ALPHA CENTAURI

ESG, Factor Exposures and ETF´s

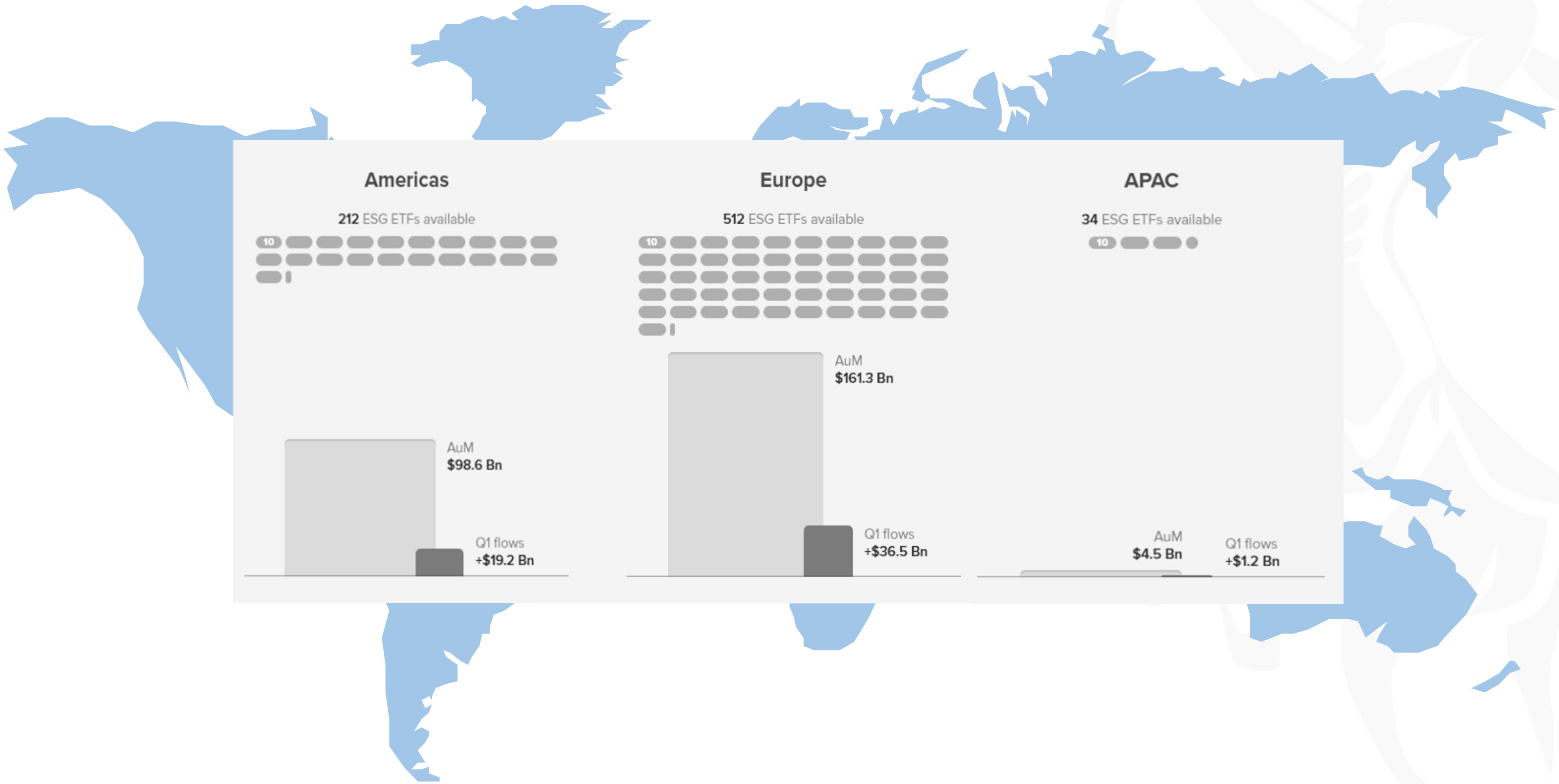
A closer look at the intersection of ESG/Low Carbon- and Factor investing

Brighttalk ETF Summit
June, 1st 2021

Introduction

ESG ETF´s – the global state of play

758 ESG ETF´s / 264,4 bln AUM / 56,9 bln inflows in Q1 2021*

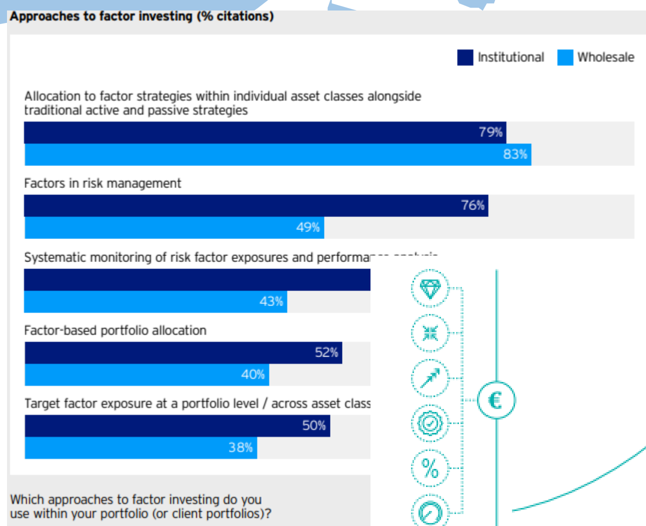


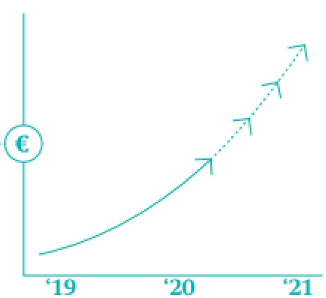
* Source: trackinsight.com

Introduction

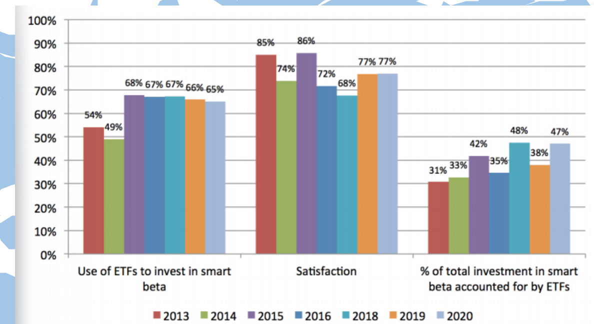
Factor investing and ETF´s – the global state of play

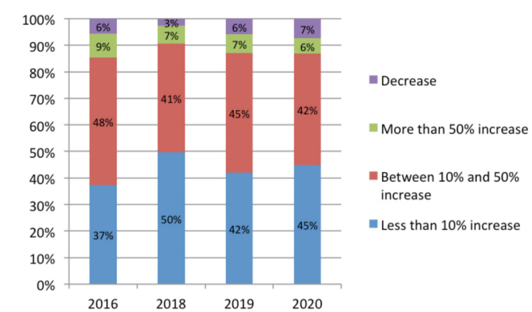
Significant growth prospects for smart beta and factor investing strategies





Investors continued to increase factor allocations in the 12 months leading up to the study, and intend to continue doing so, despite a challenging period and divergence in factor performance.





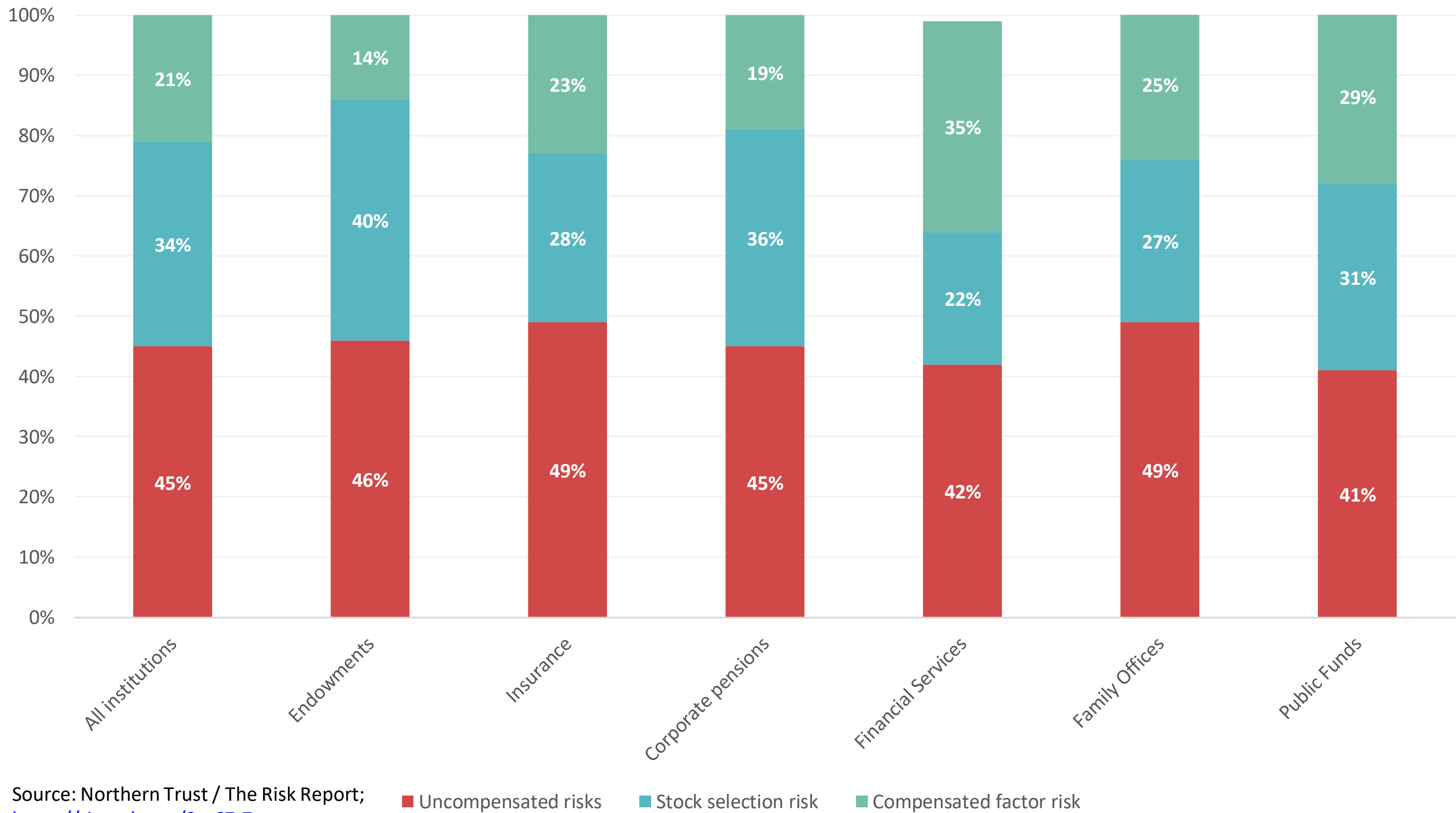
Sources:

- Invesco: Global Factor Investing Study, 2020
- EDHEC: ETF, Smart Beta and Factor Investing Survey, 2020

Introduction

ESG and factor investing as satellites: danger of “optimized island solutions”

Nearly 50% of active risks in institutional portfolios are „uncompensated“



Source: Northern Trust / The Risk Report; https://tinyurl.com/3sy67t7a

Brighttalk ETF Summit

ESG, Factor Exposures and ETF´s

Major themes	
Different approaches to ESG- and Low Carbon investments	… and their drivers of risk and return with a focus on well-known factor exposures
Data challenges in ESG	… and the risks of quantitative ESG strategies of index providers delivered via ETF´s
Passive strategies with a low tracking error to traditional benchmarks	… and the question, if they can add economic value beyond "doing good"
Factor Investing in combination with carbon footprint reduction	… and the question if this combination can deliver a better risk-/return trade-off than passive approaches via ETF or active Long Only-strategies

ALPHA CENTAURI

About us

Who we are

Alpha Centauri works for and with leading players in financial services

Explore our world class network

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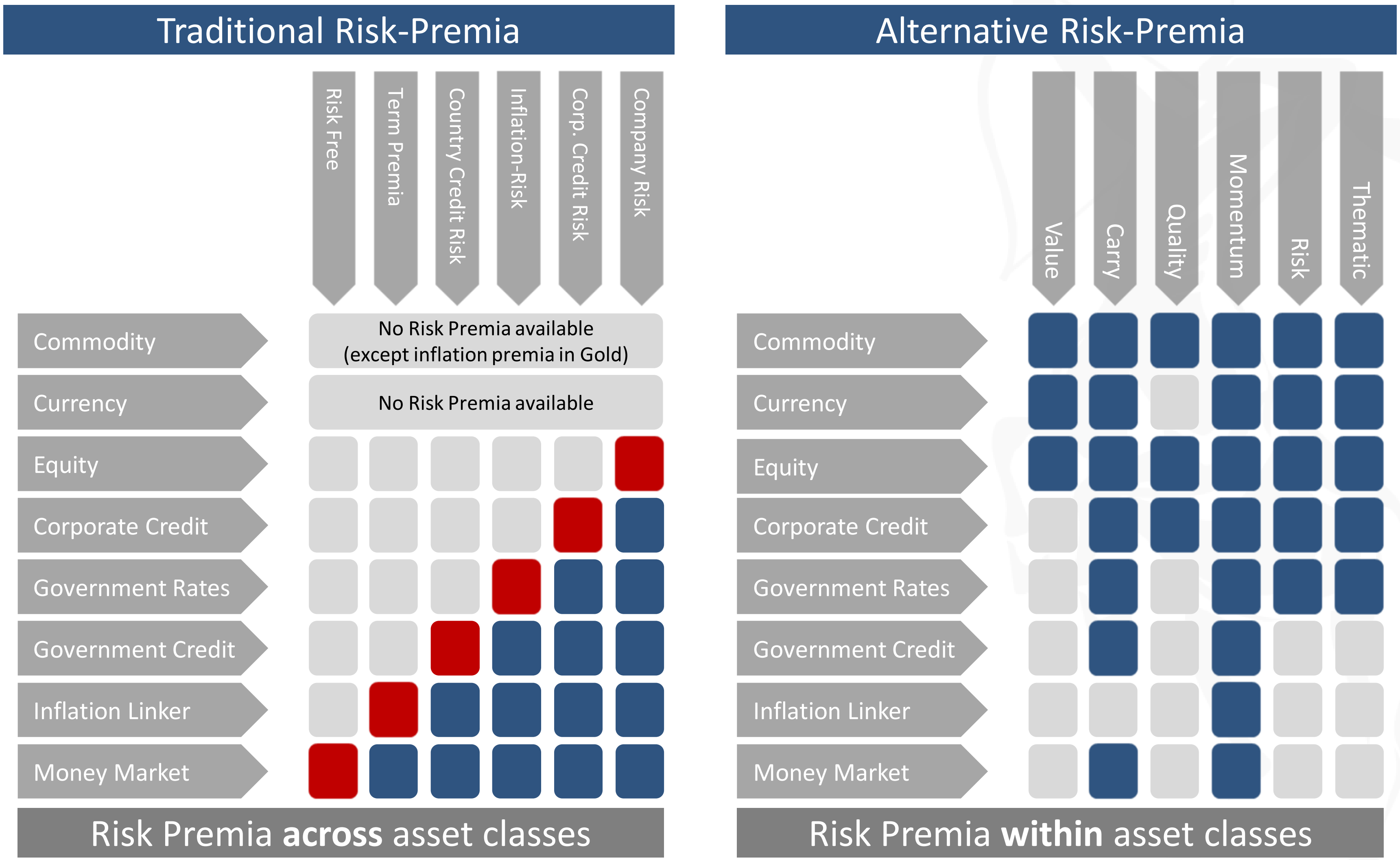
Our approach

Our approach

Our whole work is deeply-rooted in a risk-factor framework



Our approach

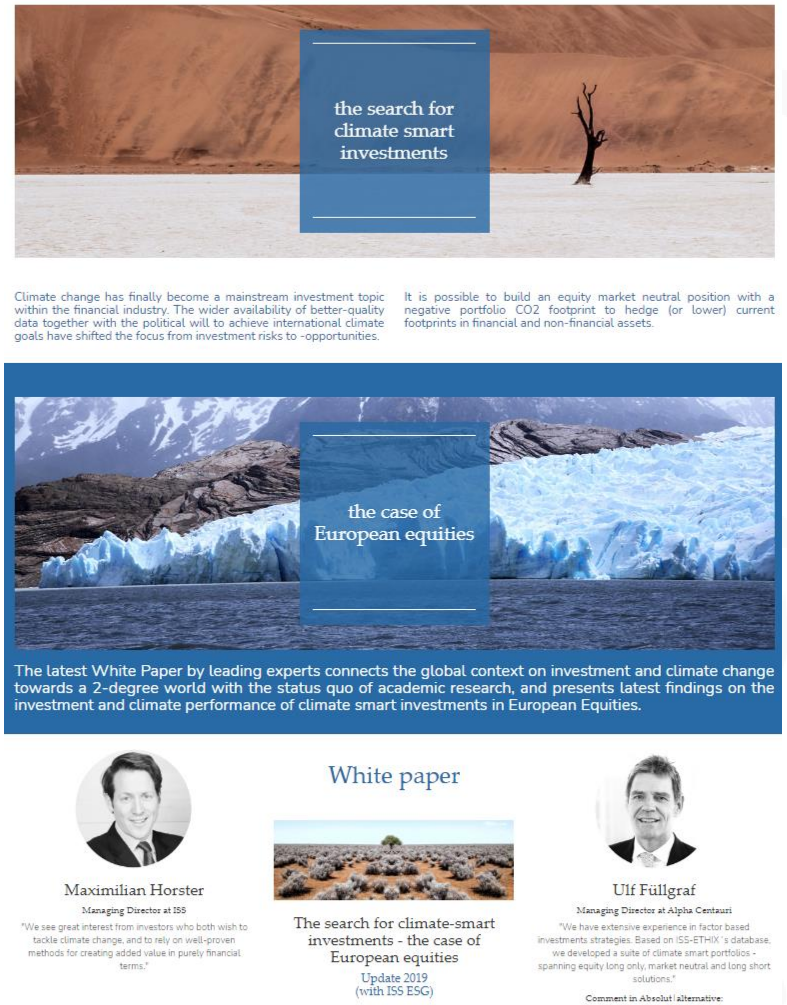
First steps in ESG: Whitepaper Alpha Centauri/ISS ESG/Prof. Bassen, Uni HH

Research - Whitepaper

"Comprehensive carbon data can help generate financial outperformance and investing in line with a 2-degree scenario is a clear opportunity for value creation - helping to differentiate active managers from passive competitors.

*These are the findings of the recently published paper by South Pole Group, global sustainability solutions provider, and **Alpha Centauri**, the Hamburg-based boutique asset manager, who today announce their partnership."*
(SPG press release / RESPONSIBLE INVESTOR)

More information on our website



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Different approaches to ESG- and Low Carbon investments

… and their drivers of risk and return with a focus on well-known factor exposures

Different Approaches

Institutional investors pursue six major ESG - strategies according to CERULLI*

Approaches differ – **from outputs to outcomes**		
Method	**Value Proposition**	**Available ETF´s****
Negative Screening	Value Alignment	76
ESG Integration	Value Enhancement	272
Positive Screening	Value Enhancement	156
Thematic Investment	Value Enhancement + ESG Impact	134
Impact Investment	Value Enhancement + ESG Impact	
Active Ownership	Value Alignment + Value Enhancement + ESG Impact	none

*CERULLI Associates: "Environmental, Social, and Governance (ESG) Investing in the United States" https://info.cerulli.com/US-ESG-2019.html
** Trackinsight.com; CONSER

Different Approaches

Two sides of the ESG-medal: principles and economic materiality

Principles, values & beliefs	Materiality
Exclusions/negative screening	**“Cash Flow”- channel**
• Nuclear Energy	• Sales
• Controversial weapons	• Cash Flows
• Human and working rights	• Earnings
• Alcohol and tobacco	• Dividends/Buybacks
• Biogenetics	**“Discount factor” (cost of capital)-channel**
• Gambling	• Interest rate
• Fossil Energy (Coal/Oil/Gas etc.)	• Risk premia / Beta

Different Approaches

Factors can be a reasonable basis for materiality

Economic materiality of factors is well documented

Factor	Description
Value	In the long run, stocks that appear cheap according to accepted metrics tend to outperform. Empiricism cites distress risk, overreaction, forced selling and index migration *(Graham/Dodd; 1934; Fama/French 1992;1997; Basu; 1977)*
Carry	Stocks from companies that deliver sustainable growth, underpinned by low analyst earnings dispersion and distributed via dividends and share buybacks tend to deliver excess returns in the long run. Empirical papers cite carry, low earnings dispersion and underreaction to good news *(Harvey, 2000; Liodakis, 2003; Gwilym,2008; Moskowitz, 2013)*
Quality	In the long run, stocks from companies that exhibit higher balance sheet, income and cash flow statement quality tend to outperform. Empiricism cites expensiveness of junk stocks, lottery tickets and beta constraints *(Altmann, 1968; Ohlson, 1980; Piotroski, 2000; Asness 2013)*
Size	Stocks with lower market capitalization tend to outperform large caps over time. Empirical literature cites higher default and liquidity risk as well as index migration *(Banz, 1980; Fama/French, 1993; Barry, 2002; Guidolin, 2005; Asness 2015)*
Momentum	In the long run, stocks with higher price momentum deliver higher returns. Researchers from various fields found reversal risk, over- and under-reaction as an explanation *(Jegadeesh/Titman, 1993; Chan/Jegadeesh/Lakonishok,1996; Carhardt, 1997)*
Low Risk	Stocks with lower stock price volatility tend to outperform in the long run. Empiricism cites expensiveness of junk stocks, lottery tickets, over-confidence, shorting/leverage/beta constraints and fund flows as possible explanations *(Haugen/Baker, 1991; Blitz/van Vliet, 2007; Haugen/Baker, 2008; Cowan/Wilderman, 2011)*
Low Carbon	Stocks with lower carbon exposure outperform due to higher growth opportunities *(Wesentlichkeit von CO_2-Emissionen für Investitionsentscheidungen Prof. Dr. Alexander Bassen/Prof. Dr. Timo Busch/Stefan Lewandowski / Franziska Sump, 2016); In search for climate smart investments – the case of European equities (Alpha Centauri, ISS ESG, Prof. Bassen, Uni Hamburg; Decarbonization Factors, Harvard University 2019*

Different Approaches

Some papers validate the existence of factors in ESG and Low Carbon

Papers

Findings	
Bassen et all (2015)	Growth
Alpha Centauri/ISS (2017)	Historical: Low Risk Forward: Momentum
Ang et all (2020)	Quality and Momentum
MSCI (2021)	Quality and Growth
Scientific Beta (2021)	Quality

Data challenges in ESG

… and the risks of quantitative ESG strategies of index providers delivered via ETF´s

Data challenges in ESG

Disagreement in ESG data and ratings across providers

MIT /2019	Scientific Beta/2020

IDEAS MADE TO MATTER | SUSTAINABILITY

Why ESG ratings vary so widely (and what you can do about it)

by Tracy Mayor | Aug 26, 2019

Why It Matters

It's hard to assess corporate social responsibility when ratings diverge so dramatically. Research suggests ways to work around the 'aggregate confusion.'

Share

Environmental. Social. Governance. In recent years, ESG, also known as sustainability or corporate social responsibility, has moved from the feel-good fringes to the center of business decision-making.

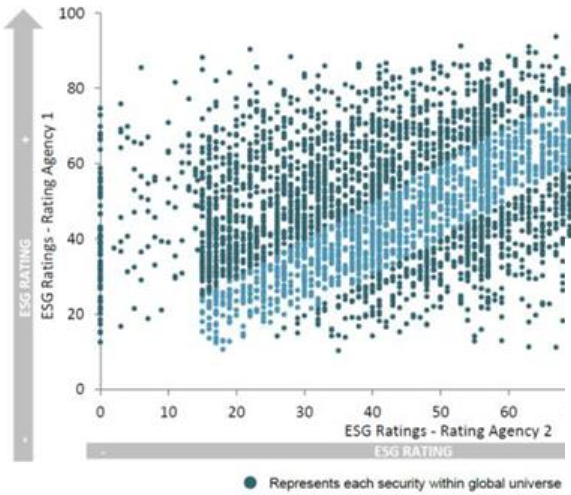
Consumers want to purchase products from companies that reflect their values — environmental protection, the empowerment of women, or the absence of child labor, for example. Investors, meanwhile, want to know if they are financing activities that might pose a reputational risk.

Their message is getting through — by one estimate, some 80% of CEOs believe demonstrating a commitment to society is important and look to sustainability ratings for guidance and benchmarking. An estimated $30 trillion of assets are invested worldwide that rely in some way on ESG information, a figure that has grown 34% since 2016.

Data challenges in ESG
Disagreement in ESG data across providers

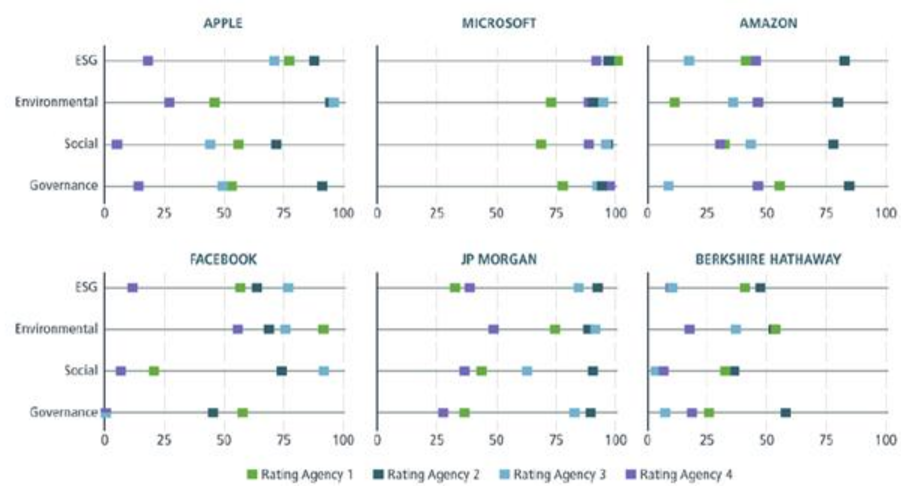
Correlation of ESG data/ratings lower than 0,3 compared to 0,99 in credit ratings

EXHIBIT 1: DIVERGENCE OF TWO ESG DATA RATING AGENCIES ACROSS GLOBAL UNIVERSE OF SECURITIES



Source: Refinitiv and MSCI and QS Investors Research. Rating Agency 1 represents MSCI E
Thomson Reuters ESG ratings. Universe: MSCI World. Data as of December 31, 2018.

EXHIBIT 3: DIVERGENCE IN ESG RATINGS ACROSS LARGE, GLOBAL COMPANIES



Source: MSCI, Sustainalytics, Robeco and Refinitiv. Ratings as of February 2019. Rating Agency 1 represents MSCI ESG ratings; Rating Agency 2 represents Thomson Reuters ESG ratings; Rating Agency 3 represents Sustainalytics ESG ratings; Rating Agency 4 represents Robeco ESG ratings.

Passive strategies with a low tracking-error to traditional benchmarks

… and the question, if they can add economic value beyond "doing good"

Passive strategies

Passive means low tracking error to benchmark not ETF to underlying index

Investors shouldn´t expect outperformance - even in an adverse scenario

Passive strategies

Passive exposures target the left side, everything else needs active risk-taking

Principles, values & beliefs	Economic materiality
Exclusions/negative screening	**“Cash Flow”- channel**
• Nuclear Energy	• Sales
• Controversial weapons	• Cash Flows
• Human and working rights	• Earnings
• Alcohol and tobacco	• Dividends
• Biogenetics	**“Discount factor” (cost of capital)-channel**
• Gambling	• Interest rate
• Fossil Energy (Coal/Oil/Gas etc.)	• Risk premia / beta

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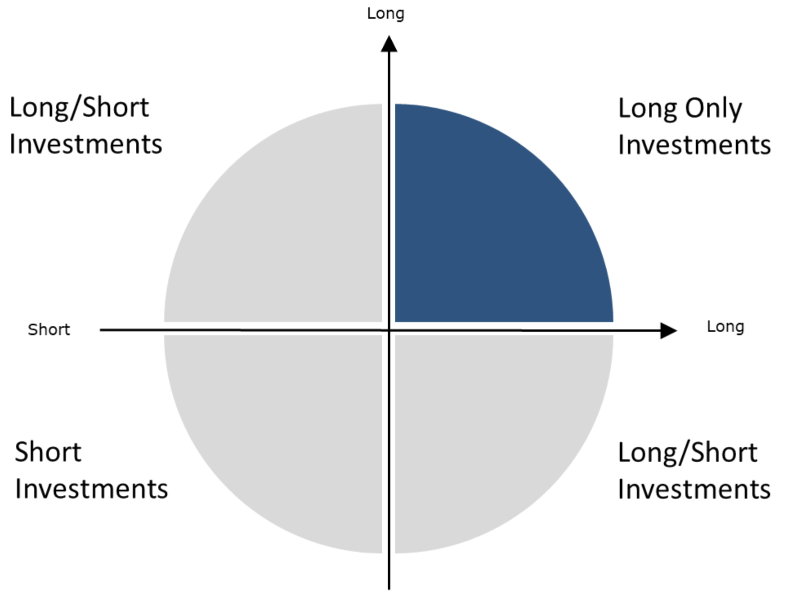
Factor Investing in combination with carbon footprint reduction

… and the question if this combination can deliver a better risk-/return trade-off than passive approaches via ETF or active Long Only-strategies

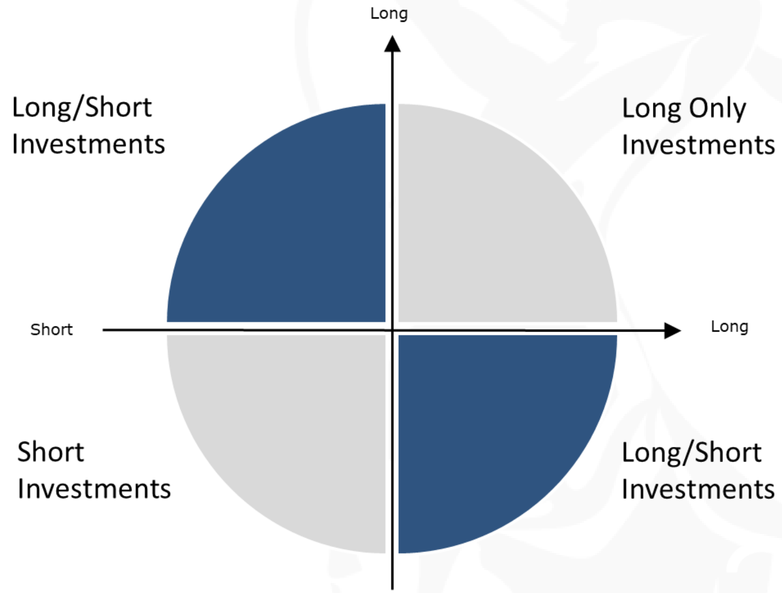
The case for Long/Short

Long/Short - higher returns, lower level of „unintended risks“

Wasted return opportunites (grey)



Better opportunity set

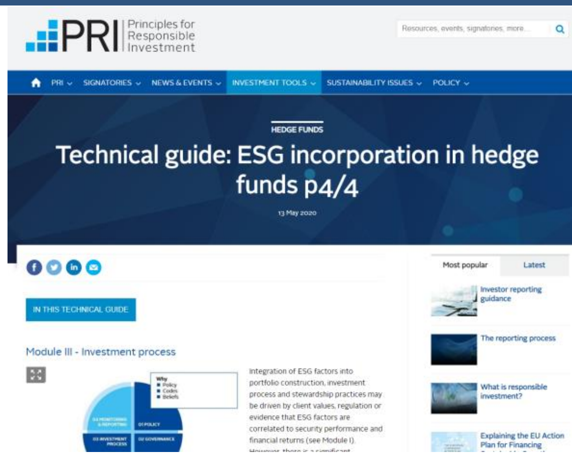


- Long Only active
  - „Wasted opportunities“ in Long Only investments
  - „Unintended bets“ because of weights-based allocation instead of risk-based portfolio construction
- Long/Short
  - Higher return potential, better risk control
  - Higher transfer coefficient for active positions

The case for Long/Short

UN-PRI and AIMA: Short Selling excellent way to implement ESG

UN-PRI Technical Guide



Quotation

…."There are a range of questions around the relationship between ESG and short selling. Short selling is one way for a hedge fund manager to express the view that an entity is not adequately incorporating ESG factors."….

AIMA Whitepaper

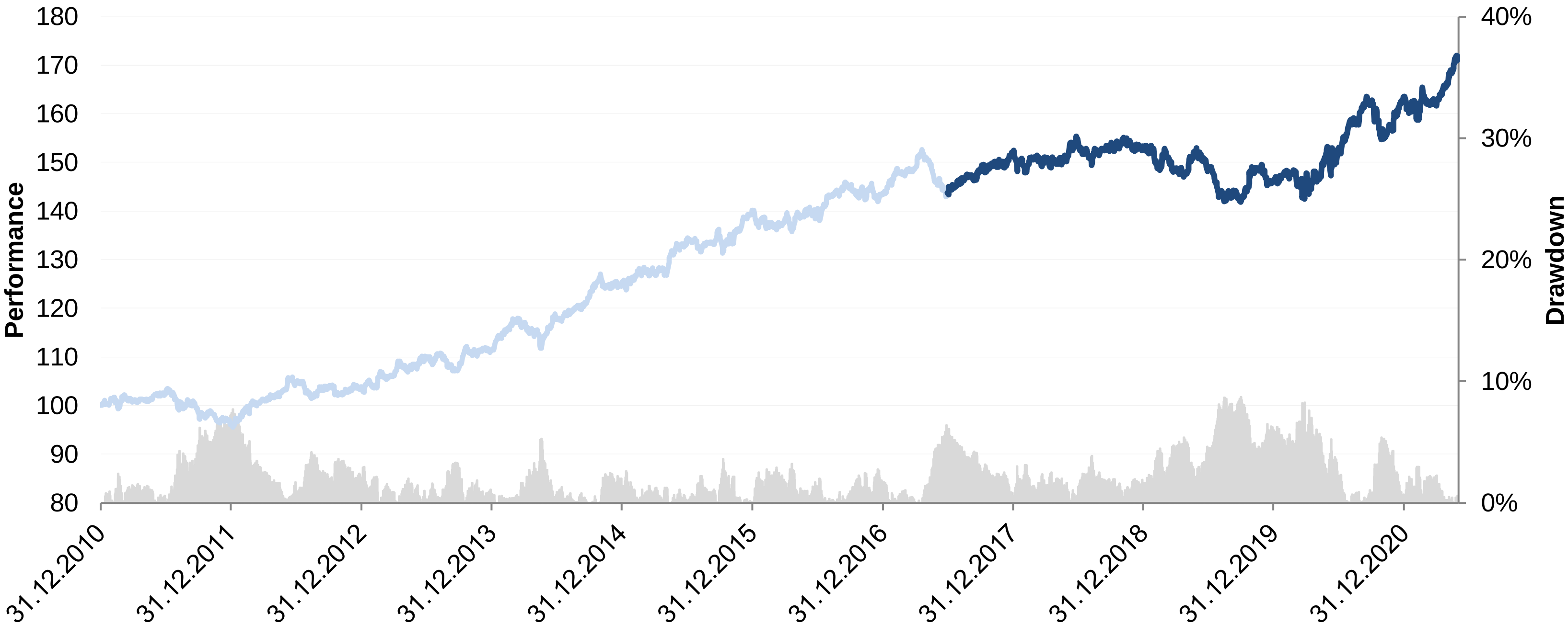
Quotation

…."Short selling can be an excellent tool for achieving two common goals of contemporary responsible investment: mitigating undesired ESG risks, and, when taken in aggregate, creating an economic impact by influencing the nature of capital flows through 'active' investing."…..

AC Climate Smart Long Short

Combination of equity factors + low carbon factor

Focus on Excess Return and CO_2 footprint reduction



	2021	2020	2019	2018	2017	2016
Performance	4,96%	11,87%	-4,30%	0,51%	5,83%	2,5%
Volatility	4,81%	8,43%				

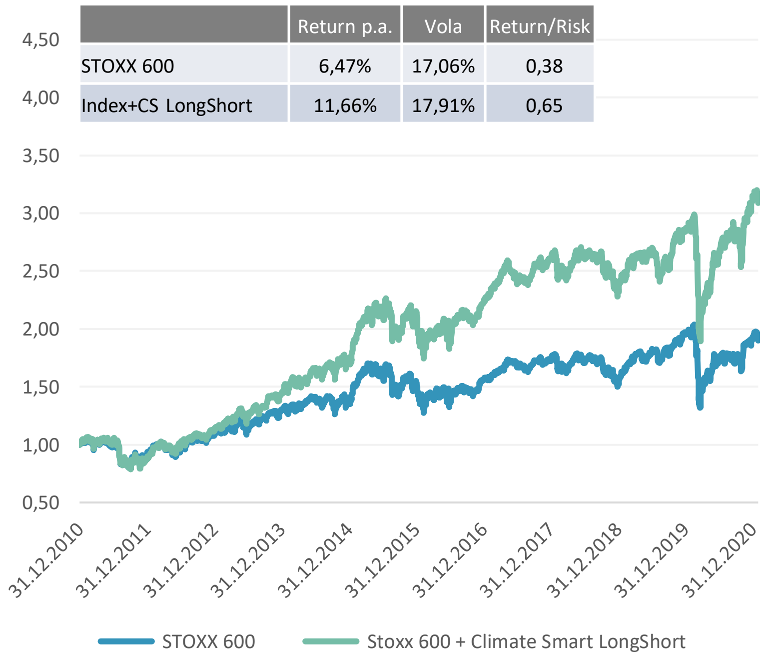
*** Past performance is no guarantee of future returns.** *Fees, commissions and other costs may have a negative impact on performance. Returns may increase or decrease due to currency fluctuations. The performance is the percentage change between the value of assets at the beginning and at the end of the investment period. Source: Alpha Centauri Investment Management GmbH. Simulation includes transaction costs but excludes management fees; out of sample performance starting 01.01.2015 time period under consideration: 01.01.2011 –31.05..2021*

Portable Beta

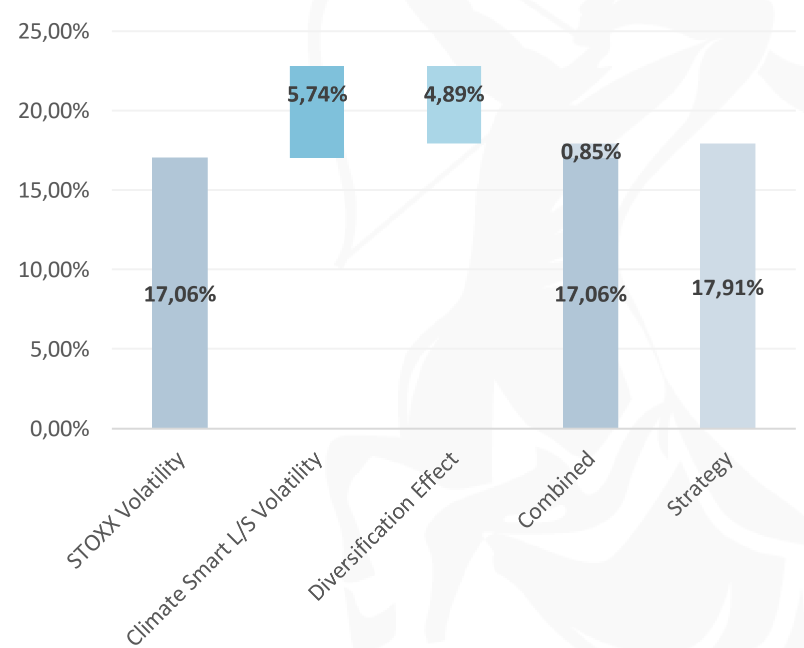
Long/Short can be „ported“ on any benchmark

STOXX 600 Europe

	Return p.a.	Vola	Return/Risk
STOXX 600	6,47%	17,06%	0,38
Index+CS LongShort	11,66%	17,91%	0,65



Volatility

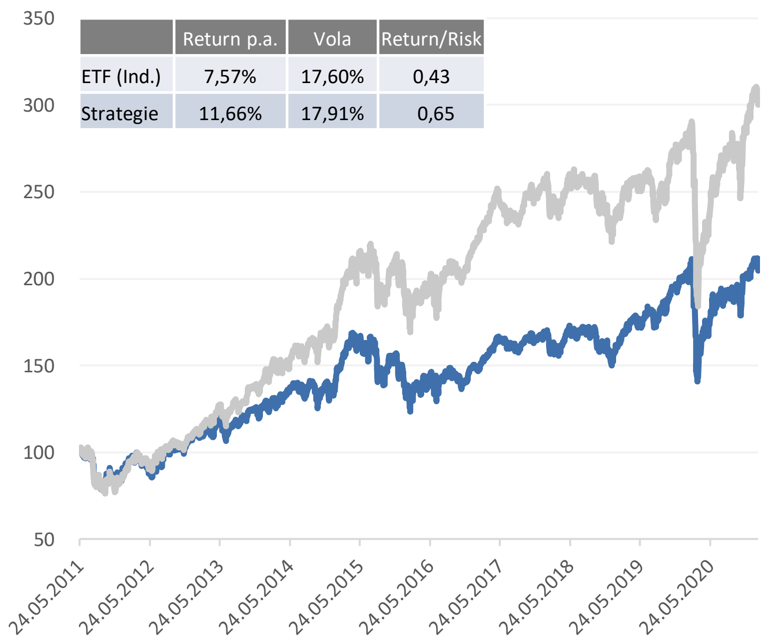


- Combination of Long Only (Benchmark) and Long/Short in one product
- Substantial improvement in return without a material impact on risk

Portable Beta

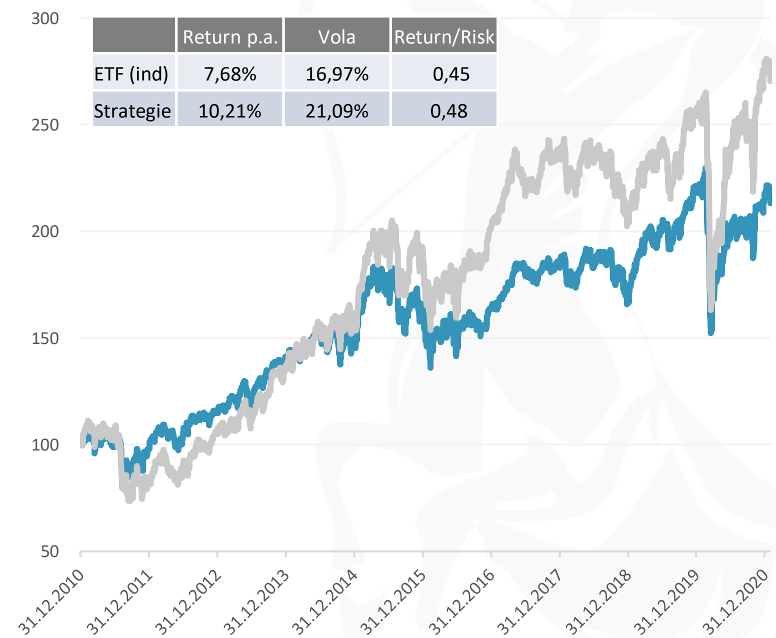
Comparison to ESG ETF´s – higher Sharpe ratio, **negative CO_2 footprint**

Europe



	Return p.a.	Vola	Return/Risk
ETF (Ind.)	7,57%	17,60%	0,43
Strategie	11,66%	17,91%	0,65

Eurozone



	Return p.a.	Vola	Return/Risk
ETF (ind)	7,68%	16,97%	0,45
Strategie	10,21%	21,09%	0,48

- „Porting“ of Long/Short- factor betas on a Long Only benchmark or existing equity portfolio more efficient than conventional active Long Only
- **Higher return expectation, better Sharpe Ratio and higher carbon efficiency**

*Sources: Provider data, ISS ESG data, Alpha Centauri calculations

ESG, Factor Exposures and ETF´s

Summary

Key takeaways / Our views	
Different approaches to ESG- and Low Carbon investments	• … are easy to implement in the light of more than 700 ESG ETF´s • … need a holistic view on portfolio risk with respect to the findings of Northern Trust
Data challenges in ESG	• … are a major problem in ESG • … will persist even with a more unified taxonomy (backfilling & overwriting)
Passive strategies with a low tracking error to traditional benchmarks	• … add no economic value (in terms of outperformance) beyond “doing good” in our point of view
Factor Investing in combination with carbon footprint reduction	• … can deliver a better risk-/return trade-off than passive approaches via ETF or active Long Only-strategies

Thank you for your attention

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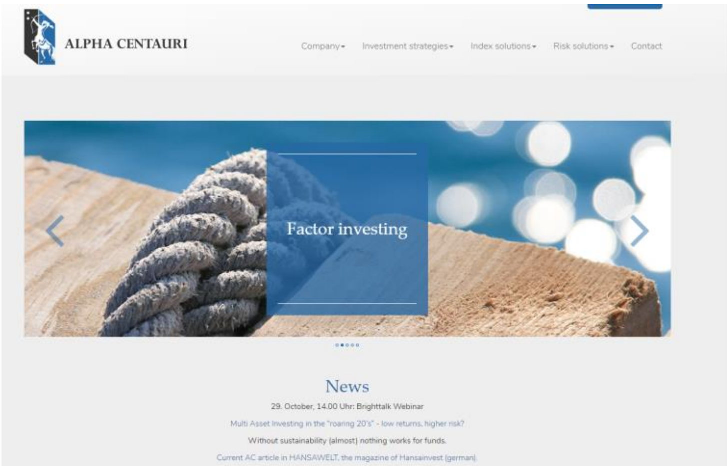
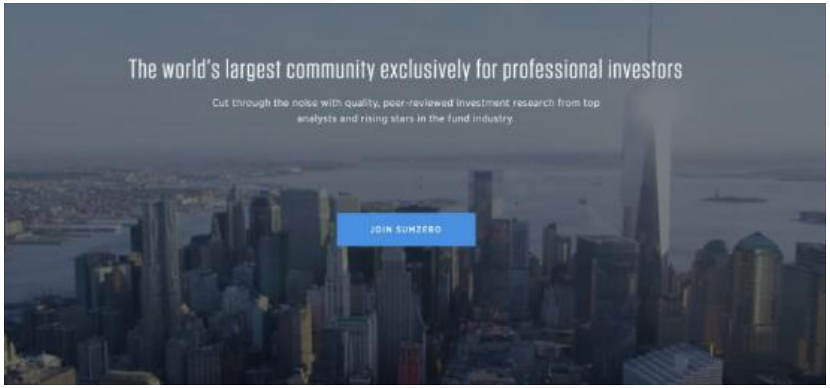
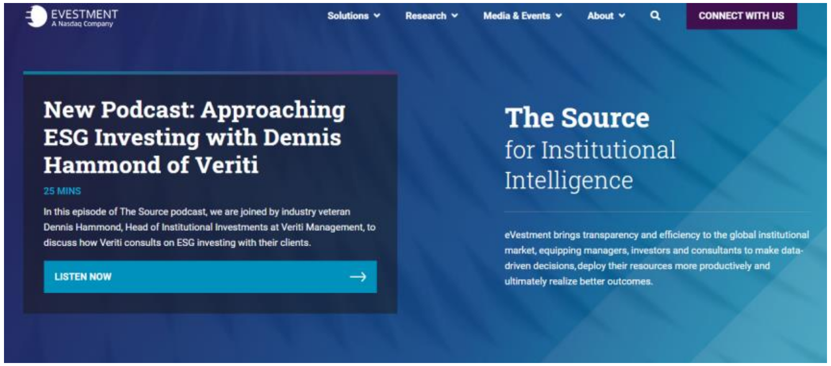


SumZero



eVestment



Contact

ALPHA CENTAURI

Alpha Centauri Investment Management GmbH
Willy-Brandt-Straße 23 • 20457 Hamburg
+49 (40) 89 72 73-0 • info@alpha-centauri.com

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