What is ESG screening and exclusion?

Wealth Management
Dominion Securities

The topic of responsible investing is drawing a lot of attention, especially from investors. In Canada alone, responsible investing assets increased from $2.1 (CAD) trillion at the start of 2018 to $3.0 (CAD) trillion at the start of 2022, an increase of 43%.[1]

ESG screening and exclusion falls under the umbrella category of responsible investing. Ask your advisor for the ESG integration, thematic ESG investing and impact investing definitions if you are interested in those.

Responsible investing

Responsible investing is an umbrella term encompassing the approaches used to deliberately incorporate environmental, social and governance (ESG) considerations into an investment portfolio. We believe there are four main applications of this data, and each applies this data very differently. The four applications are:

ESG integration

Systematically incorporating material ESG factors into investment decision making to identify potential risks and opportunities and help improve long-term, risk-adjusted returns.

ESG screening and exclusion

Applying positive or negative screens to include or exclude assets from the investment universe.

Thematic ESG investing

Investing in assets involved in a particular ESG-related theme or seeking to address a specific social or environmental issue.

Impact investing

Investing in assets that intend to generate a measureable positive social or environmental impact.

Beginnings of ESG screening and exclusion

ESG screening and exclusion is the earliest form of responsible investing. The idea is for investors to reflect their values in an investment portfolio. The application of this can be in either a negative or positive screen on the activities or characteristics of a company. Negative screening will exclude a company from an investment portfolio while positive screening will seek out companies that meet the basic requirement.

Religious beliefs have always been a part of ESG screening and exclusion. For example, different religious groups may apply various screens (i.e., alcohol, contraceptives, adult entertainment, tobacco, gambling, and pork products). To this day, most religious groups have guidelines for how their assets must be invested. This expression of values in a portfolio has opened the door to expressing other, more secular values in investment portfolios.

ESG screening and exclusion has been at the center of responsible investing since the beginning. In its 2018 survey, the Global Sustainable Investment Association (GSIA) found that negative screening was the most popular form of responsible investing in the world, accounting for almost $20 trillion in assets.[2]

Positive and negative screening

Positive and negative screening identifies assets that meet a defined set of desired ESG-related criteria (which may be product or conduct based). Positive screening is also often referred to as best-in-class screening as it involves selecting only the companies that meet a defined ESG score threshold. On the other hand, negative screening excludes certain companies for their poor ESG performance or controversies. Investors can use screening to align their portfolio with certain values or themes.

One application is to include businesses that produce a predefined amount of revenue from a particular product or service or who are growing that product or service at a specific rate. Many exchange-traded funds focus on solar or wind energy, water or alternative energy solutions.

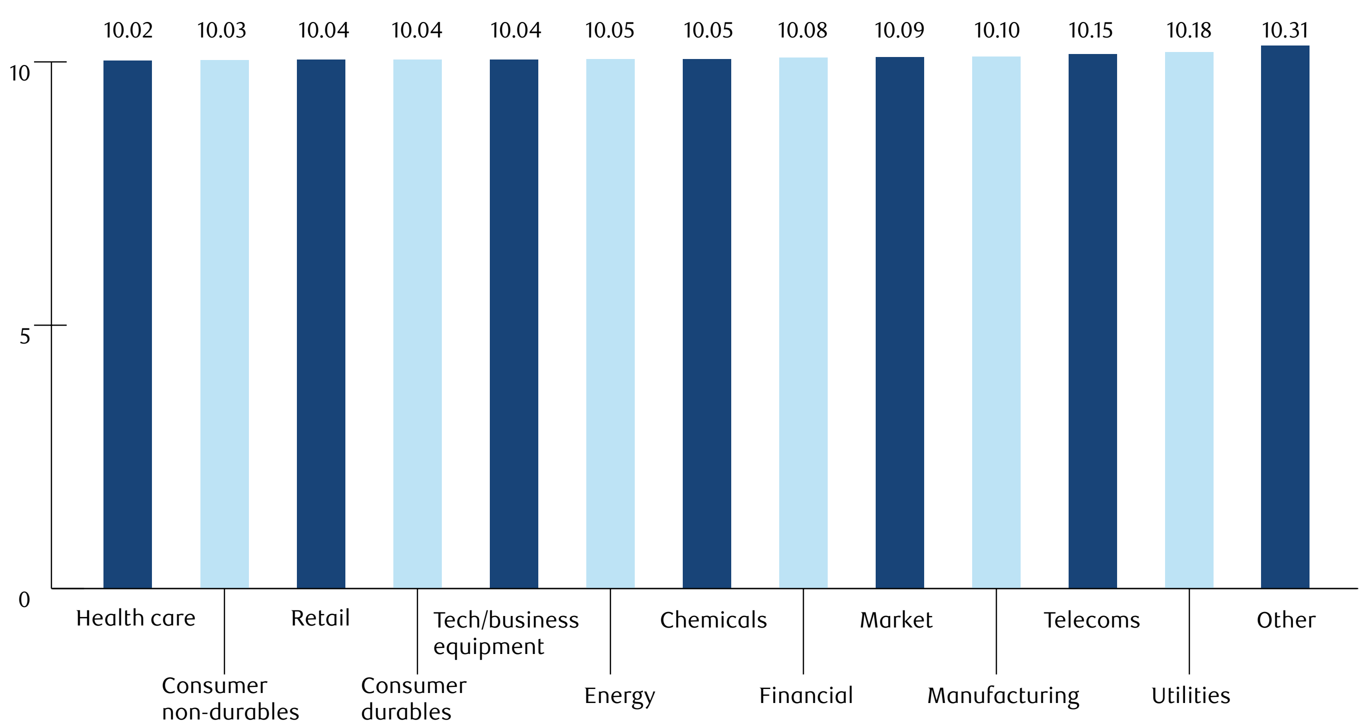
Other positive screens can look at social issues. Some portfolios may look to include companies with a defined number or percentage of diverse board members. Still others may look at the human rights records of companies relative to key stakeholders. Positive social screening may be difficult to quantify, but reporting in this area is making product creation easier.

Ethical and faith-based screening

This type of screening refers to investing in line with certain principles based on international norms and religious beliefs, using screens to exclude assets from the investment universe that are deemed morally objectionable by the investor. Examples include screening out

Divesting sectors from the U.S. market, 1926–2019[3]

Annualized return (%) of a U.S. market indices when excluding identified sector



predefined criteria from a third party, such as the UN Global Compact, Catholic Bishops Convention or other religious groups.

Socially responsible investing (SRI)

SRI is an investment strategy that applies the ESG screening and exclusion approach based on a defined set of ESG-related criteria or norms, generally stemming from a certain principle or set of values. Examples of SRI include excluding weapons or tobacco companies.

The purest form of SRI is to simply remove companies from your portfolio that do not align with a personal value. The most popular way to identify companies for removal is to use a percentage of revenue or market share, or business involvement. Company A earns X% of its revenue from selling tobacco products. Investors need to simply identify what the issue is and the level of revenue they are comfortable with relative to that product.

The difficulty can come in separating investable values versus non-investable values. Said another way, there needs to be a quantifiable way to identify if a company is violating your defined value or not. Sales of a product that is a direct violation, like firearms, alcohol or tobacco, can rather easily be identified by simply reviewing a company's income statement. Things that are difficult to measure are very difficult to screen out of a portfolio. How diverse is a company's staff? How many LGBTQ employees are at a company? Does the company sell its product to a terrorist? Companies need to report some metrics for investors to be able to screen out companies that violate the predefined value.

Another weakness of negative screening comes in the percent of revenue requirements. If an investor's requirement is too strict, they may have unintended consequences. A 0% of revenue pornography screen would eliminate video distribution companies, credit card companies and most hotels from consideration as all earn revenue from the sale of those products.

On the other side of the coin, investors may not obtain the impact that they want if they aren't strict enough. For example, Company A is a retail store, and one of the largest retailers of firearms. However, firearms are still less than 1% of Company A's total revenue. The company sells too many other products for firearms to be a large piece of its revenue. Investors who want to remove gun sales from their portfolio would likely want to remove the largest retailers, but would miss Company A unless they did a 0% of revenue requirement.

And finally, it is important to be specific about the issue you want to remove. Fossil fuel free investing is a movement that is gaining popularity. However, it can be difficult to ensure that the portfolio you invest in has the desired outcome. Several portfolios may only remove coal from their portfolio. Others will only remove fossil fuel reserves from their universe. These portfolios may still hold large refiners, consumers and transporters of fossil fuels not defined.

Passive application

One of the most important concepts to understand about ESG screening and exclusion is that it is largely a passive application. It is rather black and white. An investor states the value he or she would like reflected, determines the metric used to measure it, and then a portfolio manager applies that quantitative screen to an investment universe. After the screen, a new smaller investment universe is used to create an investment portfolio. The other three applications of responsible investing, ESG integration, thematic ESG investing and impact investing, are much more qualitative. As such, there is more room for interpretation and different opinions on the risks or opportunities presented in these portfolios.

The performance question

One common misconception around ESG screening and exclusion investing is that it always causes your portfolio to underperform. One study in the U.S. found that in short periods, returns fluctuated relative to the traditional benchmark as certain names or sectors were excluded from a portfolio. However, between 1926 and 2019, that variation evened out and performance ends up relatively similar.[4]

Key considerations

ESG screening and exclusion remains a large portion of the responsible investing world. Many investors have strong beliefs and would rather not hold companies that do not align with them, no matter what the implications are for their portfolio. When working with your advisor to establish your responsible investing portfolio, consider the following:

- Is your value easily defined and able to be screened? If not, it may not be possible to use ESG screening and exclusion.
- Does your value have a religious affiliation? If so, is there a group that provides guidelines that you can follow when applying these restrictions?
- How strict do you want to be? Be sure to consider what impacts may happen to the portfolio if you put extremely strict requirements on it.
- Do you have any values that you want to be sure are included in the portfolio? If so, are they investable? If not, perhaps consider a charitable donation.

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[1] "Technical Report-2022 Canadian Responsible Investing Trends." Responsible Investment Association.

[2] Global Sustainable Investment Alliance. (2018). 2018 Global Sustainable Investment Review. www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf As of March 2021.

[3] Credit Suisse Global ESG. (2020). Drawing on the Credit Suisse Global Investment Returns Yearbook 2020 by Elroy Dimson, Paul Marsh & Mike Staunton. This chart shows market returns using Farma-French full market indexes for the U.S. For each of the separate "excluded" sectors, they were compared with returns of the entire market, and assume reinvesting dividends and capital gains.

[4] Schroders. (2017). Demystifying negative screens: The full implications of ESG exclusions. www.schroders.com/en/sysglobalassets/digital/insights/2018/thought-leadership/demystifying-negative-screens---the-full-implications-of-esg-exclusions.pdf. Accessed March 2021.

Past performance is no guarantee of future results. Due diligence processes do not assure a profit or protect against loss. Like any type of investing, ESG investing involves risks, including possible loss of principal.