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How responsible investing standards and policies affect returns

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Executive summary

- Excluding companies from investment portfolios due to certain business activities, products and services on sustainability considerations was arguably the first notable approach which came to define socially responsible investing as it emerged in the 1970s and 1980s. Exclusions continue to be the most widely adopted sustainable investment strategy, with more than 64%[1] of global sustainable assets under management using this approach.
- AXA Investment Managers has implemented a series of exclusion-based policies and standards[2] and in this research paper, we assess their effect on investment returns.
- Our analysis showed that AXA IM's exclusion policies have a relatively limited impact on the investment choice available to fund managers - and excluding certain companies did not come at expense of risk-adjusted performance. What's more, we also saw that it drove outperformance over the period studied.

The asset management industry has traditionally adhered to the notion that excluding certain companies from investment portfolios based on sustainability considerations linked to certain business activities, products and services will inevitably harm returns by reducing the investable universe. We have seen increasing volume of academic research which has dispelled this myth and shown this not to always be the case[3].

When it comes to environmental, social and governance (ESG) policies, the first question we are often asked is: What is the cost on return? As a result, we decided to assess the impact of our exclusion policies on investment returns.

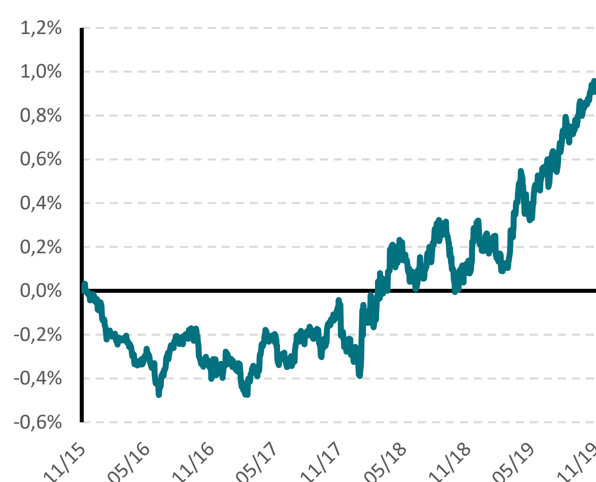
[1] 2018 Global Sustainable investment review, Global Sustainable Investment Alliance
[2] https://www.axa-im.com/responsible-investing/sector-investment-guidelines?linkid=responsibleinvesting-menu-sectorguidelines
[3] For more please refer to "ESG and Financial Returns – an academic perspective" AXA Investment Managers, July 2019.

As shown in Exhibit 1 (right), over a period of 49 months to 31 December 2019, the excess return[4] generated by excluding issuers across AXA IM's exclusion policies (including all sectorial policies and ESG Standards policies) from the MSCI All country World Index[5] (ACWI) is positive: +0.92%. The outperformance has accelerated over the final 12 months of the study. The main drivers of this were companies in the climate risk and tobacco exclusion policies which dragged down the MSCI ACWI compared to a portfolio composing the same index constituents without the exclusion list companies.

See Appendix for more details of our exclusion policies.

Going into more detail as presented in Exhibit 2, the excess return generated by excluding issuers in the sectorial exclusion policies is +0.17%. The excess return generated by excluding issuers in the ESG standards policies is higher with +0.82%.

Exhibit 1: Cumulative excess return of AXA IM's exclusions on MSCI ACWI from 30 Nov 2015 to 31 Dec 2019



Source: Responsible Investment - Core platform, MSCI.

Exhibit 2: Excess return of MSCI ACWI with exclusions split by policy from 30 Nov 2015 to 31 Dec 2019

	Universe excluded (%)	Excess return (%)
MSCI ACWI ex. sectorial policies	**2.17**	**0.17**
MSCI ACWI ex. controversial weapons policy	0.49	-0.03
MSCI ACWI ex. palm oil policy	0.03	0.00
MSCI ACWI ex. climate risk policy	1.66	0.22
MSCI ACWI ex. ESG standards policies	**3.20**	**0.82**
MSCI ACWI ex. tobacco policy	0.81	0.90
MSCI ACWI ex. white phosphorus policy	0.28	-0.01
MSCI ACWI ex. United Nations Global Compact violations policy	1.04	-0.56
MSCI ACWI ex. tail-risk ESG policy	1.79	0.35

Source: Responsible Investment - Core platform, MSCI.

[4] Study is performed using daily chain-linked returns at instrument level. Exclusions over time are evolving due to stringent rules or in-out companies into exclusion lists, therefore official ban lists at the date of rebalancing have been excluded ("as was" rule) to reflect real implementation. The study is not a retropolated return study based on the last available ban lists ("as is" rule). A linear weight rescaling is applied to each instrument of the index after exclusion filters.

[5] MSCI All Country World Index, net return, in euro currency unhedged.

A look at risk

While the return component is important, risk has to be considered to have a full picture of the impact of exclusion policies.

From a risk perspective, we can see in Exhibit 3 that annualised volatility of indices with exclusion policies are in line with the parent index. The tracking error of filtered indices is similar to passive management and ranges from eight basis points for the sectorial policies to 32 basis points for AXA IM exclusion policies.

We notice the risk/reward ratio[6] is slightly improving with the increase of exclusions. We also see that MSCI ACWI ex. AXA IM exclusion policies has the highest risk/reward, while the excess return of 0.92% is lower than the sum of MSCI ACWI ex. sectorial policies' and MSCI ACWI ex. ESG standards policies' excess returns at 0.17% and 0.82% respectively, indicating some diversification benefit. **Over the long term, AXA IM exclusion policies have not come at the expense of risk-adjusted performance on a broad equity market index.**

Exhibit 3: Risk/return profile of each indices from 30 Nov 2015 to 31 Dec 2019

	Universe excluded (%)	Excess return (%)	Annualised volatility (%)	Risk/ Reward	Tracking error (%)
MSCI All Country World Index	n/a	n/a	11.74	0.7578	n/a
MSCI ACWI ex. sectorial policies	2.17	0.17	11.76	0.7594	0.08
MSCI ACWI ex. ESG standards policies	3.20	0.82	11.74	0.7710	0.30
MSCI ACWI ex. AXA IM exclusion policies	**5.18**	**0.92**	**11.76**	**0.7713**	**0.32**

Source: Responsible Investment - Core platform, MSCI.

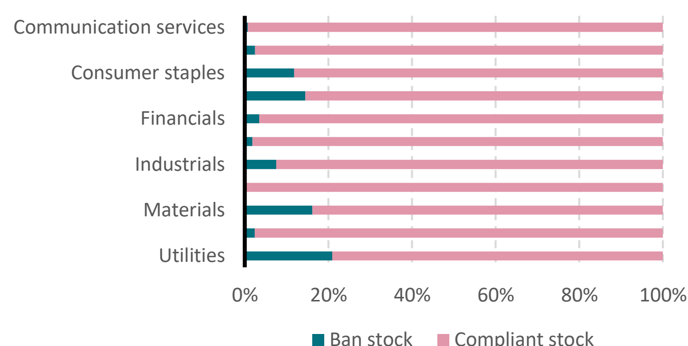
Diversification is preserved

Exclusions, by definition, reduce investment possibilities for portfolio managers. As described in Exhibit 3, exclusions from all policies represents 5.2% (market weight) of the MSCI ACWI index, of which 35% is explained by the tail risk ESG screen. This is why AXA IM has decided to give leeway to portfolio managers with regards to tail risk ESG policy; thus, issuers where there is a robust investment rationale - or a clear sign of positive momentum - can remain eligible for investment. The goal is to retain the opportunity to invest in transitioning companies.

To put this 5.2% impact in perspective, the French socially responsible investment fund label ISR requires a 20% reduction in the initial investment universe using ESG indicators to meet the criteria of an ESG investable universe[7]. From a sector perspective, we can see in Exhibit 4 that exclusions have the main impact on the utilities, materials and energy sectors - but this is still limited with a maximum impact of 20% on utilities.

The impact of AXA IM's exclusion policies on the investment universe is material, with an impact above 5%, but limited compared to criteria applied to an ESG investment universe or sector biases.

Exhibit 4: Sector breakdown of the MSCI ACWI Index with exclusions as at 31 Dec 2019



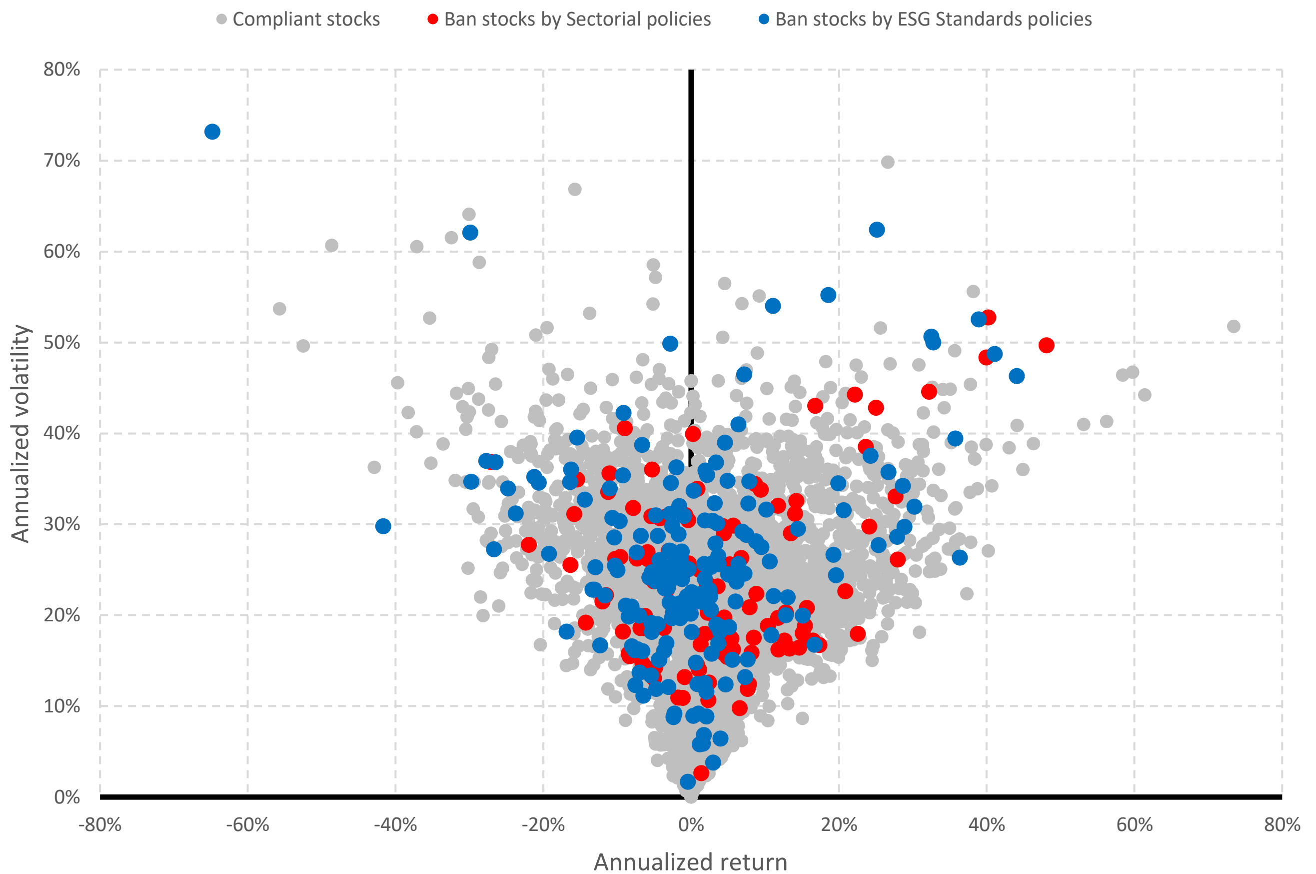
Source: Responsible Investment - Core platform, MSCI.

[6] Risk/reward corresponds to annualised return divided by annualised volatility and gives the amount of return per unit of ex-post volatility.

[7] Source : https://www.lelabelisr.fr/wp-content/uploads/2019/10/Referentiel_LabelISR_Novembre2018-1.pdf

On the other hand, for diversification purpose portfolio managers aim to build portfolios made up of multiple stocks with various characteristics. In Exhibit 5, we see excluded stocks are well scattered across the risk profile spectrum of the MSCI ACWI. There are many other candidates or stocks with similar risk profiles available within the universe. **We believe this shows that AXA IM exclusion policies do not affect the ability to build diversified portfolios from a risk-profile or sector perspective.**

Exhibit 5: Risk/return profile of each stock in the MSCI ACWI from 30 Nov 2015 to 31 Dec 2019



Source: Responsible Investment - Core platform, MSCI.

Laurence Devivier and David Baudouin of the AXA Investment Managers' Responsible Investment team also contributed to the research for this paper.

Appendix: Our exclusion policies

At AXA IM, exclusion policies are a core aspect of our wide-ranging approach to responsible investment. We believe exclusions serve as:

- The first building block of our Responsible Investment framework, defining the investable universe
- A way to signal our corporate values by clearly exhibiting low tolerance for harmful products and services as well as unsustainable corporate practices

At fund-level, we believe exclusions serve as a way to:

- Reduce financially material risk to reputation and brand as intangible assets are the main enterprise value component[8]
- Reduce sustainability-related transition risk, such as climate transition on coal activities, regulatory tightening on tobacco

As a result, we commit resources to managing ESG-related exclusions. We consider sector classification, company revenues split for threshold definition, or third-party providers for criteria used to build filters.

A track record in developing and implementing this approach

We have a long track record of developing and implementing exclusions which apply to the large portion of our assets under management. We have currently the following approaches, listed in order of the date of implementation:

Controversial weapons: AXA Investment Managers first implemented a firm-wide investment exclusion in 2008. We banned investments in controversial weapons[9]. This sector and norms-based exclusion sought to address the harm to the health and safety of the civilian population from the use of these weapons.

Palm oil: In 2014 we expanded our exclusion approach to include palm oil producers. This was due to rising environmental concerns about deforestation and the harming of animal, insect and plant species which were pushed to the threat of extinction. The same year, we also stopped trading in soft commodity derivatives[10] in order to not contribute to price inflation in basic agricultural and marine commodities.

Climate risks: Arguably, the most significant of the exclusions came in 2017 when we decided to divest from companies involved in the production or the use of coal and tar sands. We took this active stance as we considered coal and tar sands to be inconsistent with the climate change goals as set by the COP21 Paris Agreement. This policy was further tightened in 2019.

Alongside these firm-wide exclusion policies, we have another set of exclusions which apply to a sub-set of our investments - namely those which we have labelled internally as being ESG Integrated, Sustainable Investing, and Impact. These apply to both mutual funds and segregated client mandates.

Tobacco / white phosphorous: Our ESG standards also exclude tobacco producers and companies involved in weapons using white phosphorus. This ammunition ingredient can cause severe burn injury to the civilian population.

UN Global Compact: We also chose to only invest in companies which abide by the United Nations Global Compact's ten principles[11]. We conduct analysis of companies which have been involved in serious controversies that are feared to have breached these principles. We divest from those which have breached them and where we have also assessed that investor engagement is unlikely to yield any positive and meaningful progress.

Low ESG scores: We developed our own proprietary ESG scoring system. We closely monitor any investment holdings in issuers scoring below two[12]. We defined this as the point at which the tail risk of ESG concerns is most potentially alarming. Without a robust rationale or clear sign of positive momentum, the issuer is excluded. The aim is to avoid tail risk investments with poor ESG companies.

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[8] For more, please refer to AXA Investment Managers' "ESG and intangibles: Driving value creation across companies" November 2019

[9] Controversial weapons regulated by international conventions of Ottawa and Oslo conventions are anti-personnel landmines, cluster munitions, chemical, biological and nuclear weapons.

[10] Including basic agricultural or marine commodities such as wheat, rice, meat, soy, sugar, dairy, fish, and corn.

[11] https://www.unglobalcompact.org/

[12] ESG Score on a scale from 0 to 10, the latter being the highest performance.

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