

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

## Global Matters Weekly

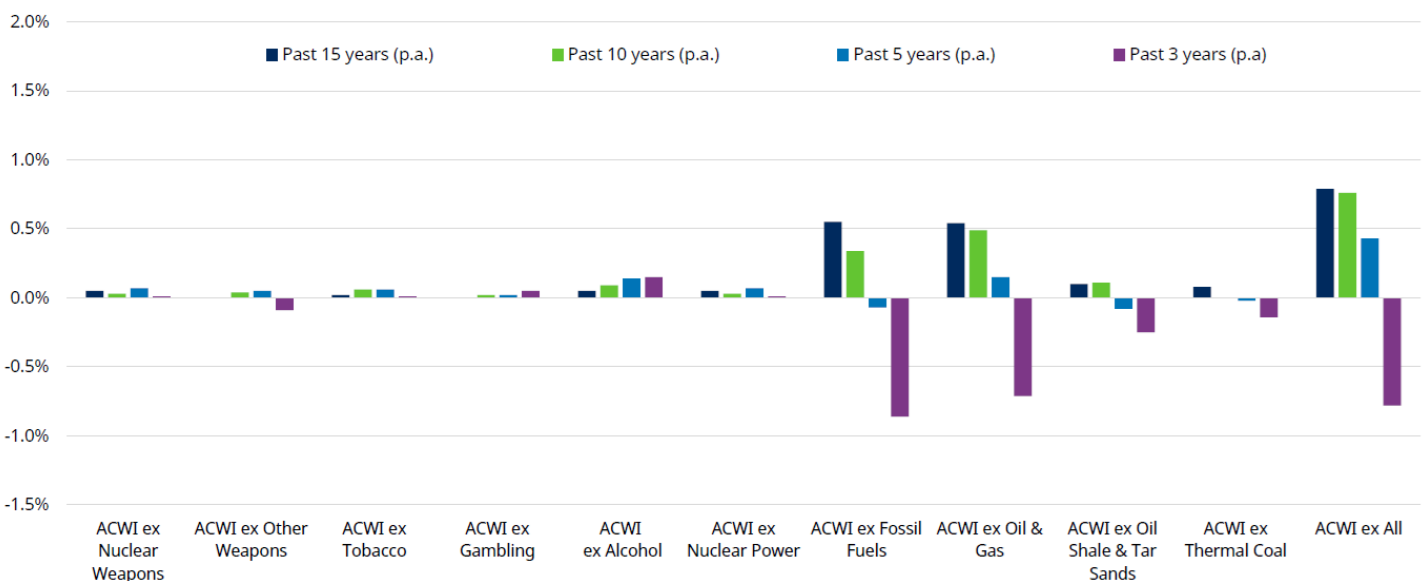
9 September 2024

– Jade Coysh — Senior Research Analyst & ESG Specialist

Excluding cohorts of stocks from an investment 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. This chart shows performance of the global equities universe excluding specific industries over three to fifteen years. 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.

“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.”

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



Source: Schroders, MSCI.

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.

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## The Marketplace

- Global equities fell 3.9%
- Markets saw a significant risk-off move with the major US equity index experiencing its worst weekly performance since March 2023, with a more than 4% decline
- Brent crude fell 9.8% last week to \$71.06 per barrel
- Gold fell 0.2% to \$2,497.41 per ounce

## Market Focus

### US

- US equities fell 4.2%
- The US unemployment rate retraced some of its prior rise, coming in at 4.2% (vs 4.3% in July)
- The US ISM manufacturing print came in beneath expectations at 47.2 in August (vs 47.5 expected) whilst the ISM services index remained in expansionary territory in August at 51.5 (vs 51.4 expected)
- The Job Openings and Labor Turnover Summary (JOLTS) report showed the number of job openings fell to a three-and-a-half year low of 7.7m in July (vs 8.1m expected)
- Weekly initial jobless claims fell to an 8-week low of 227k (vs 230k expected) over the week ending August 30
- Current polls are pointing to a tight US election race, with the polling lead for Trump within the margin of error for most polls

### Europe

- European equities fell 3.9%
- The Euro Area composite PMI (Purchasing Managers Index) fell to 51.0 (vs 51.2 expected) whilst the Euro Area Manufacturing PMI rose to 45.8 (vs 45.6 expected)
- In German state elections, the far-right Alternative for Deutschland (AfD) came in first place in Thuringia, marking the first time that they had won a state election
- French President Macron named Michel Barnier as the new Prime Minister following legislative elections that took place in July where no group achieved a governing majority

### UK

- UK equities fell 2.3%
- Composite PMI numbers surprised to the upside at 53.8 (vs 53.4 expected)
- Construction PMI fell to 53.6 from 55.3 (vs 54.5 expected)
- The UK government's net foreign reserves increased by \$3,618 million

### Asia/Rest of The World

- Global emerging market equities fell 2.2%
- Japanese equities fell 4.2% and Chinese equities fell 2.4%
- China's Caixin services PMI for August expanded at a slower rate compared to July, with the index falling to 51.6 (vs 51.8 expected) from 52.1
- Australia's second quarter GDP growth slowed to 1.0% year-on-year (vs 0.9% expected), the weakest annual pace since the 1990's recession, outside of the Covid-19 pandemic period. It followed an upwardly revised gain of 1.3% in the previous quarter
- The Bank of Canada delivered another 25bp interest rate cut to 4.25%, the third consecutive meeting where they've cut rates, in line with expectations

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Asset Class/Region	Currency	Currency returns			
		Week ending 6 Sep. 2024	Month to date	YTD 2024	12 months
<b>Developed Market Equities</b>					
United States	USD	-4.2%	-4.2%	14.2%	22.4%
United Kingdom	GBP	-2.3%	-2.3%	9.1%	14.9%
Continental Europe	EUR	-3.9%	-3.9%	7.0%	13.4%
Japan	JPY	-4.2%	-4.2%	11.1%	11.1%
Asia Pacific (ex Japan)	USD	-2.1%	-2.1%	8.8%	14.0%
Australia	AUD	-0.6%	-0.6%	8.4%	14.7%
Global	USD	-3.9%	-3.9%	12.2%	20.8%
<b>Emerging markets equities</b>					
Emerging Europe	USD	-1.5%	-1.5%	11.2%	21.8%
Emerging Asia	USD	-2.5%	-2.5%	9.8%	13.4%
Emerging Latin America	USD	-2.1%	-2.1%	-14.4%	-0.1%
BRICs	USD	-1.9%	-1.9%	6.9%	7.8%
China	USD	-2.4%	-2.4%	1.9%	-6.1%
MENA countries	USD	0.2%	0.2%	0.7%	5.3%
South Africa	USD	-3.1%	-3.1%	10.4%	22.7%
India	USD	-1.6%	-1.6%	14.5%	27.1%
Global emerging markets	USD	-2.2%	-2.2%	7.1%	12.4%
<b>Bonds</b>					
US Treasuries	USD	1.4%	1.4%	4.2%	8.7%
US Treasuries (inflation protected)	USD	0.6%	0.6%	3.9%	7.6%
US Corporate (investment grade)	USD	1.2%	1.2%	5.3%	12.1%
US High Yield	USD	0.3%	0.3%	6.6%	13.3%
UK Gilts	GBP	1.0%	1.0%	0.6%	9.2%
UK Corporate (investment grade)	GBP	0.7%	0.7%	2.9%	12.9%
Euro Government Bonds	EUR	0.9%	0.9%	1.6%	7.4%
Euro Corporate (investment grade)	EUR	0.6%	0.6%	3.1%	8.7%
Euro High Yield	EUR	0.0%	0.0%	5.7%	11.7%
Global Government Bonds	USD	1.4%	1.4%	2.5%	8.6%
Global Bonds	USD	1.3%	1.3%	3.3%	10.1%
Global Convertible Bonds	USD	-1.1%	-1.1%	1.2%	6.2%
Emerging Market Bonds	USD	0.4%	0.4%	6.4%	14.6%

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Asset Class/Region	Currency	Currency returns			
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<b>Property</b>					
US Property Securities	USD	-0.7%	-0.7%	11.2%	21.1%
Australian Property Securities	AUD	1.2%	1.2%	16.9%	25.1%
Asia Property Securities	USD	-0.5%	-0.5%	-0.9%	1.1%
Global Property Securities	USD	-0.2%	-0.2%	9.1%	19.2%
<b>Currencies</b>					
Euro	USD	0.2%	0.2%	0.1%	3.3%
UK Pound Sterling	USD	0.0%	0.0%	2.8%	4.9%
Japanese Yen	USD	2.6%	2.6%	-1.1%	3.6%
Australian Dollar	USD	-1.3%	-1.3%	-2.5%	4.5%
South African Rand	USD	-0.3%	-0.3%	2.2%	7.6%
Swiss Franc	USD	0.9%	0.9%	-0.5%	5.8%
Chinese Yuan	USD	-0.1%	-0.1%	0.0%	3.1%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	-3.2%	-3.2%	-0.3%	-6.4%
Agricultural Commodities	USD	-0.4%	-0.4%	-0.7%	-4.5%
Oil	USD	-9.8%	-9.8%	-7.8%	-21.6%
Gold	USD	-0.2%	-0.2%	21.1%	30.1%

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