HKEX 香港交易所

July 2023

ETF Spotlight

The ESG debate: The evolving landscape of ESG investments

Contents

The Great ESG Debate

4 Proponents of ESG

5 Critics of ESG

6 Where does the ESG debate go from here?

The Evolving Landscape of ESG Investments

8 Growth trend continues despite lower inflows

Asia is becoming a key driver of ESG growth

9 ESG ETFs on the rise

10 Hong Kong-listed ESG ETFs at a glance

11 Green bonds: Financing for a sustainable future

12 Carbon futures: Gaining exposure to the carbon credit market

FAQs

The Great ESG Debate

Although ESG investing has grown significantly in recent years, the effectiveness of ESG criteria in investment decision-making and driving change remains a hotly debated topic. Critics argue that ESG investing lacks clear standards and may not always lead to the most profitable investments, while proponents maintain that it can lead to better long-term performance and positive societal and environmental impacts.

In the upcoming paragraphs, we will delve deeper into the ESG debate, analysing both sides of the argument and evaluating whether the trade-offs between financial returns and sustainability outcomes are justified. Additionally, we will explore the future of ESG and offer insights on how investors can navigate this changing landscape.

Proponents of ESG

Supporters of ESG believe that ESG considerations are essential for identifying emerging risks and opportunities that traditional metrics may overlook. Key benefits of ESG investing include:

Investing with purpose
ESG investing provides an avenue for investors to align their financial objectives with their personal values and ethical principles. For example, an investor who values sustainability may choose to invest in companies with a strong commitment to environmental practices, while an investor who prioritises social justice may choose to avoid companies with a history of labour exploitation. Some investors may also choose to practise investment stewardship, by taking steps as simple as monitoring the ESG performance of companies, and participating in shareholder meetings as a way to influence corporate decisions. Through these efforts, investors can help drive positive change and contribute towards building a better world.

New investment opportunities
Regulatory and policy changes are opening up new opportunities in the realm of ESG investing. For example, China has set ambitious goals to reach peak carbon emissions by 2030 and become carbon neutral by 2060, which necessitates the transition to a lower-carbon business model for companies. To achieve this, there is a pressing need to rapidly scale up renewable energy capacity in the nation. To meet its net-zero emissions target by 2060, the power and transport sectors alone in China require between US$14 trillion - US$17 trillion of additional investments for green infrastructure and technology, according to the World Bank[1]. This presents an opportunity for investors to invest in clean energy infrastructure and innovative technology projects.

Long-term value creation
Incorporating ESG factors into business practices can create long-term financial value for companies through various sources. For instance, a study conducted by MSCI[2] showed that companies with high ESG scores generally experience lower costs of capital. Additionally, companies that prioritise diversity in their workforce can better attract and retain top talent, leading to increased productivity.

Sources of value creation from incorporating ESG factors[3]

Resource Efficiency	Better Reputation	Insurance Premium
New Customers & Market	Access to Capital	Labour Productivity
New Revenue Streams	Lower Interest Rate	Compliance

1 Source: The World Bank, "China's transition to a low-carbon economy and climate resilience needs shifts in resources and technologies", October 2022.
2 Source: MSCI, "ESG and the cost of capital", February 2020.
3 Source: PwC and MSCI, "ESG value creation journey", November 2022.

Risk mitigation
Risks associated with climate change and environmental issues are transforming the risk landscape for businesses. In today's world, where consumer preferences are evolving, ESG factors are becoming increasingly important for businesses to maintain their competitive edge and earn the trust of consumers. Companies that neglect ESG risks may experience reputational harm, and even legal risks, potentially harming their financial performance and long-term viability.

Impact of ESG commitments on consumer purchases and employee engagement[4]

How likely are you to buy from/work for a company that stands up for E/S/G?

	Consumers	Employees
Environment	80%	84%
Social	76%	83%
Governance	80%	86%

Critics of ESG

Despite gaining traction and becoming mainstream, ESG has faced persistent doubts and criticism, with the following being some of the main concerns:

Lack of standardisation
The lack of a common standard in ESG definitions and ratings can pose challenges for investors seeking to compare performance across companies and industries. While several rating agencies and data providers exist, their methodologies can vary widely, leading to divergent scoring results. An analysis by the OECD found that different methodologies used by market data providers, such as Bloomberg, Thomson Reuters, FTSE, MSCI and Sustainalytics, can lead to wide variance in scoring results, and the correlation among the scores they assign to the same companies can be low[5]. Furthermore, there is no regulatory body or standardised framework governing ESG data, which can create confusion and uncertainty for investors.

Limited data availability
The short supply of ESG data is another hurdle for investors seeking to fully evaluate ESG investments. As noted by the OECD analysis based on Refinitiv data, the market coverage of ESG scores worldwide is only around 10%[6]. Moreover, the coverage is largely dominated by large capitalised companies due to limited resources that small and mid-sized companies can dedicate to ESG disclosures.

Greenwashing
Greenwashing is a common criticism of ESG investing, as companies and funds may use the label to attract socially conscious investors while not actually aligning with ESG principles. Greenwashing can take many forms, such as exaggerating a product's eco-friendliness or social responsibility, or using vague or misleading language to suggest ESG alignment without actually making meaningful changes to business practices. As such, investors must be diligent in their research to ensure that their investments truly align with ESG values.

4 Source: PwC, "2021 Consumer intelligence series survey on ESG", June 2021.
5 Source: OECD Paris, "ESG investing: Practices, progress and challenges", 2020.
6 Ibid.

Where does the ESG debate go from here?

Different stakeholders and the wider investment community can take several measures to support the continued growth of ESG investments. Some of these measures include:

Establish standardised ESG definitions and ratings

Having a standardised framework for evaluating ESG performance can provide investors with a consistent basis for evaluating ESG investments. In 2019, the Hong Kong Securities and Futures Commission (SFC) began issuing guidance on disclosure standards for ESG funds, with enhanced guidance subsequently issued in 2021, covering various aspects such as naming, methodologies used to measure ESG performance, engagement policies, investment strategies and asset allocation, among others. This enhanced guidance can promote transparency and responsible investing practices in Hong Kong's financial markets, instilling investor confidence when investing in ESG funds.

Enhance ESG disclosure

More standardised and specific ESG disclosure requirements can help address the issue of limited data availability and ensure a more level-playing field for all companies, regardless of their size. In fact, as a frontline regulator of more than 2,600 listed companies, HKEX has been requiring listed companies to publish their ESG reports on an annual basis since 2016[7,8], and the disclosure requirements have been continuously enhanced ever since to meet the Hong Kong government's goal to implement mandatory climate-related disclosures aligned with TCFD by 2025[9].

Combat greenwashing

Regulators can take a proactive role in monitoring and enforcing against greenwashing practices. This could include stronger penalties for companies found to be engaging in greenwashing, as well as increased scrutiny of the marketing materials and claims made by investment managers promoting ESG products. In addition, investors should be encouraged to perform thorough due diligence on the ESG credentials of potential investments and to hold companies accountable for their ESG performance.

In conclusion, the growth of the ESG investment landscape will require a collaborative effort from various stakeholders. By establishing standardised ESG definitions and ratings, enhancing ESG disclosure, combating greenwashing, and promoting ESG education and awareness, it is possible to overcome the challenges faced by ESG investing and support its role as a vital component of the global investment market.

7 Source: Charltons, "Comply or explain ESG reporting for Hong Kong listed companies for financial years starting from 1 January 2016", January 2016.
8 Source: HKEX, "Main board listing rules".
9 Source: HKEX, "Enhancement of climate-related disclosures under the environmental, social and governance framework", April 2023.

The Evolving Landscape of ESG Investments

Investor interest in sustainability has soared in recent years, leading to a surge in ESG investing. According to Morningstar, the assets under management (AUM) of sustainable funds, including open-end funds and exchange-traded funds (ETFs), reached US$2.74 trillion globally by the end of March 2023 across more than 7,000 funds.[10] In the following paragraphs, we will explore the current ESG investment landscape and hone in on ETFs as a hassle-free and straightforward investment vehicle to access ESG opportunities.

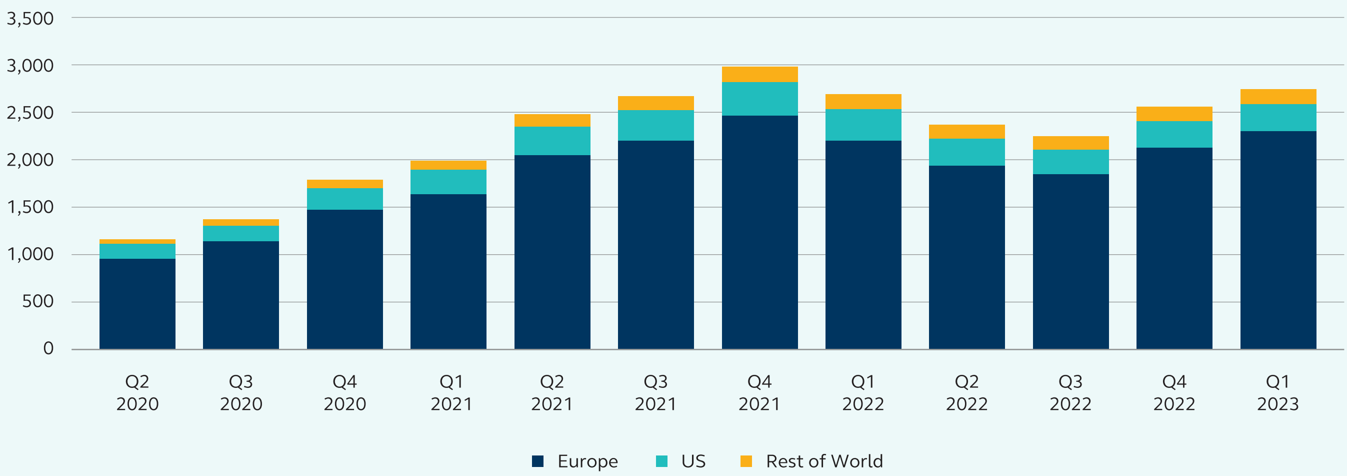
Growth trend continues despite lower inflows

In the first quarter of 2023, sustainable funds worldwide attracted a net inflow of US$29 billion from investors, a decline from the previous quarter's US$38 billion as increasing interest rates, inflation and recession risks weighed on markets. However, the growth rate of 1.4%, calculated as net inflows relative to total assets at the start of the first quarter, remained higher than the growth rate of 0.2% for the overall global fund universe.

Europe maintained its dominant position in the sustainable fund market, accounting for 84% of global sustainable fund assets as of March 2023. The US followed with a 11% share of global sustainable fund assets.

In Asia ex-Japan, China emerged as the largest sustainable fund market, contributing over 68% of the region's total assets.

Global sustainable fund assets (USD billion)[11]

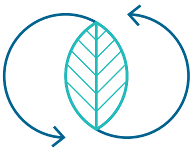


Asia is becoming a key driver of ESG growth

Although Asia ex-Japan ranks third with only 2% of global sustainable fund assets, the region is quickly catching up in sustainable investing. According to one estimate by Invesco[12], Asia's ESG-related AUM is projected to exceed US$500 billion by 2025, driven by a growing societal focus on sustainability, increasing demand for asset owners and managers to adopt ESG investment principles, and supportive policies and regulations that promote sustainable investment.

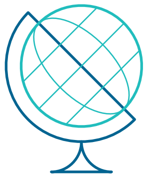
10 Source: Morningstar, "Global sustainable fund flows: Q1 2023 in review", April 2023.
11 Ibid.
12 Source: Invesco, "ESG opportunities and challenges in Asia", April 2022.

Factors driving wider ESG adoption in Asia



Investment opportunity for Asia's energy supply to achieve net zero is estimated to be between US$26 trillion and US$37 trillion cumulatively from 2020 to 2050.[13]

Enhancing ESG regulations are improving the transparency of ESG investments in APAC. E.g. Hong Kong's SFC in January 2022 introduced enhanced disclosure requirements for ESG funds.[14]



Millennials, who make up almost 25% of the Asian population, are twice as likely to consider investing in companies that target social or environmental outcomes.[15]

ESG ETFs on the rise

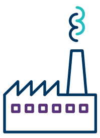
As the demand for sustainable investing rises, ESG product innovation is also on the rise to cater to diverse investment needs. One investment vehicle that has gained significant popularity in recent years for accessing ESG themes is ETFs. The number of ESG ETFs has grown significantly in the past two years to reach almost 1,300 at the end of 2022[16], offering investors a broad range of options to invest in various sustainable themes, such as renewable energy and gender diversity, among others.

How to choose the right ETF for your ESG portfolio?

E, S or G?
Some ETFs may focus on a specific aspect of ESG, such as climate change, while others may adopt a more comprehensive strategy

Value or growth?
Even though many ESG equity funds tend to favour growth, there exist ETFs for investors who want to build style-neutral to value-leaning portfolios

Geographical exposure
Different markets have distinct opportunities and challenges due to varying degrees of ESG development and regulations



Sectoral exposures
Certain industries, such as carbon-intensive industries, involve higher levels of material ESG risks compared to other sectors

Portfolio concentration
Concentrated portfolios may outperform their less concentrated peers but also lead to increased volatility

Investment style
Passive funds are more likely to be impacted by ESG ratings while active funds are more likely to engage directly with companies

13 Source: Asia Investor Group on Climate Change estimates, "Asia's net zero energy investment potential", March 2021.
14 Source: ASIFMA, with reference to BNP Paribas report, "Rising importance of ESG in Asia-Pacific", 2022.
15 Ibid.
16 Source: ETFGI, data as of 31 December 2022.

Hong Kong-listed ESG ETFs at a glance

Investors seeking ESG exposure through ETFs can find a variety of choices in Hong Kong – Asia's leading ETF marketplace. Currently, there are 11 ESG-related ETFs listed in Hong Kong, with a market capitalisation of approximately HK$2.6 billion and an average daily turnover of around HK$5.5 million[17], offering access to various ESG themes such as clean energy, sustainable consumption and technology.

In addition, for investors interested in China's ESG sector, the Hong Kong market provides convenient access to a range of China-focused ETFs, including exposure to ESG opportunities in the Greater Bay Area and A-shares.

A continuously diversifying product ecosystem

17 Jan 2020
Hong Kong's first clean energy ETF

15 Oct 2020
Hong Kong's first ESG ETF focusing on China A-shares

19 Aug 2022
Hong Kong's first Asia ex-Japan green bond ETF

30 Mar 2023
Hong Kong's first low carbon ETF

31 Mar 2023
Hong Kong's first climate ETF

A significant milestone in Hong Kong's ESG ETF market has been the recent launch of a green bond ETF, which is also the world's first green bond ETF to focus on Asia ex-Japan. In the following two pages, let's take a closer look at the underlying instrument behind this innovative investment vehicle.

17 Source: HKEX, data as of 30 June 2023.

Green bonds: Financing for a sustainable future

According to Bloomberg's estimates, the transition to a net-zero economy will necessitate a global investment of almost US$7 trillion per annum until 2050, and the largest investment required will be in electric vehicles and low-carbon power and grids.[18] Green bonds can play a crucial role in raising the necessary funds for the transition.

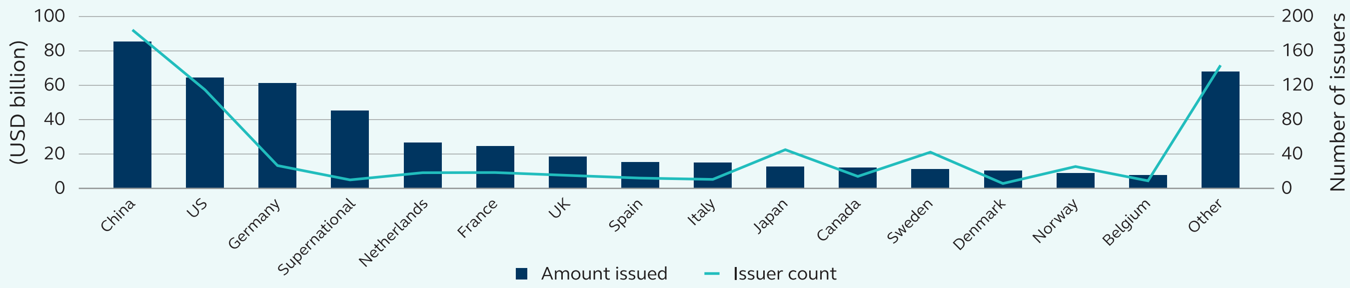
Green bonds enable capital-raising and investment for new and existing projects with environmental benefits. An example close to home is the green bonds issued by the Hong Kong government, which are exclusively used to fund green projects such as the construction of an organic resources recovery centre in North Lantau that will convert food waste to biogas for electricity generation, and the adoption of energy efficient features at the East Kowloon Cultural Centre.[19]

Since the issuance of the world's first green bonds in 2007[20], cumulative global green bond issuance has reached US$2.2 trillion by 2,457 issuers from 85 countries at the end of 2022.[21]

Europe dominates the green bond landscape with the most green bond issuance, as the region has the most advanced policy measures and the largest number of dedicated investment mandates. On the other hand, China has surpassed the US as the main source of green debt, accounting for 18% of global green bond issuance in 2022.

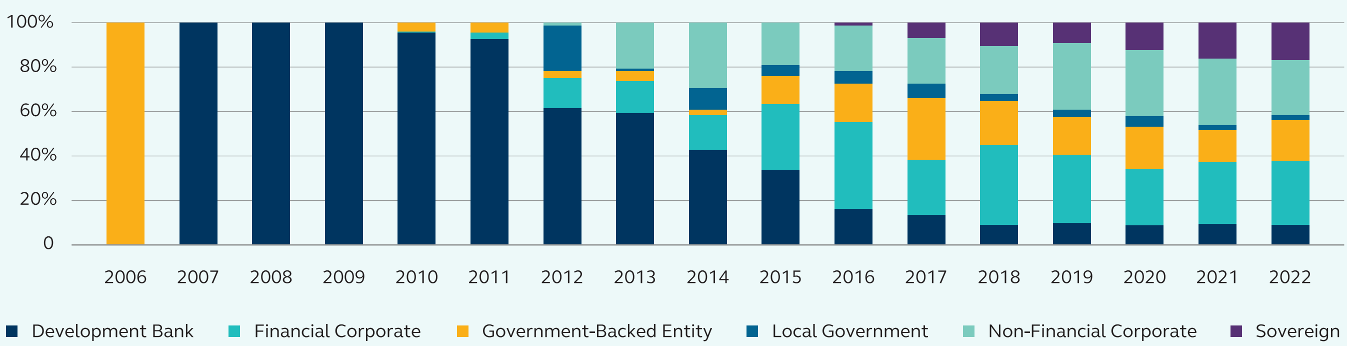
The year 2022 also saw a significant increase in CNY-denominated issuance, which reached US$73.3 billion, representing a year-on-year growth of 21%.

Green bond issuance by countries in 2022[22]



Green bonds represent a diversified investment opportunity for investors as the issuer base covers a broad range of sectors and countries. While the green bond market used to be dominated by government-backed entities and development banks, the private sector has been playing an increasingly important role in the past decade, contributing around half of global green bond issuance in 2022.

Growing diversity in green bond volume contribution[23]



18 Source: Bloomberg, "The $7 trillion a year needed to hit net-zero goal", December 2022.
19 Source: HKSAR Government, "Green bond report 2021", 2021.
20 Source: BlackRock, "How green is your bond?", March 2020.
21 Source: Climate Bonds Initiative, "Sustainable debt global state of the market 2022", April 2023.
22 Ibid.
23 Ibid.

Carbon futures: Gaining exposure to the carbon credit market

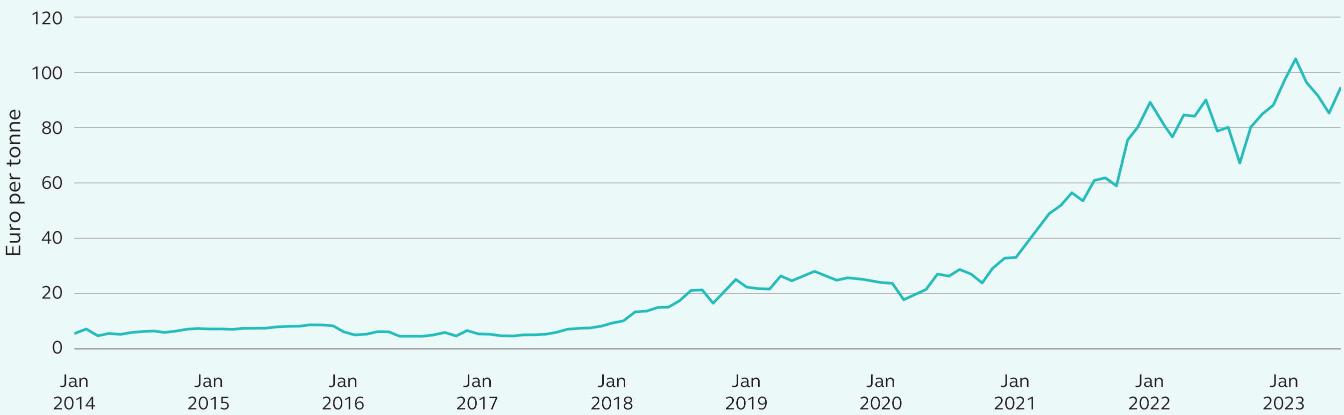
Decarbonisation is an important step in keeping global warming below 1.5°C this century, the goal of the Paris Agreement on climate change. Carbon markets, where corporations and investors trade carbon emission allowances, can play a key part in achieving this goal.

Carbon emission allowances, or carbon credits, are permits issued by governmental organisations that allow the holder to produce one metric tonne of CO_2 or equivalent amounts of greenhouse gases. In a regulated carbon market, also known as emissions-trading systems (ETS), each company is allotted a certain number of carbon credits per year and allowed to sell any unused credits if they produce less CO_2 than permitted. The overall supply of credits issued by regulators will decrease over time in a quota-based market to reduce emissions gradually.

There are approximately 28 ETS around the world today covering almost one-third of the global population, with China's national ETS being the largest ETS in force, followed by EU's ETS. The share of global greenhouse gases emissions covered by emissions trading is over 17%, more than triple the amount than when EU's ETS was launched in 2005.[24]

As high energy prices and more ambitious emissions caps may drive up carbon prices in these markets, carbon credit as an asset class is presenting an attractive investment potential to investors. One way to enter this market is through carbon futures. This type of derivative has carbon credits as the underlying asset, allowing companies to hedge the risk of carbon pricing and giving investors leveraged exposure to the carbon credit market.

Surging prices of permits on EU's carbon market[25]



Carbon futures are derivatives products that allow investors to buy or sell the right to emit CO_2 or other greenhouse gases at a predetermined price, at a future date. They are a way for businesses to manage their exposure to the financial risks associated with carbon emissions. For example, a company that emits a lot of CO_2 may choose to buy carbon futures as a way to hedge against the risk of rising carbon prices or potential future carbon taxes.

For individual investors, carbon futures ETFs provide a convenient way to gain exposure to carbon emission allowance with added advantages, such as diversification, low transaction cost, no expiration date, and lower investment minimums than trading carbon futures contracts directly.

24 Source: International Carbon Action Partnership, "Emissions Trading Worldwide Status Report 2023"
25 Source: Tradingeconomics.com, data as of 30 April 2023

FAQs

Trade Asia. In Asia.

What are the benefits of trading Hong Kong-listed ETFs?

There are a number of advantages to trading ETFs listed in Hong Kong, including the opportunity to diversify portfolios with exposure to a range of geographies and asset classes, including but not limited to commodities, fixed income, sector-based, thematic (e.g. ESG, technology and digital asset) and smart beta funds.

In addition, Hong Kong-listed ETFs trade in the Asian time zone, enabling investors to trade Asian underlying within a much narrower band of premiums and discounts compared to US-listed ETFs. This means that they do not deviate from their fair values as much, making them an ideal choice for trading in the secondary market.

Further, investors opting for a Hong Kong-listed ETF benefit from the city's simple and low tax regime, where the tax rate on ETFs is up to 30% lower than that of their US-listed counterparts.

The cost advantage

How has Hong Kong's ETF market been affected by the government's decision to raise stamp duty on stock transactions from 0.1% to 0.13%?

The stamp duty for trading ETFs in the secondary market in Hong Kong has been waived since 2015, which is still effective after the increase in stamp duty on stock transactions. In other words, when trading Hong Kong-listed ETFs in the secondary market, investors do not incur stamp duty.

Additionally, in the primary market, since August 2020, ETF market makers have been enjoying zero stamp duty on stock transactions when they create and redeem ETF units in Hong Kong, resulting in lower creation and redemption costs for market makers.

As a whole, all stamp duty waivers reduce transaction costs for trading ETFs.

Inclusion of ETFs in Stock Connect

What does the inclusion of ETFs in Stock Connect mean for HKEX?

The inclusion of ETFs in Stock Connect is the latest milestone in HKEX's landmark mutual market access programme with Mainland exchanges. It broadens the Connect product ecosystem and opens up opportunities for investors. In addition, it helps support Mainland Chinese investors' diversification to offshore assets and strengthens our position as the global base for China-bound investments.

The expansion of Stock Connect to include ETFs also provides issuers with an additional channel to access Mainland Chinese investors, thus encouraging more active ETF issuance and trading in Hong Kong. This, in turn, will further expand HKEX's ETF product diversity and enhance liquidity.

What are the benefits of the inclusion for Hong Kong and international investors?

Investors are now able to access new pools of established liquidity across the border, and capture new investment opportunities that are uniquely available in the Mainland China market.

Why were ETFs included in 2022?

The inclusion of ETFs in Stock Connect followed a strong year for ETFs in Hong Kong and:

- Growing investor demand for A-share products;
- Increasing diversification needs among Mainland Chinese investors;
- Continuing RMB internationalisation; and
- Increasing use of ETFs as an investment tool by investors

We expect these factors to drive wider adoption of China-focused ETFs and broaden the investor base.

Growth of ESG ETFs

Since 2020, HKEX has welcomed 11 new ESG ETFs and 20 counters, representing more than 7% of the overall number of ETFs listed in Hong Kong. Did this product innovation receive the support from ETF liquidity providers?

Hong Kong currently has more than 30 securities market makers and designated specialists providing ETF liquidity on-exchange. ESG ETFs listed in Hong Kong have an average of 2.7 market makers by listing (or counter) and there are currently 9 ETF market makers covering at least one ESG ETF counter listed on HKEX. This comprehensive pool of ETF market makers contributes to the further development of the ESG ETF liquidity ecosystem in Hong Kong, facilitating the adoption of ESG ETFs among investors.

Market Maker	Number of ESG ETF counters covered
Flow Traders Hong Kong Limited	13
China Merchants Securities (HK) Co., Limited	9
Jane Street Asia Trading Limited	7
Optiver Trading Hong Kong Limited	7
BNP Paribas Securities (Asia) Limited	6
Mirae Asset Securities Co., Ltd	5
Vivienne Court Trading Pty. Ltd.	4
CLSA Limited	2
HSBC Securities Brokers (Asia) Limited	1

Hong Kong Exchanges and Clearing Limited

8/F, Two Exchange Square,
8 Connaught Place,
Central, Hong Kong

hkexgroup.com | **hkex.com.hk**

info@hkex.com.hk
T +852 2522 1122
F +852 2295 3106