Looking at trends in the US and Europe

On a global basis, negative/exclusionary screening is the most used sustainable investing strategy (#1 in Europe and #2 in the US). In a 2018 report, the Global Sustainable Investment Alliance estimated that $19.8 trillion in assets under management (AUM) employed this type of strategy (up 31% from 2016). The 2020 report has not been published, and while ESG integration is the fastest growing strategy (+69% from 2016-2018), we would expect an absolute increase in exclusionary screening given the significant flows into sustainable investing since 2018.

Figure 1: Sustainable investing assets by strategy and region in 2018 (in USD'bn)
What are typical exclusions? Some asset managers will determine firm wide exclusionary mandates while others will offer funds that negatively screen certain exposures, typically with a threshold based on % of revenue derived from the activity our product. The more utilized exclusions include what are often referred to as “SIN” stocks: adult entertainment, alcohol, gambling, tobacco, small arms & weapons, though climate and energy base exclusions for thermal coal and nuclear energy have grown meaningfully in Europe. Other focuses include palm oil production, GMOs, animal testing, fur & leather, and military contracting.

Additionally, certain investment strategies will be biased towards investment in companies that are considered more environmentally friendly or seek social objectives such as diversity, but this % is harder to track without a formal exclusion. In Europe, we are also getting more questions regarding a companies ability to address UN Sustainable Development Goals (SDGs) or UN Compact objectives. Looking ahead, the EU Taxonomy classification system will likely lead to additional screens.

To answer our question (with help from DB’s Asset Manager team), the best data we have to analyze this is exclusionary retail fund data from Morningstar Direct. Specifically, we chose to evaluate tracked assets under management (AUM) from 2015 to March of 2021. The year 2015 is arguably a good year to start as the Paris Agreement (2015) and the introduction of the UN SDGs in 2015 provided another wave of demand for sustainable investment.

The data (see figure 2 below) shows that the % of AUM in Europe with exclusionary strategies (both active and passive) increased over the time period (2015 to current), especially for coal, nuclear, tobacco and weapons exposure. The percentage of exclusionary investment strategies in the US increased as well, but not meaningfully, with the exception of tobacco and small arms exposure.

In 2018, the GSIA estimated that retail investing AUM represented 25% of total sustainable investing assets (retail + institutional).

**Figure 2: Retail AUM with exclusionary investing policies (% of AUM), ETFs vs. Mutual Funds by region (2015 to March 2021)**

Source: Morningstar Direct, Deutsche Bank Estimates
We caution that what likely isn’t captured in data shown above is the exclusionary preferences of pensions, endowment funds, and governments, which flow into institutional AUM. That said, there is plenty of anecdotal evidence that absolute exclusions have increased here. Our conversations with asset managers reveal that a common request from institutional clients is for their investment strategies be managed with certain exclusions, which are to either be decided upon and managed by the investment manager, or the investment manager may have a strategy and then custom-fit the exclusions desired by the client.

Some institutional investors are also more public in their declarations. For example, Norway’s largest pension fund, KLP (~$80B in assets) refrains from owning stocks and bonds of companies that earn meaningful revenues from the production of alcohol, tobacco, coal, oil sands, gambling and pornography. Moreover, a screen of signatories to the Principals for Responsible Investing will suggest a high number of institutional AUM have made sustainable investing commitments.

Exclusionary trends in retail investing aren’t overly surprising, but some of the nuances are revealing.

Notable exclusionary shifts (2015 to present):
1) Alcohol, a notable exclusionary increase by European ETFs and US active funds. Exclusions for companies that derive a significant percentage of revenue from alcohol product/sales increased 570bps to 6.0% for ETFs in Europe. This compares to active fund exclusion at 3.9% (+180bps). Exclusionary strategies in the US are less pronounced, though there was a 110bps uptick to 2.1% for active mutual funds. This was the largest increase for all active and passive exclusionary strategies in the US, with the exception of Tobacco. The exclusionary rationale for some investors, including KLP noted above, takes the position that harmful alcohol consumption as a hindrance to achieving certain UN SDGs such as good health and well-being.

What is less clear, however, is how far down the value chain investors might take this stance over time. For example, a number of packaging companies derive more than 10% of revenues from alcohol-related packaging.

2) Gambling exclusions continue to increase in Europe; what about ESG ratings? Exclusions for companies that derive a significant percentage of revenue from gambling increased 650bps to 6.8% for ETFs in Europe. Active fund exclusions are also higher at 6.0%, up from 3.5%. Exclusionary strategies in the US are less pronounced, though the region did see a 60bps exclusionary uptick for active mutual funds to 1.0%.

The uptick in gambling exclusions in Europe has arguably pushed companies in the region to focus more on their sustainability efforts to attract investors. For example, most stocks listed in Europe have a MSCI rating of A or above, while all but one US stock falls squarely in the B range.

Figure 3: MSCI ESG ratings for European and US stocks with significant gambling exposure (AAA = highest score, CCC = lowest score) (Green denotes European listed stocks, Blue denotes US listed stocks)
3) Thermal Coal exclusions less of a focus in the US. Exclusions for companies that derive a significant percentage of revenue from the production or sale of thermal coal increased 510bps to 5.4% for ETFs in Europe. Active fund exclusion are also higher at 7.7%, up from 4.5%. The uptick in the US was minimal (+40bps to 0.6% for active mutual funds), which is modestly surprising (modest only because they US doesn’t exclude much). The Trump administration clearly had a pro-coal stance, but access to capital for the coal industry is restrained and the long-term outlook (even under Trump) was always clouded in uncertainty.

4) Nuclear Energy exclusions move higher in Europe, where policy is uncertain. Exclusions for companies that are significantly involved in the production or research of nuclear energy increased significantly for ETFs in Europe (up 710bps to 7.4%), while the US showed a very negligible uptick for both active and passive strategies.

Given that use of nuclear energy is likely to be a part of Biden’s net zero strategy, it makes sense to us that exclusions aren’t notably increasing in the US, and we don’t expect them to increase materially from here.

Interestingly, in a release on April 21, 2021 the EU is still waiting to determine the sustainability classification of nuclear energy in its Taxonomy. It noted a delicate compromise on whether to include nuclear energy is needed and that another assessment will be issued within three months. For details on the process, see the release here.

5) Palm Oil exclusions increase, but market cap is relatively low; looking at the supply chain. Exposure to Palm Oil (edible vegetable oil from the fruit of oil palm trees) has attracted more attention in recent years as its production has been a major source of deforestation. In addition, there are concerns over worker exploitation and use of child labor. But, it doesn’t appear to be a big exclusionary focus for investors. The only notable exclusion is for actively managed European funds at a rate of 1.9% (up 40bps). This may be in part because the public market cap for palm oil producers/distributors is quite low. Note the exclusion generally only needs to apply to producers with a significant percentage of non certified operations.

Indonesia and Malaysia produce ~85% of palm oil supply, though the WWF reports that over 42 countries produce palm oil. The product is in almost 50% of packaged products due to stability at high temperatures, odorless quality and resistance to oxidation. The additional benefit of palm oil is that the crop yield is very efficient.

We expect that as the potential for regulation and reporting around biodiversity increases, investors are likely to focus more on customers who use palm oil and assurances that their supply chain is sustainable.

6) Small Arms and Weapons exposure are among the top exclusions in Europe. Exclusions for companies that derive a significant percentage of revenue from the production or sale of small arms increased 850bps to 8.8% for ETFs in Europe. Active fund exclusion are also higher at 6.3%, up from 3.2%. The uptick in the US for active funds was high relative to other exclusions (up 60bps to 0.9%), with ETF exclusions increasing 30bps to 0.3%.

Exclusions for weapons increased 890bps to 12.0% for ETFs in Europe. Active fund exclusion are also higher at 16.9%, up from 11.8%. The uptick in the US for active funds was +60bps to 1.0%, while ETF exclusions increased 40bps to 0.4%.

While there aren’t a lot of publicly traded investment options with this type of exposure, it is still somewhat surprising that there aren’t many ETFs in the US that employ this exclusion given the ever escalating dialogue over gun control in the US. That said, 44% of US adults do report living in a gun household (2020 Gallup poll), though the percentage of those aged 18-29 is 38% and the percentage of women is 35%. Gun ownership in Europe varies by country, but levels are significantly lower, especially France, Germany, Sweden, Italy and the UK.

7) Tobacco exclusions increased significantly for European ETFs and is the largest exclusionary category in the US for active funds. Exclusions for companies that derive a significant percentage of revenue from tobacco product/sales increased 940bps to 9.8% for ETFs in Europe. This compares to active fund exclusion at 9.7% (+430bps). It remains the largest exclusionary factor in the US at 21.1% for active funds, up 120bps. Exclusions in US ETFs remains minimal at ~0.4%.

It is interesting to note that over the past 5 years most Tobacco stocks have underperformed the S&P 500, though there are a few outliers (e.g. Swedish Match). One question that has come up in recent years is the exclusionary potential for cannabis exposure. There doesn’t appear to be a clear answer, though we sense that the long-term legal uncertainty is the biggest potential issue for investors.
What’s next? Diversity & Inclusion. This has become a clear focus in recent years. In fact, we have seen some funds announce various diversity objectives or requirements, including Fidelity’s Women’s fund, launched in 2019, which seeks to invest in companies where women are playing critical roles in senior management and/or the fund has women that make greater than 33% of the board. Additionally, State Street launched a gender diversity Index ETF in 2016 (SPDR). Looking ahead, however, we think the more widespread exclusionary impact could come from exchanges that set diversity & inclusion mandates, such as Nasdaq, which has proposed a rule to require all its listed companies to have at least two diverse directors or explain why they couldn’t.

We think that investors will continue push further down the supply chain when it comes to negative screening for the categories highlighted in this report. This is already happening, but we expect the trend to be magnified via stewardship action as asset managers try to enhance their ESG frameworks. Investors have been engaging in more discussions with management teams to encourage them to better understand the sustainability of their supply chains (e.g. certified suppliers of palm oil, and forest product inputs). Moreover, they will continue to press companies to manage their energy usage in efficient and sustainable ways, which will become even more of a focus as the full EU Taxonomy emerges.
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