[ESMA – Investors face increasing risks amid renewed market volatility]

Investors are facing very high market risk, as they navigate an environment of potentially inflated asset valuations, subdued economic growth prospects, and flattening yield curves. Changed monetary policy expectations may boost their risk appetite and reignite search-for-yield strategies, leaving investors vulnerable to volatility episodes and abrupt shifts in market sentiment.

Credit risk and liquidity risk remain high, with isolated events highlighting pockets of risk in the asset management industry. While the level of credit risk is stable, the deteriorating quality of outstanding corporate debt, the growth in leveraged loans and collateralised loan obligations should warrant the attention of public authorities. As a result, ESMA's risk outlook for the asset management sector has deteriorated.

In this edition of the TRV, ESMA also looks in more detail at three vulnerabilities facing the financial markets:

– **Leveraged loans and collateralised loan obligations (CLOs):** Simulations carried out by ESMA show that uncertainties can impact the credit ratings of CLOs, potentially triggering forced sales from some types of investors. Considering the significant increase in the issuance of leveraged loans and CLOs in both the US and the EU, and the context of looser underwriting standards, higher indebtedness of borrowers and compressed credit spreads, this is a potential vulnerability in the market. In addition, ESMA has for the first time conducted a study of the exposure of investment funds to this market and finds that the exposure of the EU fund industry remains limited;

– **Performance and cost of active and passive EU equity UCITS:** Active equity funds have in past years underperformed, in net terms, both passive equity funds and equity ETFs, as well as their own benchmarks. This is shown in an analysis of the cost and performance of EU equity UCITS funds, which distinguishes between active and passive investment management, and ETFs, and is due to the large impact of ongoing costs; and

– **Use of derivatives by UCITS equity funds**: Using data collected under the EMIR framework, ESMA has conducted a study on the use of derivatives by UCITS equity funds. The tendency, and frequency, of these funds to trade derivatives is explained to a large extent by asset managers characteristics, such as fund family and fund family size. Over time, cash inflows as well as currency risk seem to have a significant influence, which suggests that derivatives are used for transaction costs or risk reduction purposes.

This report is split into two parts with the statistical annex published as a separate document. Also accompanying the report is the third Risk Dashboard for 2019.