Principles for Responsible Investment

FINANCE INITIATIVE UNEP | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

SCREENING

OVERVIEW

- Screening is one of several widely used tools that investment managers or asset owners can use to implement a responsible investment policy across their investments.
- The six Principles for Responsible Investment provide a framework for other activities including active ownership, ESG integration and reporting.
- This guide highlights several reasons investors use screening, outlines some key steps to follow and explains some implications to consider when using screening.
- Selected further reading is provided throughout. For more information on anything in this guide, or screening more broadly, please get in touch.

The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.

AN INTRODUCTION TO RESPONSIBLE INVESTMENT

EXPLORE THE SERIES

Screening is one of several approaches that can be used when considering ESG issues in portfolio construction and asset selection, as outlined in the table below:

CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation)			IMPROVING INVESTEES' ESG PERFORMANCE (known as: active ownership or stewardship)	
ESG issues can be incorporated into existing investment practices using a combination of three approaches: integration, screening and thematic.			Investors can encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices.	
Integration	**Screening**	**Thematic**	**Engagement**	**Proxy voting**
Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns.	Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values or ethics.	Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing.	Discussing ESG issues with companies to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors.	Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues.

WHAT IS SCREENING?

Screening uses a set of filters to determine which companies, sectors or activities are eligible or ineligible to be included in a specific portfolio. These criteria might be based on an investor's preferences, values and ethics. For example, a screen might be used to exclude the highest emitters of greenhouse gases from a portfolio (negative screening) or to target only the lowest emitters (positive screening). It can be based on the policy of an asset manager or asset owner.

The use of screening for ESG issues when constructing a portfolio has a long history within responsible investment. This can be traced to faith-based approaches to avoiding, or divesting from, companies which were involved in activities seen as incompatible with a set of beliefs or values.

Milestones in the use of screening in responsible investment

- **1758** Quaker movement in the US prohibits members from participating in the slave trade
- **1971** Launch of Pax World Fund, first socially responsible mutual fund in the US
- **1980s** Widespread divestment from South Africa in protest of the apartheid
- **1985** Friends Provident in UK launches first ethically screened investment fund
- **1993** $625bn invested using exclusionary screens
- **2006** Launch of the UNPRI
- **2016** Norges Bank Investment Management commences divestment from thermal coal companies
- **2018** California State Teachers' Retirement System divests from operators of private prisons in the US
- **2019** French pension fund ERAFP divests from all tobacco holdings

Screening remains one of the most widely used approaches to implement a responsible investment policy. Negative screening represented US$19.8 trillion assets under management globally in 2018[1]. Positive screening was deployed across US$1.8 trillion in assets and norms-based screening across US$4.7 trillion in assets. (See below for explanations of negative, norms-based and positive screening.)

This guide solely focuses on screening. The PRI has also published guidance and resources covering other approaches.

PRI resources:

- An introduction to responsible investment series
- Active Ownership 2.0
- ESG listed equity integration guide
- ESG fixed income integration guide
- ESG Integration in Europe, the Middle East, and Africa: Markets, practices, and data

1 2018 Global Sustainable Investment Review

Screening can be done in different ways, including:

NEGATIVE SCREENING Avoid the worst performers	**NORMS-BASED SCREENING** Use an existing framework	**POSITIVE SCREENING** Include the best performers
▪ Excluding certain sectors, issuers or securities for poor ESG performance relative to industry peers, or based on specific ESG criteria, e.g. avoiding particular products/services, regions or business practices ▪ Absolute avoidance of activities such as: alcohol, tobacco, gambling, adult entertainment, military weapons, fossil fuels, nuclear energy ▪ Sets a materiality threshold (e.g. 10%) based on revenue exposure or business activity/operation ▪ Avoidance of worst-in-class investments using quantitative ESG measurements ▪ Shariah screening, guided by Islamic principles, is a sub-category of negative screening	▪ Screening issuers against minimum standards of business practice based on international norms. Useful frameworks include UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights Declaration and OECD guidelines ▪ A sub-category of negative screening which excludes companies or government debt on account of any failure by the issuer to meet internationally accepted 'norms' such as the UN Global Compact, Kyoto Protocol, UN Declaration of Human Rights, International Labour Organization standards, UN Convention Against Corruption, OECD Guidelines for Multinational Enterprises ▪ Can be called 'controversy screens' or negative screening when companies engage in unethical behaviour	▪ Investing in sectors, issuers or projects selected for positive ESG performance relative to industry peers ▪ Active inclusion of companies within an investment universe because of the social or environmental benefits of their products, services and/or processes ▪ Endorsing best-in-class or 'leaders' in best practice against peer group using quantitative ESG measurements ▪ Positive thematic development such as: transitioning companies, renewable/clean tech, social enterprises or initiatives

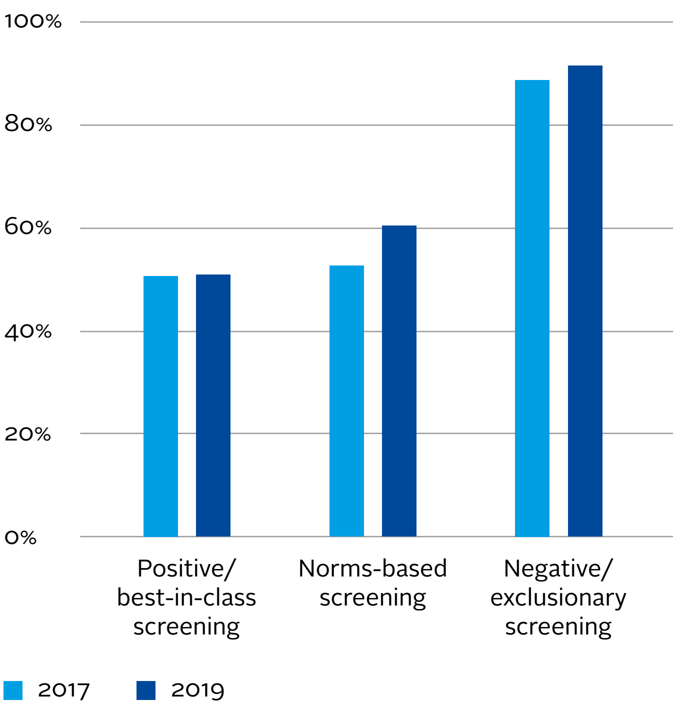
PRI resources:

PRI Reporting Framework main definitions 2018

Among the PRI's signatory base, most listed equity and fixed income investors use positive, negative or norms-based screening as part of their investment process or for specific funds. A larger proportion of active fixed income investors compared to listed equity investors do so, either as a standalone approach or combined with ESG integration or thematic investing.

In 2019, 95% of the sample of PRI signatories that completed the fixed income reporting framework module used a negative screening approach for some aspects of their fixed income investments, while 65% and 61% used norms-based or positive screens respectively.

Screening methods by asset class (percentage of signatories)



Screening often serves as a basic tool, to which ESG integration can be added. A global study of 800 institutional investors[2] found that most early-stage 'adopters' of responsible investment deploy a combination of screening and integration into their investment decision making. The screens used in responsible investment can be based on fixed rules or criteria or connected to engagement[3].

ENGAGEMENT AND DIVESTMENT

As values and social expectations change, or scientific understanding develops, some investors may choose to change existing screens or introduce new ones. This may result in divestment from certain investments. Divestment is often preceded by a period of engagement between the investor and the portfolio company.

Engagement sees investors working with portfolio companies or issuers to improve how they manage or disclose ESG performance or issues. It can be a proactive attempt to address something the investor's own research and analysis has highlighted, or a reactive move, in response to a controversial event.

If initial engagement efforts are unsuccessful, investors can consider escalation strategies, including collaborating with other investors, contacting the board, reducing exposure or, as a last resort, divesting.

For example, concerns over climate change and increasing government action to decrease greenhouse gas emissions through agreements such as the Paris Agreement, has led some investors to engage on climate change issues through discussion, identifying targets and in some cases introducing shareholder resolutions. Increasing numbers of investors and asset owners are introducing exclusions and divesting from fossil fuels in their investment portfolios. AUM excluding or divesting from certain types of fossil fuels increased from US$2.6trn to US$5.4trn between 2015 and 2017, predominantly driven by faith-based and philanthropic organisations[4].

2 See Institutional investors yet to fully embrace ESG, says new research

3 CFA Institute ESG survey, 2017

4 Demystifying negative screens: The full implications of ESG exclusions

WHY USE SCREENING?

MATERIALITY

Value-based investing might use a screening process to identify a universe of companies or assets that have a certain set of attributes which the fund manager believes contribute to outperformance. These attributes could be related to ESG or other factors and can be used to construct an ESG portfolio or identify a stock universe. The fund manager introduces this screen as they believe it will help them outperform a chosen benchmark. As an example, these could be minimum standards of business practices such as those outlined in the UN Global Compact or Declaration on Human Rights.

CLIENT DEMAND

Screening helps to reflect values outlined in a mission statement or purpose or to reflect a general approach taken by an organisation – an asset owner or manager. For example, a health care foundation might choose to exclude tobacco investments due to tobacco's negative impact on health.

Screening for values-based reasons limits the investment universe and, by extension, potentially results in a portfolio with different risk-return characteristics. The fund manager may need to adapt their approach to achieve similar risk-return characteristics to a non-screened portfolio or benchmark.

REGULATION

In some countries, financial regulators prohibit investment in certain asset classes or in companies engaged in certain activities – for example, the manufacture of controversial weapons such as cluster bombs and landmines.

As well as ensuring compliance with such regulatory controls by filtering out the affected assets, issuers or companies, screening for certain poor practices can help investors invest in companies that are ahead of evolving regulatory expectations and standards.[5]

ISLAMIC FINANCE

Islamic finance refers to the banking and investment products in which capital is raised and invested in accordance with Shariah, the principles governing all aspects of behaviour for those practising Islam. Islamic finance shares some similarities with certain approaches to ESG screening in using screens to reflect an underlining set of values or principles.

Responsible investment and Islamic finance approaches share some characteristics:

PRACTICE	ESG INVESTING	ISLAMIC FINANCE	CONVENTIONAL FINANCE
Screening	High levels based on client-specific/fund-specific screening policies	100% application based on Shariah	Low levels
Interest/riba earned	No restrictions	No riba permitted	No restrictions
Security lending	High levels with leading practitioners applying rules that ensure they can vote	No security lending permitted, assets must be owned, and riba is prohibited	No restrictions
Shorting	Low levels	No shorting permitted and assets must be owned	Low levels

5 https://www.sustainalytics.com/controversial-weapons-radar/

KEY STEPS

There are six key steps asset managers or asset owners can take when using screening as an investment approach:

1

Identify client priorities - for retail funds, ensure clear presentation of objectives in marketing documentation. For institutional products, discuss these in negotiations with client/trustee board. Objectives should be added to/ included in the Investment Management Agreement or as part of an RFP.

2

Publicise clear screening criteria - in contractual agreements such as the Investment Management Agreement or marketing literature.

3

Introduce oversight - through an advisory committee or by empowering internal compliance to conduct reviews, monitor implementation and results, and criteria changes.

4

Adapt investment process - screens may utilise different approaches based on corporate activity (e.g. proportion of a company's revenue, either directly or indirectly, derived from a screened activity), sector activity (e.g. what sector is the company categorised in) or related to other metrics or indicators (e.g. supply chain issues, labour or human rights record). This might be applied utilising a range of absolute or relative measures and will differ between investment vehicles.

ABSOLUTE EXCLUSION	no investment in exclusionary criteria e.g. no direct investment in fossil fuels or in a company found to be violating human rights
THRESHOLD EXCLUSION	partial investment, tolerance level set e.g. up to 10% of revenues derived from indirect exposure to fossil fuels or for services connected to it
RELATIVE EXCLUSION	best-in-class investments e.g where energy transition is occurring or where board diversity is improving, not determined through revenue exposures

These screens are often based on data, obtained from third-party providers, which feeds into internal order management systems to ensure compliance during portfolio construction.

5

Review portfolio implications - asset managers may want to review the implications of screens and discuss with clients before implementation and on an ongoing basis. Factors or metrics to monitor and discuss might include:

- **Tracking error**
  Screening reduces the investable universe, thereby raising a portfolio's tracking error against a benchmark. Different screens and screening processes will have different implications.
- **Style factors**
  Screens may introduce underweight or overweight sector exposures within a portfolio. This may introduce a style bias, 'tilts' to a portfolio or different foreign exchange exposures. Other screens might introduce bias to larger capitalised companies or styles (e.g. growth over value).

6

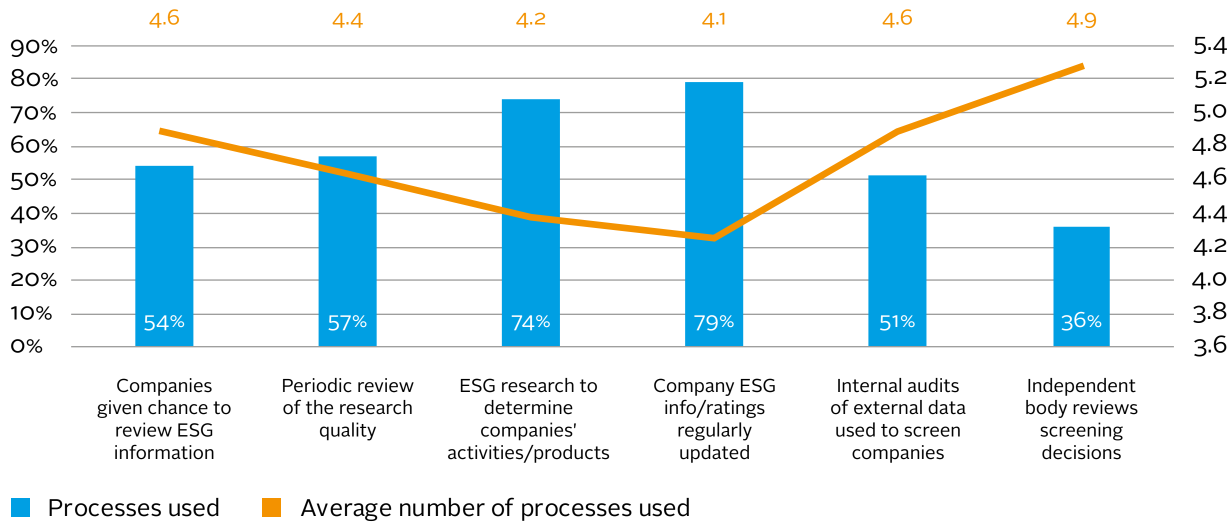
Monitoring, reporting and audit - asset owners or asset managers may want to introduce a series of controls or checks to ensure the agreed-upon screening criteria are being implemented. This might be through internal compliance personnel, who can conduct periodic quality reviews of research or data used to conduct screening or an external advisory committee. Many signatories use an independent body or committee to ensure review of the screening decisions made.

PRI REPORTING DATA - EXAMPLES OF LEADING PRACTICE

Over a third of signatories have an independent internal body that reviews screening decisions, with >40% of Asian and Oceanian signatories reporting doing so. On average, they use the highest number of processes compared to signatories not using an independent body.

Other advanced practices include internal audits of external data (61% in Europe) and reaching out to companies to confirm and correct ESG information signatories hold on them (61% in Asia).

Screening - processes used to ensure robust analysis



Screening represents a single step in developing an approach to responsible investment and implementing a policy. The six Principles for Responsible Investment outline a number of different steps in relation to active ownership, ESG integration and reporting.

FURTHER READING

For a list of resources on responsible investment screening from other organisations, [visit the PRI website.]

CREDITS

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