

## SHINING A LIGHT ON POSSIBLE UNINTENDED RISKS WHEN ALLOCATING SUSTAINABLY

The Portfolio Construction and Strategy (PCS) Team share practical insights from recent consultations with global investors on sustainable investing, specifically whether unintended risks are introduced into sustainable model portfolios and why it is important to follow an active, forward-looking approach when using environmental, social and governance (ESG) factors as criteria.

### Key takeaways

- The inconsistency of risk profiles between traditional (non-sustainable) and sustainable model portfolios is arguably because the asset management industry's product offering is still catching up to investor demand on sustainable investment solutions.
- Differences between traditional and sustainable strategies are not just attributed to regions but can also be influenced by a style and sector tilt, all of which can have an impact on returns, often introducing unexpected risks.
- These are important considerations for investors in maintaining asset allocation risk consistency across model portfolios and finding a sustainable method to accomplish sustainable investing goals in the long term.

The war in the Ukraine and the subsequent pressure on oil and gas supplies, particularly in Europe, we believe has and will lead to a greater focus on sustainable investing in the future – particularly around localised renewable energy production.

In the case of sustainable investing, an ESG criteria is often considered in the portfolio construction processes. But what if many of these new sustainable portfolios are actually unrecognisable to their traditional portfolios when it comes to regional biases, style drifts, and sector concentrations? Are there unintended risks introduced by a shift to 'sustainable' investing?

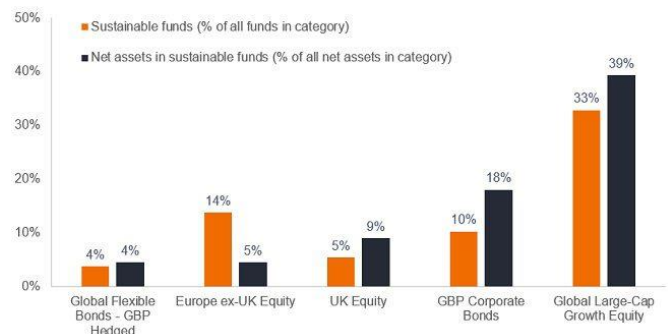
### The scarcity of sustainability

The inconsistency of risk profiles between traditional and sustainable portfolios is a result of the asset management industry's product offering still catching up

to investor demand for suitable sustainable investment solutions.

For example, an investor in traditional Europe ex-UK Equity or UK Equity has a plethora of strategies available. That same investor looking to mirror this selection in their sustainable portfolio is limited to a much smaller selection, as only 14% of European funds in that Morningstar Category explicitly indicate any kind of ESG impact in their strategy and only 5% of UK equity managers. There is a similar discrepancy within fixed income – where investors severely struggle to find sustainable options for their global flexible managers and tend to invest in traditional corporate bond managers.

**Figure 1: The share of sustainable funds and total net assets in the respective Morningstar fund category**



Source: Portfolio Construction and Strategy, Morningstar. Number of funds in the respective Morningstar category (Europe OE & MM market, ex funds of funds and feeder funds, excluding obsolete funds) and percentage of total net assets that explicitly indicate any kind of sustainability, impact or ESG strategy in their prospectus or offering documents, as at February 2022.

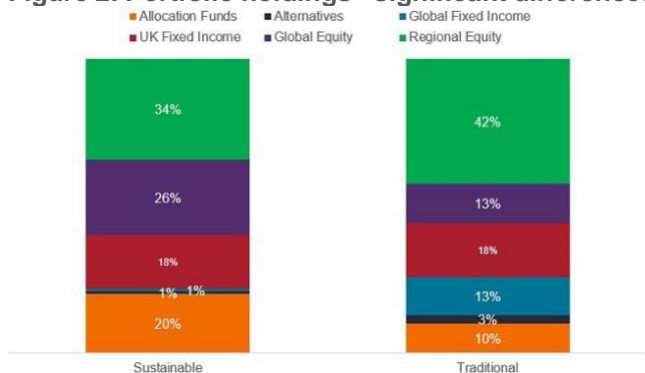
(\*) Esta columna solo refleja la opinión del autor, y no necesariamente la opinión de CFA Society Chile, ni la del comité editorial, ni tampoco la opinión de CFA Institute.

### Granular or global?

The result of this availability challenge for investors is that many sustainable portfolios look and feel different to traditional portfolios and therefore are exposed to a different set of risks.

For example, this is demonstrated in Figure 2 below by taking an average of the moderate portfolio allocations of UK investors based on PCS team consultations. Within equities, the traditional model portfolio includes mainly regional equity allocations, such as UK equities or US equities, while the sustainable model portfolio has a higher allocation to global equity. Within fixed income, the phenomenon is the opposite with the traditional model portfolio fixed income allocation split between UK and global fixed income, while the sustainable model portfolio has almost all its fixed income allocated to the UK. We believe these asset allocation shifts – and therefore risk shifts – are attributable to the relative paucity of sustainable strategies in certain categories.

**Figure 2: Portfolio holdings - significant differences**



Source: Portfolio Construction and Strategy, as at February 2022. The allocations are shown for illustrative purposes to represent a model and are based on sample allocations from our database.

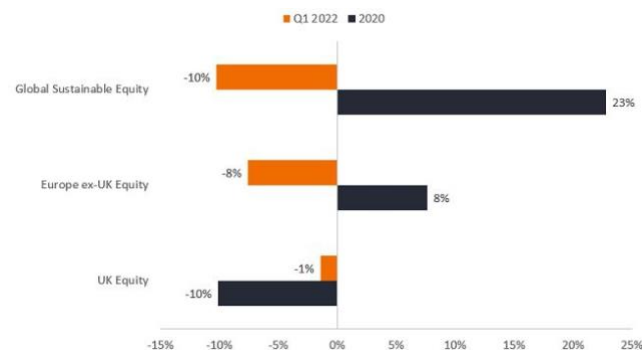
### Different risks mean different returns

The scarcity of suitable regional sustainable equity strategies is one of the many reasons for the sustainable model being underweight regional equities and overweight global equities. This introduces meaningful return differentials.

Global sustainable strategies experienced a strong surge in performance post-pandemic, however that has been fading year to date as concerns increase about inflation as well as the impact of the war in Ukraine, including rising oil and gas prices which many sustainable strategies will typically not be exposed to. Thus, many sustainable portfolios containing a global equities overweight have been impacted negatively year to date as shown in figures 3 and 4.

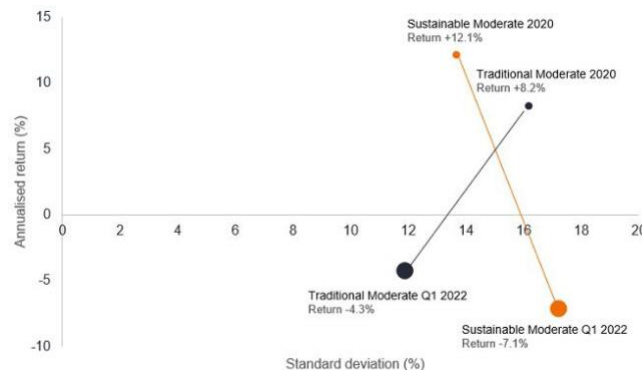


**Figure 3: Regional vs global sustainable equity Morningstar Category – 2020 and Q1 2022 average returns**



Source: Portfolio Construction and Strategy, Morningstar. Average 2020 calendar year and Q1 2022 returns of global sustainable equity, Europe ex-UK and UK equity Morningstar categories, in local currency, net of fees, as at 31 March 2022. Returns assume reinvestment of dividends and capital gains. Past performance does not predict future returns.

**Figure 4: Traditional vs Sustainable Sample Moderate Portfolio – 2020 and Q1 2022 risk and returns**



Source: Portfolio Construction and Strategy, Morningstar. Cumulative 2020 calendar year and Q1 2022 returns in local currency, net of fees, as at 31 March 2022. Returns assume reinvestment of dividends and capital gains. The allocations are shown for illustrative purposes to represent a model portfolio and are based on sample allocations from our database. Past performance does not predict future returns.

### Style and sector considerations

The differences between traditional and sustainable solutions are not just attributed to regions. When we look at a sustainable equity portfolio versus traditional, there is a significant difference in the exposure to the growth factor as well as sector allocations.

**Figure 5: Growth vs. Value Equity Style Bias**



Source: Portfolio Construction and Strategy, Morningstar. Average UK advisor allocation based on data shared with the PCS Team by UK financial advisory clients, as at March 2022.

This large exposure to growth has obvious consequences, especially during periods of market volatility. That is not to say investors should avoid sustainable investments, rather that investors should carefully consider the implications for portfolio construction and make necessary adjustments to balance some of these skews.

In the case example of UK investors, it is important to be aware of sector tilts that can be introduced by an overweight in traditional or sustainable funds.

Comparing the sector exposures of global and UK funds versus their sustainable counterparts, we see global sustainable equity funds tend to have a stronger bias towards the industrials and healthcare sectors (see Figure 6). These sectors generally outperformed in recent years, especially in 2020 as ‘beneficiaries’ of the COVID-19 crisis. Our analysis shows that managers of sustainable funds have typically been less exposed to cyclical sectors, such as energy, relative to broader equity funds.

**Figure 6: Sustainable sector exposures compared with Traditional**



Source: Portfolio Construction and Strategy, Morningstar as at March 2022. Sector exposures of funds’ holdings in the Morningstar categories, comparing global equity vs global ESG equity and UK equity vs. UK ESG Equity. ESG defined by Morningstar, as prospectus with a clear sustainability objective.

### Looking forward

The key point to understand here is that moving between traditional and sustainable portfolios introduces different risks, which in turn may have implications for returns. Sustainable model portfolios come with their own unintended risks due to a limited number of fund choices at the moment, which may prevent effective diversification given the biases and concentrations in the portfolio.

We believe that sustainability should be an implementation decision, i.e. your overall asset allocation should be diversified in terms of regions, styles etc and then you choose your implementation/managers that fit your asset allocation. There is no one-size-fits-all solution to sustainable investing. Our Portfolio Construction and Strategy Team partners with global investors to build sustainable portfolios by utilising the whole spectrum of ESG tools and resources at Janus Henderson. We would be delighted to contribute to your conversations on the issue.

### About the Portfolio Construction and Strategy Team

The PCS Team performs customised analyses on investment portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that the team believes will be interesting and beneficial to any investor.

Los puntos de vista que aquí figuran corresponden a la fecha de publicación. Se ofrecen exclusivamente con fines informativos y no deben considerarse ni utilizarse como asesoramiento de inversión, jurídico o fiscal ni como oferta de venta, solicitud de una oferta de compra o recomendación para comprar, vender o mantener ningún valor, estrategia de inversión o sector de mercado. Nada de lo incluido en el presente material debe considerarse una prestación directa o indirecta de servicios de gestión de inversión específicos para los requisitos de ningún cliente. Las opiniones y los ejemplos se ofrecen a efectos ilustrativos de temas más

generales, no son indicativos de ninguna intención de operar, pueden variar y podrían no reflejar los puntos de vista de otros miembros de la organización. No se pretende indicar o dar a entender que cualquier ilustración/ejemplo mencionado forma parte o formó parte en algún momento de ninguna cartera. Las previsiones no pueden garantizarse y no es seguro que la información proporcionada sea completa o puntual, ni hay garantía con respecto a los resultados que se obtengan de su uso. A no ser que se indique lo contrario, Janus Henderson Investors es la fuente de los datos y confía razonablemente en la información y los datos facilitados por terceros. La rentabilidad histórica no predice las rentabilidades futuras. La inversión conlleva riesgo, incluida la posible pérdida de capital y la fluctuación del valor.

No todos los productos o servicios están disponibles en todas las jurisdicciones. El presente material o la información contenida en él podrían estar restringidos por ley y no podrán reproducirse ni mencionarse sin autorización expresa por escrito, ni utilizarse en ninguna jurisdicción o en circunstancias en que su uso resulte ilícito. Janus Henderson no es responsable de cualquier distribución ilícita del presente material a terceros, en parte o su totalidad. El contenido de este material no ha sido aprobado ni respaldado por ningún organismo regulador.

Janus Henderson Investors es el nombre bajo el cual las entidades que se indican ofrecen productos y servicios de inversión en las siguientes jurisdicciones: (a) En Europa, Janus Capital International Limited (n.º de registro 3594615), Henderson Global Investors Limited (n.º de registro 906355), Henderson Investment Funds Limited (n.º de registro 2678531), Henderson Equity Partners Limited (n.º de registro 2606646), (cada una de ellas registrada en Inglaterra y Gales en 201 Bishopsgate, Londres EC2M 3AE y regulada por la Autoridad de Conducta Financiera) y Henderson Management S.A. (n.º de registro B22848, en 2 Rue de Bitbourg, L-1273, Luxemburgo y regulada por la Commission de Surveillance du Secteur Financier) ofrecen productos y servicios de inversión; (b) En EE. UU., los asesores de inversión registrados ante la SEC filiales de Janus Henderson Group plc; (c) En Canadá, a través de Janus Henderson Investors US LLC, solo para inversores institucionales de determinadas jurisdicciones; (d) En Singapur, Janus Henderson Investors (Singapore) Limited (número de registro de la sociedad: 199700782N). Este anuncio o publicación no ha sido revisado por la Autoridad Monetaria de Singapur; (e) En Hong Kong, Janus Henderson Investors Hong Kong Limited. Este material no ha sido revisado por la Comisión de Valores y Futuros de Hong Kong («SFC»); (f) En Taiwán (República de China), Janus Henderson Investors Taiwan Limited (con funcionamiento independiente), Suite 45 A-1, Taipei 101 Tower, No. 7, Sec. 5, Xin Yi Road, Taipéi (110). Tel.: (02) 8101-1001. Número de licencia SICE autorizada 023, emitida en 2018 por la Comisión de Supervisión Financiera; (g) En Corea del Sur, Janus Henderson Investors Limited (Singapur), exclusivamente para Inversores profesionales cualificados (según se definen en la Ley de servicios de inversión financiera y mercados de capitales y sus subreglamentos); (h) En Japón, Janus Henderson Investors (Japan) Limited, regulada por la Agencia de Servicios Financieros y registrada como Entidad de servicios financieros que realiza actividades de gestión de inversión, asesoramiento de inversión y actividad de agencia y actividades de instrumentos financieros de tipo II; (i) En Australia y Nueva Zelanda, por Janus Henderson Investors (Australia) Limited ABN 47 124 279 518 y sus entidades relacionadas, incluida Janus Henderson Investors (Australia) Institutional Funds Management Limited (ABN 16 165 119 531, AFSL 444266) y Janus Henderson Investors (Australia) Funds Management Limited (ABN 43 164 177 244, AFSL 444268); (j) En Oriente Medio, Janus Capital International Limited, regulada por la Autoridad de Servicios Financieros de Dubái como Oficina de representación. No se realizarán transacciones en Oriente Medio y cualquier consulta deberá dirigirse a Janus Henderson. Las llamadas telefónicas podrán ser grabadas para nuestra mutua protección, para mejorar el servicio al cliente y a efectos de mantenimiento de registros reglamentario.

Fuera de EE. UU: Para uso exclusivo de inversores institucionales, profesionales, cualificados y sofisticados, distribuidores cualificados, inversores y clientes comerciales, según se definen en la jurisdicción aplicable. Prohibida su visualización o distribución al público. Comunicación Publicitaria.

Janus Henderson, Knowledge Shared y Knowledge Labs son marcas comerciales de Janus Henderson Group plc o una de sus filiales. © Janus Henderson Group plc.