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## DerivSource Podcast Transcript

**Environmental, Social and Governance (ESG): Spotlight on ESG Asset Management**

Julia Schieffer: Hello and welcome to this DerivSource podcast. I'm Julia Schieffer, the founder and editor of derivsource.com. Welcome to the third episode in our four-part ESG podcast series. We're looking at the rise of environmental, social and governance investing. ESG is obviously a big trend in both wealth and asset management.

ESG Derivatives provide a very exciting opportunity to mainstream sustainable investing and it also provides the ability to hedge and speculate using sustainable investing instruments. In this episode, I'm speaking with James Purcell of UBS and we're talking about the potential for growth in ESG derivatives and ESG-related fixed income investing. We also talk a little bit about some of the challenges associated with this growth. James, welcome to the podcast.

James Purcell: Thank you very much.

**Julia Schieffer: So James, can you tell us a little bit about yourself to begin with?**

James Purcell: So originally, I am from England, but I've left the country in 2012 to live in both Hong Kong and Switzerland. In my current role at UBS global wealth management, I head the sustainable and impact investing teams.

**Julia Schieffer: So starting with the very beginning, what is the impact of having an ESG derivative?**

James Purcell: ESG derivatives have a huge potential for the mainstreaming of sustainable investing. The ability to hedge and also to speculate while using fully compliant sustainable investing instruments can really help us mainstream and accelerate the growth of this very important sector.

**Julia Schieffer: And can you tell me a little bit about how it differs from other asset classes?**

James Purcell: ESG derivatives in themselves don't differ from other asset classes. What they actually provide is an extension to the toolkit that you would normally find in bonds or equities. So the ability to be able to hedge our exposure by using ESG derivatives will also allow us to actually take either larger positions or scale into positions quicker as we are acting as investors.

**Julia Schieffer: And can you tell me a little bit about how you see these being used?**

James Purcell: The application of ESG derivatives will differ depending upon the client. So in a wealth management context, we may well see ESG derivatives being predominantly used to gain access to asset classes that previously haven't been able to be accessed by private wealth clients. However, if we look at the asset management industry, their ESG derivatives are more likely to be employed as a hedging tool and also as a tool to gain synthetic exposure in a way that's quicker than what our conventional approach to investing would be.

**Julia Schieffer: And obviously ESG is a big trend in both wealth management and asset management. Is this something that you're seeing amongst your clients in terms of increasing demand?**

James Purcell: The broad demand for ESG is clearly there and it's due to a number of factors. The first of course is demographics. As money gets transferred to younger generations who generally have more socially conscious attitudes, we see a corresponding leap in the interest for ESG related products. However, when it comes to ESG derivatives, the actual picture is slightly more clouded. It's also the sophistication of investors and the maturing understanding of these products that will drive adoption.

**Julia Schieffer: And looking at ESG specifically, do you see other exchanges launching them in the future?**

James Purcell: So Eurex has clearly led the way when it's come to equity ESG derivatives, but there's a whole market out there that is untapped in the fixed income world. Now fixed income ESG derivatives are more complex than equity due to the lower underlying liquidity. But there is great potential for exchanges who want to be proactive in spaces like development bank debt. So for example, the debt issued by multilateral organizations such as the World Bank. Here you have extremely liquid underlying markets, they'll be large as well. Now these may well be quite well suited for ESG derivatives in the future.

**Julia Schieffer: So, a question that always comes up of course is both the benefits and some of the challenges inherent in investing in these products. I know for instance, traditionally ESG has been more expensive. Sticking with the benefits first, what are some of the advantages that you associate with ESG?**

James Purcell: So the core benefit is probably to enable a portfolio that in Delta one cash assets that is already sustainable to be able to express itself through derivatives as well. So at the minute, if you would have a portfolio of stocks and bonds, all of which meet your ESG criteria, you would have to take a position in a derivative that you, yourself would not be comfortable with as it stands today. However the development of ESG derivatives gives you an opportunity to continue to invest alongside your values and preferences, without having to compromise that stance when moving from cash assets into derivative markets.

**Julia Schieffer: And any challenges that come up frequently?**

James Purcell: There are several challenges and I think they vary dependent upon different asset classes. The obvious challenge in the fixed income market comes down to issues around liquidity and how to deliver bonds in the cheapest to deliver framework. More broadly, when we look at more exotic forms of derivatives, for example, derivatives that tie interest rate or loan costs to ESG performance, we have a huge range of questions that emerge, particularly around measurement and tracking of the underlying data that will in turn determine the cost of the loan and of course have a very significant impact in terms of real money flows.

**Julia Schieffer: So we've talked about the increasing interest in the ESG trend. In your view, what is the growth potential?**

James Purcell: So the growth potential of ESG derivatives in equities is pretty much linked one-to-one to the growth of ESG equity assets in general. There are no significant barriers as to why ESG derivatives for equities can't become increasingly popular and grow at the same pace as ESG assets overall.

However, when we step outside of this vanilla application of ESG derivatives and we look at more exotic approaches, for example, if you were to tie certain sustainability characteristics such as carbon output to the cost of a loan, there you really begin to see how technology can make a big difference to how fast ESG derivatives grow. So if you have a world where you can accurately measure some of these environmental and sustainability factors in real time, such as through the Internet of Things, you have a world where you can effectively price loans according to the sustainability characteristics in real time. And that's what's going to trigger large growth in the more exotic elements of ESG derivatives.

**Julia Schieffer: And looking to the future, how do you see the trend for ESG or sustainable investing evolving?**

James Purcell : So from here, the trend for sustainable investing is one where it's very hard to see it become anything other than increasingly popular, and increasingly mainstream. It is driven by social factors, demographic factors, and shifts in the economy at large. These are large structural drivers that should not be influenced by any short-term market movements.

That said, one of the things we have to be extremely cognizant of when we look at the growth of ESG is exactly what are the definitions and what are the standards that we're applying. There is an increasing risk that as it becomes a very commercially attractive proposition, we see what we in the industry would refer to as greenwashing, and people use some substandard data or methodology approaches to try and claim that they are operating within the realms of sustainability, when in fact they probably are not. So the growth is going to be very strong, but the quality of the growth is a lot more uncertain.

**Julia Schieffer: And to your point previously about technology, technology will hopefully aid in kind of reducing the lack of quality and some of these growth areas in the future.**

James Purcell: That's absolutely right. If we take a look at say corporate disclosure, about 85% of firms in the S&P 500 report with a sustainability dedicated report these days. That's up from about 20% back in 2011. However, within that, the disparity of what's reported is ginormous. You really are comparing apples and oranges when you look at the data that two companies will produce. As technology becomes a greater and greater role within ESG, we rely less upon self-disclosures, less upon what companies say, and of course can measure what they're doing often in real time.

**Julia Schieffer: And it gives legitimacy to this trend as well.**

James Purcell: I think legitimacy comes from independent verification and that can come from a number of sources. One of course is being able to collect data independently of the surveys and the second I would attribute to a constructive regulatory environment that encourages these trends and accelerates them without being overly prescriptive.

**Julia Schieffer: Great. Well, thank you for sharing your insight with us in this podcast. I know this information has been very useful to our audience. Thank you again.**

James Purcell: Thank you very much.

**Julia Schieffer: Thank you for listening to this derivsource podcast. We hope you found it informative and useful. You can find related resources on our show notes page on derivsource.com and please consider subscribing on iTunes. Join us soon for our next episode in this ESG series. Thank you for listening. Join us next time.**