Learning from recent history

Wayne Bishop explains what changing interest rate dynamic, pandemics and wars can teach us about positive and negative screens

Anyone involved in financial markets for any period of time will understand that the concept of a normal market can be vague and fleeting, even if the past six months have felt like the closest to normality for some time. Within four years, markets have endured a global pandemic, war in Europe, supply chain disruption, a surge in inflation, the first meaningful interest rate rises in a generation and game-changing developments in Artificial Intelligence (AI).

Equity markets have risen with this shift in global dynamics, but the relative performance of sectors has been highly diverse, something that has been most keenly felt in sustainable and impact portfolios.

Driving this variance in performance is the application of positive and negative screens. Specifically, the sectors and companies that investors have wanted to see included and excluded from their portfolios. Over the past eight years, this has been pronounced in both directions. Understanding this is essential for all involved, not just for investment decision-makers, but also for advisers, as we seek to provide the highest duty of care to our clients. Even long-term investors need to understand short-term dynamics.

There are several approaches when it comes to applying screens: from the application of negative and positive screens in many ethical portfolios; to a less restrictive screen based on Environmental, Social and Governance (ESG) risk metrics to focus on sector leaders. Other approaches include thematic investing, which predominantly targets solutions around megatrends, such as clean energy to address climate change, or healthcare to address an ageing population.

In most cases, the best of class approach based on ESG risk factors, means having fewer negative screens, usually just excluding the most traditionally controversial issues, namely tobacco and controversial weapons. It is important to note that the screen is based on the company's management of material ESG risks (those risks that are specific to that company's sector), and not whether they are undertaking a positive or negative activity. Given this broad exposure, investors can expect a similar performance dynamic to an unscreened fund.

Some deride screens as illogical vanity or unnecessary risk and the impact it plays in diverting capital from damaging to more positive sectors remain disputed. More recent evidence from Harvard has pointed to the fact that ESG factors are raising the costs on new capital. Anecdotally, the political backlash taking place with the US states of Texas and Florida alone is evidence something is working. More importantly, it is a matter of choice; investors have the right to choose how their capital is deployed.

Over the past eight years, negative screens have developed from the traditional sin sectors of tobacco, weapons, pornography, gambling and alcohol, to increasingly include fossil fuels (extraction, high usage and even financing), and poor corporate citizenship, particularly aggressive tax and labour practices. This leaves many of the Big Tech companies, like Alphabet, Amazon, Apple and Facebook falling short of expectations.

In 2016, these additional screens were common with new and existing bespoke clients we manage and were incorporated into our model portfolio range as a result. These new exclusions had significant market weightings of anywhere between 25-50% of a mainstream index, meaning most portfolios now excluded over half of the weighted holdings of many traditional indices. This also created a divergence between more inclusive ESG strategies compared to the ethical, sustainable and impact approaches.

The magnification of screens does mean investments are replaced by more positively focused alternatives. For example, fossil fuels could be replaced by renewable energy companies, ranging from equipment makers, developers and operators. Given the greater level of scrutiny on large banks' lending practices, finance can be tweaked to more positive areas, from lower risk mortgages to SME lending, or even microfinance in certain riskier portfolios.

On top of the sector weights, these portfolios would differ in geographical exposure by country of listing. If, and only if, an unscreened benchmark is applied, it can be said there is a high degree of unsystematic risk.

In the run-up to COVID, this difference contributed to substantial outperformance of genuine sustainable and impact strategies versus unscreened portfolios. A number of factors, including style and cap exposure, contributed to the outperformance, with key sectors such as renewable energy attracting large inflows.

This outperformance, which was approaching around seven years heading into 2020, was also driven by the underperformance of oil & gas, mining and the large banks - prevalent in unscreened portfolios. In 2021, this pattern reversed as travel and consumption returned. In 2022, higher interest rates helped banks and impacted growth assets, while Russia's invasion of Ukraine helped armaments and fossil fuels higher.

In more recent quarters, the variation of technology stocks, particularly those associated with the artificial intelligence rally, has had a varied impact on performance depending on the level of screen applied. Some strategies with more inclusive ESG approaches have not avoided many of the Magnificent Seven, who have dominated performance since 2023, causing a divergence across various strategies with varying levels of screening.

The past eight years have been an almost symmetrical demonstration of out- and under-performance for portfolios, with the material size of screens and their weighting in portfolios having clearly made a material impact on performance over this period.

History does not repeat itself, but understanding it helps. Energy, healthcare, resources, food, finance and infrastructure remain key investment areas and the interest rate scenario is increasingly dovish. The fate of areas that are both included and excluded by stricter screens have varying futures. Grasping this will help advisers and investors understand future risks.

Please remember that the value of investments and the income arising from them may fall as well as rise and is not guaranteed. King & Shaxson Asset Management Limited (FCA Reg. No. 823315) is authorised and regulated by the Financial Conduct Authority.

Wayne Bishop is CEO of King & Shaxson Asset Management