Global Matters Weekly

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To exclude or not to exclude? That is the question.

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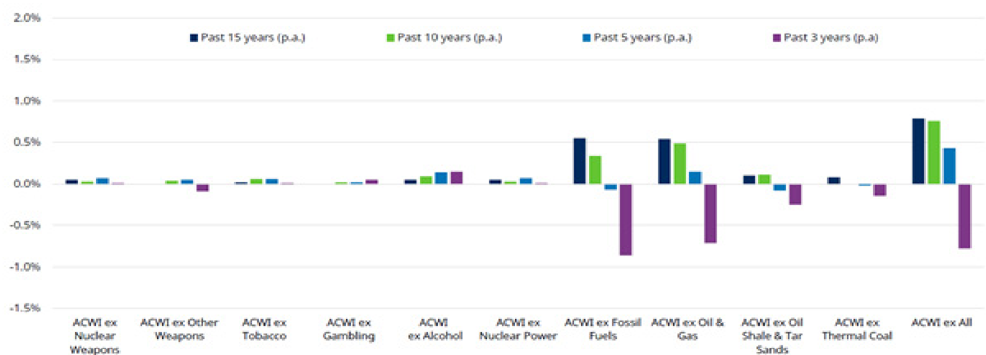
Excluding cohorts of stocks from an estment universe often sparks debate about how this impacts overall fund performance because, if you remove the best performers you can't benefit from the strong returns that they generate. Whilst this observation is true at a high level, the reality is that certain stocks are excluded for specific reasons, and many are unlikely to generate positive returns over the longer term. Looking at the data, we find that in the short term there may be a negative impact on relative performance as some of these companies experience short, sharp bounces in valuations, but over the longer term the impact is neutral to positive.

What we can observe is that excluding weapons, tobacco and alcohol has an immaterial impact on both short and long-term performance. The picture looks different when considering the energy sector; generally excluding industries within the energy sector has a negative impact on short term performance (3 years) but over the longer term (10-15 years) performance is improved (see chart).

This chart shows performance of the global equities universe excluding specific industries over three to fifteen years.



Source: Schroders, MSCI.

Overall, when excluding the industries listed in the chart, global equity returns improve by about 0.8% per annum. One might consider that this is not a material number, but returns are only one piece of the puzzle.

We can also consider the risk profile of investing in challenged industries: tobacco companies supply products that negatively impact the health of the population, and although new products are better they still cannot be considered good for our health, even in moderation. This exposes the industry to various risks including increased regulation, increased costs, redundant products and reputational damage, to name a few. There is also the opportunity cost to consider: if capital is allocated to companies that are facing challenges, like in the case of energy companies who are having to spend huge amounts of capital to transition towards renewable energy, then there is less capital available to invest in companies that are profiting from this shift in capital expenditure. Finally, there is the 'added bonus' of driving positive change in the world; excluding companies sends a stark message to companies that their products or practices are having a detrimental impact on people's health or the environment for example.

A key consideration when putting an exclusion policy together is deciding which companies or industries to exclude. The chart above only considers a limited number of industries, and this makes sense because if an exclusion policy is overly discriminatory then this will reduce the overall investment universe materially, which could have a negative impact on performance.

At MGIM, our preference is to select fund managers that engage with companies to drive positive change, but when this is not possible (as with tobacco where the product cannot become healthy) or unsuccessful (as with specific companies in the energy sector), exclusion can be the logical answer or final step.

The extent to which exclusion policies are implemented depends on many aspects, including fund manager processes, investment styles and regional preferences. In Europe extensive exclusions have long been a preferred method to implement a responsible investment strategy however, in the US and UK there is a preference to remain invested and engage for positive change. In these regions exclusions are often still applied as part of the process, but to a lesser extent.

Often, even when a fund does not formally exclude companies, the process will naturally direct the portfolio manager away from investments in challenged industries anyway, so formally applied exclusions would make little to no difference to the investment universe. The practicalities around this make sense because investors aim to avoid risks and to identify interesting business opportunities, taking advantage of capital expenditure shifts and directing investment towards areas that are seeing significant levels of investment.

Exclusions and sustainable investing doesn't just mean saving the planet or driving positive change, but also makes investment sense which can lead to better returns.

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