR Capital Markets, FlowTraders, as of 7 February 2022. Indications are based on market conditions as of the date indicated and are subject to change.

For further information please reach out to the SPDR Capital Markets team:
EMEASPDRCapitalMarkets@ssga.com.

Endnote

- 1 Where SPDR does not offer a non-ESG exposure, an average switch price of selected competitor products was used for these indications.

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* Pensions & Investments Research Center, as of 31 December 2020.

[†] This figure is presented as of December 31, 2021 and includes approximately \$61.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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