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Commentary, Q4 2016

Hermes Global Equities

From faith to fact in ESG exclusions: a behind-the-scenes analysis

Key points

The exclusion of certain businesses from investment portfolios – such as tobacco or weapons stocks – whose activities oppose the ethical views held by an investor, was initially practiced by a fervent few as one of the earliest forms of responsible investing

Now the movement has a broad following. We support the rise of active ownership as an effective way for investors to exercise their responsibilities, but also recognise that exclusion lists – or screens – can help investors practise their beliefs

Exclusion lists seem simple in principle, but can be complex in implementation: tolerance levels must be set to govern exposures to companies directly involved in one or more screened-out lines of business, as well as those forming related supply chains

Any exclusion list should be enforced carefully. This helps to ensure that an investor's financial objectives concerning return and volatility can be achieved while also fulfilling their long-term responsibilities

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From its narrow religious origins, ethical investing has evolved into a broad church with a rapidly-expanding congregation of secular converts. But the new converts do not necessarily cling to the doctrines of the founders.

Indeed, along the way the sector has shed the somewhat moralistic 'ethical' tag in exchange for the more inclusive 'socially responsible investing' (SRI), or 'sustainable investing' descriptors.

As a CFA Institute guide[1] published in November 2015 points out, the variety of labels applied to SRI-style strategies obscure their chief similarity: that they are based on environmental, social and governance (ESG) principles.

"Today, those who say they practice socially responsible investing describe it in much the same way as those who say they practice sustainable investing," the CFA guide says. "The common theme underlying the various labels is an emphasis on ESG issues."

The 15-fold increase in signatories to the United Nations Principles for Responsible Investment (PRI) over the last 10 years is further evidence that ESG has become much more than a niche concern.

According to PRI statistics, at April 2016 about 1,500 institutional investors and asset owners representing almost $60tn in assets had agreed to implement the six responsible investment principles contained in the UN PRI. In 2006 the 100 or so original PRI signatories had influence over assets totaling $5tn.

In this transition from the pulpit to the portfolio, the SRI sector has developed a range of sophisticated investment techniques based on those ESG measures that go well beyond the all-or-nothing approach of the ethical investing pioneers.

In addition to the original sinner-versus-saint method of excluding investments that breached the ethical standards of asset owners, the CFA guide lists five other tools that ESG investors now have at their disposal:

- Best-in-class selection
- Thematic investing
- Active ownership
- Impact investing, and
- ESG integration

Of the six ESG methods listed by the CFA paper, exclusion – or 'negative screening' – perhaps offers investors the most direct approach to aligning their money with their morals.

However, while exiting from 'sin' stocks might, in one sense, purify a portfolio, the divestment approach risks straying into Pontius Pilate territory – where investors 'wash their hands' of problems rather than attempt to solve them.

In recent years the debate has centred on more positive approaches to SRI, such as tilting portfolios to companies offering sustainable solutions (for example, clean-energy providers), integrating ESG factors into the overall investment process, and using active ownership to engage for corporate improvement.

According to the CFA, "engagement with a company could be for monitoring or influencing outcomes and practices regarding ESG issues". Meanwhile, "active ownership is in sharp contrast to the idea that investors should vote with their feet – that is, simply sell off the investments with questionable practices."

We welcome ESG investors' growing willingness to seek a seat at the table – Hermes has a 33-year track record of engaging with companies on behalf of investors. However we also regard screening as a valid means of meeting investors' needs and reducing ESG risk in an their portfolios.

Here we discuss how investors may make use of exclusion lists, how negative screening can affect performance and what challenges divestment brings – and how to overcome them. We will also show how we build exclusion lists that match investors' SRI preferences, while maintaining – or even improving – portfolio risk/return attributes.

Although we will outline our approach to negative screening, we are not recommending this as the ultimate approach to ESG investing. The choices made will depend on the targeted outcome. Our aim is to show that, whatever ESG doctrine investors adopt, they should light the way with evidence, and not rush ahead in blind faith.

Negative screening now: how to view divestment strategies

Negative screening is the oldest ESG investment method, and it's easy to see why. Carving out entire sectors, companies or countries from a portfolio offers a relatively simple and transparent way for investors to express their particular ESG or ethical views.

Further, a pre-specified list of prohibited investments removes the subjectivity that can surround ESG concerns and can be very easy to explain to the end investor.

While there are subtle differences in how investors approach negative screening – usually divided into values-based or norms-based philosophies – popular taboo sectors include tobacco, alcohol, gambling, adult entertainment and weapons manufacturers.

Sometimes investors may also be required by law to exclude certain industries – for example, many jurisdictions ban investments in cluster munitions manufacturers.

But, as the 2015 CFA guide notes, "exclusionary screening based on values and norms [means] that the particular security will not be invested in regardless of how economically attractive it may become".

Clearly, negative screening could cause investors to give up some performance and diversification benefits to comply with their ESG goals. In our view, though, the outcomes of screening are more nuanced: divestment needn't skew performance one way or the other and the effect will vary across timeframes and industries.

[1] "Environmental, Social & Governance Issues in Investments: A Guide for Investment Professionals," published by the CFA Institute in November 2015.

For example, let's compare two of the most notorious 'sin' industries – tobacco and fossil fuels (using oil companies as a proxy for the latter). Over the last 10 years the growing cohort of investors that avoids tobacco firms has missed out on some very healthy portfolio returns. During this period the MSCI Tobacco Index has outperformed the wider index by more than 10% per annum on average.

On closer inspection, we can see that the sector returns have been driven primarily by the defensive, dividend-generating nature of tobacco companies rather than long-term industry fundamentals. Since the global financial crisis, yield-addicted investors have inflated income stocks to historical highs.

In the longer term, however, the tobacco sector is likely to run out of puff: increasingly harsh global regulations and the rise of e-cigarettes, for example, present considerable challenges to the industry.

Once the tide truly turns against these companies, investors who have given up tobacco may enjoy a reversal in performance outcomes.

The case for total fossil fuel divestment is less compelling. Over the short term investors who have dumped fossil fuel stocks may, in fact, have benefited from the collapse in the oil price. However, if the oil price reverts from the current $50 per barrel range back to levels seen five years ago, fossil-fuel abstainers could suffer portfolio losses.

Regardless of the short-term performance fluctuations, divestment from oil stocks may have less impact on the industry compared to divestment from the tobacco sector. About 80% of oil reserves globally are held in state hands, reducing the power of active stock owners to drive change.

Furthermore, by rescinding their ownership of oil company shares, ESG-conscious investors forfeit the ability to influence an industry that, arguably, requires the closest scrutiny and investor pressure to drive positive change.

For divestment to fully succeed in driving corporate improvements it's also true that a majority of investors must make the same choice – a hard-to-orchestrate outcome made even more difficult by the secular shift to passive investing.

Devil in the data: how to beat exclusion confusion

In principle, negative screening provides a clean, simple solution for an ESG-inclined investor. And in practice, it is relatively easy to implement an exclusion list.

The tricky part is creating that list.

Investors usually come to us with well-formed ideas of what they'd like to screen from their portfolios. For instance, we have looked at creating exclusion lists covering the archetypal sin stocks mentioned earlier, as well as sectors including (but not limited to):

- High carbon emissions
- Old-growth forest logging
- Fast food
- Stem cell research, and
- Nuclear power

But, as always, the devil is in the detail.

Let's revisit the example of tobacco. The sector has a global industry classification standard (GICS) all to itself. In theory, armed with the GICS code, it should be easy to isolate and excise tobacco stocks from any portfolio.

The GICS-defined tobacco sector, though, only covers manufacturers. When we ask tobacco-averse investors whether they'd also like to exclude retailers that derive substantial revenue from cigarette sales, the answer is usually yes. The answer, however, raises further questions: what is 'substantial revenue': 20% or 5%?

Or consider the plight of an investor trying to de-militarise their portfolio. It might be simple to strike out the major gun, tank, fighter jet, cluster bomb and nuclear weapons manufacturers. But what about radar or parachute providers, or producers of other equipment that has both military and civilian uses?

Ultimately, it is up to the asset owner to answer these curly questions. As an investment manager, it is our job to turn our clients' wish lists into a workable exclusion list that matches their bespoke ESG standards.

But transcribing high-level ESG screening decisions into quantitative, stock-specific exclusions brings further issues into focus. We require robust data on a wide range of ESG factors for each company in order to build an appropriate screening list – data that is not necessarily available.

Even though the availability of ESG data has grown rapidly over the last five years but there is still much room for improvement. Many of the metrics are backward-looking and often the data is out of date by the time it reaches investors.

Also, there are no standards among data providers about what constitutes a particular ESG risk, or how scores are presented in those categories. We must recall that the level of disclosure proffered by the underlying companies in question also limits the quality of ESG researchers' data.

Turn on the monitor: why ESG redemption could be at hand

Given the current data deficiencies, we encourage investors to adopt a flexible approach when setting ESG exclusion thresholds. For instance, investors aiming to decarbonise their portfolios might automatically exclude many utility companies based on current ESG scores. However, the data driving those scores may not take account of the fact many firms are moving towards clean energy production.

This point also emphasises why investors should view exclusion lists as provisional documents rather than final judgements. In fact, screening lists require regular monitoring to reflect changes in ESG data and information garnered from qualitative research. Also, companies are constantly changing how they manage ESG risks – perhaps even more so when activist investors are applying pressure.

To use the above example, a utility firm could be in the process of decommissioning its coal-burning electricity generation plants while switching to green energy sources such as solar or wind farms. The transition would likely not show up in ESG data for many years, while qualitative research might add some valuable real-time insight.

Some investors would probably exclude these firms based on the available ESG scores alone, but we see huge potential in both financial and ESG terms in helping companies progress towards a sustainable economy.

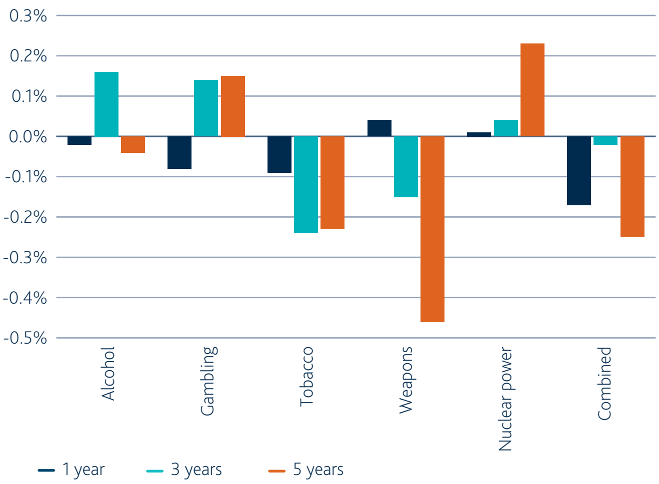
Exclusive: how to build lists that last

Definitional concerns aside, an investor must carefully consider the impact of their exclusion decisions on the rest of their portfolio.

For a detailed illustration of how screening may affect a real portfolio, let's consider five screens based on some of the most common ESG product themes with each applying a 10%-of-revenue threshold to exclude stocks in specific industries: alcohol, gambling, tobacco, armaments and nuclear power. This data has been sourced from ESG research firm Sustainalytics.

Figure 1 shows how these exclusion lists, and a list combining all five product factors plus coal (either reserves or power generation) would have impacted the performance of the MSCI World index over one-, three- and five-year periods.

Figure 1. The impact of exclusion screens on portfolio performance



Source: Hermes, FactSet, Sustainalytics at 30 September 2016

It's clear that even over five years the exclusion of any one of these product groups would not have a dramatic impact on performance. This is not surprising since these lists represent a small portion of the overall benchmark – no category is much more than 2% of the MSCI World index and the combined list represents less than 8%. The tobacco and weapons screens fared the worst while the combined exclusion list shows slight underperformance over all time periods.

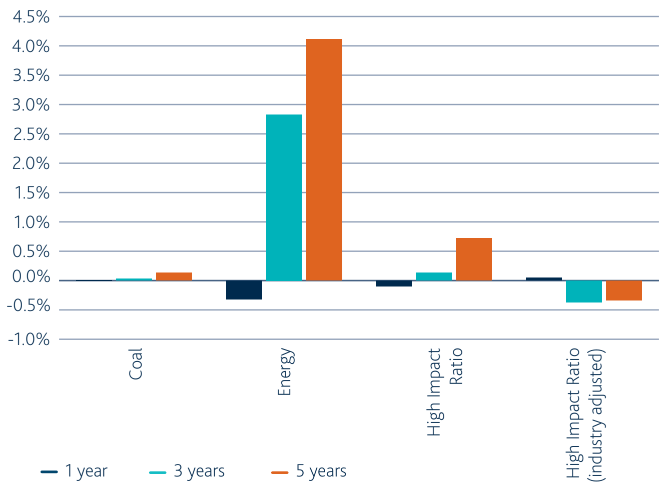
However, any variation in performance is more likely due to idiosyncratic factors (such as the high returns recently generated by tobacco companies driven by demand for high-yielding stocks) rather than identifiable ESG trends.

In addition to choosing which sectors to screen, investors also have to consider what level of customisation they would like. Let's say an investor wants to address climate change concerns through an exclusion list. We could create models for four different approaches that, while ostensibly meeting the same goal, produce diverse risk and performance outcomes:

- Screen out coal stocks by omitting any company deriving more than 50% of its revenue from coal, or is categorised in the coal sub-industry GICS classification
- Create an exclusion list covering the entire energy sector
- Compile a 'high-impact' list that screens out the most environmentally damaging companies in the investment universe. The list features the top 10% of firms according to their respective Impact Ratio, a metric supplied by data provider Trucost that is based on the total direct and indirect environmental costs per unit of revenue
- Implementing an industry-adjusted high-Impact Ratio list to recalibrate for biases in the previous method. This contains the companies with impact ratios in the top 10% of their industry peer group

As figure 2 shows, screening out the energy sector over the last few years was by far the most successful strategy, adding a 4% surge in performance over a five-year period that featured a massive collapse in oil prices.

Figure 2. Performance of different exclusion lists focused on the energy sector



Source: Hermes, FactSet, Sustainalytics, Trucost at 30 September 2016

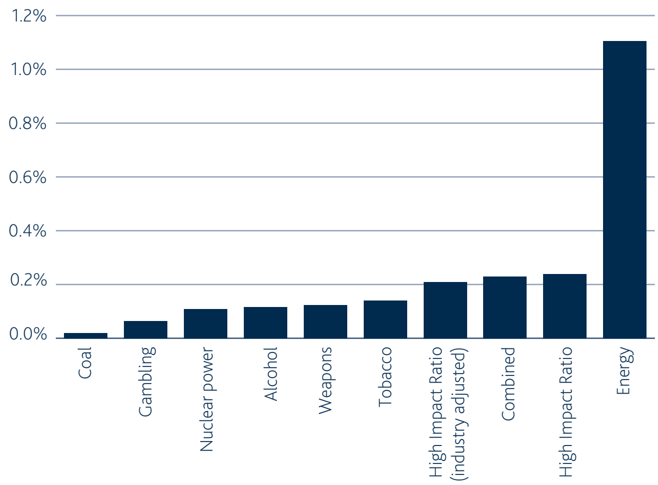
Interestingly, excluding the heaviest polluters as measured by Impact Ratio also generated outperformance over five years, while excluding the worst polluters within each industry would not have benefited performance. Our previous research has found no statistically meaningful link between measures of environmental efficiency and shareholder returns within industry groups[2]. Given this finding, we would expect that any impact from an exclusion list has historically been driven by sector moves – through the omission of energy companies, for example – rather than from stock-level effects.

While our sample exclusion lists generally show a muted effect on returns, it's useful, too, to consider their influence on risk.

According to our analysis in figure 3, it is clear that the smaller, more diversified lists incur lower risk (as expected), while excluding the energy sector adds significant relative volatility.

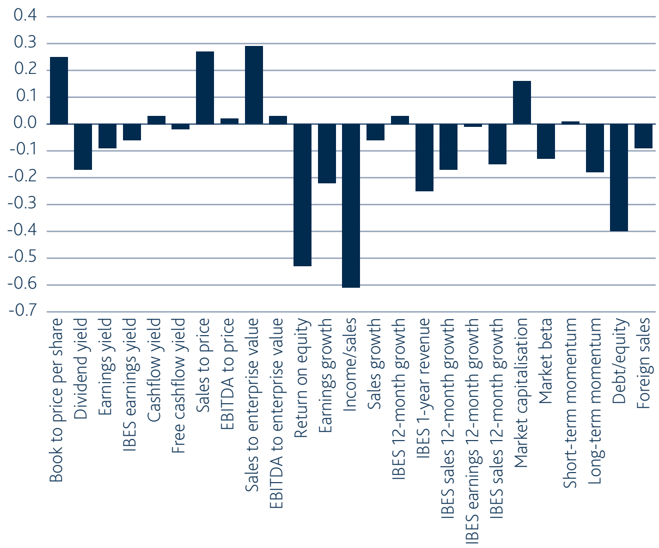
[2] "ESG: it still makes you feel good, it still makes you money," published by Hermes Investment Management in September 2016.

Figure 3. The difference in relative volatility created by exclusion lists



Source: Hermes at 30 September 2016

Figure 4. Style bias caused by the multi-industry screen on the MSCI World



The power of diversification is also evident in the result for the combined list, which, by generating 23bps of tracking error, adds far less risk than the sum of its parts.

If we delve further into the data, we can see that some of the exclusion lists also introduce style bias into a portfolio (see figures 4 and 5). For the combined list, the metrics indicate a shift towards a value bias while a similar analysis of the energy list reveals a style drift towards higher growth names.

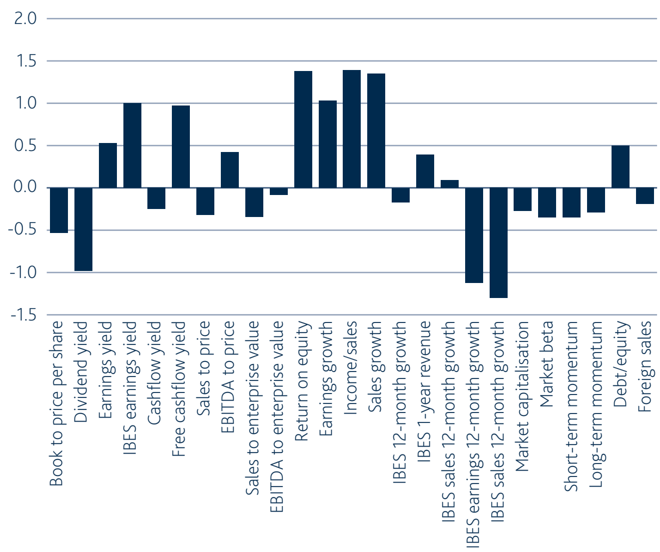
Our analysis has shown that applying exclusion lists will affect investment portfolios in a number of ways depending on the scope, concentration and idiosyncratic features of the screens in question.

We believe that undertaking detailed research is essential in helping investors manage the risks involved in negative screening, but that the potential for varied outcomes should not deter investors from embarking on the process.

To recap our findings:

- Excluding any one of the typical sin-stock categories has historically had little impact on overall portfolio performance
- Even if an industry or sector scores low on ESG measures (for example, tobacco), it can still outperform – investors banking on sustainable returns from exclusion lists may have to adopt a longer-term view
- Combining exclusion lists has historically shown a smoother risk/return profile than those focused on single factors – although investors need to keep watch on correlations among excluded companies
- Exiting entire industries – such as energy – can have a very significant impact on performance and risk exposures

Figure 5. Style bias caused by the energy-industry screen on the MSCI World



Source: Style Research at 30 September 2016

Why ESG investors need believable benchmarks

Given that negative screens necessarily introduce a deviation from index exposures, some investors have argued that such portfolios should be measured against bespoke ESG benchmarks.

However, in our view ESG factors should be incorporated as part of overall portfolio risk attribution – distinguishing the performance related to exclusions as well as manager alpha – rather than redefined as a separate form of equity investing.

We believe that the use of a specialist ESG index is neither required nor prudent. Such indices often introduce additional biases to the investment universe, while failing to take account of firms with improving ESG profiles or those whose positive headline data hide less obvious risks.

For clients who choose to implement exclusions, we use ESG metrics alongside more traditional fundamental investment factors to create a portfolio that can generate consistent outperformance when measured against the traditional equity indices.

As active managers, we seek to outperform the market regardless of the exclusion criteria or market environment.

Let us pray

The CFA Institute argues that ESG concerns should be considered as "a complement to (not a substitute for) traditional fundamental analysis".

"ESG issues remain relevant throughout the investment process – from the initial analysis to the buy, sell or hold decision to ongoing ownership practices," the CFA guide says.

We certainly echo these sentiments and the growth in PRI signatories confirms that we are not alone.

But as the CFA notes, while the investment industry has made significant progress in defining the 'whats' and 'whys' of ESG investing, "there is a need to clarify 'how to' apply ESG methods…".

In this paper we have sought to contribute to the collective ESG 'how to' manual with regard to the oldest SRI technique: negative screening.

At first glance, excluding sin stocks offers ESG-conscious investors an incontrovertible way of reflecting their SRI beliefs in real portfolios.

However, in addition to multiple complexities in actually defining exclusion lists, investors face many practical issues when implementing negative screening strategies – such as how performance and volatility can vary according to the way an exclusion list is constructed.

Despite their challenges, exclusion lists remain a valid ESG strategy – particularly in industries not open to behavioural change – and in many cases are a direct consequence of principles held by asset owners.

Where investors elect to apply exclusion lists, we advocate for careful analysis every step of the way: from defining the appropriate list, to monitoring exclusions on an ongoing basis and to thoroughly reviewing the risk/return characteristics of the screened portfolios.

As the CFA guide says: "systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions".

Amen to that.

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Hermes Investment Management

Hermes Investment Management is focused on delivering superior, sustainable, risk-adjusted returns – responsibly.

Hermes aims to deliver long-term outperformance through active management. Our investment professionals manage equity, fixed income, real estate and alternative portfolios on behalf of a global clientele of institutions and wholesale investors. We are also one of the market leaders in responsible investment advisory services.

Our investment solutions include:

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Credit

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Multi asset

Multi asset inflation

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Why Hermes Global Equities?

Transparency

Our accessible investment process and analysis is based on clearly defined statistical and economic evidence. It is not a 'black box' and the drivers of returns can be clearly explained.

Expertise

Our bottom-up stock-selection model systematically analyses companies' financial statements and gauges investor sentiment to generate an optimal portfolio. The team draws on its deep investment experience to identify unquantifiable risks such as negative news flow and regulatory change.

Flexibility

We partner with clients to create portfolios addressing their needs, amending the risk profile, investment universe and benchmark, and portfolio characteristics such as dividend yield and ESG exposure as required.

Broad risk awareness

MultiFRAME, our proprietary risk modelling system, detects exposures to all quantifiable risks. The Hermes Investment Office performs independent risk management services for clients and sustainability risks are identified by our ESG Dashboard.

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