HOW MUCH IS TOO MUCH?

Negative Screening and Performance Consequences

By Leola Ross, PhD, CFA®
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Clearly, we know that a tracking error will result from restricting portfolios. By performing a general analysis of security exclusions by sector (based on simulations of multiple sectors) investors can understand better what it means to exclude specific industries from a portfolio.

To do so, they have actively removed from their portfolios specific industries such as tobacco producers, carbon emitters, or controversial weapons manufacturers. As a result, investors may expect to deviate from optimal portfolios in a material way. In this article, we discover at what point exclusions may begin to impact portfolios in a material way.

To understand the impact of exclusions, backtests often are performed to show how portfolios would have performed over an historical period without, for example, tobacco. However, these tests cannot act as a guide for what to expect going forward. Our goal in this analysis is twofold:

1. To develop expectations for the future based on certain exclusions.
2. To understand the role that managing unintended exposures may play.

TRACKING ERROR

To establish these forward-looking expectations, we create and evaluate a distribution of portfolios with exclusions.1

We intend to answer the following three questions through our analysis:

1. What is an approximate distribution of outcomes created by excluding securities from the portfolio?
2. At what point are we excluding so much that the portfolio looks quite different from peers?
3. How do different methods of compensating for missing securities affect that distribution?

Clearly, we know that a tracking error will result from restricting portfolios. By performing a general analysis of security exclusions by sector (based on simulations of multiple sectors) investors can understand better what it means to exclude specific industries from a portfolio.

From our analysis, we now have a better understanding of when exclusions become material to a portfolio. We outline our methodology and review the results below.
METHODOLOGY AND DATA
To demonstrate the range of outcomes caused by exclusions, we use bootstrapping to simulate and evaluate the impact of security exclusions on the performance of a portfolio. We examine exclusions from the MSCI World Index. We obtain the monthly holdings and returns data from November 1997 to November 2017. Therefore, we have a total of 20 years of data. To understand how different market environments may impact results, we break the whole sample of the index into two 10-year sub periods (1997–2007 and 2008–2017). We then select the securities to be excluded through bootstrapping at the beginning of each subperiod and evaluate the impact on portfolio performance when the same set of securities are always excluded in each month during this subperiod.

BOOTSTRAPPING
At the beginning of each sub period, we randomly select approximately 1 percent, 2 percent, 3 percent, 4 percent, and 5 percent of securities (measured in beginning-of-subperiod portfolio weight), respectively, from the benchmark index portfolio in the first month of each subperiod. We assume that the chosen securities are always excluded during the whole subperiod.

We run the simulation 6,000 times and examine the distribution of performance measures of the newly formed portfolios to assess how exclusions would have affected the original portfolio. By comparing the impact of exclusions at different percentage levels, we can assess at what level the exclusions would start to detract from portfolio performance.

SECTOR-NAÏVE VERSUS SECTOR-NEUTRAL REWEIGHTING
When securities have been excluded from the portfolio, we must reweight (or normalize) the portfolio so that it is fully invested. We simulate two different reweighting schemes to assess how one’s approach to reweighting after excluding securities would affect performance outcomes.

Case 1: Sector- naïve reweighting
We randomly exclude securities that initially represent X percent of the benchmark portfolio from a specific sector and reweight all the remaining securities in the portfolio to add up to 100 percent in all subsequent months during the sub period. Because there are eight sectors in total, and 750 simulations are conducted for each sector, there are 6,000 simulations total. In the case of the naïve reweighting, sector biases are preserved and new risks are introduced into the portfolio due to the exclusions.

Case 2: Sector- neutral reweighting
We randomly exclude securities that initially represent X percent of the benchmark portfolio from a specific sector and reweight only the remaining securities in this sector. Again, 750 simulations are conducted for each sector, leading to a total of 6,000 simulations. We are reweighting the portfolio in such a manner that the sector exposure and weights remain the same before and after exclusions. As well, we control, as much as possible, for country exposures in the sector- neutral reweighted simulations. In the case of the sector- neutral reweighting, sector biases are managed because active sector bets are not added to the portfolio.

Next, we compare the distributions of outcomes with sector- naïve and sector- neutral reweighting schemes to see the impact of managing sector risk on ex post distributions of excess returns and tracking errors.

RESULTS
To get a sense of how exclusions may impact portfolio performance, we examine excess return and tracking error distributions from our simulations for our two sample periods and the two cases — sector- naïve and sector- neutral reweighting schemes. We exhibit these distributions in graphic form in figures 1 and 2. We first review excess returns and then turn our attention to tracking errors below.

EXCESS RETURNS
We exhibit annualized excess returns distributions for the sector- naïve reweighting scheme and the sector- neutral reweighting scheme in figure 1. Our first, much expected, observation is that increasing the percentage of security exclusions quite quickly increases the range of excess return outcomes. What is more interesting is how managing exposures, such as sector (and country), can influence how quickly the range of outcomes increases.

By visually inspecting the distributions in figure 1, we can see quite easily that the sector- neutral distributions are taller, skinnier, and more bell- shaped than the sector- naïve distributions, which are multi-modal/lumpy and move around quite a lot. To get a more precise view, we exhibit the coordinates of the highest modes from the sector- naïve distributions and the modes of the sector- neutral distributions in table 1.

From table 1, we observe that the mode (or highest mode) values are consistently closer to zero for the sector- neutral simulations. Ultimately, the sector- neutral mode values stay between ± 0.01 for all exclusion levels up to 5 percent. By contrast, the sector- naïve mode values jump past that mark after 1- percent or 2- percent exclusions.

As well, the modal heights are consistently higher. In the earlier sample...
period, 1997–2007, the mode height difference is more dramatic at higher exclusion levels of 4 percent and 5 percent. Taking the 1997–2007 sample period as an example, the height of the 3–percent exclusion for sector–naïve (5.0 percent) is similar to the height of the 5–percent exclusions for the sector–neutral (5.4 percent). The same is true for the 2008–2017 sample period where the 3–percent exclusion exhibits a height of 6.0 for sector–naïve, and the 4–percent exclusion exhibits a height of 6.2 percent.

These numbers tell us that the range of excess return outcomes increases more when not controlling for sector (and country) effects. On the other hand, we might consider managing such exposures to be a mechanism for including more exclusions without impacting excess return expectations. For a small exclusion from an index, such as tobacco, which is less than 1 percent of a global index, return expectations should not be material. However, for actively managed portfolios, even a tobacco exclusion may represent a higher percentage of the investable universe.

As we move into exclusions of 5–percent and more (which might be similar to tobacco plus controversial weapons plus relative carbon footprint for an index), we find that simple sector–neutrality is
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DISTRIBUTIONS OF TRACKING ERRORS FOR BOTH SAMPLE PERIODS AND MULTIPLE EXCLUSION LEVELS

MODE COORDINATES OF TRACKING ERRORS FOR SAMPLE PERIODS AND MULTIPLE EXCLUSION LEVELS

Table 2

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<tbody>
<tr>
<td></td>
<td>Sector–Naive</td>
<td>Mode value</td>
<td>Mode height</td>
<td>Sector–Neutral</td>
</tr>
<tr>
<td>1%</td>
<td>0.09</td>
<td>8.2%</td>
<td>0.07</td>
<td>10.1%</td>
</tr>
<tr>
<td>2%</td>
<td>0.17</td>
<td>3.9%</td>
<td>0.14</td>
<td>5.5%</td>
</tr>
<tr>
<td>3%</td>
<td>0.40</td>
<td>2.9%</td>
<td>0.21</td>
<td>4.9%</td>
</tr>
<tr>
<td>4%</td>
<td>0.46</td>
<td>2.3%</td>
<td>0.32</td>
<td>4.2%</td>
</tr>
<tr>
<td>5%</td>
<td>0.37</td>
<td>1.9%</td>
<td>0.41</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

no longer sufficient to manage the widening of the excess return distribution. Therefore, with exclusions of more than 5 percent, additional sophistication in managing exposures will be important for divesting investors.

Ultimately, we confirm that excluding a modest percent of the index from portfolios does not impact return expectations, but that the range of expected outcomes can increase very quickly past the 2-percent mark unless exposures are managed. What we haven’t reviewed is how those returns deviate from index returns over time. To do that, next we review the tracking errors of our simulations.

TRACKING ERRORS

Long-term return expectations are material considerations for fiduciaries and investors considering portfolio exclusions. However, the reality is that month-to-month return differences can cause anxiety and erode confidence. Here, we review how much deviation one might expect from making a divestment choice.

In figure 2 we examine the distribution of tracking error and observe that increasing exclusion levels, quite expectedly, increases tracking errors for both sample periods. That said, again we start with the high-level visual observation that

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the sector-neutral distributions are taller, more left, and less lumpy than their sector-naïve counterparts. In other words, tracking errors are smaller when we control for sector exposures.

We exhibit the coordinates for mode values and mode heights for tracking errors from each of our simulations in table 2. Similar to the excess return distributions, the mode values are systematically smaller for sector-naïve distributions than for sector-neutral distributions. For example, in the 1997–2007 sample period we observe a mode of 0.40 for the 3-percent sector-naïve exclusions—we see a similar mode value of 0.41 at 5-percent exclusions in the sector-neutral columns. For the later sample period we see the same mode height of 0.22 appear at 3-percent exclusions for sector-naïve and not until 4 percent for sector-neutral. Therefore, we see that sector-neutral reweighting softens the disruption of exclusions not only to a portfolio’s expected returns but in how those returns would behave from month to month.

The mode heights for the tracking error distributions tell a similar story. In both sample periods, the 2-percent exclusions with sector-naïve reweighting have a similar modal height to the 5-percent exclusions under sector-neutral. It seems that managing sector (and country) exposures has a more profound impact on tracking error distributions than on excess return distributions. Given the sensitivities many investors have to tracking error, such a result is important.

Finally, we remind ourselves that indexes are different from active portfolios, where exclusions may represent more material portions of the active universe. In these cases, the ability to manage unintended exposures becomes more critical when accommodating investor-preferred exclusions.

We conclude that simple measures to manage exposures can improve portfolio performance materially when security exclusions are imposed on a portfolio. These simple measures buy the investor an additional 1–3 percent in exclusions before tracking errors become more of an issue. However, in moving past 5-percent exclusions, tracking error may be difficult to forecast and more sophisticated exposure management may be necessary.

We see clearly from our analysis that small levels of exclusions do not impact return expectations. More importantly, we observe that minor exclusions, in the range of 1 percent of a universe, will not induce material monthly deviations.

CONCLUSIONS
Increasingly, investors express preferences for excluding from their portfolios securities such as those related to tobacco, carbon emissions, and controversial weapons. As investment managers, we want to understand the impact of these exclusions. In the past, investment managers utilized backtests to assess how the portfolio would have performed with those exclusions over some historical period. However, a backtest does not tell us what to expect going forward. In this article, we have examined a range of outcomes that moves us closer to building forward-looking expectations for excluding securities from portfolios.

To build these forward-looking expectations, we create a distribution of exclusions and evaluate that distribution. In particular, we use a bootstrapping method to answer a few important questions: First, what is an approximate distribution of outcomes created by excluding securities from a portfolio? Second, at what point does the distribution broaden in a way that expectations become less stable? Lastly, how do different methods of compensating for missing securities affect that distribution?

We see clearly from our analysis that small levels of exclusions do not impact return expectations. More importantly, we observe that minor exclusions, in the range of 1 percent of a universe, will not induce material monthly deviations.

This exercise quantifies our intuition and puts some sensible limits on just how much a portfolio can be restricted. These results are extremely useful to help investors to assess exclusions and their potential impact.

ACKNOWLEDGMENTS
With special thanks to Miao Ouyang, PhD, for co-authoring the original research and thanks to Xun (Aaron) Cui, a master’s candidate at Massey University, Auckland, New Zealand, who coded this simulation exercise to produce many of the results we are sharing.

Leola Ross, PhD, CFA®, is director, investment strategy research, at Russell Investments. She earned a BS from Drew University and a PhD from Southern Methodist University. Contact her at webmast@russellinvestments.com.
ENDNOTES

1. Specifically, we use a bootstrap method for forming our distribution. In the case of a bootstrap, we draw 6,000 random portfolios from a known population (in this case, the stocks in the indexes) with specific rules in place (in this case, restricting the sampling from selecting specified industries).

2. Note that these percentage levels are only approximate because the weights of a set of securities might not add up to an exact percentage. On account of this possibility, we allow for a small band (20 basis points) around these percentage levels.

3. These include the following four GICS sectors and four combined GICS sectors: Consumer Discretionary, Consumer Staples, Energy & Utilities, Financials & Real Estate, Health Care, Industrials & Materials, Information Technology & Telecommunication Services, Unassigned.