



## COMPARING FUNDS WITH FACTS

If you're a pension fund, family office or wealth manager, perhaps you've been asked by an investor if the portfolio is aligned to his or her ESG interests? Or if you are trying to select external managers, perhaps you want to understand how they are integrating ESG considerations in the investment process? Investors increasingly want to see ESG factors taken into account. Fail to do so, and they may take their money elsewhere.

Providing evidence that you're making such considerations can be tricky. Sending your managers questionnaires is useful - it allows them to respond about their policies and processes for integrating ESG into the investment process. Finding out if managers' policies end up in the portfolio, however, is challenging.

### Apples to oranges scores

Many managers rely on third-party ESG scores or their own in-house proprietary rating. If different managers use different scoring recipes, then it becomes almost impossible to compare them. How do you compare a fund with an ESG rating of "A-" to one with a rating of "64/100"?

	Fund ESG Score
Manager A, Fund X	A-
Manager B, Fund Y	🌐🌐🌐
Manager C, Fund Z	64

## **More transparency**

ESG ratings aren't always transparent on the underlying metrics that contribute to the score, making it hard for an investor to see why a strategy has been ranked a certain way. If an investor is interested in climate, how can that be evaluated using a subjective score based on dozens, if not hundreds, of disparate environmental, social and governance considerations? Even if the strategy gets a good overall score, is it doing well on the specific ESG considerations that your investor cares about?

## **Grading on a curve**

Another challenge when comparing funds is that most ESG scores are "relative" values, which means the score is not an absolute measure of ESG or impact. Instead, the ESG score has been adjusted so that it is relative to a peer group. For example, fund level ESG scores are calculated based on underlying holdings, but those ESG scores are then normally distributed with a bell curve across funds within the fund category. It is similar to a college professor whose students' exam scores range from 95 to 70, but he then adjusts them relative to each other to grade on a curve. An 85 might become an "A" or a "C" depending how other students perform.

For investors trying to compare securities in different peer groups, this makes meaningful comparison impossible. An A-rated emerging market equity fund could have a completely different ESG profile to an A-rated global bond fund. This is like saying Usain Bolt (the world's fastest human) is in the same category as a cheetah (the world's fastest feline) and then being surprised when a race between them isn't close.

## **Tech-based tools powered by objective data for better insights**

To get around these problems, Impact Cubed has developed a tech-based toolkit that provides transparency into funds' underlying holdings with objective, factual data on ESG and impact. This means an investor can do a speedy side-by-side comparison of managers or funds relative to the respective benchmark - just like he would when comparing financial performance of different funds.

Factual data also provides valuable insights into the investment strategy. For example, it shows whether a manager's strategy is intentional on environmental factors but not social ones, or whether a manager's strategy depends on a wide range of sustainability measures or just one theme.

## **Validating ESG strategies**

To see this in action, the images below show two funds with very different sustainable investing strategies: a low carbon energy fund and a social empowerment fund. As you would expect, the low carbon fund performs better than its benchmark (the dotted black circle) on carbon efficiency, and also avoids environmentally harmful business activities<sup>1</sup> (like coal fired power) and amplifies environmentally good business activities (like renewable energy). The social empowerment fund, as you would expect, outperforms the benchmark on all social factors (employment, tax gap, avoiding water scarcity, economic development), as well as socially harmful and socially good activities.

---

<sup>1</sup> Impact Cubed defines environmentally or socially good or harmful activities based on a literal reading of the UN Sustainable Development goals.



**Low carbon energy fund**



**Social empowerment fund**

**Same fund name; different impact**

Many funds now include “ESG Leader” or “Sustainability Leader” in the fund name. How can an investor tell whether there is any difference between them? The image below compares two such similarly named funds. Fund A does better than the benchmark on many ESG and impact factors. It has an overall impact of 13 bps, or 4% of its overall tracking error. But Fund B outperforms Fund A by a much larger amount. Its overall impact is 124 bps, almost 10 times greater.<sup>2</sup>



**Fund A manager (orange)** used 4.1% of overall tracking error to create a net impact of 13 bps

**Fund B manager (blue)** used 20.7% of overall tracking error to create a net impact of 124 bps

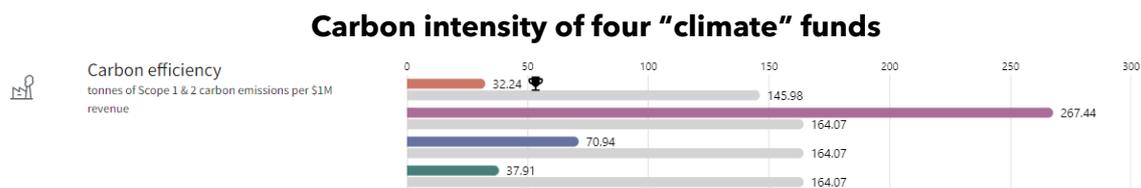
For pension funds or wealth managers relying on external managers, this approach is a powerful tool for manager due diligence. The due diligence analyst can quickly and easily validate the stated ESG strategy by seeing how it is aligned with the actual holdings’

<sup>2</sup> Impact Cubed measures net impact in the same way a fund manager measures conventional tracking error in basis points. We take the active exposures on each ESG factor and sum the positive and negative exposures to obtain net impact.

ESG performance. The analyst can also see how much the portfolio manager is using her active shares to create impact.

### What about net zero strategies?

Many asset management firms are making commitments to have net zero financed carbon emissions in their portfolios. In this case, we selected four global equity climate funds and analysed the carbon footprint, shown below. Three of the funds are much better than their benchmark on carbon emissions and could help an investor meet a net zero strategy. But Fund 2, a “climate and social impact fund” (shown in pink), has 1.65 times more financed carbon emissions than its benchmark and would be a bad choice.



### Compare funds with facts

In the early days of sustainable investing, ESG scores became a fast, easy way to screen a fund. Today, tech-enabled tools allow investors to overcome many of the challenges using ESG scores and compare funds with facts.

To see how you can compare funds and managers with our tools, we would be happy to help you get on our platform and please contact us at [info@impact-cubed.com](mailto:info@impact-cubed.com).

## ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customised sustainable investing.

You can find out more about our data and portfolio models at [www.impact-cubed.com](http://www.impact-cubed.com) and if you would like to contact us at [info@impact-cubed.com](mailto:info@impact-cubed.com) we would be happy to hear from you.

### DISCLAIMER

No reliance: Impact Cubed LLP provides this material as a general overview of our firm and our capabilities. It has been provided for informational purposes only. Impact Cubed LLP has taken all reasonable care to ensure that the information contained in this material is accurate at the time of its distribution, no representation or warranty, express or implied, is made as to the accuracy, reliability or completeness of such information. Any distribution, reproduction or other use of this material by recipients is strictly prohibited. Hyperlinks: If the material contains links to websites provided by third parties, these links are provided for your convenience only and you may access them at your own risk. Impact Cubed LLP does not make any representation as to the accuracy or completeness of such websites and will not review or update such websites or information

contained therein. No offer/no advice: This material does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or to purchase, shares, units or other interests in investments that may be referred to herein and must not be construed as investment or financial product advice. References to "Impact Cubed LLP" may include Impact Cubed Ltd, an affiliated business. Impact Cubed has offices in London and Jersey. Impact Cubed LLP is registered in England and Wales