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The Evolution of ESG Integration in Investing: Exclusion Priorities and Applications

ESG & Sustainability Transformation

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In the investment world, screening represents the simplest and oldest approach to ESG investing. Negative screening imposes a series of exclusions based on ethical preferences or related to standard worldviews to shape the investible scope of a portfolio. Indeed, the first formal use of this technique was in line with religious values, when followers of this approach avoided investing in businesses dealing in alcohol, tobacco, and gambling. In the 18th century, Quakers adapted their investment approach to their stance against slavery, choosing to screen investments and boycott business interests that supported the slave trade. In a similar way, Islamic investment approaches apply hard or soft interpretations of Shariah principles to filter out companies that do not comply with Shariah rules.

Many investors use exclusions to limit their exposure to certain sectors or securities if they conflict with their worldview. Exclusions often take the form of so-called 'sin sectors' or industries including tobacco, pornography, gambling and alcohol. But exclusions can just as easily be targeted at specific companies or even specific countries. Traditionally, exclusions represent ethical and normative restrictions. For example, a church pension fund might exclude gambling, alcohol and pornography while a pension fund representing healthcare workers might exclude investment in the tobacco sector.

According to statistics compiled by the Global Sustainable Investment Alliance (GSIA), exclusion-based approaches still rank second in total ESG-screened assets under management (AUM). Their size and growth represent an expansion from traditionally excluded areas, such as controversial arms and ammunition, to other areas, such as tobacco, thermal power, coal and nuclear weapons. Because of their subjective nature and their specificity based on regions, beliefs and norms, exclusions are often considered irreconcilable. For example, it is rare to find two pension funds whose worldviews and normative expectations completely overlap.

However, exclusions can be grouped into four basic categories:

- Universal;
- Behavior-related;
- Faith-based; and
- Specific exclusions.

Universal Exclusions:

Universal exclusions represent exclusions supported by global norms and conventions, such as those of the United Nations (UN) and the World Health Organization (WHO). It could be argued that controversial weapons and munitions (cluster munitions and anti-personnel mines), nuclear weapons, tobacco, and varying degrees of exposure to coal-based power generation or extraction would all qualify for universal exclusions based on the norm and the growing asset owner support for the AUM they represent.

Example: Excluding weapons, ammunition and tobacco

Excluding weapons and ammunition

• Exclusionary provisions governing investment in controversial arms and ammunition are supported by multilateral treaties, conventions and national laws.

• The Ottawa Treaty (1997) prohibits the use, stockpiling, production and transfer of anti-personnel mines.

• The United Nations Convention on Cluster Munitions (2008) prohibits the use, stockpiling, production and transfer of cluster munitions.

• The United Nations Chemical Weapons Convention (1997) prohibits the use, stockpiling, production and transfer of chemical weapons.

• The United Nations Biological Weapons Convention (1975) prohibits the use, stockpiling, production and transfer of biological weapons.

• The Nuclear Non-Proliferation Treaty (1968) limits the spread of nuclear weapons to a group of states known as the nuclear weapons states (the United States, Russia, the United Kingdom, France and China).

• Belgium (2009) banned investment in depleted uranium weapons.

• The UN Global Compact announced its decision (2017) to exclude controversial arms sectors from participating in the initiative.

Tobacco elimination

While tobacco does not enjoy the same level of widespread acceptance as the controversial elimination of arms and ammunition, it provides another example that can be supported by the following:

• The WHO Framework Convention on Tobacco Control (2003), with 181 Parties committing to a range of tobacco control measures.

• The United Nations Global Compact (UNGC) announced its decision (2017) to exclude tobacco companies from the initiative because tobacco products are fundamentally inconsistent with the UNGC’s commitment to promote business action towards Sustainable Development Goal (SDG) 3 and directly conflict with the right to public health.

• The United Nations SDGs (2015) promote a set of 17 global goals to end poverty, protect the planet and improve prosperity; Many targets mention tobacco as an obstacle to improving social and environmental outcomes.

Conduct-Related Exclusions:

Conduct-related exclusions are generally company or country specific and are not usually claims against the nature of the business. Labor violations in the form of violations of International Labor Organization (ILO) principles are often invoked.

Faith-Based Exclusions:

Faith-based exclusions are specific to individual investors or religious organizations.

Idiosyncratic Exclusions:

Idiosyncratic exclusions are exclusions that do not have global consensus. For example, New Zealand's superannuation fund is bound by law to exclude companies involved in processing whale meat products.

Application of Exclusion Preferences:

Exclusion preferences are generally accepted and applied by asset owners rather than asset managers. While there are certainly asset managers who have formally instituted some form of value-based exclusion screening, they currently represent a small minority. This is often due to their global reach and the subjective nature of negative screening. As a result, pooled or mixed investments and listed funds (such as collective investment undertakings in transferable securities [UCITS] funds) typically do not implement exclusion screening, unless noted in their investment mandates. That said, asset managers who administer obligations specific to asset owners often impose some form of exclusion screening.

Among global asset owners, Norges Bank, part of the Norwegian sovereign wealth fund (SWF), has most clearly developed and implemented this asset owner exclusion list. Due to its large AUM size, Norges Bank's exclusion list has been adopted by other Norwegian asset owners and continues to influence the development of exclusion lists among other Nordic asset owners. Due to its relative ease of implementation, screening is one of the main popular approaches in ESG investing. While the simplicity of exclusions means they are often widely applied across traditional asset classes as well as private markets and alternatives, the level of exclusion can have implications for portfolios.

It is important to highlight that some issues continue to be difficult to address from a screening perspective, meaning that investors often adopt a best efforts approach in these cases. The level of exclusions can have important implications from a portfolio management perspective, not only in terms of higher tracking error and active share, but also in terms of unintended factor exposure. Tracking error and active share are measures of how much a portfolio deviates from its benchmark. A portfolio that employs a wide range of exclusions (especially sector exclusions, which make up a significant portion of its benchmark) is likely to have high tracking error and active share. This level of divergence may lead a portfolio manager to adopt a more appropriate ESG benchmark rather than a broad market benchmark. On the other hand, a portfolio that uses a narrow exclusion list that does not by itself generate a higher active weight or tracking error may leave the benchmark unchanged unless the exclusions represent a meaningful change to the fund's risk-return profile. Additionally, the exclusion list may not apply to derivative index instruments or proprietary index construction. This trade-off is often made to reflect the burden of multiple index splits. In some cases—particularly for smaller, less well-known indexes—investors make this trade-off because the cost of purchasing the underlying constituent weights is too high.

Another challenge is dealing with asset classes and securities that fall outside the scope of traditional responsible investing, which often focus on:

- Listed stocks;
- Listed corporate debt; and
- Real assets.

Indeed, the PRI itself acknowledges this limitation in its commitment, acknowledging that ESG can impact portfolio performance "to varying degrees across companies, sectors, regions, asset classes, and over time."

As discussed earlier, ESG integration tends to be biased toward corporate-related assets, which are represented in the capital markets through equities and fixed income. By monitoring these assets, management teams and boards drive decision-making and shape

long-term corporate strategy through feedback loops to shareholders and other stakeholders.

However, other asset classes that lack the direction of a management team or board pose more problems. For example, synthetic assets (currencies, interest rate derivatives, broad equity indexes, and commodity futures) are not single-use assets and fall outside the scope of conventional ESG analysis. For some types of securities, it is possible to draw tenuous links between currency forward contracts and the ESG profile of the underlying sovereign debt issuer, but other instruments are more difficult. For example, an interest rate swap represents a derivative contract that exchanges the floating interest rate payment of a sovereign bond or loan for a fixed interest rate. Investors should certainly be aware of the potential risks to that sovereign payment, but simply removing the ESG risk profile of the same sovereign loan on both sides of the contract would effectively create a wash or a write-off.

In addition, investment strategies, especially at the multi-asset level, often invest in indices for a variety of reasons, including managing cash to cover potential redemptions by investors. In this context, regularly breaking down indices from a screening perspective would be complex and often costly. Highly liquid, widely traded indices are often easier and less costly to disaggregate into their constituent weights or components, while the opposite is true for less popular, less traded indices. Therefore, while investors may maintain a formal exclusion list, they may also include in their exclusion policy a specific policy of excluding indices in the interest of efficient portfolio management.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!