Cornerstones for Growth

A *Future of Finance* Report from SIX

An Insight into Buy-Side Institutions around the Globe Regarding Digital Assets and ESG Investing

June 2023

Jos Dijsselhof
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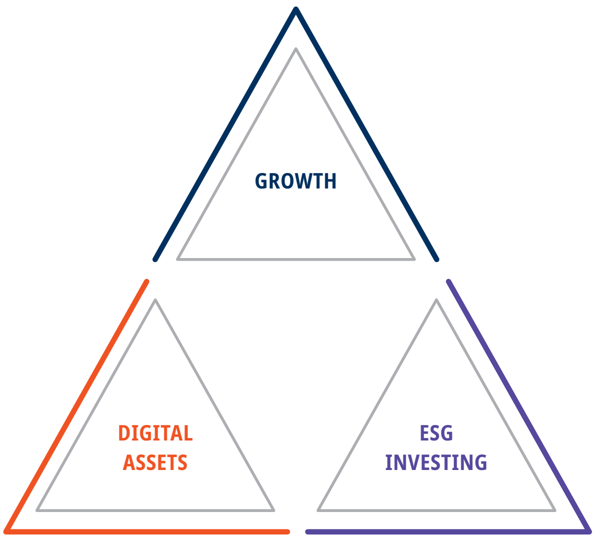
Foreword

The investment management space is unique in its power to enact sharp and significant change through the collective allocation of capital. It is in a perpetual state of evolution, constantly adapting to new investing methodologies, emerging investment trends, and technological innovation. Digital assets have significantly permeated the agendas of financial institutions, while the conversation surrounding ESG investing roars louder than ever.

Digital assets have reached a pivotal point in their journey towards mainstream, widespread institutional adoption. Market participants are seeking partnerships with providers who can manage risk and utilize blockchain technology in a way that promotes greater confidence. Meanwhile, although the integration of ESG considerations into investment strategies is nothing new, the pace and scale at which this is now happening across the global investment space is unprecedented.

The findings of this research indicate investment managers recognize the significant growth potential presented by both areas, and – critically – possess strong expectations for heightened industry uptake over the coming months. Yet, at this critical juncture in their development and adoption, the buy-side must be able to rely fully on the expertise of trusted partners. Without this, realizing their growing ambitions and remaining competitive in the rapidly evolving global investment landscape seems a near insurmountable challenge.

Jos Dijsselhof
CEO SIX



EXECUTIVE SUMMARY

Cornerstones for Growth is the latest report in the *Future of Finance* series from SIX. Looking specifically at buy-side market participants, it gauges the growth drivers and challenges surrounding mass institutional adoption of two developing and topical areas: digital assets and ESG investing.

Digital assets and ESG investing are topics practically unavoidable in current investment discourse, frequently making headlines across leading financial publications globally. This report aims to explore the current attitudes of the buy-side to these two very different, but similarly significant areas of the market, and examine how they will affect the investment decision-making. This report will help to spark further dialogue among market participants, regulators, data providers, and market infrastructure players.

There are some notable similarities around the drivers and challenges in both areas. However, there are also important differences, reflective of how advanced each market has become. According to the survey participants, the digital assets sector is experiencing rapid evolution and holds immense potential. However, they emphasized the need for effective and secure market infrastructure to boost confidence and accelerate its growth. ESG investing is more established among buy-side institutions, with the focus now on high-quality data and the mechanisms needed to report accurately and compliantly in a changing regulatory landscape.

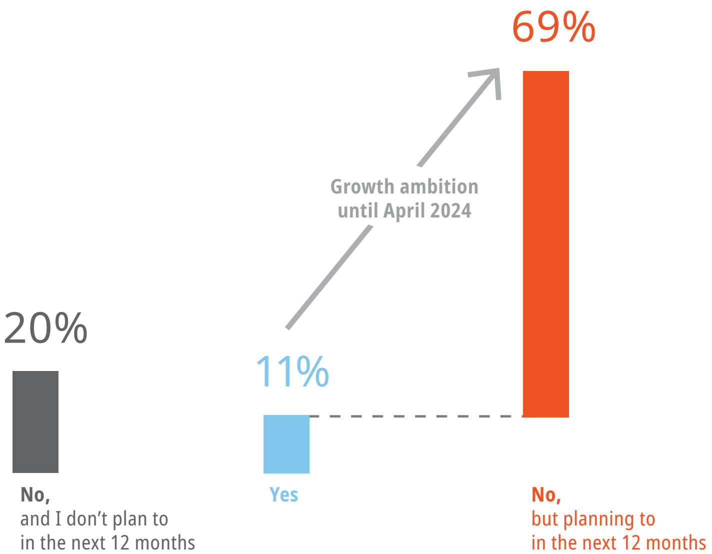
Survey Framework

For the global *Cornerstones for Growth* study, part of the *Future of Finance* series, Censuswide on behalf of SIX surveyed portfolio managers, asset allocators, and hedge fund managers across 300 international financial institutions covering asset management, wealth management, and hedge funds in the UK, the US, Hong Kong, Singapore, Germany, Spain, and Switzerland. The survey was carried out between April 10 and 24, 2023 and was comprised of a total of ten questions across two key topics: digital assets and ESG investing.

Demand for Digital: All About Confidence as Appetite for Digital Assets Grows

Global investors are growing increasingly hungry for digital assets, but generating greater confidence will be vital to accelerating their adoption. From higher levels of liquidity on regulated exchanges to reduced counterparty risk, portfolio managers reveal the developments they need to see in the digital assets arena over the coming months to unlock its true potential.

1. DO YOU CURRENTLY HOLD ANY DIGITAL TOKENS* IN YOUR PORTFOLIO(S)?



* Utility tokens and asset-backed tokens but not digital currencies (cryptocurrencies, CBDCs, and stablecoins)

It appears that digital tokens[1] are at an inflection point in terms of adoption by international buy-side companies. Nearly seven in ten (69%) buy-side companies that took part in the survey have plans to include digital tokens in their portfolios over the next 12 months (see graphic 1). This figure rises to a substantial 83% of buy-side companies in Asia.

At present, 11% of respondents currently hold digital tokens in their portfolio. The US, where more than a quarter (29%) of those surveyed currently hold digital tokens, is presently leading the pack. With ambitions among the survey respondents to increase the total proportion of those holding digital tokens from 11% to 80% in the next 12 months, there is clearly strong momentum for the adoption of digital assets around the world.

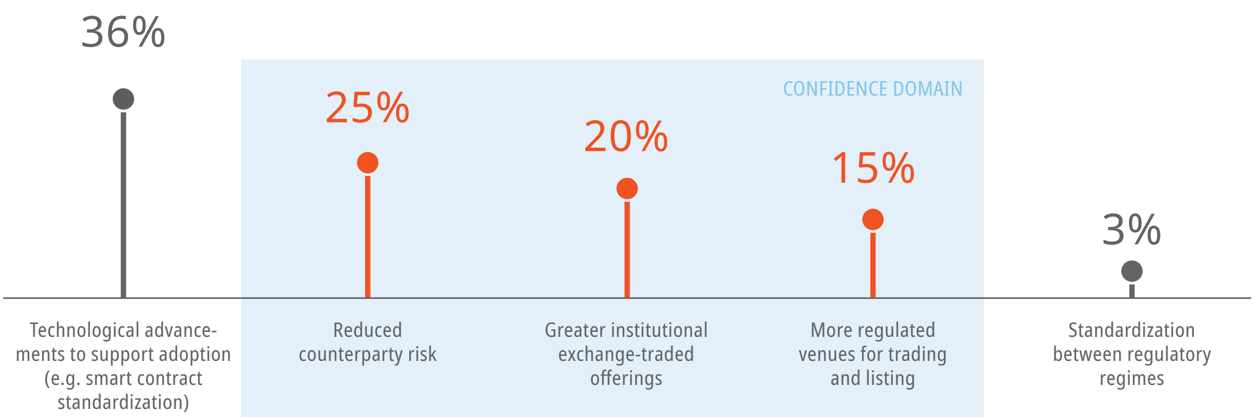
State of Play

It is also recognized that there are barriers to early adopters with these ambitions that need to be understood and overcome.

Among those who do hold digital tokens, less than one in ten currently trades more than 80% of their holdings on regulated marketplaces. Overall,

[1] This survey asked questions about digital assets in general, and also some specifically about digital tokens. Digital assets tends to be applied as umbrella term comprising assets created in digital form and their associated value. They are broadly comprised of digital currencies (cryptocurrencies, CBDCs, and stablecoins) as well as digital tokens (utility tokens and asset-backed tokens).

2. WHAT DO YOU SEE AS THE KEY DRIVER TO GREATER INSTITUTIONAL ADOPTION OF DIGITAL ASSETS*?



* Digital tokens (utility tokens and asset-backed tokens) as well as digital currencies (cryptocurrencies, CBDCs, and stablecoins)

respondents estimate that just 54% of their digital token holdings are traded on marketplaces with regulatory oversight.

In other words, almost half of the respondents' volume of digital tokens is being traded in the dark. The shortage of regulated venues that offer digital tokens could be slowing progress towards greater institutional adoption of digital assets.

Drivers to Adoption

If availability on institutional platforms and marketplaces is the main hurdle, then technological advancements, regulatory oversight and sound risk management are the main accelerators of adoption. This includes smart contract standardization, which has a considerable role to play (see graphic 2).

Confidence in the way that digital assets are traded was consistently cited as a key driver to greater adoption – with over 60% of respondents pointing to a desire for a safer trading environment. This was supported by a belief that a regulated exchange would provide such an environment. A quarter of respondents (25%) said that reduced counterparty risk would be the key driver in their adoption plans; while a fifth (20%) mentioned greater availability of institutional exchange-traded offerings; and another 15% said that regulated venues for trading and listing would help to push their plans forward.

It's another indication that it is not necessarily a concern with the digital assets themselves or blockchain technology that is holding buy-side companies back from increasing their current allocation levels. Instead, it is a focus on the potential to increase institutional governance and management of this infrastructure that supports them. There is space here for experienced exchange and market infrastructure operators to make the trading, settlement, and custody of these exciting assets both more accessible, and more secure, underpinned with the appropriate application of blockchain technology.

The Role of the Exchange

When buy-side companies were asked what they expected from a regulated platform for digital assets, increased transparency was the most common answer. In fact, 42% of respondents identified transparency as the key role such a platform should play (see graphic 3). Meanwhile,

"Regulated exchanges provide a transparent and level playing field for issuers and investors, where capital can be raised, products listed, and reference prices formed. They establish the elementary trust between market participants and enable informed decision-making in any asset class."

Christian Reuss
Head SIX Swiss Exchange

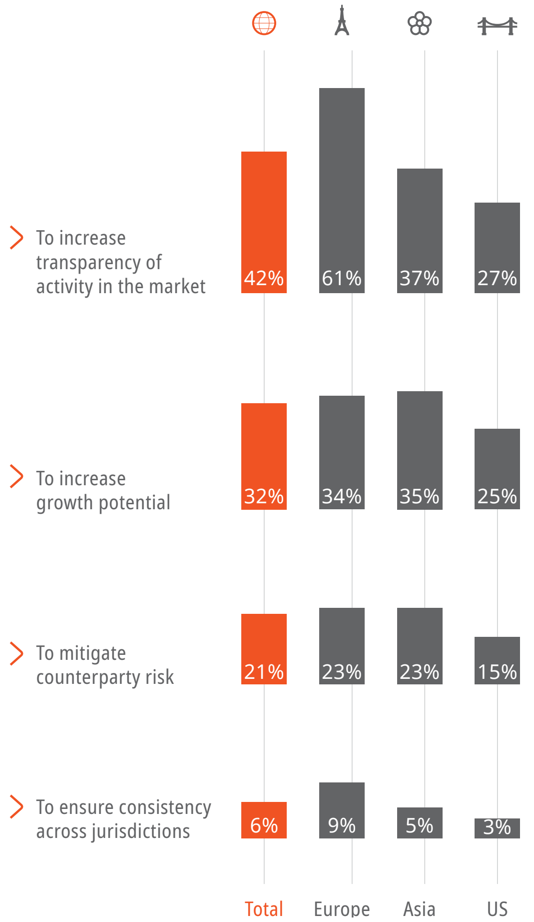
"Investors need the same levels of protection and market resilience in digital assets as they experience in more traditional markets. The market for digital assets needs to be fully brought into the institutional financial system in order to manage the risks and standards to improve security and provide more confidence to its participants."

Javier Hernani
Head Securities Services, SIX

a third (32%) were explicit that increasing growth potential of the market is where a regulated exchange can make its best contribution. With its unique position, the regulated exchange for digital assets has the capacity to provide visibility, security, liquidity, and ultimately instill confidence in the industry. Echoing the desire for greater confidence, a fifth (21%) attributed the most important role to mitigating counterparty risk.

Buy-side market participants, whose support will be key to achieving widespread institutional adoption and meeting outlined growth targets, also see a place for experienced market infrastructure providers to deliver greater governance, trust, and security to the market. A majority (55%) of the respondents indicated that they would be more likely to trade digital assets if they were held by a recognized, traditional custodian. ▲

3. WHAT SHOULD BE THE MOST IMPORTANT ROLE OF A REGULATED EXCHANGE IN THE DIGITAL ASSETS* SPACE?



* Digital tokens (utility tokens and asset-backed tokens) as well as digital currencies (cryptocurrencies, CBDCs, and stablecoins)

Conclusion

Confidence in Infrastructure

There is a clear desire among buy-side companies to trade digital tokens on institutional platforms with regulatory oversight and to increase the options for consumers when it comes to institutionally attractive, safely tradeable digital tokens. For the industry to get where it wants to be, more focus should be turned to the availability of regulated marketplaces and the liquidity of the digital tokens traded on them.

Confidence in the infrastructure that underpins the trading process is regularly cited as a key enabler for growth, and an existing challenge. It is important to reiterate that it is not a lack of confidence in the assets themselves that has decelerated or even prevented engagement with this market. It is the need for institutional platforms that have robust governance as well as sound risk and regulatory oversight. Our view is that, alongside experienced market infrastructure providers, regulated and traditional trading and custody venues have a key role to play in the development of the digital assets space based on blockchain technology. They are vital in accelerating the market adoption of digital assets by institutional investors.

David Newns
Head SDX

Investing for the Future: Widespread ESG Allocation Expected but Data Concerns Persist

A seismic adoption of ESG-linked investment strategies is underway, but the complexities of executing a capital allocation of this scale are significant. Read how investment managers see the ESG space developing, with particular insight into opportunities and challenges surrounding data availability, regulatory compliance, and cost pressures.

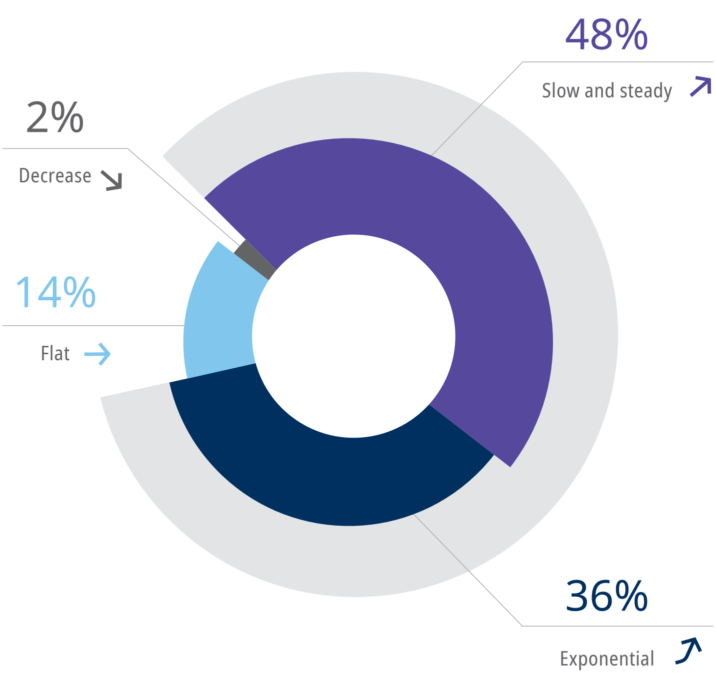
ESG investing is more mature relative to the digital assets space, and as a result is more frequently incorporated into the investment decision-making processes of buy-side market participants. On average, 54% of respondents' portfolios are currently estimated to be allocated to ESG investments strategies. The share of respondents whose ESG allocations have not yet reached 20% of their total portfolio(s) is now in single figures.

It is still true that, on average, almost half of portfolios are not currently allocated to an ESG investment strategy. Yet, it is an area that has experienced a significant surge in interest over the past decade, with its increased presence in investing discourse reflective of a rapidly growing relevance.

Ambitions to Expand

While ESG isn't yet the overwhelmingly dominant force in investing, the survey indicates that this is likely to change in the next five years (see graphic 4). 84% of respondents expect their ESG allocations to grow in that period. This is an apparently universal ambition: The proportion of respondents in Asia, Europe, and the US that expect growth is between 80% and 90%. Whilst countries like Germany and the US did not predict any decrease in their ESG allocations at portfolio

4. HOW DO YOU PROJECT THE PERCENTAGE OF YOUR ESG HOLDINGS WILL GROW IN THE NEXT FIVE YEARS?



level, there was no country where more than 5% of survey participants predicted a decrease over the next five years.

Buy-side companies with intentions to raise their ESG allocations will be more likely to reach their goals if they work closely with a global market infrastructure and data provider that can deliver cross-border ESG data, regulatory services and infrastructure for financial markets at scale. In particular, providers of market data will play a key role, both in helping companies navigate the evolving regulatory landscape and enabling greater diversity in asset allocation in line with changing investor preferences.

Cost Pressures Acknowledged

It is widely acknowledged that meeting regulatory requirements and additional ESG risk specifications comes with additional costs. 89% of respondents believe they will have to increase their expenditure to comply with ESG-related regulations and adequately manage their risk. In Asia, this percentage rises to 96%, reflecting the different levels of regulatory development across jurisdictions.

There is also a clear indication that buy-side companies are willing to increase operating costs to support a change in investment approach and the evolving requirement for new business models it demands. The key pillars that prop up all regulatory processes are: access to appropriate data; and developing effective and efficient means of reporting to regulators and clients alike considering ESG metrics.

In every country, the expectation is that the regulatory environment will evolve across jurisdictions over the next few years, and that ESG practices will become more tightly integrated with the investment process.

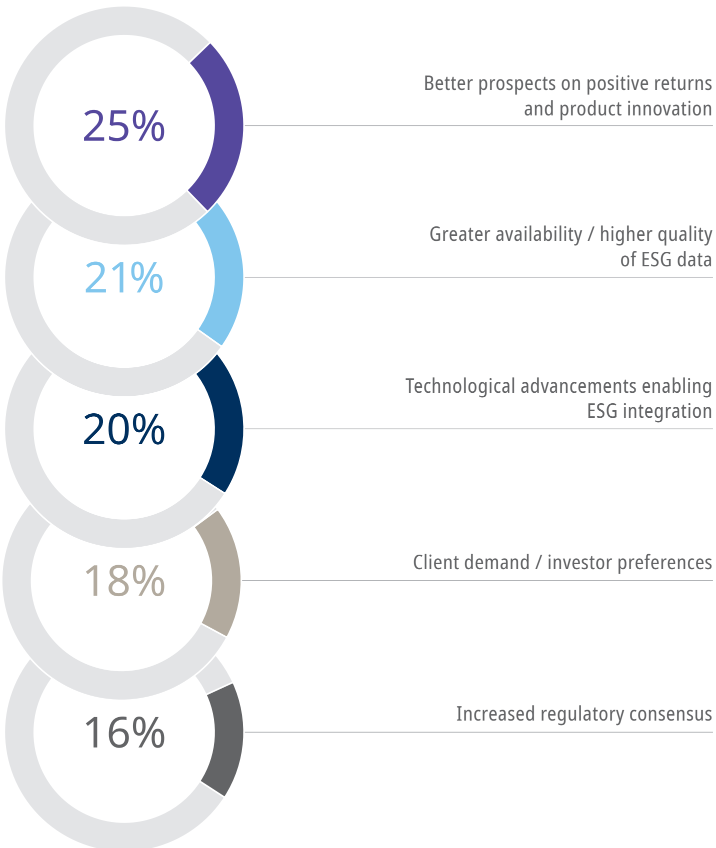
Data in Demand

When considering the key drivers for growth, 25% of respondents worldwide indicated that ESG-guided investment would be driven by improved opportunities to deliver positive portfolio performance and product innovation (see graphic 5). In the US (34%) and the UK (31%) companies said that increased availability and higher quality of ESG data were the main enablers to support growth. This reflects the slightly more advanced nature of these two markets, as well as their

"For asset managers attempting to navigate the complex jungle that is ESG investing, there is a clear need for modern analytical solutions spanning both primary and secondary markets. Market participants must be able to rely on providers that can tackle their interconnected data needs, changing regulatory requirements, and critically address positive performance management expectations through an E2E workflow."

Martina Macpherson
Lead Sustainability Products and Services, SIX

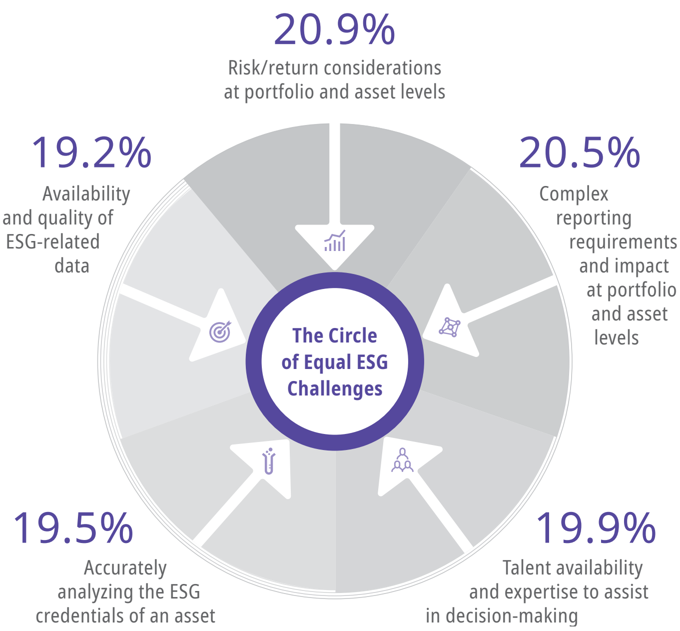
5. WHAT DO YOU SEE AS THE KEY DRIVER FOR GROWTH IN THE ESG INVESTING SPACE?



“The regulatory environment is continuously evolving. This evolution is reflected in the host of internal processes developing within companies, including compliance and related expenditure.”

Fabienne Strobel
Head Sustainability, SIX

6. WHAT DO YOU FEEL PRESENTS THE BIGGEST CHALLENGE TO IMPLEMENTING AN EFFECTIVE ESG INVESTMENT STRATEGY?



international focus which requires source data for multiple jurisdictions. Technological advancements that enable ESG integration were also highlighted by respondents as significant to the development of the space.

Regarding the challenges to overcome when implementing an effective ESG investment strategy, asset managers agreed that all of the following were of almost equal concern (see graphic 6): the availability and quality of ESG-related data; complex reporting requirements and impact at portfolio and asset levels; accurately analyzing the ESG credentials of an asset; risk/return considerations at portfolio and asset levels; and talent availability and expertise to assist in decision making.

This represents a broad range of challenges that could prevent ESG investing from reaching the buy-side’s stated growth ambitions. However, it is also an indication of how far the investing principle has come: Respondents understand the space and recognize the various barriers to fully and consistently integrating it into their portfolio. ▲

Conclusion

Strong Development Potential

There are regional nuances when it comes to the increase in ESG investment strategies, both in terms of the drivers of growth and the challenges that buy-side companies face in implementation.

Different regions are at different stages of development, but all believe that ESG holdings will rise over the next five years. We are at a key stage in the development of ESG investing, which is showing significant growth potential.

There are many factors impacting the challenges the buy-side faces. These include access to high-quality ESG data, as well as technology to enable better ESG integration, reporting, and compliance. As a result, companies are demanding more from their technology and data vendors. As volumes rise, the strain on operational and analytical processes will inevitably intensify, resulting in a need for greater automation, quality, and access to expertise.

Marion Leslie
Head Financial Information, SIX

CONCLUSION

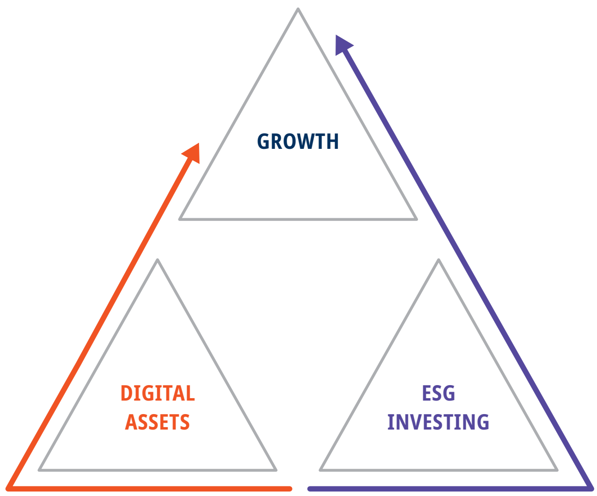
Both digital assets and the ESG investing space are attracting considerable interest from buy-side institutions, who expect to expand their involvement in both areas.

There are strong indications from the respondents to the survey that there is a significant role to play for market infrastructure providers, data vendors, and technology providers. The demand for extensive institutional experience is particularly felt in the digital assets arena, where the most significant challenges are risk mitigation and a lack of trustworthy governed infrastructure.

Compared to this, the ESG space is much further along its development curve, which was clearly shown by the level of take-up revealed in the research. The challenges that are felt by buy-side companies are more varied, with several different, equally complex issues to contend with. Nevertheless, both areas continue to show substantial growth potential.

There were also distinct regional nuances in both spaces that reflect different approaches to investment, established regulatory frameworks, cultural expectations, and more. While many buy-side participants expressed very similar ambitions, their starting positions varied considerably.

What is clear from this report is that there are strong drivers for expansion in both digital assets and ESG investing, and many ambitious institutions seeking to initiate new investment strategies. The overarching message from the respondents was that by partnering with global market infrastructure and data providers for support, they will be better positioned to achieve the growth that they expect in these two evolving areas. To accomplish these ambitions and overcome the hurdles that have been identified, leveraging this level of expertise is a clear advantage.



Publisher

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