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The Evolution of ESG Integrated Investing: Exclusionary Preferences and Their Application

ESG & Sustainability Transformation

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Screening represents the oldest, simplest approach to ESG investing. Negative screening imposes a set of exclusions based on ethical preferences or around a normative worldview to shape the investable universe of a portfolio. Indeed, its first formal use was aligned to religious values, when the Methodists avoided investing in businesses that dealt in alcohol, tobacco, and gambling. In the 18th century, the Quakers aligned their investment approach to their stance against slavery, choosing to screen out investments and boycott business interests that supported the slave trade. In a similar manner, Islamic approaches to investment apply hard or soft interpretations of Shariah principles to filter out companies that are not Shariah-compliant.

Many investors apply exclusions to restrict exposure to certain sectors or securities that conflict with their worldview. Exclusions typically take the form of sectors or industries commonly known as ‘sin sectors’ that include tobacco, pornography, gaming, and alcohol. But exclusions can just as easily target specific companies or even countries. Exclusions have traditionally represented ethical and normative restrictions. For example, a church pension plan may exclude gambling, alcohol, and pornography while a pension fund that represents healthcare workers may exclude investment in the tobacco sector.

According to statistics maintained by the Global Sustainable Investment Alliance (GSIA), exclusions-based approaches remain the second largest portion of dedicated, ESG-screened assets under management (AUM). Their size and growth points to the expansion from traditional areas of exclusion, such as controversial arms and munitions, into other areas, such as tobacco, thermal, coal, and nuclear weapons. Because of their subjective nature and their regional, faith-based and normative specificity, exclusions are often treated as irreconcilable. For instance, it would be rare to find two pension funds with perfectly overlapping worldviews and normative expectations.

Nonetheless, it is possible to organize exclusions across four basic categories:

- Universal;
- Conduct-related;
- Faith-based; and
- Idiosyncratic exclusions.

Universal Exclusions:

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

Examples: Arms and Munitions and Tobacco Exclusions

Arms and Munitions Exclusions

- Exclusions governing investment in controversial arms and munitions are supported by multilateral treaties, conventions, and national legislation.
- Ottawa Treaty (1997) prohibits the use, stockpiling, production, and transfer of anti-personnel mines.
- UN Convention on Cluster Munitions (2008) prohibits the use, stockpiling, production, and transfer of cluster munitions.
- UN Chemical Weapons Convention (1997) prohibits the use, stockpiling, production, and transfer of chemical weapons.
- UN Biological Weapons Convention (1975) prohibits the use, stockpiling, production, and transfer of biological weapons.
- Treaty on the Non-Proliferation of Nuclear Weapons (1968) limits the spread of nuclear weapons to the group of so-called Nuclear-Weapons States (USA, Russia, UK, France, and China).
- Belgium (2009) bans investments in depleted uranium weapons.
- UN Global Compact announced the decision (2017) to exclude controversial weapons sectors from participating in the initiative.

Tobacco Exclusions

Although tobacco does not exhibit the same degree of universal acceptance that the exclusion over controversial arms and munitions does, it provides another example that can be said to be supported by the following:

- WHO Framework Convention (2003) on Tobacco Control, with 181 parties committing to implementing a broad range of tobacco control measures.
- UN Global Compact (UNGC) announced the decision (2017) to exclude tobacco companies from participating in the initiative as tobacco products are fundamentally misaligned with UNGC's commitment to advancing business action towards Sustainable Development Goal (SDG) 3 and are in direct conflict with the right to public health.
- UN SDGs (2015) drive a collection of 17 global goals to eradicate poverty, protect the planet, and improve prosperity; many of the goals touch on tobacco as an impediment to improved social and environmental outcomes.

Conduct-Related Exclusions:

Conduct-related exclusions are generally company or country-specific and often not a statement against the nature of the business itself. Labor infractions in the form of violations against the International Labour Organization (ILO) principles are often cited.

Faith-Based Exclusions:

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

Idiosyncratic Exclusions:

Idiosyncratic exclusions are exclusions that are not supported by global consensus. For example, New Zealand's pension funds are singularly bound by statutory law to exclude companies involved in the processing of whale meat products.

Applying Exclusionary Preferences:

Exclusionary preferences are most commonly adopted and applied by asset owners rather than asset managers. While there are certainly asset managers who have formally instituted some form of values-based exclusionary screens, they currently represent a small

minority. This is often because of their global reach and the subjective nature of negative screens. Hence, pooled or commingled investments and listed funds (such as undertakings for the collective investment in transferable securities [UCITS] funds) generally do not have exclusionary screens implemented, unless noted within their investment mandate. That said, asset managers do manage dedicated mandates for asset owners that commonly impose some form of an exclusionary screen.

Among global asset owners, Norges Bank, in its Norwegian sovereign wealth fund (SWF), constructs and implements the most visible of these asset owner exclusion lists. Because of the size of its AUM, Norges Bank's exclusion list has been adopted by other Norwegian asset owners and continues to influence the construction of exclusions lists among other Nordic asset owners.

Because of its relative ease of implementation, screening is one of the main universal approaches within ESG investing. While the simplicity of exclusions means that they are often widely applied in both traditional asset classes as well as private markets and alternatives, the extent of exclusions may carry implications for a portfolio.

It is important to highlight that some issues continue to remain difficult to reconcile from a screening perspective, which means that investors often assume a best-efforts approach in these cases. The degree of exclusions may carry significant implications from a portfolio management perspective, not just in terms of higher tracking error and active share, but also unintended factor exposure. Tracking error and active share are measures that represent the degree to which a portfolio deviates from its benchmark. A portfolio that imposes a broad set of exclusions (particularly sector exclusions, which represent a significant weight of their benchmark), will likely produce high active share and tracking error. This magnitude of difference may lead the portfolio manager to adopt a more appropriate ESG benchmark rather than a broad market benchmark.

On the other hand, a portfolio that applies a narrow exclusion list that doesn't by itself produce higher active share or tracking error may leave the benchmark index unchanged unless the exclusions represent a meaningful change to the risk–return profile to the investment fund. In addition, the list of excluded companies may not apply to index derivatives or proprietary index construction. This compromise is generally done to reflect the burden of repeatedly decomposing indexes. In some cases - particularly for smaller, more obscure indexes - investors make this compromise because of the prohibitive cost of purchasing the underlying constituent weights.

Another challenge is the treatment of asset classes and securities that fall outside of the traditional spectrum of responsible investment, which has generally been focused on:

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

Indeed, the PRI itself acknowledges this limitation in the language of its signatory commitment, which recognizes that ESG may impact the performance of portfolios to "varying degrees across companies, sectors, regions, asset classes and through time."

As discussed earlier, ESG integration has a natural bias towards company-related assets, manifested in capital markets through equities and fixed income. With oversight of these assets, management teams and boards of directors drive decision-making and long-term corporate strategy with feedback loops to shareholders and other stakeholders.

However, other asset classes that lack the directed actions of a management team or board of directors prove more problematic. For instance, synthetic assets (currencies, interest rate derivatives, broad-based equity indexes, and commodity futures) are not single-operated assets and fall outside the conventional framework of ESG analysis. For some security types, it is possible to draw tenuous linkages between, say, currency forward contracts and the ESG profile of the underlying sovereign 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, say, a sovereign bond or loan for a fixed interest rate. Investors should certainly be aware of the underlying risks to that sovereign payment, but simply netting out the ESG risk profile of the same sovereign on both sides of the contract effectively creates a wash or cancellation.

In addition, investment strategies, particularly at the multi-asset level, commonly invest in indexes for various reasons, including for cash management to cover potential redemptions by investors. Within this context, it is complicated and often can become expensive to frequently break down indexes from a screening perspective. Widely traded, liquid indexes are generally easier and less costly to decompose into their constituent or member weights, while the opposite is true for less popular, thinly-traded indexes. Hence, while an investor may maintain a formal exclusion list, they may also include a specific policy in their exclusion policy that omits indexes in the interest of efficient portfolio management.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!