An aerial photograph of the EPFL campus in Lausanne, Switzerland, taken during sunset. The sky is filled with dramatic, dark clouds with a hint of orange light from the setting sun. In the background, a large body of water (Lake Geneva) stretches across the horizon, with mountains visible in the distance. The foreground and middle ground are dominated by modern, multi-story university buildings with various architectural styles, including glass facades and flat roofs. A prominent feature is a large, white, curved building with a unique, organic shape. The overall scene is a mix of urban architecture and natural beauty.

**Financial Engineering  
and Grand Challenges**

**Dr. Benoit Cornet**  
**October 31st, 2025**

*MGT 641*  
*EPFL*  
*Pr. Dominique Foray*

# The financial sector in a nutshell



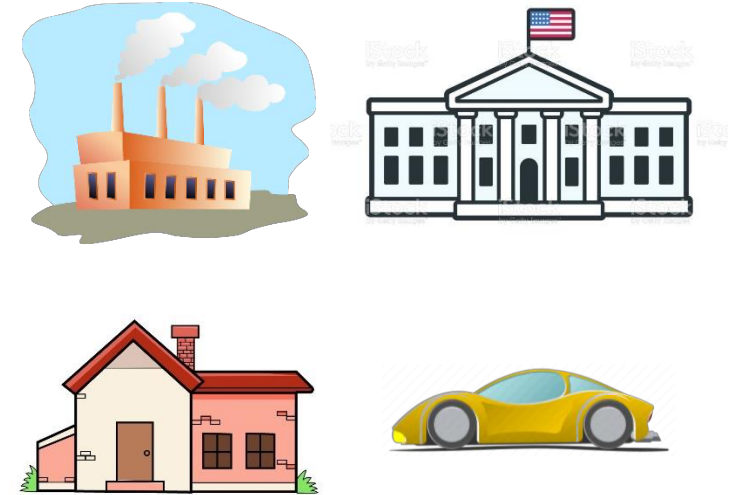
## Investors

Have money to invest  
(savings)



## Financial sector

Channels **savings** towards  
**investments**



## Projects

Need money to be implemented  
(investments)

## Definition

- **To invest in projects, firms raise funds from investors by**
  - Borrowing from **debt** investors
  - Selling part of the firm to **equity** investors, who become shareholders/stockholders
- **Debt** (loans or bonds): Buyer (e.g. bank, bond investor) gives the firm **money today** in exchange for a **financial contract** containing a **promise to pay a cash flow** stream to the holder of the contract
- **Equity** (stocks): **Share of ownership** in a corporation. Firms obtain equity capital either internally by earning money and retaining it (i.e. keeping it in the firm) or externally by issuing new equity

# Raising Debt

## Two types of debt

- **Loans:** Private debt
  - **Main investors:** Banks
  - Illiquid
- **Bonds:** Publicly traded debt
  - Liquid.
  - **Main investors:** Pension funds, insurance companies, foundations, individuals via ETFs, hedge funds, ...
  - Bonds are used when the firm needs to raise a lot of money
  - Bonds are graded based on the risk of default

ICE BofA US corporate index effective yield	Rating (e.g. Moody's, Fitch, Standard and Poor's)	10.11.2021	16.05.2023	10.05.2024	23.10.2024	24.10.2025
Investment grade	Aaa/AAA	1.97%	4.42%	5.05%	4.65%	4.5%
	Aa/AA	1.91%	4.65%	5.19%	4.75%	4.38%
	A/A	2%	5.13%	5.46%	4.98%	4.55%
	Baa/BBB	2.46%	5.62%	5.78%	5.31%	4.88%
	Ba/BB	3.33%	6.89%	6.43%	5.92%	5.41%
High yield	B/B	4.72%	8.76%	7.54%	6.95	6.49%
	Caa/CCC	7.57%	14.61%	13.83%	11.74%	8.43%
	Ca/CC					
	C/C					

## Several sources depending on the firm's maturity

- **Initial capital** directly provided by the entrepreneur and its family
  - *“family fools and friends”*
- Additional capital required for **growth** provided by outside investors
  - **Angel investors:** wealthy individuals who buy equity in small private firms
  - **Venture Capital (VC):** Limited Partnership specialized in buying equity in young innovative firms (start-ups)
  - **Private equity (PE):** Limited Partnership specialized in buying equity in existing privately held companies (rather than start-ups)
  - **Corporate investors:** corporates investing in private companies for financial and/or strategic reasons (e.g. Facebook & WhatsApp)
  - **Institutional investors:** pension funds, insurance companies, endowments, foundations, sovereign funds, hedge funds, mutual funds, banks, etc.
    - Institutional investors may also invest indirectly in private firms, by investing in VC and PE funds
- More mature companies can do an **Public Offering** and **raise equity** on the stock market
  - Large pool of financing: Retail investors, institutional investors, etc.

# Bonds, Stocks, and Risk-Return profile

## Equity vs debt

- Equity and debt represent **two different ways** to **raise money** to fund projects

	Debt (Loans or Bonds)	Equity (Stocks)
Ownership	Not an ownership interest	Represent an ownership stake in the firm
Position/Investor	Lender	Owner
Maturity	Known (e.g. 5 years)	Potentially unlimited
Voting rights	None	Yes
Payments	Coupon (interest) and Principal (loan amount)	Dividends Sale price of the stock
Number of payments	Known	Unknown
Priority in case of default	Have a legal claim to the payments	Residual claim
Risk	<b>Lower</b>	<b>Higher</b>
Expected return	<b>Lower</b>	<b>Higher</b>

- Risks and returns for investors are very different
- Risk-return profile measured by:  $Sharpe\ ratio = \frac{E[R] - R_f}{\sigma[R]}$

## Grand challenges

- **Examples**

- Developing commercial fusion energy; contraception and family planning in China; transforming agriculture

- **They are inherently risky...**

- Complex problems with no easy solution
- Long development times, low probability of success, coordination issues

- **... and may not generate cash flows**

- e.g. vaccination in developing countries, empowerment of minorities, mitigating effects of social network on mental health

## Financial engineering can help

- **FE:** *“It is the use of mathematical techniques, statistics, economics and computer sciences to solve financial problems”*  
(source: Investopedia)

- **How?** By increasing the Sharpe ratio to make financing GC solutions attractive to investors

$$\uparrow \text{Sharpe ratio} = \frac{E[R] - R_f}{\sigma[R]} \begin{matrix} \uparrow \\ \downarrow \end{matrix}$$

**Market failure:** large benefits for society BUT risk ( $\sigma[R]$ ) is too large and expected return ( $E[R]$ ) too low to attract investors using **conventional tools** (bonds and equity)

# Outline – 4 Examples

1. How can financial engineering **help local communities adapt to climate change**
2. How can financial engineering **accelerate vaccination** in developing countries
3. How can financial engineering **cure cancer**
4. How can financial engineering **enable the empowerment of minorities**

## A simple example

*“A bond is a security sold by governments and corporations to raise money from investors today in exchange for the promised future payment.” (Berk, De Marzo, 2011)*

- **Several types of bonds**

	Pure discount bond	Coupon-paying bond
Maturity	5 years	5 years
Face value	\$100	\$100
rate	2%	2%, ann.
$P_0$	$P_0 = \frac{100}{(1 + 2\%)^5} = \$90.57$	$P_0 = \$100$



- The difference between the two types of bonds lies in the **timing** of cash flows
- Other types of bonds exist (e.g. convertible bonds, **Social/Environmental Impact Bonds (S/EIB)**)

## What are they?

- Financial instrument issued to **finance public policies** (social/environmental)
- **Payoff depends on** the realisation of a desired social/environmental **outcome**
  - If the objectives are met, investors get a **larger** return
  - If the objectives are not met, investors get a **lower** return
- **Goal:** mobilizing private capital investors to supplement public investment dollars by **sharing risk**
  - Investors are only repaid if and when improved social/environmental outcomes are achieved
  - Principle: **hedging/risk sharing**
    - Reducing (or even eliminating) the financial risks associated to a future uncertain situation
    - Similar to insurance
- Examples of programs: recidivism, homelessness, early childhood education, **adapting to climate change**

# Example – DC Water EIB to fund GI (1/2)

## DC Water's project

- **Objective:** building Green Infrastructures to manage storm water runoff and reduce pollution from combined sewer overflow (CSOs)

- CSOs drain sewershed...
- ... and the polluted waters Creek and Potomak rivers

- **Investors:**



- **Municipal bond**

- **Tender date:** 5 years
- **Amount:** \$25M
- **Coupon Rate:** 3.43%, semi-annually

- $C = \frac{3.43\%}{2} \times 25 = \$0.43M$

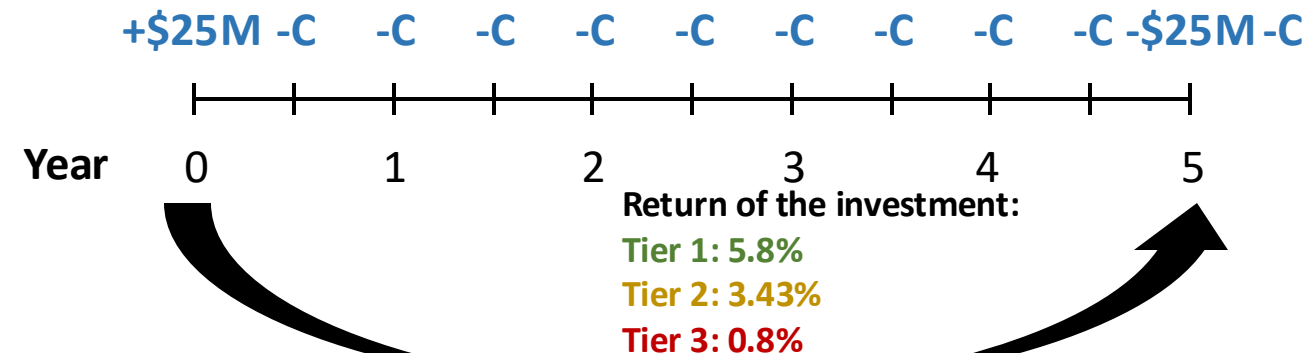
## Financial engineering: EIB

- **Mechanism:** the financing is linked to performance outcomes

EIB Outcome Ranges		
Tier	Runoff Reduction	Payments
1	Greater than 41.3%	DC Water pays Outcome Payment of \$3,300,319.00 to Purchasers
2	18.6% to 41.3%	No Outcome Payment or Risk Share Payment
3	Less than 18.6%	Purchasers pay Risk Share Payment of \$3,300,319.00 to DC Water

Source: DC Water (2020)

↑  $Sharpe\ ratio = \frac{E[R] - R_f}{\sigma[R]}$  ↑↑



# Example – DC Water EIB to fund GI (2/2)

## Infrastructures funded by the project



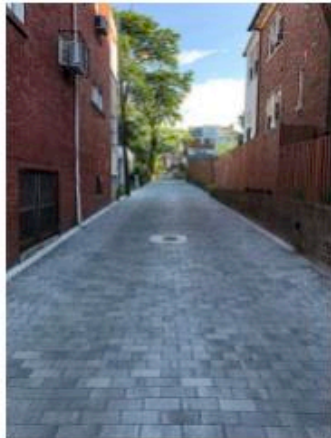
This parklet at Kansas Avenue & 2nd Street, NW was funded via the EIB.



Cobble lined swale



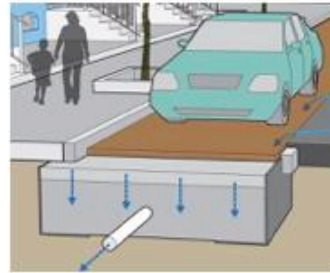
Curb extension bioretention



Parking lane permeable pavement



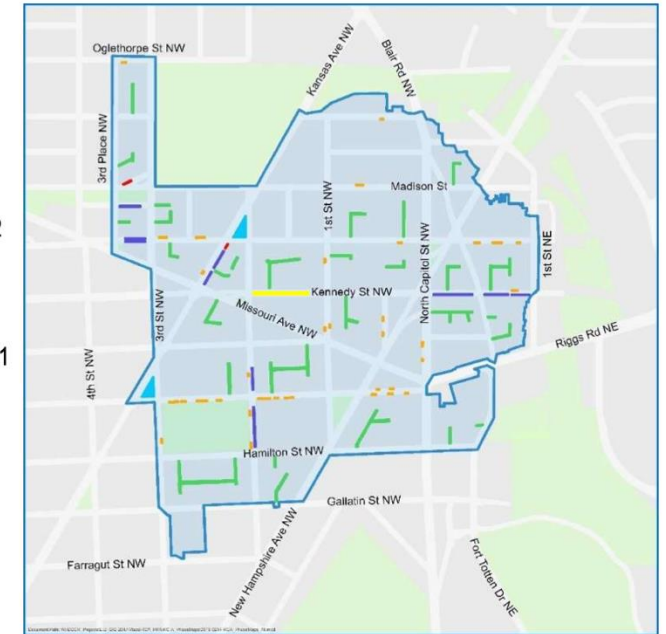
Planter Bioretention



Parking lane permeable pavement

### Number and Distribution of GI Facilities:

- Planter Bioretention – 36
- Curb Extension Bioretention - 2
- Parking Lane Permeable Pavement - 8
- Alley Permeable Pavement – 31
- GI Park – 2
- Kennedy Street



Source: DC Water (2021)



- **Pilot project:** Assess efficiency of GI & learning
- **Outcome:** -19.56% reduction in water runoff (Tier 2)

1. How can financial engineering **help local communities adapt to climate change**
2. How can financial engineering **accelerate vaccination** in developing countries
3. How can financial engineering **cure cancer**
4. How can financial engineering **enable the empowerment of minorities**

# The 2000 MDGs

## Context (Keohane, and Madsbjerg 2016)

- **2000:** 191 countries pledged to finance actions related to 8 development goals for 2015
  - Note: The **Sustainable Development Goals** succeeded to the MDG in 2016
- **2002:** Lack of funding
  - Good intentions and bold aid pledges did not yield enough money to make good on the countries promises
  - The chancellor of the exchequer (G. Brown) solicited the finance industry (Goldman Sachs) to find innovative solutions to bridge the gap
    - **Solution:** «Frontloading»
    - **Intuition:** Transforming pledges for future aid spending into immediate funding for MDGs
    - **MDG:** Public health goal through immunization campaigns

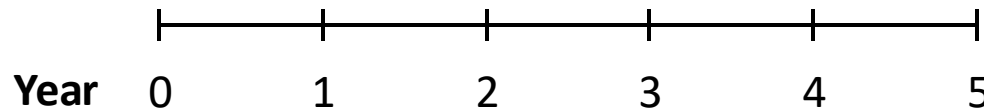


# Vaccine Bonds – In Theory

## A new type of Social Bond: «Vaccine Bonds»

- A country pledges \$125 M paid in \$25 M tranches annually over 5 years to finance a vaccination campaign in a developing country

### Scenario 1 – Traditional mechanism

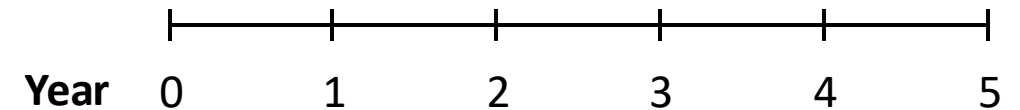


Pledge                    +\$25M   +\$25M   +\$25M   +\$25M   +\$25M

Cash flows

High Sharpe ratio =  $\frac{E[R] - R_f}{\sigma[R]}$

### Scenario 2 – Use of “Vaccine Bond”



Pledge                    -\$25M   +\$25M   +\$25M   +\$25M   +\$25M

Low

Low

-\$5M   -\$5M   -\$5M   -\$105M

Financing mechanism

- Pledge: Money is received

**New, safe asset that provides diversification benefit to investors**

Payments, are used to back the bonds (simplifying assumption: the money is put in non-interest-bearing reserve)

- Bond: 100M, 5% coupon rate, 5-year maturity

Implications

- Lower volume at inception of the project
- Money received in increments
- Need 5 years to see the impacts
- “There is zero value vaccinating a child in 5 years if he or she dies from a vaccine-preventable disease this year” (IFFIm 2019)

- Scaling effects lowering costs
- Immediate impact
- Diversification of investors’ portfolio
- But payment of interests and costs if intermediation

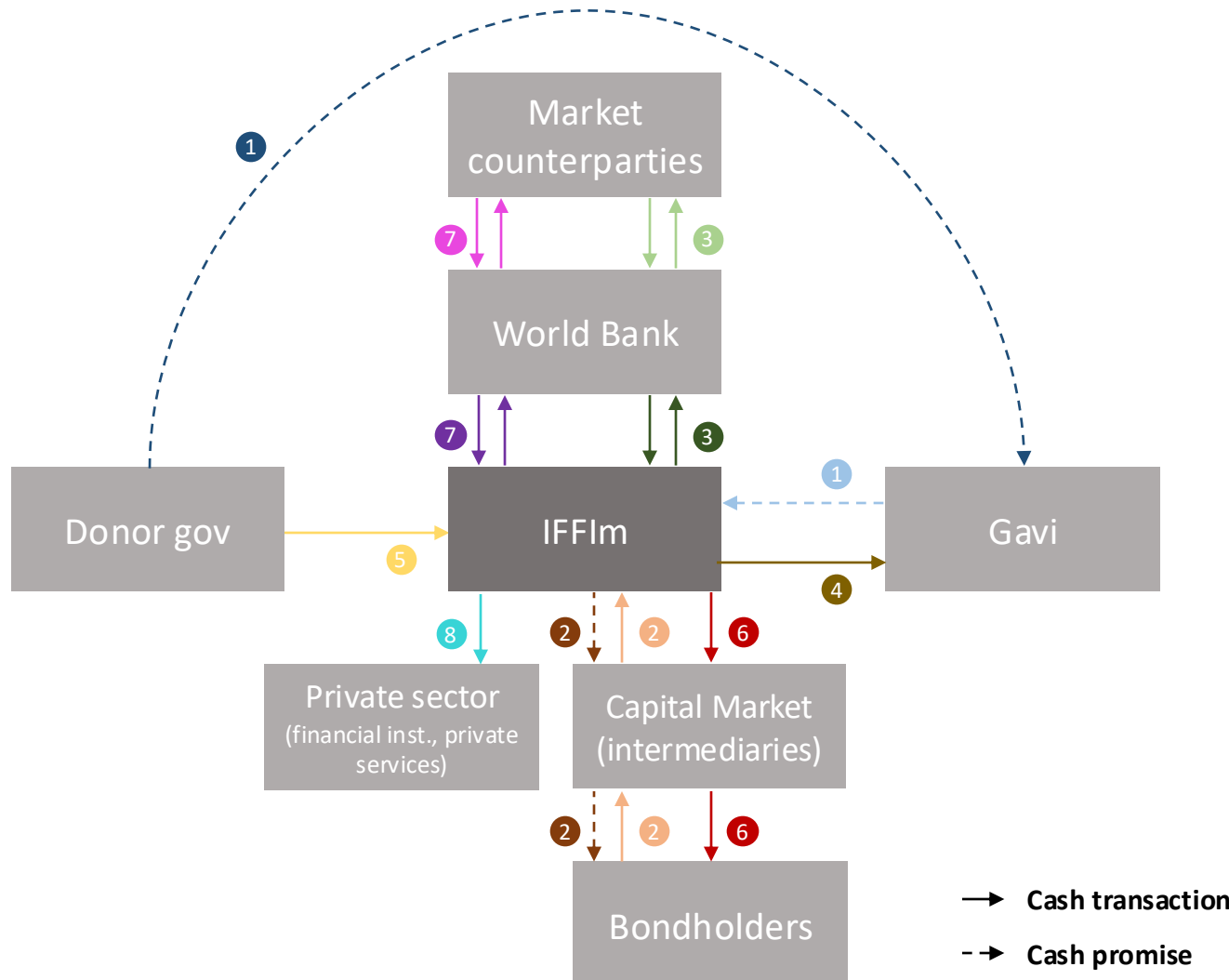
# Vaccine Bonds – In practice

## The International Finance Facility for Immunisation (IFFIm)

- **Creation:** 2006
- **Objective:** leveraging private finance to accelerate the implementation of MDG 6
- **Mechanism (Keohane and Madsbjerg 2016)**
  - Created the first «Vaccine Bond»
  - 5 years bond, at **5% interest rate**, 31 bp above the 5-year US Treasury rate (note: 1%=100pb)
  - **Rated AAA** or equivalent by credit-rating agencies
  - First bond issue in November 2006
  - \$1B raised from Central Banks, retail investors, institutional investors
  - The money is used to finance the nonprofit Gavi, the Vaccine Alliance (also partly funded by the Bill & Melinda Gates Foundation) which conducts several large scale immunization programs in developing countries
- **Impact – 2006-2019 (Hughes-McLure, Mawdsley 2022)**
  - IFFIm secured \$6.5 Bn in government pledges; \$3.1 Bn received, i.e. payments made by governments to IFFIm
  - 35 bonds issues in various currencies, raising \$6.1 Bn, 2.9 Bn disbursed to Gavi
  - Saved **2.9 million lives** and improvement of the quality of millions more
  - **\$934 Mn** paid to finance industry as **interests to investors** (\$879 Mn) and **fees to financial institutions** and professional services (\$55 M)

# Vaccine Bonds – In practice

## How does IFFIm works? (Hughes-McLure, Mawdsley 2022)

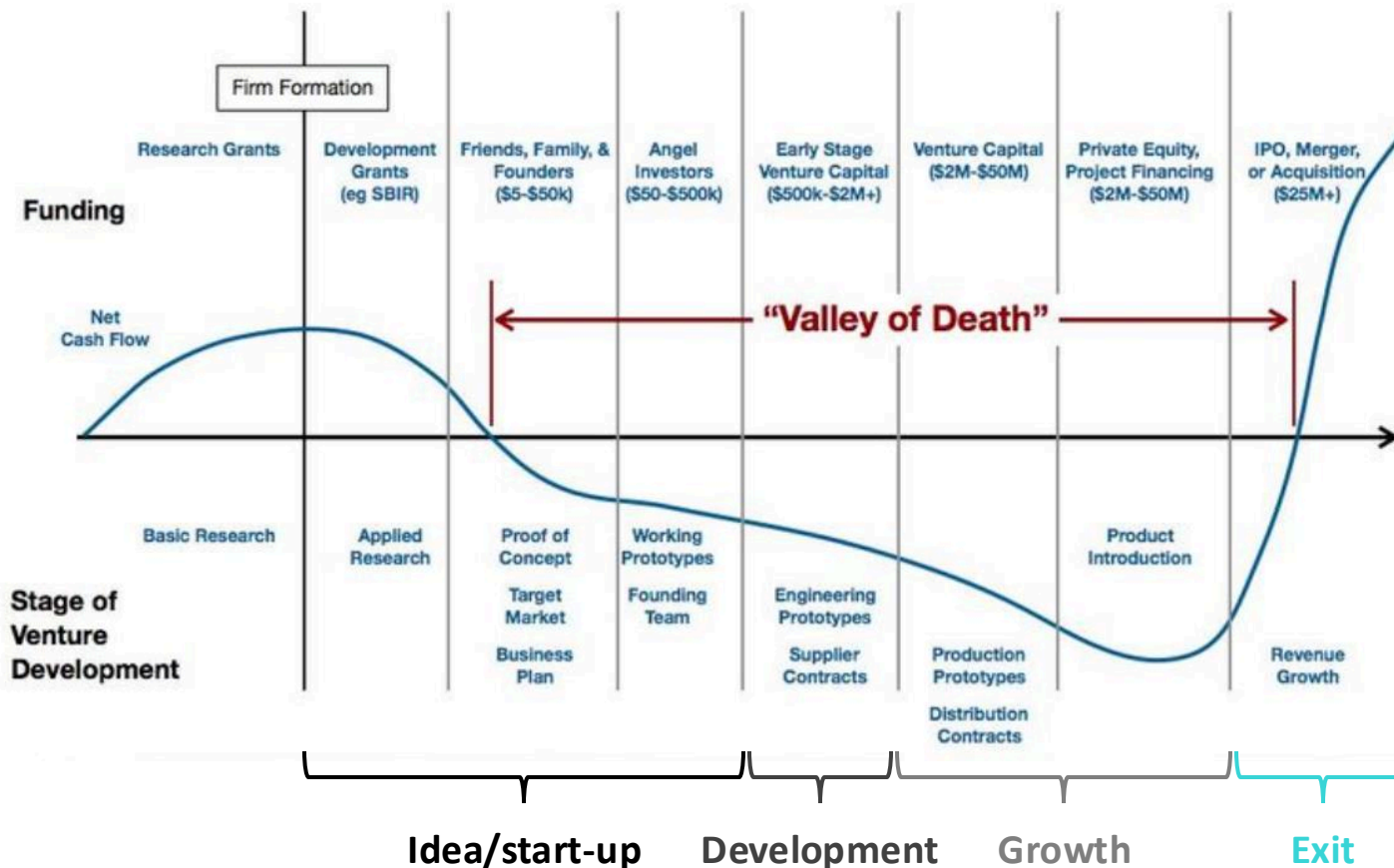


1. Donor governments sign irrevocable **grant agreements** (often spanning **fifteen to twenty years**) with Gavi, which **assigns the grant rights** to IFFIm
2. IFFIm **issues bonds** in capital markets, backed by donor governments' pledges, and **receives the bond proceeds**
3. IFFIm enters into **hedging agreements with the World Bank** for its currency and interest rate risk exposure for donor government grants, and bond interest and principal payments; the World Bank enters into **hedging agreements with market counterparties**
4. Following a funding request from Gavi, IFFIm makes **disbursements** to immunization programs
5. Donor governments make **grant payments** to IFFIm, fulfilling their pledges
6. IFFIm makes **interest and principal payments** to bondholders
7. Throughout, IFFIm is transacting with the World Bank as its **treasury manager**, including in respect to IFFIm's significant investment portfolio, which holds **investments with market counterparties**
8. IFFIm incurs a variety of **fees** due to financial institutions, professional services and other companies

1. How can financial engineering **help local communities adapt to climate change**
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# Introduction to the financing of a new company (1/3)

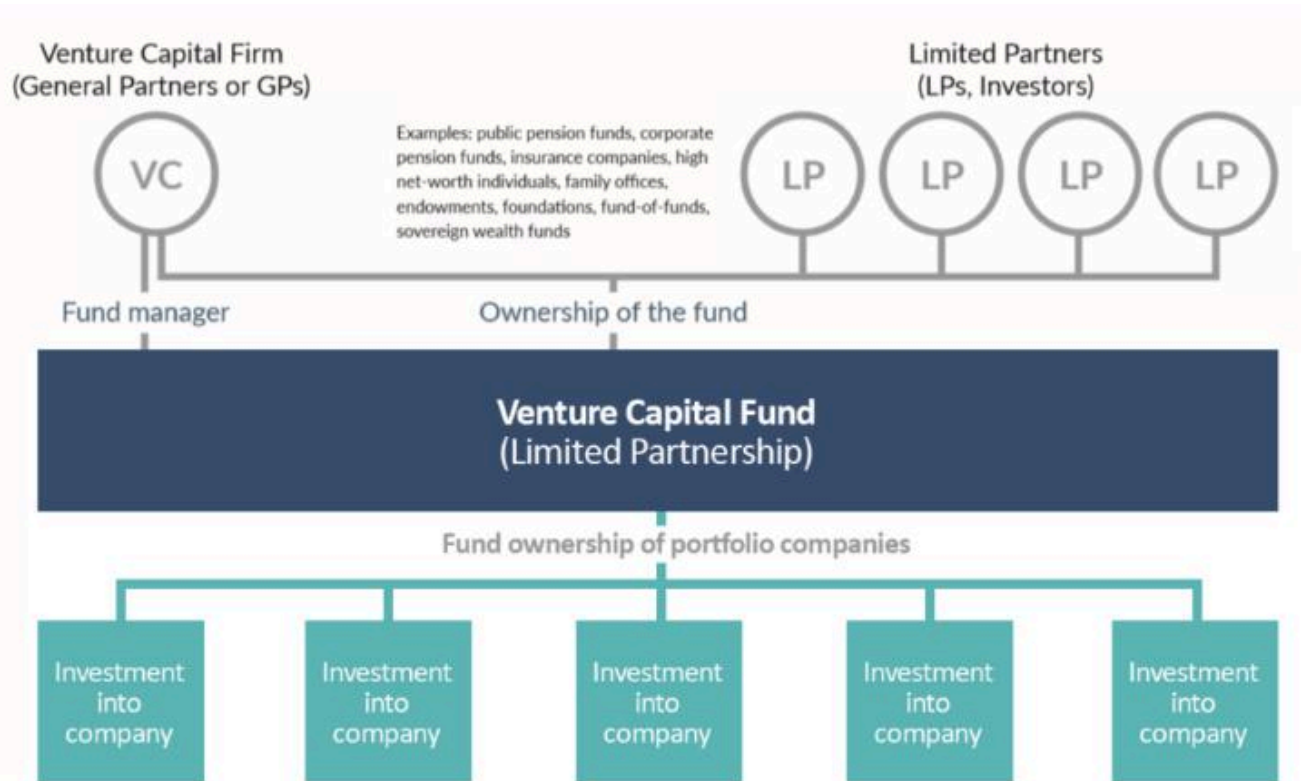
## Lifecycle of a new venture



- **“Valley of death” (VoD):** period during which operations have started but the company does not yet generate enough revenue to finance them
- **Venture Capital:** provide capital that bridge the VoD

# Introduction to the financing of a new company (2/3)

## Venture Capital fund structure



Source: U.S. National Venture Capital Association (NVCA)

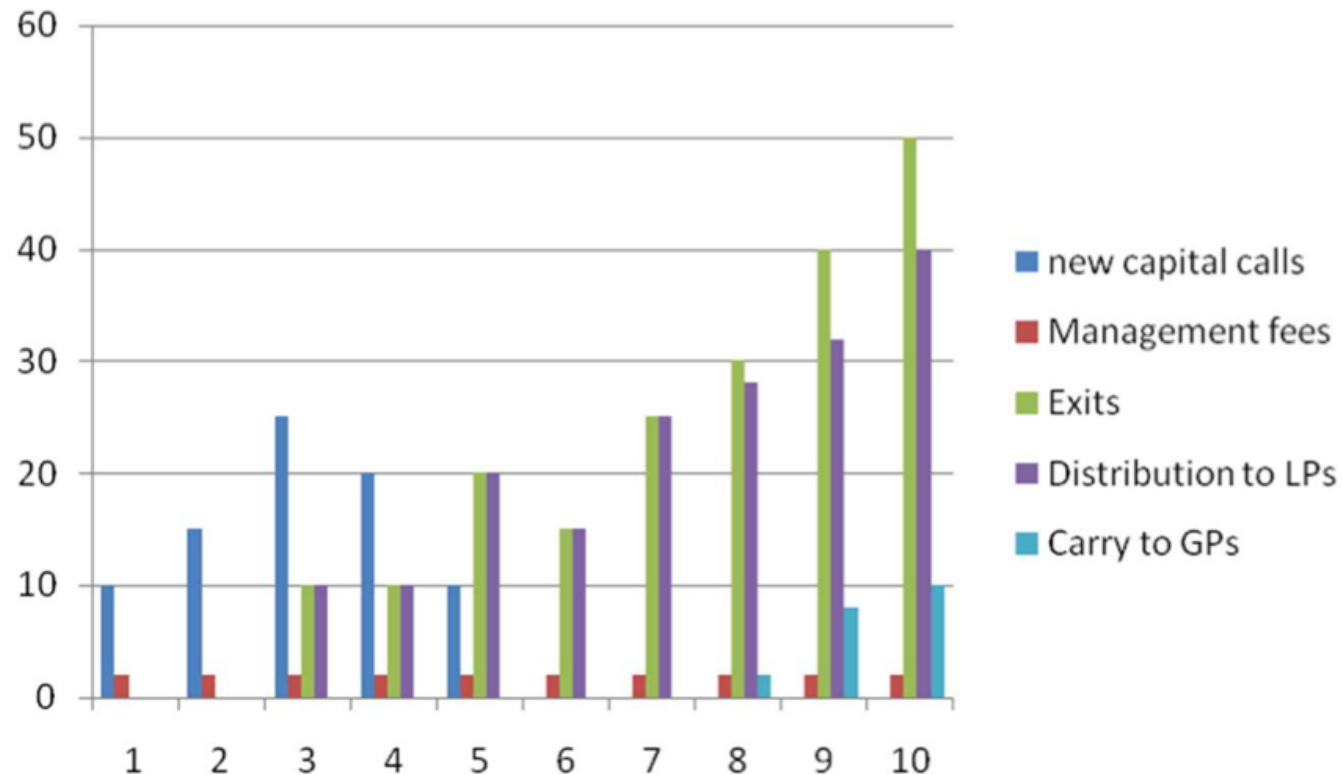
- **Partnership Agreement** between GP and LP to set up the fund
- Investors commit to a **fixed level of capital** at inception of the fund (e.g. \$100M)
- GP **manages** the fund by investing in several promising companies
- **Key figures - US**

\$ Billion	2020	2022	2023	2024
Assets under management (AUM)	694	1'116	1'213	1'254
Amount raised/year	89	163	67	77
Avg VC fund size	0.134	0.226	0.127	0.165
Largest VC fund raised	3.75	12.7	4	4.5

Source: NVCA Yearbook 2024, 2023, 2020

# Introduction to the financing of a new company (3/3)

## Hypothetical performance of a \$100M fund

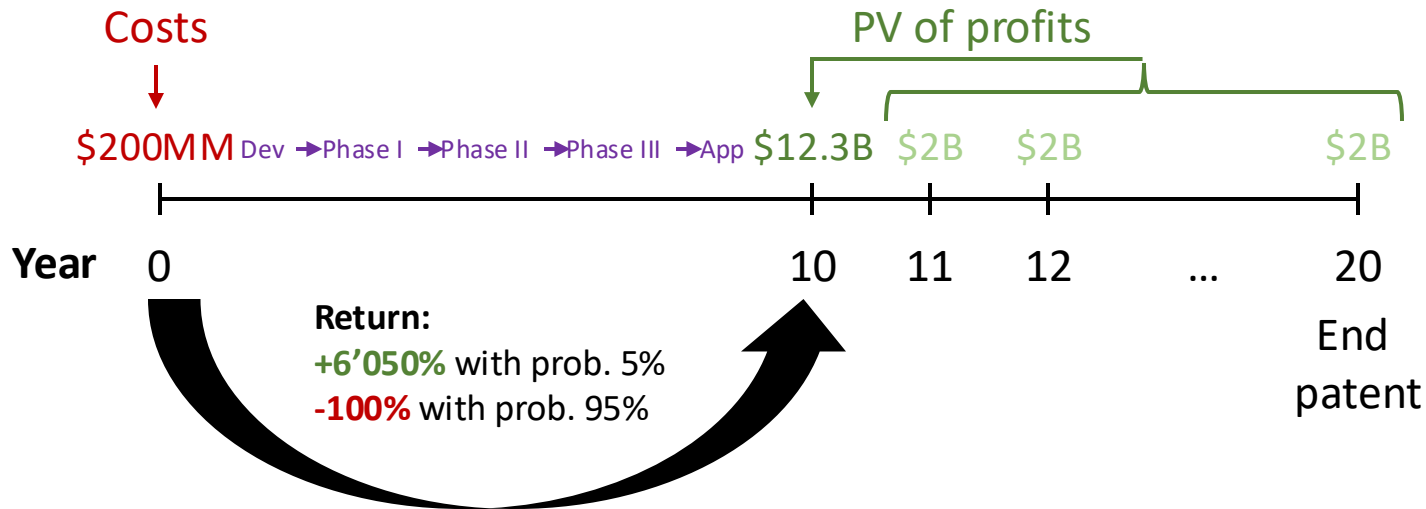


- Life of the fund: ~10-12 years
  - Investment period: **first 5 years** – funds are drawn when opportunities are found by GP
  - Holding period: **3-7 years**
  - Exit period: **before expiration** of the fund – no reinvestment are usually made\*
  - Compensation of the fund: “**2/20 structure**”
    - 2% of Assets Under Management per year (management fee)
    - 20% of profits (carried interest)
- Carries are collected when LP’s capital is recovered

# Curing Cancer: A simple example (Hull, Lo, Stein 2019)

## Example: Development of a new drug

- \$200 MM investment
- 10 years development, trials, FDA Approval
- Probability of success is 5%
- If successful, annual profits of \$2B for 10 years (patent)



## Risk/reward tradeoff

- $Sharpe\ ratio = \frac{E[R] - R_f}{SD[R]}$ 
  - $R_f = 1.5\%$  (U.S. 10-year Treasury yield)

2001-2020	Investment	S&P 500	Pfizer
Expected return ( $E[R]$ )	11.9%	6.4%	4.6%
Volatility ( $SD[R]$ )	423.9%	15.1%	19.7%
Sharpe ratio	0.02	0.33	0.17

**Risk/Reward profile not attractive**

# Megafund – Diversification (1/2)

## Invest in 150 drug candidates simultaneously

- Assume the projects are IID
- Requires  $0.2 \times 150 = \$30B$  of capital
  - Each project has weight  $w = \frac{0.2}{0.2 \times 150} = \frac{1}{150}$  in portfolio  $P$
- The risk reward tradeoff becomes

2001-2020	Investment (1)	S&P 500	Pfizer	Investment (150)
Expected return ( $E[R]$ )	11.9%	6.4%	4.6%	11.9%
Volatility ( $SD[R]$ )	423.9%	15.1%	19.7%	34.6%
Sharpe ratio	0.02	0.33	0.17	0.30

- $E[R_p] = E[\sum_{i=1}^{150} wR] = \frac{1}{150} \sum_{i=1}^{150} R = 11.9\%$

- $SD[R_p] = \frac{423.9\%}{\sqrt{150}} = 34.6\%$

- $Sharpe\ ratio = \frac{11.9\% - 1.5\%}{34.6\%} = 0.30$

Risk/Reward profile attractive thanks to diversification

$\uparrow$  Sharpe ratio =  $\frac{E[R] - R_f}{\sigma[R]}$ 
 $\downarrow$

# Megafund – Diversification (2/2)

## Reduced risk allows debt financing

Event	Probability	Minimum year-10 NPV	Max year-0 proceed at 2% (BofAML A 10-Yr as of 10.11.2021)
At least 1 hit	99.95%	\$ 12.3 B	\$ 10.1 B
At least 2 hits	99.59%	\$ 24.6 B	\$ 20.2 B
<b>At least 3 hits</b>	<b>98.18%</b>	<b>\$ 36.9 B</b>	<b>\$ 30.2 B</b>
At least 4 hits	87.44%	\$ 49.2 B	\$ 40.3 B

Source: Modification from Lo's seminar presentation @EPFL (04.06.2021)

- 3 hits enable to generate a NPV **\$ 36.9 B** in year 10 with prob. **98.18%**
- Probability of default after 10 years is **1.82%**: **A**-rating yield of 2%
- Possible to raise **\$ 30.2 B** today

## Why is this important?

- Size of VC vs Bond market (2024)
  - US VC AUM (amount raised): **\$ 1'254 B** (\$ 77 B)
  - Outstanding (issuance) US fixed income securities (source: sifma)
    - **Total: \$ 46'809 B (\$10'432 B)**
    - Incl. \$11'137 B (\$ 1'969 B) of corporate debt



Enables to attract new investors with  
(1) a different risk/reward profile and  
(2) a larger amount of funding

# Megafund – Diversification (2/2)

## Reduced risk

Event	Probability	ICE BofA US corporate index effective yield	Rating (e.g. Moody's, Fitch, Standard and Poor's)	10.11. 2021	16.05. 2023	10.05. 2024	23.10. 2024	24.10. 2025
At least 1 hit	99.9%	Investment grade	Aaa/AAA	1.97%	4.42%	5.05%	4.65%	4.5%
At least 2 hits	99.5%		Aa/AA	1.91%	4.65%	5.19%	4.75%	4.38%
<b>At least 3 hits</b>	<b>98.1%</b>		<b>A/A</b>	<b>2%</b>	<b>5.13%</b>	<b>5.46%</b>	<b>4.98%</b>	<b>4.55%</b>
At least 4 hits	87.4%		Baa/BBB	2.46%	5.62%	5.78%	5.31%	4.88%
		High yield	Ba/BB	3.33%	6.89%	6.43%	5.92%	5.41%
			B/B	4.72%	8.76%	7.54%	6.95%	6.49%
			Caa/CCC	7.57%	14.61%	13.83%	11.74%	8.43%
			Ca/CC					
			c/C					

Source: Modification from Lo's seminar presentation

- 3 hits enable raising **\$ 36.9 B** in debt
- Probability of **1.82%: A-** rating
- Possible to raise **\$ 30.2 B** today



Net (2024)  
\$ 1'254 B (\$  
d income

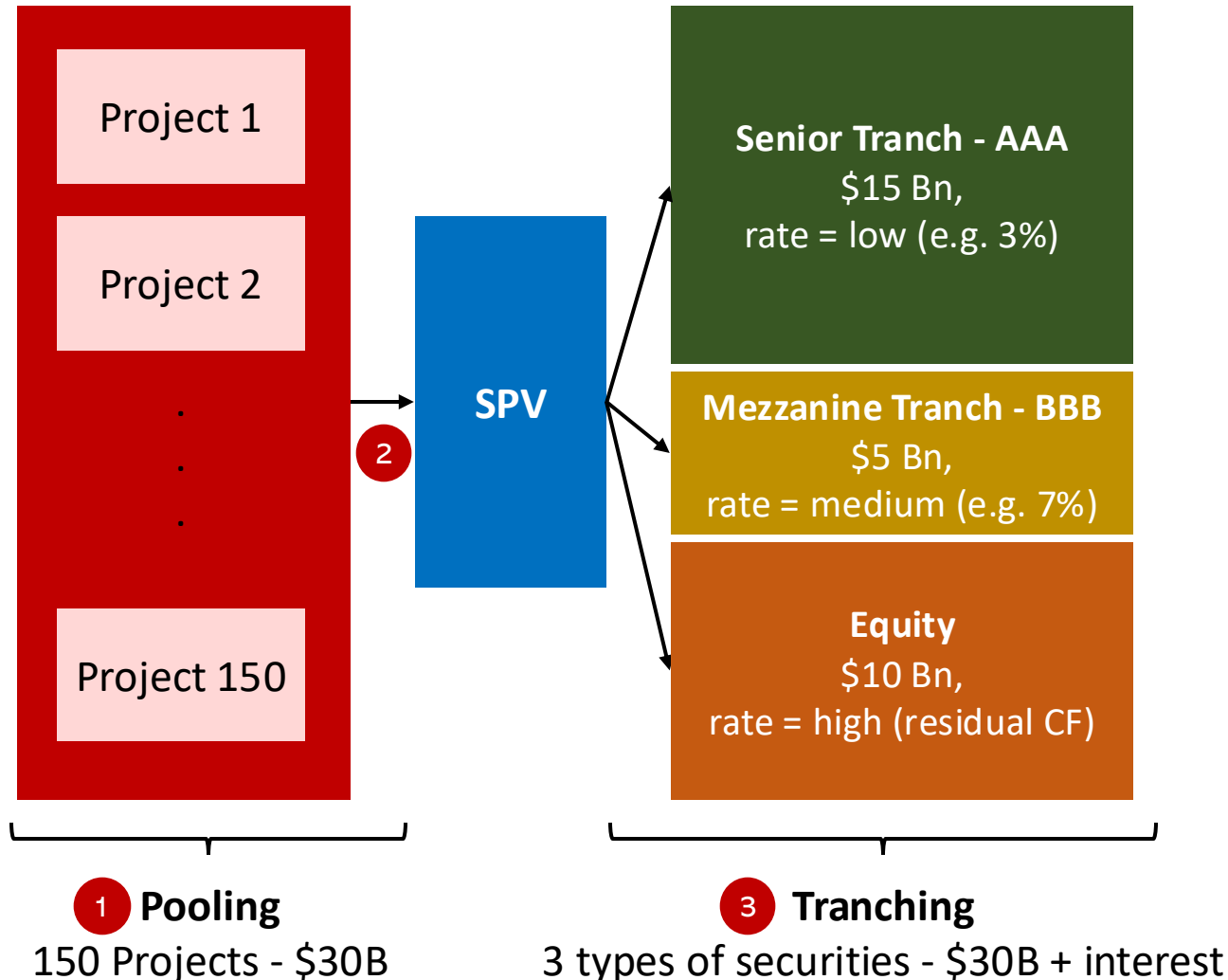
Amount at t=0:  
**\$ 23.6 B** corporate debt



to attract new investors with  
different risk/reward profile and  
(2) a larger amount of funding

# Megafund – Securitization – Theory

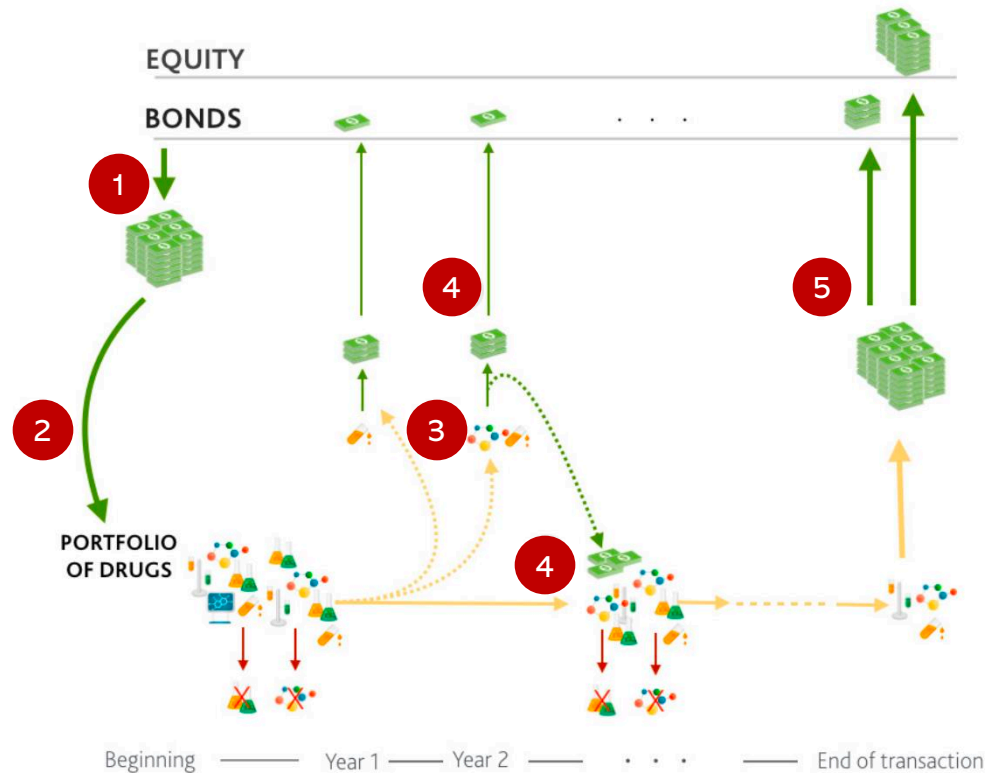
## What is Securitization?



1. CF from risky projects are **pooled** together in a portfolio
2. A *Special Purpose Vehicle* (SPV) **acquires** that portfolio
3. The SPV transforms the portfolio's **cash flow** in different **Tranches** - Research Backed Obligations (RBO) - with different levels of **seniority** (risk)

# Megafund – Securitization – In practice

## Schematic design of cash-flow securitization, with coupon-paying debt, for a portfolio of early-stage drug development projects



1. Securities are issued
2. Proceeds from the sale of the securities are used to purchase a portfolio of candidate therapies
3. As therapies move through the approval process, they gain value and are sold or they fail and are withdrawn
4. Proceeds of the sales are used to pay principal and interest and to fund trials on remaining drugs
5. At the end of the process, the remaining portfolio is sold and the proceeds distributed

# Example – BridgeBio Pharna Inc. (1/2)



## BridgeBio – Portfolio of Orphan drugs

*“We have created a sustainable engine for the systematic discovery, development, and commercialization of medicines for genetic disease”  
(Bridgebio Company Presentation)*

- Rare diseases
  - < 200'000 people in the U.S
  - Low correlation between projects successes
  - Larger probability of success
  - Shorter and cheaper development & approval time
- 2 important principles: (source: BridgeBio)
  - “The **willingness** and **scale to fail** and to re-allocate capital, within a de-centralized company model”
  - “**Distinctive early-stage asset selection**, based on a deep understanding of clinical unmet need, genetics, and underlying molecular pathophysiology“

## Key metrics

- Creation: 2014
- IPO: 2019
  - IPO stock price: \$17
  - Stock price (Mkt cap) 10/11/2021: \$49.31 (\$7.3B)
  - Stock price (Mkt cap) 16/05/2023: \$14.3 (\$2.3B)
  - Stock price (Mkt cap) 15/05/2024: \$30.1 (\$5.6B)
  - Stock price (Mkt cap) 23/10/2024: \$24.3 (\$4.5B)
  - Stock price (Mkt cap) 28/10/2025: \$63.6 (\$12.1B)
- Portfolio: 30+ initiated programs since creation of the company (10.2024, 05.2024, 2023) (source: BridgeBio)
  - 1 in Pre-clinical (1, 3, N/A)
  - 0 drugs in phase I (1, 4, 4)
  - 3 drugs in phase II (1, 0, 2)
  - 4 drugs in phase III (4, 2, 2)
  - 3 drugs approved since company creation (2, 2, 2)
- Funding: \$3+ B raised in 10+ rounds

# Example – BridgeBio Pharma Inc. (2/2)



#	Deal Type	Date	Amount	Raised to Date ⓘ	Stage
11	Debt Refinancing	28-Feb-2025	\$500.00M	\$3.03B	
10	2PO	06-Mar-2024	\$250.00M	\$2.53B	Generating Revenue/Not Profitable
9	Debt Refinancing	18-Jan-2024	\$450.00M	\$2.28B	Generating Revenue
8	PIPE	27-Sep-2023	\$250.00M	\$1.83B	Generating Revenue
7	Debt Refinancing	17-Nov-2021	\$750.00M <sup>F</sup>	\$1.58B	Clinical Trials - General
6	IPO	27-Jun-2019	\$348.50M	\$832.25M	Clinical Trials - General
5	Later Stage VC (Series D)	23-Jan-2019	\$299.20M	\$483.75M	Clinical Trials - General
4	Debt - General	30-Jun-2018	\$35.00M	\$184.55M	Clinical Trials - General
3	Later Stage VC (Series C)	10-Apr-2018	\$135.00M	\$149.55M	Clinical Trials - General
2	Early Stage VC (Series B)	26-Mar-2016	\$8.00M	\$14.55M	Startup
1	Seed Round	26-May-2015	\$6.55M	\$6.55M	Startup

## BridgeBio Pharma funds raised

Source: crunchbase

## BridgeBio Pharma Inc



NASDAQ: BBIO ⓘ

Market Summary > BridgeBio Pharma Inc

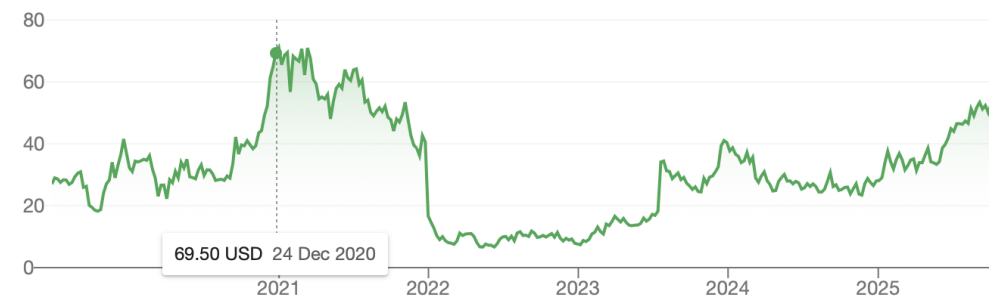
64.30 USD

+ Follow

+37.33 (138.41%) ↑ all time

28 Oct, 15:56 GMT-4 • Disclaimer

1D | 5D | 1M | 6M | YTD | 1Y | 5Y | Max



Open	63.02	Mkt cap	12.11B	52-wk high	65.00
High	64.61	P/E ratio	-	52-wk low	21.72
Low	62.51	Div yield	-	Qtrly Div Amt	-

## BridgeBio Pharma stock price evolution

Source: Yahoo Finance

# Outline – 4 Examples

1. How can financial engineering **help local communities adapt to climate change**
2. How can financial engineering **accelerate vaccination** in developing countries
3. How can financial engineering **cure cancer**
4. How can financial engineering **enable the empowerment of minorities**

## Definitions

- **Index:** method to track the performance of a basket of securities
  - **S&P 500:** tracks the performance of the 500 *leading* publicly traded companies in the U.S.
    - Market cap weighting method
    - Examples of criteria to be included: U.S. company; mkt cap > 11.8 B, be highly liquid, etc.
  - **SMI:** tracks the 20 largest Swiss stocks
    - Market cap weighting method; weight capped at 20%
- **Passive Investment:** Strategy that consists in maximizing returns by minimizing the number of trades
  - *Buy and hold* strategy
  - Examples of passive investing methods: **Index funds**, **Exchange Traded Funds (ETF)**

## Index Funds

- Introduced in the 1970s
- Type of mutual fund which portfolio tracks a financial market index
- How does it work?
  - Investors' money is pooled in a fund
  - The manager of the fund uses the money to buy the securities considered in the benchmark index
  - Managers follow the benchmark index, independent of its performance
  - Investors receive a return that mimics the benchmark

### Benefits of Index Funds and ETFs

- Diversification
- Low fees
- Good long term returns

## ETFs

- Introduced in the 1990s
- Type of security that can be structured to track **anything** (e.g. S&P500, oil price, Bitcoin, etc.)
- How does it work?
  - An investment company (e.g. Blackrock) builds a portfolio of securities
  - Shares of this portfolio are then sold and traded on an exchange
- AUM of global ETFs 2024: 14.6 T (source: PwC)

### Drawbacks of Index Funds and ETFs

- Lack of flexibility
- Vulnerability to market swings
- No human element

# Example – NAACP Minority Empowerment ETF (1/2)

## NAACP Minority Empowerment ETF (NACP)

- **NAACP:** National Association for the Advancement of Colored People
- The NAACP Minority Empowerment ETF
  - Issued by the nonprofit fund manager **Impact Share**
  - Tracks the Morningstar Minority Empowerment Index (MMEI)
    - **Objective:** “providing exposure to US companies that have embedded strong racial and ethnic diversification policies into their corporate culture and that ensure equal opportunities to employees irrespective of their race or nationality” (source: Morningstar)
    - **Criteria to be included:**
      - **Exclusion of businesses:** (1) involved in serious **social-related controversies**; (2) involved in **specific sectors** (Security Services and Correctional Facilities, tobacco, riot control-related products, and predatory lending); (3) which **do not comply** with the United Nations Global Compact (commitment to sustainable, socially responsible business practices. E.g., Procter & Gamble).
      - The index is then constituted of the **200 companies** that score best on **18 criteria established by the NAACP** (e.g. board diversity, discrimination policy, diversity programs) (list in the Appendix)
    - **Weighting method:** (1) **high scores** on the NAACP criteria, (2) **risks and returns similar** to the Morningstar US Large-Mid Cap Index (MUSLMCI)

Top 10 Companies in MUSLMCI (weight %)	Top 10 Companies in MMEI (weight %)
Apple (6.78%)	Apple (5.47%)
Microsoft (6.15%)	Microsoft (4.79%)
Amazon.com (2.53%)	NVIDIA (3.45%) <span style="color: green;">↑</span>
NVIDIA (1.83%)	Amazon.com (3.01%) <span style="color: red;">↓</span>
Alphabet Class A (1.72%)	Alphabet Class A (3.00%)
Berkshire Hathaway (1.59%)	Meta Class A (2.70%)
Alphabet Class C (1.51%)	Alphabet Class C (2.64%)
Meta Class A (1.44%)	Salesforce (2.49%)
Exxon Mobil (1.31%)	Cisco Systems (2.43%)
UnitedHealth Group (1.24%)	Exxon Mobil (2.36%)

Source: Morningstar US Large-Mid Index Factsheet (30/04/2023) | Source: Morningstar Minority Empowerment Index Factsheet (30/04/2023)

**Not part of the MMEI in 2023 due to low score across indicators**

# Example – NAACP Minority Empowerment ETF (2/2)

## Financial Engineering

- **Diversification:** portfolio of companies
- Management fee is **split in two**
- Theoretical example (Connaker, Madsbjerg 2019, HBR)
  - Consider a **management fee** of 75 basis points (bps) of AUM
  - **Impact share:** receives 25 bps to cover the expenses of the fund
  - **The NAACP** receives the difference, i.e. 50 bps: 5\$/year for each \$1'000 invested in the fund
- The NAACP receives a return for its engagement with the companies indexed

## Does it work?

- **MMEI**



Source: Morningstar Minority Empowerment Index Factsheet (30/04/2024)

- **NACP ETF**

Data as of 05/17/2023

		05/15/2024	10/24/2024
Net Assets	\$41,758,961	\$44,873,847	\$54.18m
Shares Outstanding	1,425,000	1,175,000	1,300,000
NAV	\$29.30	\$38.19	\$41.67

Source: Impact Share

# Example – NAACP Minority Empowerment ETF (2/2)

## Financial Engineering

- **Diversification:** portfolio of companies
- Management fee is **split in two**
- Theoretical example (Connaker, Madsbjerg 2019, HBR)
  - Consider a **management AUM**
  - **Impact share:** receives 25% of the fund
  - **The NAACP** receives the difference, i.e. 50 bps: 5\$/year for each \$1'000 invested in the fund
- The NAACP receives a return for its engagement with the companies indexed

$$\text{High Sharpe ratio} = \frac{E[R] - R_f}{\sigma[R]} \quad \begin{matrix} \text{Average} \\ \text{Low} \end{matrix}$$

Diversified portfolio of “good” companies

## Does it work?

- **MMEI**



- **NACP ETF**

Data as of 05/17/2023

	05/15/2024	10/24/2024
Net Assets	\$41,758,961	\$54.18m
Shares Outstanding	1,425,000	1,300,000
NAV	\$29.30	\$41.67

Source: Impact Share

- Finance is a very creative industry
- Financial engineering offers lots of flexibility to structure products that can help finance Grand Challenge
  - However it also has a cost that needs to be taken into account
- The key point is ***incentives***
  - Providing the right risk/reward tradeoff to make it attractive to investors

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## List of criteria established by the NAACP (source: morningstar)

- Board Diversity
- Discrimination Policy
- Diversity Programs
- Freedom of Association Policy
- Scope of Social Supplier Standards
- Community Development Programs
- Health and Safety Management System
- Conflict Minerals Programs
- Media Ethics Program
- Human Rights Program
- Editorial Guidelines
- Advertising Ethics
- Human Capital Development
- Responsible Product Offering
- Responsible Marketing Policy
- Human Rights Policy
- Gender Pay Equality Program
- Gender Pay Disclosure



Merci