



## INVESTING FOR IMPACT? SCREENING STRATEGIES ARE EQUIVALENT TO A PARTICIPATION TROPHY

Are you investing for impact? Strategies based on screening out companies are the sports equivalent of receiving a participation trophy for showing up at practice.

For an investor getting started with sustainable investing, the most obvious way to start may be to decide what won't be in the portfolio. Indeed, the most common ESG funds explain that they screen for controversial business activities and exclude those companies. So, for example, a climate-oriented fund might avoid companies involved in coal mining.

Screening theoretically aligns with what a lot of investors want – to avoid financing companies that are engaged in environmentally harmful activities and contribute to climate change. But is it effective?

We were curious at Impact Cubed to see whether we could create a positive impact by screening companies out of a commonly used market index,



representing about 1,500 large and mid-cap companies in developed markets. We chose three commonly used exclusions by ESG funds and ETFs:

- "Sin stocks" or companies in the following industries: (a) breweries, distilleries and vintners; (b) tobacco; (c) casinos and gaming; and (d) aerospace and defence,
- companies excluded from the Norway Council on Ethics, and
- companies with an ESG score of CCC (MSCI's lowest rating);

After removing these companies, we created a replacement portfolio by scaling up the remaining companies in the index.

Impact Cubed has analyzed the returns and impact of thousands of portfolios, enabling us to weigh investing for impact with dry eyes. But the results set off an eyebrow twitch: the screening process created only 3 bps of positive impact on the rebalanced portfolio. Carbon emissions were reduced by only 9%. Hardly the things impact investors dream of.

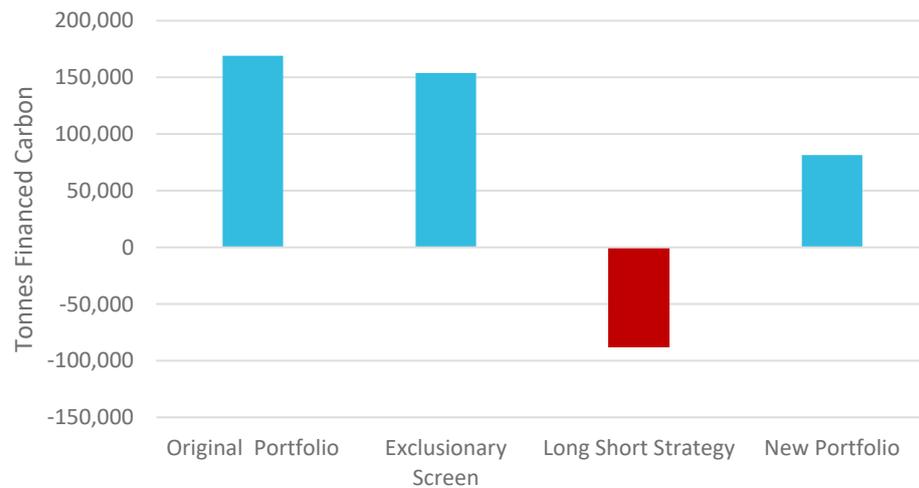
Why did this happen? It is partly due to the one-sided nature of exclusionary screens. It also turns out that choosing where to add back portfolio weight is as important as the choice of what to exclude. Scaling up the remaining holdings in the index actually added 8 bps of negative impacts. We removed "sin" stocks but amplified some of the remaining companies' bad habits. It's like a New Year's resolution to lose weight by forgoing cake and eating pie instead.

How does the impact from screening compare to the impact from a strategy that both avoids bad and amplifies good? Investors who want meaningful cuts in financed carbon emissions should consider strategies that amplify positions in companies with sustainable business practices, while shorting companies contributing to climate change and at risk from climate policies because it will affect the investment value. In other words, short the brown, long the green for impact and alpha.

For example, for a sustainable food ESG theme, we take short positions in companies that largely derive revenue from meat-based proteins and contribute to climate change from high carbon emissions. On the other side, we go long on exposures to companies developing plant-based proteins, which help cut the climate impact of our diets.

Impact Cubed's research shows that an allocation to such a strategy can significantly reduce financed carbon emissions in a portfolio. For example, substituting just 5% of an equity portfolio to an equity long-short strategy reduced net financed carbon emissions by 52%. So instead of a trophy for showing up at practice, the ESG long-short strategy gets a real trophy for winning the world cup.

## Carbon Risk of a 5% Investment in a Long-Short Strategy



Screening to avoid stocks works well for investors who want to stop financing certain business activities not aligned with their personal values. But for investors who want their portfolio to have impact - fewer financed carbon emissions while supporting businesses that actively address climate change - a better answer is a long-short strategy that avoids and amplifies.

*It's not just about carbon - please also see our long-short strategy [Impact Report](#) that covers 15 ESG and impact measures.*

## ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customised sustainable investing. You can find out more about our data and portfolio models at [www.impact-cubed.com](http://www.impact-cubed.com) and if you would like to contact us at [info@impact-cubed.com](mailto:info@impact-cubed.com) we would be happy to hear from you.

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