



# ESG WHITEPAPER

SMN Investment Service GmbH's position paper  
on  
ESG issues and responsible investment

March 2021

**smn** INVESTMENT SERVICES



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# 1. DEFINITIONS

<b>AIFM</b>	Alternative Investment Fund Manager; SMN is duly licensed as an AIFM including ancillary investment services supervised by the Financial Market Authority of Austria (“FMA”, <a href="http://www.fma.gv.at">www.fma.gv.at</a> ). SMN’s investment programs are all based on quantitative research and primarily focused on managed futures
<b>UNPRI</b>	United Nations Principles of Responsible Investment, was initiated by the United Nations (UN) and provides principles for responsible investments (RI); <a href="https://www.unpri.org/">https://www.unpri.org/</a>
<b>CTA</b>	Commodity Trading Advisor; <a href="https://www.nfa.futures.org">https://www.nfa.futures.org</a>
<b>Momentum</b>	Factor/investment style which is based on price-moves/price-trends
<b>Breakout</b>	refers to the circumstance in which the price of an asset moves either above a resistance area ( <i>refers to an area in which the price does seem to hit a cap</i> ) or below a support area ( <i>refers to an area in which the price does seem to hit a floor</i> )
<b>Basket Trade</b>	is a buy or sell order, trading a group of instruments simultaneously, which is executed for the sake of convenience as well as individualization
<b>Leverage Effect</b>	is the amplification of return on equity when boosting the invested capital by the use of debt and can also be achieved by the use of derivatives such as futures contracts
<b>Skewness</b>	is a statistical measure of the asymmetry in a bell curve, or normal distribution in a set of data ( <i>e.g. the distribution of returns</i> ); skewness differentiates extreme values in one versus the other tail
<b>Kurtosis</b>	is a statistical measure describing the shape of the distributions trend compared to a standard normal distribution in a set of data ( <i>e.g. distribution of returns</i> ); kurtosis measures extreme values in either tail; high kurtosis in this case implies that investors will experience occasional extreme returns ( <i>either positive or negative</i> )
<b>ESG</b>	refers to <u>environmental</u> ( <i>ecology and its issues such as pollution etc.</i> ), <u>social</u> ( <i>social matters such as human rights and discrimination etc.</i> ) and <u>governance</u> ( <i>issues regarding leadership, guidance, independence of the board etc.</i> ); at SMN ESG means even more; we define it as our duty in society as well as our duty towards our Stakeholders, to act responsibly and ensure a livable environment now and in future
<b>Stakeholders</b>	are people or groups, which have a rightful interest in a company’s operations, e.g. employees, clients, shareholders or suppliers
<b>RI</b>	Responsible Investment, refers to investments which do not only focus on risk and return, but also on sustainability and ethics
<b>AEOI / CRS</b>	Automatic Exchange of Information / Common Reporting Standard, is an international tax reporting standard, which obligates financial institutions and corporations to report financial information to their customers tax residence authority in countries which signed the policy
<b>FATCA</b>	Foreign Account Tax Compliance Act, is a 2010 United States federal law, which obligates foreign financial institutions to report assets of identities, connected to the United States, to the U.S. Department of the Treasury
<b>Slippage</b>	refers to the situation in which an order is not filled at the assumed price but a different one; depending on the market movement, Slippage can either be positive or negative

## 2. PREAMBLE

When it comes to responsible investments, everyone is immediately thinking about ESG issues, but mostly people only have pictures of climate change in their minds. This is mainly the case, because people still link responsibility only to environmental issues, rather than social and governance topics. Environmental issues deal with climate change, pollution, waste or water usage. Social issues are for example human health and safety, product liability or social opportunities. Governance refers to corporate governance, remuneration, management, leadership or corporate behavior which also includes business ethics, corruption, transparency and more.

### **Why is ESG an important topic for SMN as well as the whole society?**

As a financial services firm SMN regards itself as one part of the society. Our business model is only possible if we are able to attract and compensate highly motivated and well-educated employees. These employees have the choice between various other employers and base their decision on multiple factors. One very important factor is linked to our corporate culture and our corporate values. These values embrace sustainability and ESG-goals in all aspects.

We do believe that as a company we have the responsibility to hold ourselves accountable for all our actions and decisions. All our employees, our clients, our suppliers and our equity owners will be the ones to judge ourselves on our accountability. In all our decisions we have to carefully think about the potential impact of those decisions on environment, society and – in our case – the integrity of financial markets. If we take these decisions right, it will have a positive impact on nature, society and we will support healthy financial markets. This in reverse will ensure that we can employ healthy and happy employees now and hopefully for the generations to come.

### **2.1. SMN's investment principles**

Let us start with our investment principles which lead to the nature of our business as well as our goals and our place in the society.

- quantitative, systematic and comprehensible investment process
- strong focus on research
- sustainability
- targeting Alpha
- embedded risk management
- broad diversification

## 2.2. The Company

SMN is an asset management company, domiciled in Vienna, Austria. Since SMN does not trade on its own accounts but solely on behalf of its investors, various additional responsibilities arise.

As a team of well-educated financial researchers, software developers and management staff we can rely on our long lasting experience. We cover any important task by our own research, portfolio- / risk management and trading teams, having outsourced solely some support functions to external parties, subject to SMN's oversight.

SMN is also a CTA (Commodity Trading Advisor) registered with the National Futures Association ("NFA" - [www.nfa.futures.org](http://www.nfa.futures.org)), an industrywide, self-regulatory organization for the U.S. derivatives industry. SMN's main focus is on listed futures for a highly diversified spectrum of different underlying instruments. Although the term "Commodity Trading Advisor" refers to the trading of commodities, we also invest in financial futures for example. We systematically invest based on the conviction that the price of a given futures contract will either rise or fall. Thereby it is important to mention that we accept market price risk and earn risk premia for taking that risk. As a benefit to the markets we provide liquidity through our trading activities. Our investment strategy is normally classified as an alternative investment approach in comparison to classic investments such as equities or bonds.

Sometimes we are confronted with the argument that such a trading approach is not regarded sustainable as it is pure speculation. Such a criticism can be dismissed by further investigating the difference between an investor and a speculator. As per Benjamin Graham: "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."<sup>1</sup> Since our systems are based on thorough research and advanced risk management techniques, our operations are of professional nature. We thrive to systematically collect sustainable risk premia for bearing price risks while providing the markets with liquidity.

How do we "predict" price moves in futures markets? This is where one of our most important assets comes into play, data. We are of course not able to exactly forecast future prices but given that we apply extensive quantitative research in such markets, we are able to predict future price developments ("Trends" or a "Trend") to a certain level of confidence. Our algorithms use an enormous amount of data and measures, trying to identify indicators / patterns that may create alpha. Once a trend has been identified, we invest in this market, subject to other constraints. A trend can last several years or does only emerge and vanish during a couple of days for example. SMN's flagship strategy engages in systematic trend following that is only concerned with medium to long term trends.

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<sup>1</sup>(Graham, 2003, S. 18)

## 2.3. SMN's operations and investment process

SMN manages futures funds, some are approved for public distribution in certain jurisdictions, as well as dedicated mandates for institutional investors (if any). Additionally, SMN acts as an exclusive sales agent for the investment products of Union Bancaire Privée (UBP) as well as the Skandinaviska Enskilda Banken (SEB) in Austria. Moreover, we have partnered with UK investment boutique Advisors and Partners (A&P) where SMN acts as A&P's operating partner in Austria, making A&P's investment products available to the Austrian institutional market. We, as well as all our partners, are subscribers of the UNPRI.

Regarding our investment operations it is important to mention that we currently do not invest in single companies or commodities, and we do not bear single company risks. We do invest in futures contracts in order to benefit from price fluctuations. Hence, we only get involved in future price creation and we provide liquidity to the markets we operate in.

As our duty towards our clients, we aim at superior returns and offer a high level of diversification, within our trading systems. In addition our portfolios target a low correlation to traditional asset classes in order to offer high diversification benefits within a client's portfolio. A focus on a stringent risk management is crucial to us.

SMN's flagship strategy works based on a set of independent algorithms (*a main signal creation engine and a set of overlays*), which provide an instruction (*whether to go long, short or stay flat – this includes exiting of positions*) as well as a risk adjusted exposure (*signal strength – how much to invest*).

Based on mathematical modelling and maximum diversification we try to keep the correlation of individual positions within the portfolio as low as possible. The algorithms then provide the risk budget (*the higher the correlation the lower the exposure and vice versa*) for each contract. This is done in order to minimize risk.

The "SMN Diversified Futures Fund" trades many different underlings such as commodities, currencies or equity indices. Moreover, SMN also trades on the so called "Structural Alpha" markets which are not commonly traded by financial investors, are therefore less liquid than classic CTA markets and can be found mainly in the field of commodity markets. The condition that these futures contracts provide less liquidity is actually advantageous to us. The liquidity within these markets is sufficient for our trading approach – given that we have a small footprint in the market - but may be too low for larger institutional investors. This provides one of our USPs<sup>2</sup>.

When taking a position in a futures contract (*regardless if long or short*), it is not required to pay the total contract value, but rather hold a risk-adjusted deposit with the broker (*margin*). The margin necessary for each underlying varies from contract to contract. In that way a leverage effect is generated without using a credit facility (*overdraft*). It is to be noted that any margin deposit is subject to so called margin calls, which may happen if the actual price moves in the opposite direction of the anticipated one. Since margin requirements are lower than the real contract value there is a certain balance of the overall portfolio left (*free cash*) that is subject to counterparty risk which has to be actively managed. This means that we are also an investor in classic money market instruments or (*mainly*) government bonds to invest our cash positions.

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<sup>2</sup> unique selling proposition

### 3. ESG FRAMEWORK & SMN

The principal goal of this paper is to outline our views on ESG purposes and the ESG incorporation process in our company. Sustainable and responsible behavior is essential for the sake of humanity and our planet. Along with the creation of this document we were able to investigate the subject more carefully and become even more aware of its importance. Transparency towards all our stakeholders is a highly important task for us, therefore we publish this paper on our website – [www.smn.at](http://www.smn.at). Moreover, we are aware of our position within the society and we know that all our actions have consequences, therefore we record that we take full responsibility and deem full awareness. Ultimately, we want to support the trend towards sustainability in order to pass a worth living world onto future generations.

#### 3.1. Our Fiduciary Duty

Due to our activity as an asset manager, special responsibilities arise. We are managing money for institutional and private individuals all around the globe. These institutions comprise organisations such as pension funds and insurance companies and we are fully aware about our huge fiduciary responsibility towards all our clients. Since we operate without prior consultation, transparency regarding our investment process as well as our policies and statements, is especially important to SMN. More on reporting will be explained later in this document.

#### 3.2. Our Objectives

Our investment process is built upon quantitative techniques. Our systems aim to detect trading opportunities in a highly diversified set of markets. In this way we try to generate returns from risk premia by taking market risks strictly controlled by our embedded risk management systems. In order to take benefit from trend following signals, the position size taken should not be as large to have a significant impact on market prices. Significantly moving the market with one's positions is mostly harmful for oneself and therefore not desirable. To successfully apply trading signals, we need markets that work well. As a market participant we are as well responsible for the integrity of the market. We are very well aware of that responsibility and it is our goal to support the healthiness of financial markets with every step of our investment process.

Instead of capturing risk premia in markets that work in good order, it would also be possible to aim for risk-free returns using techniques of exploitation, market manipulation or insider-trading. As we believe in the benefits of a well-organised financial system for the whole society and for future generations, we apply the highest standards of market ethics when calibrating our trading systems.

We are conscious of the fact that automated trading systems often get blamed for big market moves, especially on the downside. We are fully aware that we are accountable if our systems act in accordance with the majority of market participants – which is of course the case from time to time – but we are convinced that all in all our role as market participant is beneficial for the market place as we are constantly providing liquidity for other market participants. Liquidity makes markets less vulnerable to dislocations. Computers and algorithms are useful tools for the society, and they cannot be bad per se but can rather be used badly or unwisely. We are aware of that fact and therefore we handle our systems with special care, meaning that our systems are well set up to have

ideally all likely and highly unlikely scenarios accounted for and no harmful surprises can arise.

As outlined before, our trading systems are solely based on quantitative decisions, so often these decisions will be different from other market participants' opinions which are in most cases based on fundamental views. This ensures diversity among market participants which is an important factor for market stability.

We also strive to be able to state our activities as a commitment to the common good. Clients such as institutional investors of a certain size represent the interests of such a significant proportion of people that they altogether represent the populations' interests. It follows that, pension funds are able to pay higher distributions to their clients if their investments develop positively. These additional income/earnings may be used for consumption, which will boost the economy and hence support the general public. Moreover, we provide liquidity to the market and its participants, such as farmers etc., who want to secure future selling or buying prices. Accordingly, our operations support the availability of risk bearing capital, provide liquidity and ultimately contribute to common welfare.

Risk management is an important task, internally as well as externally. We have state of the art systems in place dealing with macro and micro risk. Our portfolios are diversified on a maximum level, and exposures are constantly adjusted based on specific risk measures. Our research and our risk management team are constantly improving our trading and risk management systems.

We aspire to be a sustainable member of society. Therefore, we strongly engage with our stakeholders and try to settle issues to everyone's satisfaction (*more about our stakeholder relations later*). Our activities as an asset manager and as a part of our society may result in significant consequences, therefore we are strongly committed to act with the highest level of diligence and special care.

### **3.3. Implementing ESG spirit into our investment strategies**

Our flagship strategy "SMN Diversified Futures Fund" has been trading solely future contracts (*except some minor OTC positions used for currency hedging purposes*) since its inception in 1996. It is important to mention that we do not have any interest in getting the underlying commodity or financial instrument delivered at any time. We neither want to own the underlying nor do we want to use, store or consume it. A futures contract binds two parties, where one contractor is positioned long (*profits if the future price increases*), whereas the other is positioned short (*profits if the future price decreases*). This might sound like a futures contract being a lucky bet where there is always one winner and one loser, but this is in fact not the case. A futures contract enables contractors to take risk on purpose and earn a return for it, whereas the other party, maybe a farmer or miller can mitigate their risk by assuring future prices.

Nonetheless, the reason for the anonymous counterparties to our positions to engage in the contracts is unknown to us. Maybe the other party wants to hedge a future transaction or another position in their portfolio, hence eliminate risk or they just want to bet on a price move they anticipate, we don't know. What we ultimately want to embody is that even if we buy a future contract on e.g. live cattle or oil, we do only engage in the price creation of this asset, we never actually buy the underlying asset, hence we do neither support nor do any harm to the meat industry by buying or selling a futures contract. We might be the counterparty to a meat wholesaler whose operations are not sustainable, but we do not know if this is the actual case and even if so, this may support its operations, or it may not,

one cannot say. We solely provide liquidity and thereby support equilibrium prices and healthy financial markets.

What we do know is that we support the market's liquidity. In economics literature, future contracts were created in order to fix future prices for farmers and other parties along the supply chain. The counterparty of the future contract is the risk capital provider, who usually receives a premium for bearing the risk. These risk premiums provide long term value for our strategy. And the more liquid a market, the easier for market participants to assure selling or buying prices for their trade goods and the closer to equilibrium prices. There are plenty of studies showing that volatility is decreasing in markets with higher liquidity, which means risk for all market participants is decreasing with additional liquidity. Once more, our engagement can be attributed to the common welfare.

Since our systems are solely quantitative, our investments are free from discretionary decisions. It is the nature of a trend strategy to identify positive or negative price trends on a systematic basis. Hence, quantitative momentum strategies only support trends, which represent the widespread sentiment towards an asset or a whole market. Since we do not have a market opinion and do not express any preferences, we do not affect the market deliberately. We may sometimes unintentionally impact asset prices, because our trading volume might be significant, but even if this is the case, the impact is only marginal, especially on a macro view. Nevertheless, we constantly improve our execution techniques in order to smoothen the impact and assure better entry or exit prices.

A quantitative approach implies the use of financial data and technology. Some may be concerned, that the use of technology for investing in financial markets lacks awareness and may cause significant harm. We agree that technology itself does not have a consciousness, but it neither is the lord of its own will, its creator rather is. When setting up a system we do so responsibly, we test it in the highest possible detail and we take full responsibility for its output.

However, liquidity (*unencumbered cash*) within a fund is primarily invested in sovereign bonds and/or money market funds. Cash management follows a distinct policy containing clear directions. In 2019 we have amended our Cash Management Policy to reflect provisions considering an investment's ESG impact.

In Austria, legislature provides a strict framework for market participants of the financial industry. As we are licensed as an AIFM (Alternative Investment Fund Manager) including the ancillary investment services, such as acting as an investment advisor, we are subject to certain organizational obligations such as 4-eyes principle, risk management, compliance, anti-money laundering etc. Risk management inspects various risk and liquidity measures of the portfolio on a daily basis and does also apply stress conditions to ensure compliance with the applicable risk limits. As we do currently not invest in equities, no equity risk (*risk that develops within a company, in which, one has an equity stake*) derives. Regarding our tax policy, full transparency is provided by AEOI/CRS and FATCA, if applicable. Otherwise, SMN handles its tax duties accurately and supports fair tax practices.

Based on SMN's focus on R&D<sup>3</sup> we are keen to develop additional strategies. It is important to mention that within the testing and implementation procedures of such systems, ESG issues are already considered. If necessary, this document will be adapted accordingly.

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<sup>3</sup> Research & Development

Responsible investment commitments apply to every single member of our investment team. We do not see responsible investment as an approach by a single person, but rather as our culture within the firm. Moreover, we do employ a responsible investment professional who oversees all ESG related matters within the company and is in charge of taking care of innovations and further development.

### 3.4. Stakeholder Relations

Stakeholder relations are highly important for SMN, not only for the company's commercial success or for client satisfaction, but also in terms of sustainability and responsible investment. In order to support long term cooperation, we handle stakeholder issues with special care.

Due to fiduciary duties towards our customers, certain responsibilities arise. Transparency is and will always be of high concern, which is why we foster close relationships and provide frequent reporting to our clients. We do also offer individual solutions for our client's portfolios. On the grounds of our high level of service, we can add sophisticated know how to our customers risk management and solve issues in due course. We also want to offer fair conditions to our customers, which is why we provide a transparent pricing model and are not afraid of spending high effort to reduce unwanted costs such as negative Slippage.

Our shareholders do not only provide a good capital base but also engage in the company's daily business themselves. This is of high interest to all other Stakeholders, since it is crucial that the ones bearing the risk are also involved in decision making. We regularly invest in employee education, new office equipment, external support and additional manpower, if required.

We also try to form long term relationships with our suppliers and other stakeholders. In order to preserve these relationships, we host meetings as well as gatherings with less reference to business, but high reference to cooperation. Whenever possible and economically reasonable we prefer local suppliers and face to face business. Based on our satisfaction as a customer, we are happy to pay fair prices and support the local economy. We endeavor close contact with all our service providers (*e.g. clearing brokers, custodian bank, central administration agencies, among others*) in order to assure frictionless and effective operations.

### 3.5. SMN as an Employer

Employees represent one of a company's key assets. In order to assure a satisfied workforce and a pleasant working atmosphere, SMN offers many benefits. We are convinced that one of the key success factors of having loyal employees is based on our compensation scheme, which strives to support long term relationships and compliance with our policies, which are not solely linked to individuals or the company's success. Moreover, we have implemented procedures to eliminate, disclose and mitigate possible conflicts of interest that may arise during our professional activities as an independent investment advisor. We do also offer flexible working hours depending on the individual job description as well as an employee pension fund scheme for our staff. All of the above are reasons for our historically very low annual employee turnover rate.

Alongside the hiring process, a background check is conducted for any relevant position. Almost every employee as well as the staff handling our relevant outsourced activities, need to provide a criminal record on a regular basis, in order to prevent employment of people with an illegitimate history.

Since SMN is domiciled in Austria having high employment protections standards, certain social benefits for employees are legally stipulated. Examples are paid maternity leave, employee precaution or health insurance. In addition, SMN offers an extra insurance for its employees as well as a flexible work schedule. Austrian law does also provide standards regarding diversification and inclusion. These topics are rather inapplicable due to SMN's size and number of employees, but we are aware of their importance.

### 3.6. Sustainable Practices within our Company

Climate change is a serious issue and mitigation practices need to be conducted now. In order to broaden our contribution, we pursue certain practices such as recycling, conservative resource usage or sustainable transportation. Hard copies are only provided if especially necessary. If possible, business trips are conducted by train since we do not own any company cars. Due to the office's central location in Vienna downtown, many business partners are within walking distance. Moreover, our office electricity provider is highly committed to renewable energy sources and wherever possible we use electronic devices with low energy consumption e.g. (LEDs instead of traditional energy consuming bulbs).

Recycling is a top priority to SMN. Owing to many recycling possibilities in Austria, we are able to conduct waste separation on a high level, from paper, plastic, glass etc. to the recycling of coffee pads. Furthermore, we encourage others to act sustainable regarding their paper usage.

Based on the GDPR (*General Data Protection Regulation*) implemented in 2018, data ethics are regulated by law in the European Union. The directive is mostly concerned with the protection of personal data and the acquaintance of relevant data. It regulates the gathering, storage and usage of data, especially personal data. Moreover, a certain degree of cyber security must be existent, in order to prevent any loss of data. SMN of course complies with the provisions of GDPR.

As responsible investment discussions have evolved within our company, we have developed the idea of creating an "ESG Advisor Committee". It is planned to comprise members of different standing and experience within the investment industry. This concept developed while we were looking for ESG benchmarks within the futures trading field but could not come up with satisfying results. Therefore, we are looking forward to implementing such a committee in the future, aiming to cover topics such as benchmarking, innovation as well as the exchange of information during regular meetings. Ultimately, we want to support responsible investment within the company and the community.

Furthermore, as we feel responsible to support the less fortunate ones within our society, we provide donations to charity in many different forms, from supporting charity events to contributing to charitable facilities.

### 3.7. Reporting

We provide an annual ESG statement in terms of the UNPRI-reporting. The record contains all necessary information regarding our company including our views on ESG issues.

Of course, we do also provide classic monthly reports, which contain information about fund performance etc. Investment related corporate governance issues are currently not

applicable to products managed by SMN, since we do not invest in companies on a direct basis, hence there are no voting obligations or the like.

Our reports are revised internally as well as externally, prior to publication. Internally a report is reviewed and signed by our management. Externally our independent statutory auditor, who is one of the big four, overviews SMN's operations and publications.

### 3.8. ESG related Risk

In order to fulfill the task of ESG related risk management properly, we need to distinguish between the company's risk management for our client portfolios and the one dealing with corporate risks.

Within our investment products we try to consider all risks properly and minimize them consequently by applying the appropriate risk mitigation technique by e.g. means of algorithms, which quantify our risk exposures and then adapt the risk budget correspondingly. We also consider worst case scenarios in order to act responsibly and considerate if such a scenario should materialize. Within our main strategy we have the possibility to go short an asset, therefore we can benefit from bearish market environments (*a condition in which securities prices fall amid pessimism and other negative factors*). Thus, our highly diversified portfolios can adapt to all environments imaginable and we can consequently retain value. Moreover, due to the advancing awareness on ESG issues, there may even arise trends advantageous to us, such as constant bullish movements (*opposite to bearish*) on sustainable markets.

On a portfolio level, the products offered by us are highly beneficial as an admixture to the existing asset allocation. This addition can offer further diversification and risk mitigation based on the same thoughts as in the passage above. So, it can be said that the ESG related risk is rather diminished.

Nonetheless, we are committed to constantly evolve our risk management systems and if new sources of risk arise, we will adapt our systems in due course.

## 4. RESUME

Sustainability has always been a highly important factor for SMN. As we rely on highly educated employees we always had to take special care to retain these talents as they all have knowledge about our proprietary trading algorithms. This is why we started very early to think about sustainability.

As we do not invest in individual companies, it has never been easy to explain how we treat ESG purposes on the investment side. It is much easier to explain which companies you prefer to invest in and which business models you exclude. As we do not invest in/finance individual companies, but just trade derivatives, things become more complicated. There have been long discussions about the good and the bad of trading futures on agricultural products. In the early days this was a disqualifier for ESG, in the recent discussion there are more and more studies, viewing this topic from a different angle. Neither is it clear that futures prices have a long-lasting effect on spot prices themselves, nor does a higher volume in trading these futures do any harm to anybody.

We have definitely done our homework on ESG purposes and meanwhile we evaluate ESG aspects for all our decisions – corporate- as well as investment decisions.