



Diversified ESG

I have recently been asked by one of our IFA clients to undertake a project relating to ESG. Always one to relish challenges and learn from the process, I thought it made sense to share some of the findings.

The client asked if we could construct a portfolio of global funds that only contained managers that scored 4 or 5 globes using the Morningstar Sustainability Rating screen. There was one request though – they wanted 5-10 funds and they wanted a diversified portfolio. My initial thought was – absolutely sure. We had no other constraints – nothing about an income level; nothing about minimum fund size or track record. Nothing relating to Morningstar analyst ratings or limits relating to fees. As long as the fund was GBP priced and in Unit Trust / OEIC format, we were good to go.

Before going any further, a little bit of information relating to the Morningstar Sustainability Globes. Morningstar started reviewing collective funds in 2016 and they rate over 20,000 funds. The screen is updated monthly. The screen works from 1 globe through 5.

- 1 Globe – at the bottom end of the rating for its industry group
- 2 Globes – below average
- 3 Globes – average
- 4 Globes – above average
- 5 Globes – high end

There is a whole array of work undertaken by Morningstar when they rate funds; for more information, please read the excerpt on this Investopedia weblink - <https://www.investopedia.com/terms/m/morningstar-sustainability-rating.asp>

The initial screen highlighted 65 funds – plenty to be able to build a portfolio from surely...

I'm sure you are all aware of the Morningstar Style Box when looking at equity holdings. It's a 3x3 grid relating to market cap (Small, Medium, Large) on the vertical plane and investment style on the horizontal (Value, Blend, Growth) – as shown below:

Equity StyleBox™

	Val	Blid	Gwth
Lg			
Mid			
Sm			

A great way to create “diversification” (because after all, that is what the client asked for) would be to construct the portfolio across the equity style box as above and select the best fund(s) in each of the boxes. Although it is possible to have companies that do similar things across the market capitalisation spectrum, there can certainly be correlation differences by investing in funds with different market cap biases.

The fact the Morningstar style box above is split by market cap suggests by default that investing by market capitalisation is a differentiating factor.

Taking the 65 funds in the universe and placing the number into the relevant style box, the table below shows that creating a diversified portfolio is actually quite hard.

	Value	Blend	Growth
Large	1	34	27
Medium	0	1	2
Small	0	0	0

It looks very much like ESG is a large cap game. Market cap and ESG is obviously not a diversifying factor. If you include all potential funds within the Morningstar Sustainability Ratings that fall within the small cap universe, there is a choice of 1 (Invesco Global Smaller Companies) which scores 2 globes. A choice of one is not, in my view, a choice at all.

In the same way that Morningstar consider market cap a differentiator, they also consider investment style a differentiator. Therefore, when looking at value there is a choice of one and that choice is large cap - If you are interested, it is Lazard Global Listed Infrastructure - and that fund is not even a broad-based equity fund, it is a specialist fund that invests in infrastructure stocks. With a choice of one, there really is no choice, so it probably makes sense to widen out the number of globes used to increase the size of the universe. Widening this out to include all stocks that have a Morningstar Sustainability rating (one, two, three, four or five) the number jumps to 25, so arguably the choice is good, but when looking at those 25:

8 have 1 globe
 9 have 2 globes
 7 have 3 globes
 0 have 4 globes
 1 has 5 globes

Therefore, more than 2/3 of the potential “value” funds score either 1 or 2 Morningstar globes with regard to their Sustainable Ratings and this is not really an acceptable position to find yourself in.

By shifting down the number of globes, so as to widen out the investment universe, are you forcing diversification without taking consideration of the quality of the sustainability ratings?

Taking the 27 funds that pass the screen from the Large Cap Growth Style box, I thought it would be interesting to have a look at how correlated the funds are. The data is over the last 52 weeks (to 09/04/2021) and we have created a heatmap – as shown below. The darker the blue, the higher the correlation. As should be known, a correlation number moves between +1 (perfectly correlated) and -1 (perfectly uncorrelated).

Considering the fund managers included below have the ability to invest in large cap companies all over the world, you would imagine they have plenty of scope to construct portfolios out of a universe of thousands of companies, yet as can be shown below, there is a high correlation across the board.

Start	09/04/2020	22.322	22.759	22.855	22.583	21.597	22.111	22.375	19.905	19.935	21.270	22.923	21.293	22.194	22.194	19.016	22.415	21.122	21.589	19.844	19.864	19.863	20.850	22.585	22.583	23.045	23.045	
End	09/04/2021																											
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27
1 Aberdeen Standard SICAV I World Equity A Acc GBP		0.914	0.981	0.954	0.835	0.922	0.933	0.838	0.708	0.864	0.934	0.793	0.911	0.911	0.728	0.858	0.924	0.888	0.777	0.777	0.777	0.831	0.846	0.846	0.846	0.879	0.879	
2 Aberdeen Standard Capital Falcon Acc		0.914	0.940	0.909	0.853	0.932	0.932	0.777	0.796	0.864	0.931	0.864	0.913	0.913	0.757	0.921	0.891	0.869	0.767	0.767	0.767	0.835	0.918	0.918	0.918	0.948	0.948	
3 ASI Global Equity A Acc		0.981	0.940	0.963	0.848	0.929	0.952	0.839	0.747	0.876	0.960	0.828	0.926	0.926	0.755	0.905	0.925	0.871	0.773	0.774	0.774	0.851	0.889	0.889	0.889	0.921	0.921	
4 ASI Global Ethical Equity A Acc		0.954	0.909	0.963	0.859	0.929	0.933	0.845	0.744	0.865	0.940	0.810	0.900	0.900	0.769	0.871	0.924	0.888	0.765	0.766	0.766	0.832	0.863	0.863	0.863	0.901	0.901	
5 AXA Framlington Global Thematics R Acc		0.835	0.853	0.849	0.859	0.820	0.815	0.858	0.812	0.879	0.888	0.788	0.818	0.818	0.725	0.861	0.937	0.914	0.732	0.734	0.734	0.869	0.917	0.916	0.916	0.919	0.919	
6 BMO Sustainable Opportunities Global Equity I Acc		0.922	0.932	0.929	0.929	0.820	0.854	0.801	0.797	0.867	0.886	0.832	0.874	0.874	0.744	0.848	0.934	0.885	0.721	0.721	0.721	0.870	0.939	0.939	0.939	0.887	0.887	
7 BNY Mellon Long Term Global Equity Inst 2 Acc		0.933	0.932	0.952	0.933	0.815	0.954	0.824	0.732	0.843	0.919	0.812	0.902	0.902	0.736	0.896	0.925	0.861	0.747	0.748	0.748	0.880	0.869	0.869	0.869	0.889	0.889	
8 GAM Multistock - Luxury Brands Equity B GBP		0.838	0.777	0.839	0.845	0.695	0.801	0.824	0.692	0.666	0.810	0.778	0.833	0.833	0.738	0.765	0.835	0.698	0.745	0.742	0.742	0.667	0.754	0.754	0.754	0.776	0.776	
9 Guinness Global Innovators C Acc GBP		0.708	0.795	0.747	0.744	0.812	0.757	0.732	0.692	0.748	0.772	0.931	0.747	0.747	0.745	0.820	0.661	0.764	0.651	0.650	0.650	0.790	0.838	0.838	0.838	0.849	0.849	
10 Janus Henderson Global Equity Acc		0.864	0.864	0.876	0.865	0.879	0.867	0.843	0.665	0.748	0.868	0.781	0.780	0.780	0.690	0.837	0.774	0.950	0.719	0.720	0.720	0.869	0.869	0.869	0.869	0.872	0.872	
11 Jupiter Global Managed L Acc		0.934	0.931	0.960	0.940	0.888	0.886	0.919	0.810	0.772	0.868	0.837	0.934	0.934	0.741	0.938	0.882	0.869	0.796	0.798	0.798	0.847	0.922	0.922	0.922	0.943	0.943	
12 Lazard Global Strategic Equity A Acc GBP		0.793	0.864	0.828	0.810	0.789	0.832	0.812	0.775	0.931	0.751	0.837	0.817	0.817	0.783	0.872	0.760	0.771	0.743	0.743	0.743	0.807	0.872	0.873	0.873	0.888	0.888	
13 M&G Global Select A Acc GBP		0.911	0.913	0.926	0.900	0.818	0.874	0.902	0.833	0.747	0.780	0.934	0.817	0.817	1.000	0.868	0.899	0.794	0.768	0.769	0.769	0.784	0.867	0.867	0.867	0.904	0.904	
14 M&G Global Select X Acc GBP		0.911	0.913	0.926	0.900	0.818	0.874	0.902	0.833	0.748	0.780	0.934	0.817	1.000	0.877	0.868	0.899	0.794	0.768	0.769	0.769	0.784	0.867	0.867	0.867	0.904	0.904	
15 Margetts Opes Growth Acc		0.729	0.757	0.745	0.769	0.729	0.744	0.738	0.738	0.753	0.690	0.741	0.783	0.777	0.777	0.734	0.696	0.726	0.637	0.638	0.638	0.694	0.745	0.745	0.745	0.772	0.772	
16 Ninety One Global Franchise A Acc		0.858	0.921	0.905	0.871	0.861	0.848	0.896	0.786	0.920	0.837	0.938	0.872	0.868	0.868	0.734	0.799	0.845	0.769	0.772	0.772	0.837	0.949	0.949	0.949	0.954	0.954	
17 Quilter Investors Ethical Equity A Acc GBP		0.924	0.891	0.925	0.924	0.737	0.934	0.925	0.835	0.851	0.774	0.882	0.780	0.889	0.889	0.698	0.799	0.798	0.705	0.705	0.705	0.781	0.788	0.788	0.788	0.835	0.835	
18 Rathbone Global Opportunities Fund R Acc GBP		0.858	0.869	0.871	0.888	0.914	0.885	0.861	0.698	0.764	0.950	0.869	0.771	0.794	0.794	0.726	0.845	0.798	0.721	0.722	0.722	0.901	0.869	0.869	0.869	0.881	0.881	
19 SKAGEN Global A GBP		0.777	0.767	0.773	0.786	0.722	0.721	0.747	0.745	0.651	0.719	0.796	0.743	0.768	0.768	0.637	0.769	0.706	0.721	1.000	1.000	0.660	0.776	0.776	0.776	0.766	0.766	
20 SKAGEN Global C GBP		0.777	0.767	0.774	0.786	0.734	0.721	0.748	0.742	0.650	0.720	0.796	0.743	0.769	0.769	0.638	0.772	0.705	0.722	1.000	1.000	0.662	0.776	0.776	0.776	0.768	0.768	
21 SKAGEN Global D GBP		0.777	0.767	0.774	0.786	0.734	0.721	0.748	0.742	0.650	0.720	0.796	0.743	0.769	0.769	0.638	0.772	0.705	0.722	1.000	1.000	0.662	0.776	0.776	0.776	0.768	0.768	
22 Stewart Investors World. Lead. Sust. A Acc GBP		0.831	0.835	0.851	0.832	0.869	0.870	0.850	0.667	0.790	0.869	0.847	0.807	0.784	0.784	0.894	0.837	0.781	0.901	0.680	0.682	0.682	0.822	0.822	0.822	0.850	0.849	
23 Threadneedle Global Extended Alpha A GBP		0.846	0.918	0.889	0.863	0.917	0.839	0.869	0.754	0.838	0.869	0.922	0.872	0.867	0.867	0.745	0.949	0.769	0.869	0.776	0.778	0.778	0.822	1.000	1.000	1.000	0.983	0.983
24 Threadneedle Global Extended Alpha PNA GBP		0.846	0.918	0.889	0.863	0.916	0.839	0.869	0.754	0.838	0.869	0.922	0.873	0.867	0.867	0.745	0.949	0.769	0.869	0.776	0.778	0.778	0.822	1.000	1.000	1.000	0.983	0.983
25 Threadneedle Global Extended Alpha RNA GBP		0.846	0.918	0.889	0.863	0.916	0.839	0.869	0.754	0.838	0.869	0.922	0.873	0.867	0.867	0.745	0.949	0.769	0.869	0.776	0.778	0.778	0.822	1.000	1.000	1.000	0.983	0.983
26 Threadneedle Global Select INA GBP		0.879	0.848	0.921	0.901	0.919	0.887	0.902	0.776	0.849	0.872	0.943	0.898	0.904	0.904	0.772	0.954	0.835	0.881	0.766	0.768	0.768	0.850	0.983	0.983	0.983	1.000	
27 Threadneedle Global Select RNA GBP		0.879	0.848	0.921	0.901	0.919	0.887	0.902	0.776	0.849	0.872	0.943	0.898	0.904	0.904	0.772	0.954	0.835	0.881	0.766	0.768	0.768	0.849	0.983	0.983	0.983	1.000	

Source: Wellian Investment Solutions, based on data from Financial Express.

As an extra screen, I looked at the top 10 holdings for each of the funds listed in the correlation table above. Considering the range of the top 10 went from 21.88% through 66.91% and the largest holding ranged between 8.60% and 2.65% across the funds, it does seem odd that the correlations are high.

When looking at the top 10 holdings, Microsoft was held in 21 of the portfolios, Alphabet in 18, Visa 14, Mastercard was present in 12, and Amazon in 10. Assuming all of those holdings are US companies, that could easily be a reason for the higher degree of correlation, but to consider they are all “tech” related, this could also be a factor.

As an aside, I did find it interesting that 6 portfolios had Ferrari in their top 10 holdings (as far as I am aware, they might have one or two cars in their range that are hybrid (fairly sure there are none that are entirely electric or hydrogen) and 3 had Uber (which considering the labour issues there have been going through, I would imagine the company doesn’t stack up too well from an “S” of ESG standpoint).

Back to the client request.... It’s quite hard to get a number of funds within this aspect of the universe that are diversifiers; it makes sense to pick one or two, but not many, so from the universe of 65, could you really build a portfolio of ESG funds and deliver diversification – especially when market cap biases are skewed, investment style is skewed and correlations in those styles are so high?

It might seem that the findings are negative for ESG and that was not the case. ESG is a hot topic at the moment, but the choice is probably not as wide as you would probably imagine and the ability to construct a truly diversified portfolio quite hard. Given time all these issues will be ironed out and

greater choice will present itself, but for the meantime, there will be a lot of ESG funds that are not as differentiated as you may initially have surmised.

Market Snapshot (16.04.21 – 23.04.21)

Market Snapshot (16.04.21 – 23.04.21)			10 Year Bond Yields			Currency			Commodities		
FTSE 100	6938.56	↓1.15%	UK	0.76	↑2.70%	£/\$	1.3876	↑0.34%	Brent Crude	\$66.12	↓0.90%
S&P 500	4180.17	↓0.13%	US	1.58	↑1.28%	£/€	1.1467	↓0.63%	Gold	\$1777.10	↑0.08%
NIKKEI 225	29020.63	↓2.23%	Germany	-0.26	↑0.00%	€/£	1.2100	↑1.00%			
DAX 30	15279.62	↓1.17%	Japan	0.08	↑0.00%	£/¥	149.7600	↓0.47%			
CAC 40	6257.94	↓0.46%									

Figures quoted are in local currency.
Source: FE Analytics & Financial Times

Week Ahead

Monday – Germany: German Ifo Business Climate Index (Apr)
Tuesday – Japan: BoJ Press Conference
Wednesday – US: Fed Interest Rate Decision
Thursday – China: Manufacturing PMI (Apr)
Friday – Euro Area: CPI (YoY) (Apr)

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