



SUFFERING FROM ESG FOMO? TRY OVERLAYS.

With the popularity of ESG funds continuing to build among investors, it's understandable that some asset managers are beginning to suffer from the fear of missing out, or FOMO. For example, while billions have flown out of conventional funds in recent months, ETFs marketed as ESG were "sticky" and continued to attract inflows.

But there's a fly in the ointment. Recent findings from regulators show many managers running funds branded as "ESG" or "sustainable" while making few adjustments to underlying portfolios to reflect such labels. In April, the SEC said it had found numerous incidents of "[potentially misleading](#)" claims made regarding products purporting to follow sustainable strategies. [Industry participants](#) have also noted some ESG-labelled funds are simply existing offerings, rebranded without any alterations to how the money is managed.



The assumption is that many managers are seeking to capitalise on the growing clamour for ESG investing but lack the internal expertise to run a dedicated ESG portfolio. Understandably, managers may also be anxious about making holistic changes to their portfolios, a step that potentially abandons well-established investment philosophies and approaches. So, how can those who want to offer their clients exposure to ESG investing go about it?

One solution Impact Cubed uses is adding an ESG overlay to existing products. Traditionally, overlay strategies make use of derivative instruments to alter the risk to a stock, currency or factor thereby delivering a better exposure. A common application, for example, would be using such a strategy to hedge out foreign currency exposure in a portfolio of international equities.

An ESG overlay follows the same logic – allowing managers to layer on sustainability themes while preserving the successful core of their existing portfolio construction. It may also involve the appointment of an external firm – one with the ESG expertise and know-how to identify and run compelling sustainability-focused investment strategies.

For example, an active or passive fund focusing on large-cap stocks could add on one these overlays around ESG themes of interest to investors:

- **Water use** – This overlay could consist of long and short positions, reflecting a recognition that water as a resource is becoming scarcer and this isn't being adequately priced in by the market.
- **Alignment with the United Nations' Sustainable Development Goals (SDGs)** – A manager could identify those companies within the index that align their revenue with the SDGs – and those whose business models do not gel with these. This overlay could essentially remove the offending companies from the index, reallocating capital to those firms running their business in accordance with the SDGs.
- **A long/short carbon trade** – Such an overlay could take short positions in companies representing a predetermined level of CO₂ emissions while taking long positions in those cutting emissions. This would be more nuanced than just excluding fossil fuel companies from an index.

The process of adding overlays to portfolios requires ESG expertise and investment experience. It does not mean long-standing investment processes have to be abandoned. In our experience creating overlays, the types of decisions asset managers need to wrestle with while adding ESG overlays to fund products are these:

- What ESG theme(s) should be added via the overlay? How would these factors play out in a real-world portfolio?
- Is there a need to seek out an external partner?
- Who is responsible for executing the trades?
- How frequently should the overlay be rebalanced?

In sum, Impact Cubed's point of view is that adding an ESG overlay to an existing fund is a quick way of getting a truly 'green' strategy to market that meets the demand of investors and capitalises on the performance benefits of using experts at profitably adding sustainability into portfolios. An overlay is an attractive solution for those wishing to participate in a "hot" area of the market in a sophisticated way, while avoiding the delay and investment required to build in-house expertise.

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 customized sustainable investing.

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

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