



ICGN

International Corporate Governance Network

ICGN Viewpoint

Investment exclusions: some technical considerations

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Introduction

This Viewpoint discusses the technical factors that institutional investors may wish to consider when planning and implementing an exclusion policy for their investments. It is not designed to argue for or against such policies but recognises that asset owners and asset managers will, on occasion, have to deal with calls for exclusions, whether driven by law (e.g. the various Sudan and Iran divestment laws governing some US pension investments), by beneficial owner demand, or through a fiduciary's own decision. This means both that those responsible for institutional funds, such as pension fund and charity trustees, as well as those responsible for managing funds may need to consider how to design and implement an exclusion policy, whether or not the decision to exclude originates with them, or even if they disagree with the decisions. The aim here is to help such investors navigate through a complex landscape.

General considerations

Making sure that the choice is a considered one is an important starting point for those responsible. When an asset manager creates a portfolio with exclusions, the beneficiaries have knowledge of the exclusions and have a choice as to whether to invest in that product or not. As long as the portfolio is managed in accordance with its stated policies, and those policies are explicit and transparent, beneficiary agreement with the exclusions can be assumed.

However, this is not as obvious in the case for asset owners who are considering a policy of exclusion. In such cases the trustees or governing body that oversees the investment need to take account of a range of, sometimes conflicting, considerations. These include both the obligation to act in the interest of beneficiaries and to take their views into account even though these may be hard to ascertain and often there will be no common view on detail. Therefore, an exclusions policy needs to be set in a clear framework which takes account of:

- The need for trustees, or governing boards, to make an informed judgement that balances their obligation to obtain the best returns for the beneficiaries and the need to satisfy themselves, as far as possible, that the general wishes of a majority of beneficiaries are being met. Sometimes the decision will be easier because it will reflect the stated objective of the organisation for which they are responsible. For example, it may be reasonable for a charity involved in cancer support to avoid tobacco related investments. Sometimes it will be more difficult because consideration is being driven by broad public

issues about which not everyone will agree. In these circumstances the trustees need to try to understand and reflect the priorities of the majority of stakeholders.

- Trustees must bear in mind their fiduciary duties, which vary from jurisdiction to jurisdiction but an important consideration is that they should not use their power as individuals to pursue their own public policy objectives. For example, they should not be influenced in their views on fossil fuel exclusion by their own view about how to deal with global warming, but they may decide to exclude certain investments based on the premise that this is in the interest of generating long term returns for their beneficiaries¹. It is worth noting that the announcement in November 2017 by the Norges Bank Investment Management of its intention to divest investments in fossil fuels was driven by a desire to improve diversification, rather than ethical considerations. Because of the state's involvement in oil and gas, the country was seen as over-exposed to this sector.
- Exclusions will normally involve at least an opportunity cost because the portfolio's ability to benefit from full diversification will be curtailed. This does not mean that portfolios with exclusions generate poor returns, since the subject investments may represent a particularly problematic systemic risk that is best avoided. However, it is important that trustees are kept informed of the impact on returns of their exclusion policy and report regularly to beneficiaries on this point. Otherwise they may not be able to demonstrate that their approach is in keeping with their fiduciary duties. This means regular and detailed monitoring of the cost of the policy.
- Trustees should explicitly consider whether the exclusion policy should extend to all asset classes and investment styles. While an exclusion policy applying to equities alone may be relatively simple to set up, the application of exclusions to other asset classes is much more complicated, as explained below. Where the exclusion is driven by an objection in principle, such as a moral objection to gambling, the consideration will be different to situations where the exclusion is a reflection of systemic risk. This is because the managers of some asset classes may well have their own means of addressing the risk in question.
- Either way round, monitoring is important and needs to be continuous. Trustees and beneficiaries need to be kept informed of the operation of the policy across all asset classes and management styles, and the overall cost must be calculated across the whole portfolio.

Specific issues

It is relatively easy for investors seeking to operate an exclusion policy to remove relevant companies from an actively managed equity portfolio. Complications arise, however, with companies that are involved indirectly in the activity which is being

¹ For a more detailed discussion of the issues see the UK Law Commission report *Fiduciary Duties of Investment Intermediaries*, July 2014

excluded. An example would be retailers who sell alcohol and tobacco products when the manufacturers of these products are on the excluded list. One solution to this is for the fund to set a threshold on the basis of turnover. For example, investment in a supermarket firm might be acceptable if the share of turnover taken up by the excluded products was below a given threshold.

More complicated is investment in pooled funds, including index products. Here it may not be possible to exclude specific companies because the investor making the exclusion decision does not directly control the investments in the pool. Some investors with exclusion policies may be able to find pooled products which align with those policies. However, in the event such a solution is not possible, a typical response for investors might be to set a limit which gives some leeway for investment in pooled funds and other asset classes. For example trustees might decide that exposure to the offending class might be limited to 1 per cent of the entire portfolio by value. This is the approach taken by the Church of England. This would need to apply across the whole portfolio because a similar problem can arise in other asset classes.

Operating such a threshold policy requires close monitoring, however, so that if the limit is breached adjustments can be made to the portfolio to bring it back into line. Trustees need to be comfortable that there is an appropriate monitoring and action policy that includes both actionable limitation and a reconciliation process with an explicit and acceptable time scale. Institutions may also wish to ensure that their investment in pooled funds complies as nearly as possible with their ethical objectives, including through engagement by the fund manager. The operation of an exclusion policy is made easier through the use of segregated accounts with custodians.

An exclusions policy raises important issues with other asset classes than equities. For example in the bond market, pooled funds may invest in debt of corporations or countries which are not acceptable to the institution. In the property market, the tenants of a commercial property owned by the fund may be engaged in an activity subject to exclusion, for example gambling. For pooled property funds considerations similar to those outlined above for equities may apply, but these are not always easy to operate because tenants may sub-let to others and the end-investor may not know that this has happened. Institutions may wish to agree a side-letter with the manager of their property portfolio, which limits these risks. Monitoring on a regular basis, probably at least quarterly remains important.

Similar considerations apply to hedge funds where excluded companies may feature on the portfolio in ways that are hard to track, especially in the case of funds of funds. The situation may be made more difficult by lock-in arrangements, which prevent the investor from selling out for a given period, and the reluctance of some hedge fund managers to sign a side letter setting out the desired investment policy.

Short-long funds which use derivatives to adjust the weightings in their portfolios present another issue as the derivative activity could result in pushing the institution's total exposure to the excluded sector. In some of these cases it may not be easy to

exit quickly or exit may only be possible at a substantial discount to the underlying assets and/or involve a loss to the fund. In specific cases trustees will have to agree a way forward that balances the interests of the beneficiaries.

Private equity poses issues both of control (the general partner of the private equity firm, not the institutional investor which is generally a limited partner, selects the investments), and time frame (such partnerships are usually for multi-year periods, usually 10 years with some potential annual extensions). Investors should discuss their exclusion policies with general partners before making an investment and should seek a side-letter stating their policy, though general partners may not agree. Also, investors may want to ask for a position on the partnership's limited partner advisory committee, where it can engage with the general partner and use its power of persuasion to try and affect portfolio choices.

Conclusions

Exclusion policies are more complicated than they seem and require considerable effort to operate. At an overarching level trustees have to be clear that the policy is consistent with their fiduciary duties. That requires continuous monitoring, assessment of the costs and benefits and regular feedback. Moreover, an exclusion policy needs to be explicit as to how it operates across investment styles, legal structures and asset classes. This requires a holistic approach in which all investments are scrutinised.

On occasion it may not be possible to avoid some indirect investment in excluded companies and their business activity. For that reason, some leeway needs to be set, related to the overall weighting in the portfolio or, where appropriate, the indirect contribution of the banned activity as a proportion of turnover. This requires both careful monitoring and a collaborative attitude on the part of the fund manager.

Particular problems can arise with some legal structures such as pooled funds or when the investments are illiquid and where it may only be possible to exit at a loss, or even impossible to exit at all. This will require case-by-case judgement by trustees, but it is also important to recognise that an exclusion policy involves exclusion of activities and companies that are deemed unacceptable, not exclusion of whole asset classes. Were that to be the case exclusion would become very expensive and much harder to justify.

About ICGN Viewpoints

This Viewpoint was prepared by ICGN's Ethics and Systemic Risk Committee and the text was drafted by Committee Chairman Peter Montagnon. ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate, whilst not defining a formal ICGN position on the subject. ICGN Viewpoints are produced by our member-led Policy Committees and we encourage dialogue by contacting the ICGN Secretariat or policy committee chairs as follows:

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