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# Increasing Discussions on Negative Screening and Alternative Approaches

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## Introduction

We have been involved in an increasing number of discussions with investment allocators about various approaches to environmental and social impact investing. Increasingly, our discussions turn to conversations on negative screens versus other approaches, as well as the potential impact on investment returns of these different strategies. This is particularly true on environmental issues related to negative screens on high carbon producing companies.

## Increasing Dialogue

One negative screen that over time we have undertaken at clients' requests is a ban on investments in all or a select universe of fossil fuels. Many organizations in Europe and the U.S. have announced plans to divest investments in fossil fuels. In the past year, a few higher profile examples include: a planned divestiture by 2030 of direct and non-direct fossil fuel investments by University of Cambridge; the New York State legislature has introduced a bill requiring the Teacher's Pension plans to divest fossil fuels investments; the State of Maine announced the passage of a bill to divest and ban positions in fossil fuels over the next five years in its pension plan; and New York City saw its city teachers and other employee pensions vote in favor of divesting, while its police and fire department pension plans voted against it.

These announcements align with growing interest in using investment vehicles to help influence environmental issues. This trend is likely to be accelerated by the recent United Nations 2021 report on climate change. The report advocated strongly for more accelerated reductions in emission of carbon dioxide and other greenhouse gases, and expressed alarm at the damage it found has been done to the environment, as well as projections for future damage. The discussion will get further focus as the UN Climate Change Conference (COP26) gets underway in November.

Our discussions with investment allocators indicate that they are exploring a broad array of approaches on this topic. These include those that are purely focused on fiduciary obligations on returns but that want reporting on exposure to selected industries as well as various methods of impact investing. Some methodologies discussed have included exploration of measuring a portfolio's carbon footprint versus that of an index benchmark, as well as portfolios introducing outright negative screens.

### Negative Screens

Negative screens that simply ban capital investment in an industry are relatively straightforward. For example, a common ban for an investment policy that hopes to help reduce carbon emissions is to prohibit investment in coal mining companies. These bans may focus on a wide array of environmental and social issues, but it is important to understand negative screens can impact returns and trading liquidity of individual securities.

At Shenkman, our analyst team tags any credit on our Approved List for 17 different category exposures that we have found come up commonly for negative screens. We record this information in our database which allows us to apply customized negative screens for clients. It also allows us to monitor any portfolio's exposure to these categories.

Negative screens are sometimes utilized for moral/religious/social reasons that are generally clear cut. If an investment ban is put in place for personal, moral, and/or religious reasons, there is likely little room for discussion. However, when investors are looking to impact climate issues or engage with corporations to change behavior, the issues can become more nuanced. A negative screen, or an investment ban, if accepted broadly enough, can meaningfully impact an industry's ability to obtain financing, and/or could meaningfully increase its cost of financing. A negative screen is a very simple and clear way of trying to impact an industry and a portfolio. However, if the investor's first goal is economic, or even to impact change, the question of whether or not a negative screen is the right choice becomes more complex.

### Varied Views on Negative Screens

To demonstrate some of the complexities that could arise from a seemingly simple ban, we provide a hypothetical example of a negative screen below. One investor could develop the opinion from an economic point of view that the use of tobacco products is bad for society and that regulation, taxation, and changes in personal habits will make these companies cease to exist. As a result, the investor makes the decision to implement and announce a ban on investments in all tobacco companies based on the social benefits and economic outlook they have developed for the industry. The ban likely means this investor no longer spends resources to follow the tobacco industry, has little ability to engage with these companies, and may not see if a company currently in the tobacco industry is trying to transition its product portfolio. If a tobacco company is banned by many investors, its valuation may drop, but if that company is in the process of transitioning into new business lines as it winds down a traditional tobacco company, it could create an investment opportunity for others that do not have such a ban.

We do not intend to opine on the likelihood of success or the risks of the new products at Philip Morris International, but it is worth highlighting as an example of a major tobacco company openly trying to transform its product portfolio away from cigarettes. Philip Morris has publicly stated its goal of shifting to smokeless products as well as making an acquisition in contracted drug development, particularly in inhaled medication. Note, they recently announced an acquisition of Vectura in this drug arena. There

have also been major announcements about transition plans in the energy industry, such as those by BP and Chevron.

As an interesting case in negative screens, the California Pension System (CalPERS) has banned investing in tobacco products since 2001. It has twice voted in favor of keeping the ban when it had been challenged. It was reported that Wilshire Associates estimated CalPERS would have earned an additional $3.6 billion from January 2001 to June 2020 if they had held tobacco stocks. However, more recently, it was reported that from January 2017 through June of 2020, CalPERS gained $856 million by avoiding these stocks. The investment committee member who brought the rejection of the ban up to a vote both times was quoted as saying, "This is a retirement fund, not a political fund, and that's what I want the goal to be."

Negative screens may also have a mixed impact on society. For example, if the world could eliminate the exploration, production and use of fossil fuels there is little debate that the environmental benefits would be great. However, one also needs to analyze what replaces these products, the cost-benefit analysis, and how long it takes the infrastructure to be developed to use these greener products. If investing in oil production is widely banned, it is quite likely to drive up the price of oil products to the consumer, unless there is a substitute immediately available – which could effectively work like a regressive tax on consumers for several years. An effort to focus investments (or policy) to change the demand for products such as oil or tobacco might prove more effective, although clearly not as easy to design as a negative screen.

We believe the dramatic drop in the use of coal about a decade ago was driven more by a change in demand by the end-users than any negative screen on investing in coal. In the U.S., a large portion of coal production was used in the power utility industry. We believe the combination from the regulatory front on utilities, as well as the economic benefits of using natural gas as a fuel source, caused the use of coal to decline meaningfully. These developments also made the coal industry a bad investment at that time based on ESG influenced factors, but not necessarily because of negative screens.

## Conclusion

Many investment managers are considering negative screens and other methods of using investment tools to impact social goals and because of economic concerns for industries such as "dirty" energy. At the same time, investment managers are struggling with how to best combine these social goals and ESG risks with maximizing returns. ESG factors present real risks to industries and selected businesses; however, they can also create opportunities – particularly if the market uses too broad a brush to negatively paint all industry participants.

One factor we are certain about in the business world is that things will not stay static – changes will occur. With that in mind, an approach to ESG should be flexible, and have the ability to shift to changes in industries and companies. Shenkman welcomes the opportunity to discuss and share ideas on this topic with clients to help develop best practices and to discuss the developments we are seeing from companies and clients around the globe.

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