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Multi Asset Universe DNA Icon Glossary

M&G Sustainable Multi Asset Balanced Fund

Multi Asset DNA Report

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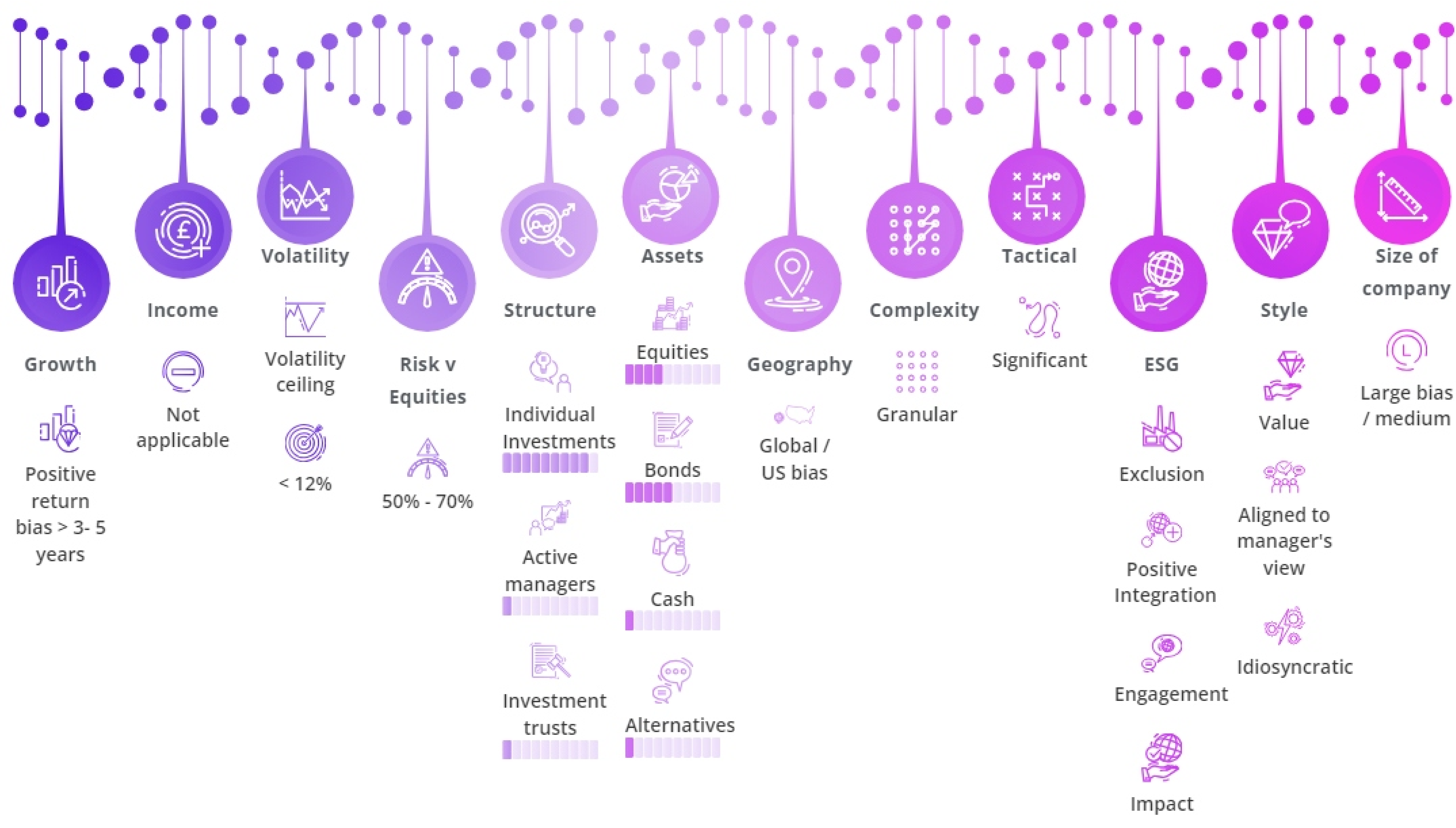

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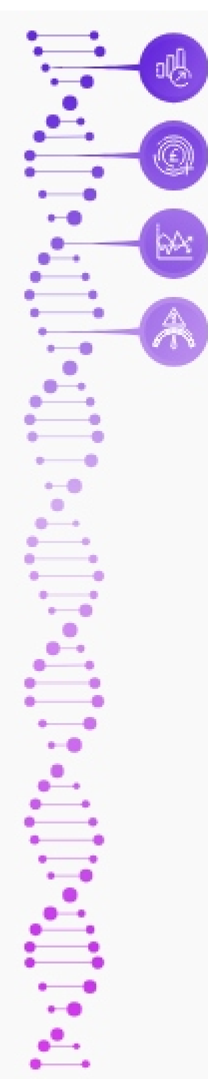
The above depiction of the portfolio's DNA is based upon its embedded biases as identified by Scopic Research. It isn't meant to reflect the portfolio's current positioning, but rather what we might expect on average over the long term.



Outcome

Key notes

- Sits within a suite of three sustainably managed volatility managed portfolios that target holdings in companies with high ESG ratings.
- As well as the high ESG ratings, between 20% and 50% is invested in companies that have positive impact characteristics that are aligned to the United Nations Sustainable Development Goals (UNSDGs).
- Each portfolio is expected to maintain a MSCI ESG rating of between A and AA.
- Unlike many peers that target returns within a corridor of volatility, each portfolio's volatility is managed to be below a ceiling level expressed in absolute terms. In this case 12%. (Measured over rolling 5-year periods).
- Arguably, operating beneath a volatility ceiling affords greater flexibility to drive positive-oriented total returns when compared to those that manage to a volatility corridor.

Details

This is one of three sustainably managed multi-asset portfolios in a volatility managed suite where each portfolio is managed to a different tolerance to volatility-risk.

Underlying investments are targeted at companies with high ESG ratings. In addition, between 20% and 50% is invested in companies that have positive impact characteristics aligned to the United Nations Sustainable Development Goals (UNSDGs).

All holdings must pass a net-zero carbon emissions pathway test

Each portfolio is expected to maintain a MSCI ESG rating of between A and AA.

Rather than seeking to manage returns within a volatility corridor as many volatility-managed peers do, the aim is for each portfolio in the suite to deliver good risk adjusted returns whilst maintaining its volatility below a different ceiling. Arguably, operating to a volatility ceiling, rather than a corridor, affords greater flexibility to be able to focus on positive-oriented total returns. The ceiling level is described in absolute terms.

For this portfolio, the volatility ceiling is 12% and tolerance versus the ceiling is measured over 5-year rolling periods.

There is no specified target level of return and the comparator for performance purposes is the IA Mixed Investment 20%-60% Shares sector.

Targets

Growth

Positive return bias > 3 - 5 years

Income

Not applicable

Volatility

Volatility ceiling

Target

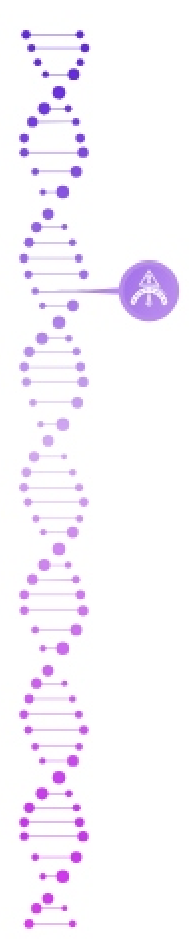
< 12%

Costs

Ongoing charges 0.65%

Transactional costs 0.05%

Total costs 0.70%



Investment Journey

Key notes

- Arguably, when compared to its peers the portfolio has a broader opportunity set with which to defend returns during poor conditions for risk assets.
- In extreme circumstances, and to help defend against downside risk, the Team is willing to tolerate volatility temporarily moving below the designated volatility ceiling of the portfolio that sits immediately beneath it in the suite in terms of 'risk' profile.
- Cash can also be used extensively to limit downside risk, and unlike some sustainable multi asset peers, US treasuries and US TIPS can be used as a counterbalance to identified risks.
- When the market recognises its mispricing of the Team's sustainable themes it can lead to strong bursts of positive returns.
- However, the high conviction approach and the patience to invest early can lead to performance continuing to decline in the short term.
- We expect bouts of moderately higher volatility and 'lumpy' returns but with more consistent good risk adjusted returns likely to emerge over longer periods.
- We might expect marginally better returns versus the sustainable peer group when the value style is in favour and when markets expect higher levels of inflation, and for the portfolio to lag when the pace of the global economy slows, and investors prefer companies with higher growth prospects.
- Periods of strong momentum and when investors fail to act upon market fundamentals are likely to prove challenging. Less valuation conscious passive peers might outperform under these conditions.
- During a commodity-led rally, the lack of exposure to companies involved in oil and gas extraction and mining, is likely to result in the portfolio lagging volatility managed peers that don't have a sustainable focus.

Risks

Suitability

Key notes

For someone who:

- Would like their investments to be managed sustainably from an ESG point of view and would specifically like an increasing proportion of their money over time to be invested in companies that offer products and services that have a beneficial impact upon society and the planet.
- Would like all their money to be invested in companies that have concrete plans in place to reduce their carbon emissions over time, and that also meet the UN Global Compact Principles.
- Would like a more qualitative-based approach to selecting sustainable investments that offers greater insight and is more forward looking when compared to using a purely passive investment approach.
- Is prepared to invest in a high conviction, tactically agile portfolio, that's likely to have a differentiated investment journey with a tilt towards the value style of investing when compared to the growth style exhibited by other sustainable multi asset strategies.
- Is prepared to accept moderately higher levels of volatility and 'lumpier' returns when compared to some other sustainable multi asset strategies.
- Will be tolerant of rare occasions when, in order to defend its capital value, the portfolio's volatility might temporarily dip below the designated volatility ceiling level of the portfolio in the same suite that has the next lowest volatility-risk profile. (Bearing in mind that the Multi Asset Team will always seek to maintain the intended hierarchy of realised volatility risk for each portfolio in the suite).
- Will be tolerant of the portfolio having a high allocation to cash when deemed appropriate.
- Is prepared to compromise on having strict adherence to sustainable principles by having pragmatic exposure to US treasuries and US TIPS to provide a counterbalance to identified risks.

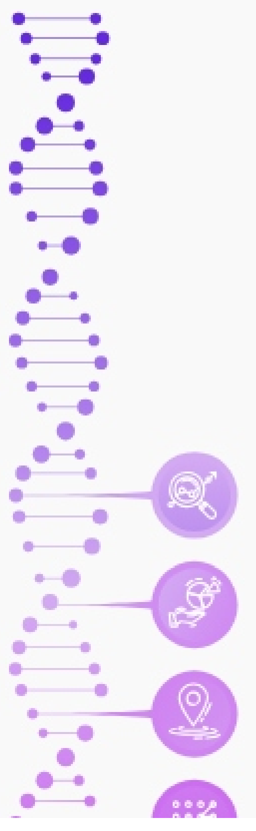
- **Is prepared to have some limited exposure to alternative-type investments, such as investment trusts and REITS.**
- **Is comfortable with the likely investment journey as set out in this report.**

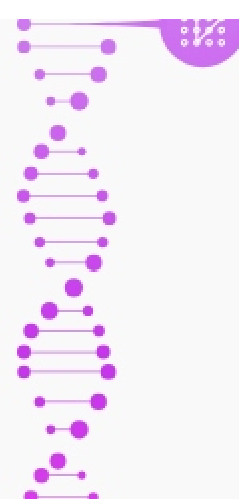
These are only potential suitability suggestions for financial intermediaries to consider alongside other factors. They are not personalised and sole responsibility for client suitability rests with the financial intermediary.

Investment Scope

Key notes

- The portfolio targets companies that have high ESG ratings – with between 20% and 50% being allocated to those offering products and services that have a positive impact upon the planet and society and with characteristics aligned to at least one of the seventeen United Nations Sustainable Development Goals (UNSDGs).
- All holdings must be consistent with UN Global Compact Principles, and need to pass science-based climate criterion to prove that they have working plans in place to transition towards net zero carbon emissions
- Investments are held in a series of actively managed themed baskets containing equally weighted individual equities and bonds, and to a small extent investment trusts and REITS.
- Equities comprise between 20% and 60% in equities (neutral 40%) – and the remainder is held in a combination of bonds, alternatives, and cash. Bonds can include green bonds and supranational bonds.
- US treasuries are permitted – in contrast to some sustainably managed peers.
- Alternatives include renewable energy and infrastructure investment trusts, specialist REITS, and potentially, convertible bonds.
- Companies involved in adult entertainment, alcohol production, controversial weapons, gambling, and tobacco production are excluded.
- Environmental considerations further limit exposure to companies depending on their maximum revenues from less sustainably desirable sources.
- Cash is used far more extensively than by many peers.
- A minimum of 70% is held in or hedged back to GBP sterling.





Details

The portfolio targets companies that have high ESG ratings – with between 20% and 50% being allocated to those offering products and services that have a positive impact upon the planet and society and with characteristics aligned to at least one of the seventeen United Nations Sustainable Development Goals (UNSDGs).

All holdings must be consistent with UN Global Compact Principles that cover human rights, labour, the environment, and anti-corruption, as well as needing to pass science-based climate criterion to prove that working plans are in place for their businesses to transition towards having net zero carbon emissions.

The investment scope is more globally oriented when compared to some – principally although not exclusively by investing in a series of actively managed themed baskets that contain equally weighted individual equities and bonds, and to a small extent investment trusts and REITS. Holding actively managed open-ended funds to provide exposure to niche sustainable themes is also a possibility but their use is likely to be quite limited. None have been included to date.

Equities comprise between 20% and 60% (neutral 40%) – and the remainder is held in a combination of bonds, alternatives, and cash. Bonds have a neutral allocation of 54% and encompass all parts of the debt spectrum and can include green and supranational bonds. At the time of our review, we note improved availability, and therefore potentially greater scope, for the team to include green bonds. Alternatives have a neutral allocation of 4% and can include renewable energy and infrastructure investment trusts, specialist REITS, and potentially, convertible bonds. Finally, although the neutral cash allocation is 2%, we note that cash can be used far more extensively when compared to others that manage to volatility parameters. For example, in June 2022 the cash allocation reached almost 20%.

Screening for high ESG scores is initially a predominantly quantitative based exercise, with the selection of positive impact holdings in particular then becoming progressively more qualitative and granular.

Exposure to companies in controversial sectors is excluded both on environmental and social grounds, but with some caveats to allow scope to include those that are transitioning towards more sustainable business models. Companies need to have minimum MSCI ESG scores of BBB for their equities and bonds to be considered.

Companies involved in adult entertainment, alcohol production, controversial weapons, gambling, and tobacco production – are therefore all automatically excluded, as is exposure to controversial countries – particularly where there are serious concerns over human rights. The use of forward contracts on agricultural commodities is also not permitted.

Environmental considerations further limit exposure to companies depending upon the maximum percentage of all revenues derived from less sustainably desirable sources. For example:

Thermal coal extraction (maximum revenue 10%).

Unconventional oil and gas extraction (maximum revenue 10%).

Conventional oil and gas extraction (maximum revenue 60% but can be excluded entirely if revenues from renewable sources of natural gas extraction are below 40%).

Electricity power generation (maximum revenue 10% from coal, 30% from oil and gas, or 30% from nuclear fuel sources). Although, in exceptional cases companies involved in generating electricity can be considered for up to a 5% portfolio weight if they can demonstrate a clear transition strategy towards low carbon neutral power production.

Government bonds must have a minimum MSCI ESG score of BB but are also subject to passing qualitative-based assessments covering social and environmental criteria using definitions from the likes of Freedom House, The World Bank and the Climate Change Index.

Unlike some sustainable propositions, however, US treasuries, US Treasury Inflation-Protected Securities (TIPS), Canadian government bonds and Australian government bonds, aren't excluded on defence spending and climate alignment grounds. Here, the Team's investment pragmatism arguably outweighs sustainability factors. This has implications for the likely investment journey we might expect relative to similar peers, as we explain later.

Whilst all holdings must pass the above ESG hurdles and exclusions, between 20% and 50% of the portfolio (an average of around 30%) is specifically allocated to positive impact investments that have characteristics aligned to at least one of the following positive impact areas:

Climate action.

Environmental solutions.

The circular economy.

Better health and savings lives.

Better work and education.

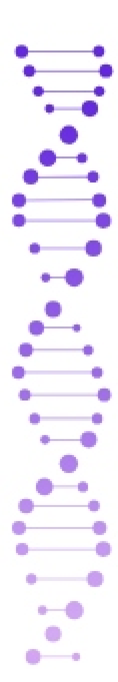
Social inclusion.

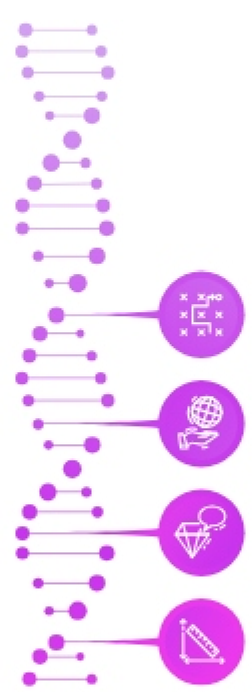
Finally, a minimum of 70% must be held in or hedged back to GBP sterling. This is a larger percentage than is mandated by the IA sector performance comparator. Thereafter, currency risk controls include limiting exposure to minor currencies to 3% (for example, individual emerging market currencies), and capping exposure to developed market currencies, other than the euro and the US dollar, to 5%. Position sizes also have restrictions; with a limit of 1.5% in an individual stock, 1% in an individual corporate bond and 3% in a single emerging market government bond issue.

Approach

Key notes

- The agenda is set by the need for each portfolio in the suite to achieve its return below its respective volatility ceiling. Thereafter, the initial search for asset themes is heavily influenced by the application of the Multi Asset Team's behavioural finance theory.
- This leads to identifying assets where the combined psychology of the market has, in the Team's opinion, led to an overreaction in response to bad news.
- Unlike other sustainable multi asset portfolios, the investment style is tilted towards value, and investments are expected to have an in-built margin of safety should broader markets fall.
- Mis-priced themes are further distilled down to those that have the required sustainable and positive impact characteristics by using a combination of exclusions and inclusionary criteria.
- Screening for high ESG scores is initially a predominantly quantitative based exercise, with the selection of positive impact holdings in particular then becoming progressively more qualitative and granular.
- Large parts of the equity and bond spectrum can be avoided for long periods and at times holdings can be highly concentrated within specific equity regions and industrial sectors.
- This isn't a stock picking portfolio; asset allocation is the primary driver of returns and views are articulated using baskets of stocks.
- This is a highly distinct portfolio, with diversification being achieved by counterbalancing one mis-priced theme against another with the likelihood of them having opposing directionality.





Details

You might expect us to begin this section by discussing how the sustainable and impact objectives are achieved, but this isn't what comes first in the process.

The agenda is set firstly by the need for each portfolio in the suite to achieve its return below its respective volatility ceiling. The maximum and minimum permitted equity allocations go some way to establishing the framework for this. Thereafter, the initial search for asset themes is heavily influenced by the application of the Multi Asset Team's behavioural finance theory. Assets are then further distilled down to those that have the required sustainable and positive impact characteristics by using a combination of exclusions and inclusionary criteria. Between 50% and 80% is then invested in companies that have high ESG ratings and between 20% and 50% in companies that also pass positive impact criteria.

Analysis of the macroeconomic environment, an assessment of asset prices and an understanding of the market's psychology are all integral parts of the team's behavioural finance process. In short, the team seeks to identify assets driven by sustainable themes where the psychology of the market has led participants to overreact in their response to bad news, announcements, and other data, or to become fixated on other issues altogether – leading the prices of these assets to fall well below both their long-term norms and when compared to what the economic reality or fundamental facts might suggest. Such assets are then expected to have an in-built margin of safety in the event that markets continue to fall. Analysis of price, earnings trends, yield, duration (sensitivity to changes in interest rates) are all key metrics used, together with an understanding of liquidity.

This is not a stock picking portfolio, however. Mis-priced themes – often, but not always equity related – are articulated using baskets of equally weighted securities chosen to represent the regional and industry sector indices that are aligned with the themes. Different baskets of securities, which may include long duration government bonds for example, can be deliberately counterbalanced or offset against one another in the expectation that they are likely to deliver performance in opposite directions in the event of a central scenario occurring – for example, a change in the direction of interest rates. As such, unlike some, diversification isn't necessarily achieved by holding a continuously diverse spread of investments, but by counterbalancing one mis-priced theme against another with the likelihood of them having opposing directionality. In the meantime, each stock or bond basket is expected to perform in a similar way to its representative index and, therefore, asset allocation, rather than stock selection, is the primary driver of returns.

It's also worth mentioning the implications of managing performance to below a volatility ceiling because it's this that offers the Team the degree of flexibility it needs to be able to execute its behavioural finance approach most effectively. Other than tolerance to equities, there are no prescribed limits – either on geography or industrial sectors, and the approach leads to a high conviction, tactically active, and differentiated portfolio – particularly within the portfolio's highly rated ESG holdings – as opposed to its impact holdings that are deliberately more diverse in terms of distribution between industry sectors and are generally held more strategically. Large parts of the equity and bond spectrum can therefore be avoided for long periods and at times holdings can be highly concentrated within specific equity regions and industrial sectors. We also note a generally low single digit exposure to the UK. Cash and US treasuries can also be used extensively to defend returns in poor markets, and in the case of the latter, to provide a counterbalance to equity related themes.

This all leads to a highly differentiated approach where the focus on price and margin of safety leads to a slight value style tilt. This is unusual in that it contrasts with the stronger growth style characteristics that we normally see in other multi asset sustainable peers where the impact from stock selection is arguably more prominent. We explain the implications of this later when we look at the likely investment journey.

All holdings need to adhere to the Team's high ESG ratings criteria and, for between 20% and 50% of the portfolio, its positive impact criteria. Here, the Multi Asset Team appears to enjoy high levels of internal support – both from the Stewardship & Sustainability Team responsible for establishing and maintaining the company's ESG framework, as well as for scoring individual companies on their ESG credentials and managing external company ESG engagements – and, from the Positive Impact Fund investment team whose stock picking expertise leads to a shared equity watch list that's used for selecting positive impact equities for the portfolio. Here, the Positive Impact Fund Team uses a iii framework to score companies separately on; 'investment' (essentially the business case and business risk), 'intention' (whether companies intend to deliver cleaner energy, for example), and 'impact' factors (the measure of companies' beneficial impacts on the planet and society, and the percentage of their own overall revenues that this involves).

High ESG rated companies are intermingled with positive impact holdings throughout the portfolio and both are articulated via equities and bonds, but with alternative holdings such as renewable energy and infrastructure investment trusts, and specialist REITS, mainly falling into the positive impact camp.

On balance, this leads to larger company exposure within holdings that have high ESG ratings, and to predominantly medium sized companies within positive impact holdings. This has implications for returns relative to peers that focus entirely on ESG ratings and that are more likely to have a bias towards larger and even giant-sized companies.

Although, industry sector exclusions go some way to avoiding companies that are most likely to contribute towards global warming, an additional climate-based assessment is overlaid across the entire portfolio to mitigate against climate related risks by ensuring that all selected companies have workable plans in place to reduce their own carbon emissions.

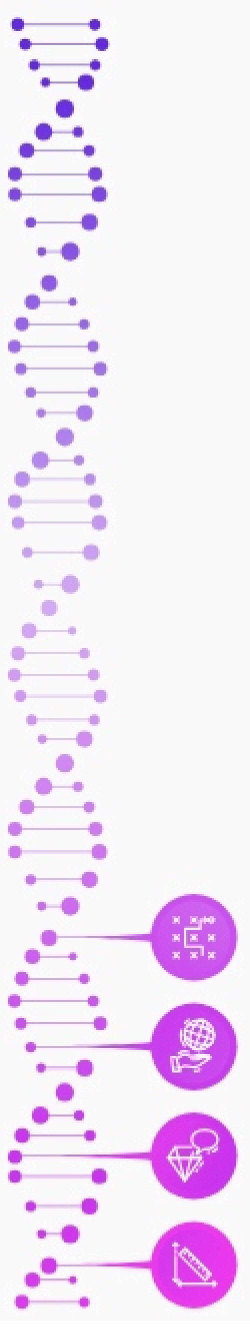
When we discuss ESG research we need to talk about the quality of the ESG data being used to select investments. Most commoditised, external ESG ratings that are used throughout the industry are compiled using quantitative data, which, by its very nature is often self-certified by the companies being researched and backward looking. This is something that supporters of passive sustainable multi asset solutions need to be aware of – bearing in mind that external ESG ratings are often used to create the sustainable index products found in these investments. In contrast, this portfolio is actively managed, and whilst the first part of the investment selection process does rely on filtering using MSCI ESG scores and reporting as a minimum threshold for inclusion, it's the Aladdin portfolio management tool that constitutes the key resource for understanding both the portfolio's positioning and a look through to the sustainable quality of its underlying holdings. The ESG related data includes qualitatively assessed factors such as in-house calibrated ESG scorecards on individual companies, visibility on the progress achieved by companies towards net zero carbon emissions, notes on M&G's engagement interactions on ESG issues, as well as information on the structure of individual bonds, their functions and purpose. In short, the information available to the team on individual companies is more forward looking and can be used to help predict the likely direction of travel when it comes to sustainable practices. We note that access to good qualitative data is particularly important when it comes to qualifying individual companies' own positive impact assessments.

This does mean that M&G's ESG scores can differ from those of external ESG raters such as MSCI – particularly when it comes to governance related issues. For example, the ESG scores of banks are generally lower when compared to MSCI's scores. We happen to think this is a good thing because qualitative data is always more insightful in our opinion. However, on the downside, it takes a lot longer to acquire qualitative data, and it'll be a long time before M&G (and most others) can amass a sufficiently large bank of qualitative ESG data to be able to significantly reduce reliance upon external ESG ratings. Nevertheless, we can see M&G's own direction of travel, and this is to be applauded.

Finally, positions are held until the market reassesses its negative overreaction to them and their prices have rebounded towards their expected norms. During the rebound phase, positions are progressively pared back or sold to lock in and capture capital gains. Holdings that breach the exclusions or ESG ratings criteria or where there's a material change in the iii assessment are promptly sold.

Investment Journey in detail

Details



Arguably, when compared to its peers the portfolio has a broader opportunity set with which to defend returns during poor conditions for risk assets.

Firstly, we note that in extreme circumstances the Team is prepared for portfolio volatility to temporarily move below the volatility ceiling of the portfolio in the suite that sits immediately below it in terms of 'risk' profile – in this case, the Sustainable Multi Asset Cautious Fund. In contrast, most volatility managed peers seek to adhere more strictly to their volatility parameters, so that achieving the volatility objective is paramount and performance then often becomes a secondary consideration. In this sense, although the Team will always seek to maintain the integrity of the portfolio's volatility profile relative to the others in the suite, it's arguably more focused on achieving a positive return-oriented performance outcome when compared to the peer group. This point is backed up by the extent to which cash can be used. For example, the portfolio held almost 20% in cash in March 2022 when opportunities within bonds appeared scarce. Relatively few volatility-managed peers – sustainable mandate or otherwise – would go this far.

Following a similar positive-return oriented theme, unlike some sustainable multi asset peers the Team doesn't exclude investing in US treasuries and TIPS on defence spending and climate alignment grounds. In practice this means having access to assets that many peers don't and that typically provide downside protection when investors seek safe havens.

There can be a reasonably high level of similarity in the drivers of performance within the portfolio's equity holdings, and a high commonality of themes and performance drivers on the bond side too but aimed at providing a deliberate counterbalance to those on the equity side. This can lead to strong bursts of positive returns when the market's mispricing of the Team's selected themes is recognised.

Equally, positions in themes and sectors can be taken up early, which can mean experiencing higher levels of volatility when compared to some peers. For example, after purchasing a themed basket of stocks that might represent a considerable portfolio holding weight, the market's negative overreaction to the theme might continue for some time – leading to an exacerbation of downside risk. In other words, the portfolio's return keeps on declining. However, sometime later – up to between 12 to 18 months in some cases – the same theme might be rewarded by a sharp rebound in its fortunes – resulting in greater upside volatility for the portfolio as investors reassess their previous overreaction to it and begin to act on investment fundamentals.

Whilst this exaggerated pattern of performance isn't likely to feature in every risk-on and risk-off equity market period, when it does, it may lead to greater variation in returns when compared to some peers. In other words, we might expect bouts of moderately higher volatility and 'lumpy' returns. A more consistent pattern of performance, however, may emerge over longer periods spanning not just one, but a series of equity market inflection points over which we might anticipate the portfolio ironing out some of the 'lumps' to produce better risk adjusted returns. Patience may therefore be required.

When we compare with other sustainable multi asset portfolios, the portfolio's investment style and capitalisation size biases are key differentiators, and their respective patterns of performance may be expected to differ as a result.

Firstly, the 50% to 80% bias towards companies with high ESG ratings offers a skew in favour of companies with sustainable plans in place, and these tend to be larger companies. This is only partially offset by the positive impact holdings that tend to be more medium and smaller in size. The resulting large to medium size bias contrasts with the giant and larger company bias we see in many sustainably managed peers – particularly those that have little or no focus on positive impact investments. This means that when medium sized companies outperform, we might expect a relative tailwind for the portfolio's performance.

Secondly, the portfolio offers lower exposure to the quality and growth styles that are typical of a sustainable approach. Whilst still in evidence, these styles are generally outweighed by the value style embedded in the team's behavioural finance theory approach and the resulting dominance of the portfolio's unloved themes. We should therefore expect the portfolio to do marginally better than many sustainable peers when the value style is in favour and when markets expect higher levels of inflation (as in the first half of 2022 for example), and marginally less well when the pace of the global economy slows, and investors tend to prefer companies with higher growth prospects.

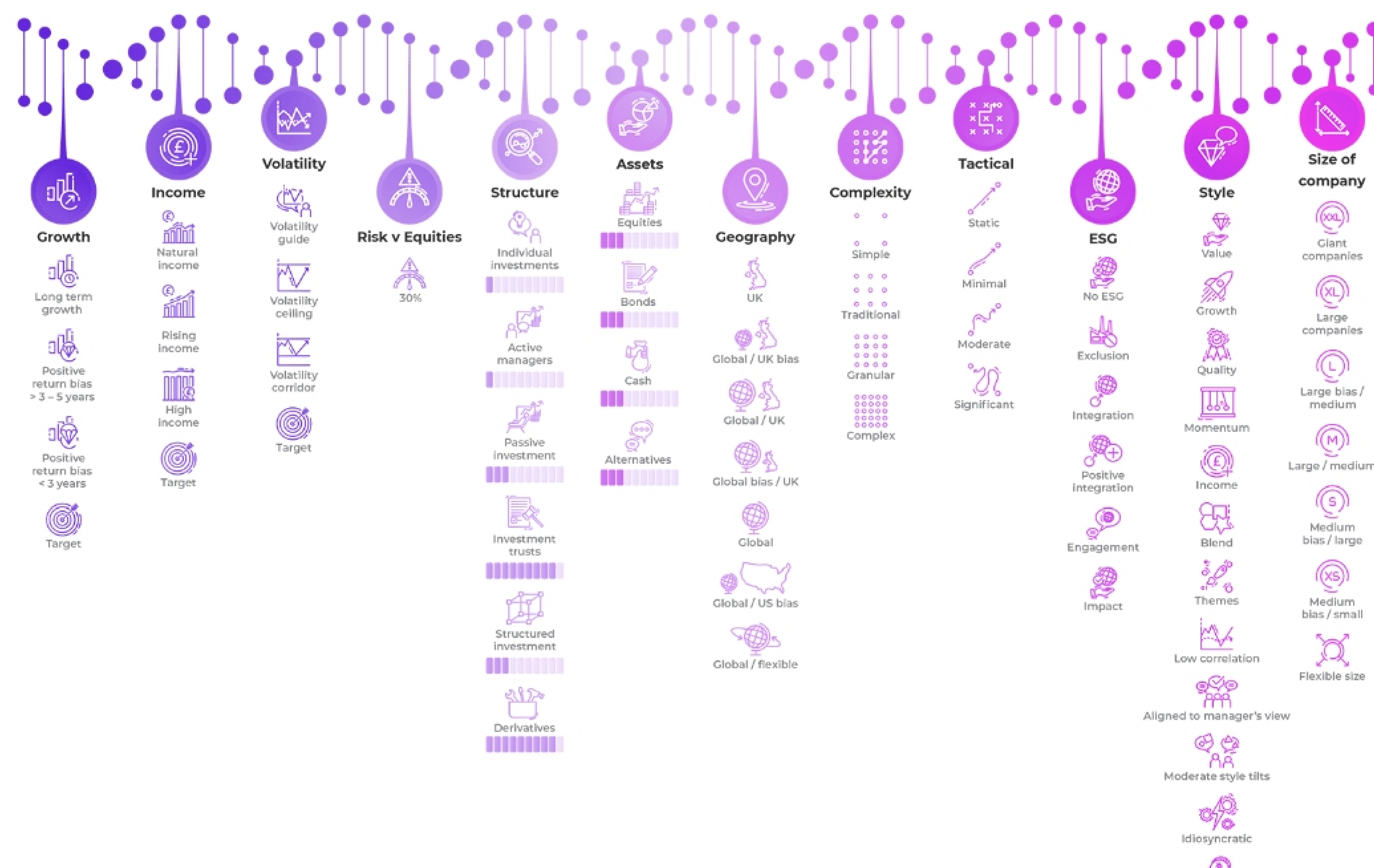
The extent to which the value style tilt takes sway will tend to vary with the magnitude of the portfolio's exposure to positive impact holdings, which can be anywhere between 20% and 50%. This is because positive impact companies tend to exhibit growth-style characteristics (such as having higher price earnings ratios). The smaller the allocation to positive impact holdings, the more noticeable the portfolio's value style tilt is likely to be by comparison, and the larger the allocation to positive impact holdings the more style-blended the portfolio becomes.

Periods characterised by strong momentum and when investors fail to act upon market fundamentals are likely to prove challenging. Less valuation conscious passive-oriented peers might outperform under these conditions.

Finally, and not unsurprisingly, during a commodity-led rally, the lack of exposure to companies involved in oil and gas extraction and mining, is likely to result in the portfolio lagging those volatility managed peers that don't have a sustainable focus.

Multi Asset Universe DNA

This represents the full pallet of DNA options for portfolios in the multi asset universe.



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The opinions expressed in this report are those formed by Scopic Research and don't represent investment advice or a recommendation to invest in a particular multi-asset portfolio. Scopic Research doesn't give investment advice. Past performance isn't a guarantee of the returns that might be achieved in the future and investment returns can be negative as well as positive.

The depiction of the portfolio's unique DNA is based upon the portfolio's embedded biases as identified by Scopic Research. The DNA isn't meant to reflect the portfolio's current positioning, but rather what we might expect on average over the long term.

The DNA can have implications for client suitability and the likely investment journey. However, users of the report should be aware that portfolio managers can sometimes seek to negate or reduce the impact of embedded biases. If this happens then performance can be different from what we might otherwise expect.

The depiction of the DNA and the likely investment journey text in this report constitutes the best efforts of Scopic Research to guide intermediaries on what they might expect from a portfolio's performance in broad relative terms under different market conditions. However, it isn't a prediction of the strength of performance and can't be guaranteed.

The key notes shown in the suitability section of the report are merely for professional intermediaries to consider alongside other factors. They are not personalised and client suitability rests solely with the professional intermediary.

Scopic Research carries out fact tests to help ensure the accuracy of our reports, but this doesn't guarantee accuracy.

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