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Three questions every ESG multi-asset investor needs to ask

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A lot has been said about the importance of financially material environmental, social and governance (ESG) risks when analysing companies. Yet comparatively little has been said about integrating these risks in the context of wider portfolio construction.

Amid the flurry of new ESG regulations and product launches, it's easy to lose sight of some valuable tools that have benefited multi-asset investors over the years in our view and remain highly relevant as ESG rises up the agenda.

Question time

Once an investor is comfortable that a portfolio is aligned with their ESG preferences or meets their ESG objective, they should also ask themselves the following:

1. Am I comfortable with the level of concentration in my portfolio in terms of countries, sectors, stocks or equity factors?
2. Am I comfortable with the charges given the inevitable drag of fees on long-term performance?
3. Am I comfortable with the stability of my portfolio's risk level?

Concentration risk

One trap ESG strategies can fall into is implicit concentration. In pursuit of better ESG credentials, investors might accidentally be fishing in a very small pond of companies; the companies that often feature among top 10 holdings in many ESG-focused thematic funds.

However, alongside their ESG profile, these stocks may introduce other biases. They may lead to over- or under-exposure to sectors or countries or other equity factor characteristics.

Consequently, the portfolio might carry implicit risks that investors might not have fully appreciated.

Key risks: The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

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Transparency triumphs

In our view, one way to potentially reduce the impact of relative biases is to choose an index strategy that limits country or sector differences but still provides an explicit ESG tilt. Ultimately, it is down to individual investors to decide on the level of concentration risk they are comfortable with in pursuit of their ESG objectives.

The challenge remains that the level of concentration or the implicit biases that creep into many strategies might not be fully appreciated by investors.

Fortunately, greater transparency and enhanced disclosures should help investors navigate this landscape and help to potentially secure ESG benefits through strategies with varying degrees of concentration, from ESG-tilted index trackers to traditional active funds.

Fee impact

Over the long term, a small increase in the level of fees can result in a large drag on performance.

Here we examine how innovation in the area of ESG has led to new, cost-effective solutions and what that could mean for investors.

In 2017, the average total expense ratio (TER) was just under 40 basis points (bps) for passive peers, around 70bps for risk-targeted peers and just over 80bps for ESG peers.[1] As new, cost-effective ESG multi-asset funds came to the market, they were added to the ESG peer group and its average TER gradually fell.

While the downward pressure on charges was experienced across all three groups, the drop in the average fee was most significant for ESG peers.

One explanation for this is the improvement in the quality of ESG data, a result of improved disclosure from companies. More reliable, financially material ESG data allowed for a more meaningful company-level comparison across most sectors and geographies. As a result, a significant share of listed corporate issuers can be consistently assessed on a set of relevant and quantifiable ESG metrics – something that simply would not have been possible 10 years ago.

That opened the door to a new way of ESG investing. Rather than choosing individual companies with an active strategy, it's now possible to construct and track an index that will tilt weightings according to the ESG credentials of the underlying constituents. While these strategies are still priced at a premium to cover the cost of additional data requirements and a more sophisticated design, the premium is materially lower than that of earlier ESG funds.[2]

Investors are certainly warming up to the new approach, with half of the top 10 funds with largest net inflows in 2021 now being ESG, sustainable or low-carbon trackers.[3]

Multi-asset investors have been blending active and index strategies for years, and today ESG investors are able to do the same thing. This allows them to monitor not only fees but also their overall level of diversification.

Reflecting the risk appetite of our clients

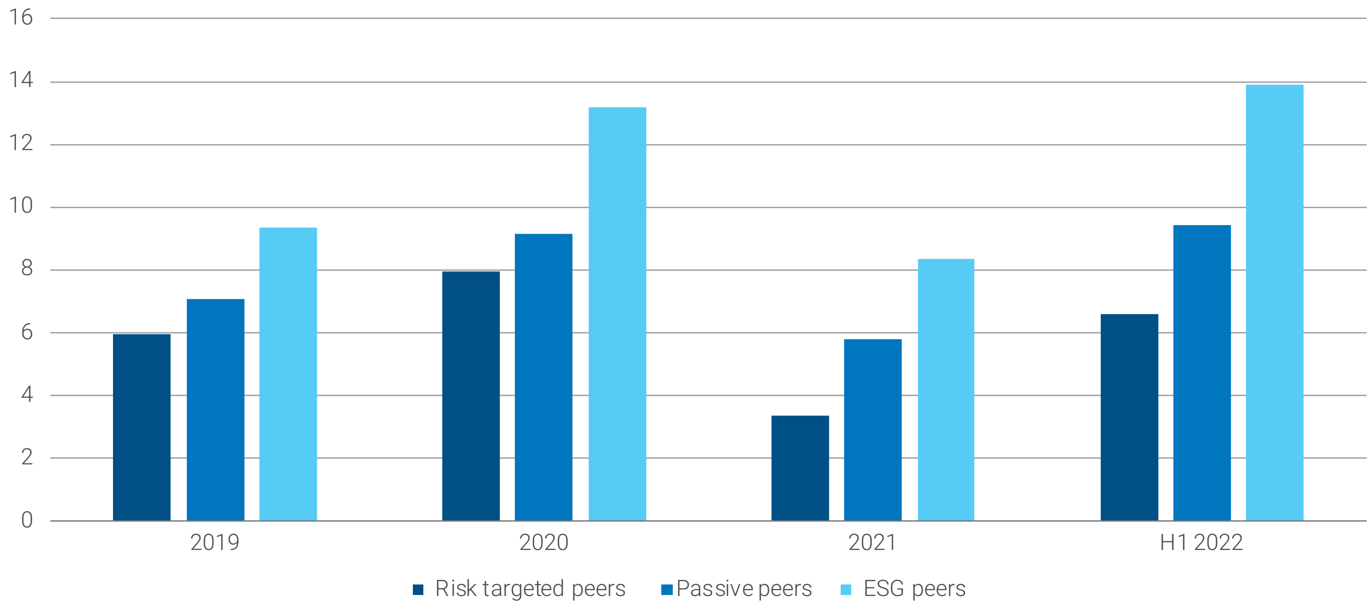
Reflecting the risk appetite of our clients on an ongoing basis is no less relevant when servicing ESG investors. However, in the UK the offering of risk-targeted funds with an ESG focus remains limited, and the lack of an explicit volatility target could potentially lead to wider dispersion of investment outcomes for those with ESG requirements in our view.

While the multi-asset ESG peer group is still relatively new, this is not necessarily a limitation as the past few years offer a wide range of distinct market regimes for our analysis of the dispersion in client outcomes:

- **2019:** markets characterised by US/China tensions against the backdrop of a multi-year late cycle
- **2020:** markets dominated by COVID-19 news and huge fiscal stimulus across the developed world
- **2021:** a broad-based recovery as markets welcomed the vaccination roll-out and a gradual re-opening
- **2022:** dominated by inflation worries, volatility in commodity prices and recession fears

1. Source: Refinitiv Lipper, as at 30/06/2022
2. Source: Refinitiv Lipper as at 30/06/2022; representative sample of actively managed and index-based ESG funds in 2017 and 2022
3. Source: Morningstar UK Fund Flows Report, 2021

Performance range among peers (%)



Source: Lipper as of 30/06/2022

Key risks: The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. Past performance is not a guide to the future

So how did our peer groups fare in such volatile times, and was risk targeting (suitability) helpful in narrowing the range of performance?

Looking at the difference between the worst and the best performers across peer groups, the gap is smallest for peers targeting a specific risk profile for every calendar year since 2019 as well as the first half of 2022.[4]

That gap then widens for multi-asset strategies that predominantly invest in index funds; it is largest for funds with an ESG/sustainable/ethical approach (as designated by the Dynamic Planner). Looking at the aggregate impact over three full calendar years to the end of 2021, the range in performance is as wide as 12.5% for risk-targeted peers, 17.2% for passive peers and 25.9% for ESG peers.

That could suggest that relying solely on the current risk rating might result in a relatively wider dispersion of future outcomes among ESG investors, given the wide range of approaches adopted by ESG multi-asset strategies. By contrast, risk-targeted funds – including those with ESG mandates – could result in a relatively narrower dispersion of future outcomes.

Greater dispersion could also be associated with a higher probability of drift for ESG funds across risk profiles. Indeed, risk-targeting might be particularly helpful for investors interested in ESG multi-asset solutions by ensuring they remain within their prescribed risk profiles over time.

Finding the right balance

Reflecting clients' sustainability preferences shouldn't come at the expense of ongoing suitability. Multi-asset ESG investing is about balance. Here, the balance is about securing material ESG benefits while not losing sight of other key portfolio considerations such as diversification, costs and risk stability. Otherwise, choosing an ESG solution could leave investors more vulnerable to changes in market conditions or result in materially different long-term outcomes. This could impact future investor preferences, drive asset flows and undermine confidence in ESG strategies.

For the good of the investor and the good of the planet, we need to get this balance right.

4. Source: Refinitiv Lipper, as at 30/06/2022

Contact us

For further information about LGIM, please visit lgim.com or contact Charities@lgim.com

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Key risks

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