

Sustainability and Climate On-Demand

“When Scandals Are Market Signals”

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Bentley Kaplan

Hello and welcome to the weekly edition of Sustainability Now, the show that explores how the environment of society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. Oil spill, data breach, labor scandal. When a company faces allegations that it has done something bad, it's not only the company's PR team gets a barrage of phone calls and emails, it's investors too. But reputational pressure isn't the same thing as financial pressure. Holding a position in a company that gets ensnared in controversial incidents can mean bad press, but does it also mean bad returns? Does it make sense for investors to use controversies as a barometer for financial performance? Or are they only an issue for PR firms and impact investors? Well on today's show, that's what we are about to find out. So, thanks for sticking around. Let's do this.

For years, residents living along Nigeria's southern coast have watched their rivers turning black from spilled oil. In 2024, Akwa Ibom state, a major spill killed fish and affected the local mangrove ecosystem. Protests broke out at one of Exxon's local facilities, with protesters demanding compensation. A year earlier, on the other side of the world, in an unrelated case, in factories in China and India, NGO reports alleged that workers were subjected to excessive overtime, worked without pay, and suffered coercive measures as part of the manufacturing of components that would ultimately end up in Apple's smartphones. And spin the globe again, and just a couple of months ago in Queens, New York, 150 Amazon delivery drivers discovered one morning that they no longer had jobs. Their union alleged that their loss of employment was retaliation for having organized under the Teamsters banner earlier this year.

These are real examples of the types of negative events or controversies that can be associated with a company. And to be fair, pretty much all companies have the potential to negatively impact the environment, society, or governance norms. But not all of them do. So if you're an investor, you may be wondering whether steering your capital away from companies that are linked to these outsized negative impacts is a sensible thing to do. And maybe that's because you don't want your investments directed to companies that are having these negative impacts on the world. Maybe it's because you're compelled to do so by regulation, say through the SFDR's principle Adverse Impacts framework, or the PAIs. Or maybe you're not so much of an altruist, but you reckon that a controversy points to something slipping operationally. Risk management that isn't quite up to scratch. A warning sign of bigger downside to come.

There are different ways to come at this question. And we're going to step out of our comfort zone into wide world of portfolio construction. We're going to ask what happens to portfolios when a company that its holding has a controversy, or what happens when you remove a company like that from your portfolio. And that's because a lot of global capital, especially the trillions sitting in index funds, is managed to track a benchmark, like the MSCI World or MSCI ACWI, for example. The goal of those funds isn't necessarily to beat the benchmark, but to match it as closely as possible. That's why the people that manage those funds care so much about tracking error – a measurement of how far a portfolio's performance drifts from its benchmark. Even small deviations can make big investors nervous, because they're judged on how tightly they mirror that index.

Here's the thing though. Adding constraints to your portfolio, like, say divesting from companies that are involved in controversies shrinks your investment universe. And shrinking your investment universe raises your tracking error. And that deviation from your benchmark raises the risk of volatility and underperformance, and you know, ultimately an awkward conversation with your clients or your board. So knowing all of that, can you still avoid investing in companies with controversies without exposing yourself to this volatility?

Well, that's what some of my top-shelf colleagues wanted to find out. One of them is Drashti Shah, a data scientist and all-round great person who works on MSCI's custom index solutions. Drashti and team took a big investment universe – the MSCI ACWI investable market index, which covers large, mid and small cap companies in both developed and emerging markets. Something just north of 8,000 companies. They took this portfolio and tested two approaches to see what happened to returns when they excluded companies that were tied to controversies. All with a big, beady eye on tracking error.

Drashti Shah

What we saw is the more you restrict your investable universe, the more diversification you lose and the higher the tracking error. We created these two hypothetical portfolios. One removed companies with scores zero to one. These are companies with red and orange flags. The other went a little broader, removing scores from zero to all the way to four, and this is basically red, orange, and yellow flags. When we excluded only the most severe cases, the portfolio stayed very close to the benchmark. Tracking error was low, returns were slightly positive, but when we applied the broader screen, tracking error rose and risk adjusted returns weakened compared with the benchmark.

And a big driver behind this pattern was size. Large cap companies are more likely to have controversies. They're more exposed, more visible, so excluding them created this small cap tilt in the portfolio. Because large caps outperformed small caps over the study period, that tilt had a negative impact on the returns. As those large names drop out, the remaining companies weights also increase. So that changes the balance of the portfolio. With targeted exclusions, investors can align their values, avoiding the most severe controversies, and at the same time stay close to the market and even seeing slightly positive results.

Bentley Kaplan

Okay, so the good news first. You can exclude companies that are involved in the worst types of controversies without facing performance impacts. So you don't have to do it, but you can without losing too much sleep. Drashti mentioned scores out of 10 and colors red, orange, and yellow. Now, without getting too lost into the weeds, we at MSCI assess controversies, tens of thousands of news stories and publications aided by AI, and we attribute these cases to the thousands of companies in our coverage. Our methodology is publicly accessible, so please feel free to download it from our website. But out of respect for your time, we're going to deal with the broader strokes for now.

And basically we look at different facets of each case, including what type they are, whether they're environmental, social, or governance. And how bad they are, the severity. The more severe a case, the worse color it gets, with red being the worst, and the lower the score it gets, with zero being the worst. And it's these scores and these colors that Drashti and team used in their analysis to build their approach to excluding companies that have controversies. So in one, they were highly selective. They narrowly excluded companies with the worst controversies, orange and red flags. Things like alleged oil spills in Nigeria or forced labor in India and China, or retaliation against union activity in the US. And then they also tested out what happens when they were more aggressive with exclusions and not only cut out companies with red and orange flags, but yellow ones too. Things like a data breach that affected Meta and Apple's customers.

And when you take out this bigger chunk of companies, that's when there was a negative impact on returns. By contrast, by being more selective and only excluding companies with the most significant controversies, tracking error didn't really rise too much, and there was actually a slightly positive nudge in terms of returns. Something that is tricky to untangle here is that controversies tend to skew towards larger companies. There are a few reasons for that. Primarily, though, it's because they have larger scale and greater likelihood of generating negative impacts, all else being equal, and they're also more visible, more likely to be reported or monitored. So removing companies with controversies can simultaneously mean skewing your portfolio towards mid and smaller cap companies. But let's put a pin in that for now. We will come back to it, I promise. Because another thing that Drashti and team wanted to know was whether there was any difference in the type of a company's controversy. Whether there was any difference if a company was tied to a negative environmental impact, say an oil spill, compared with the social one, like say forced labor allegations in its supply chain.

Drashti Shah

The overall pattern stayed the same. The more companies we exclude, the weaker the performance. But there are some interesting details that did come up when we looked at these different types of controversies. Under the targeted approach, where we only remove the most severe cases, results were mixed. So excluding companies with severe environmental or governance controversies did slightly improve performance, while removing companies with social controversies had the opposite effect. Big reason, again, was the number and size of companies affected. Social controversies were far more common even under the targeted screen, so many more companies were dropping out, and that created a bigger tracking error and led to lower performance.

But we dug deeper and looked at individual companies. Three of the largest names Apple, Amazon, Meta were excluded due to social controversies. All three performed strongly over the period, so leaving them out didn't really help the portfolio performance. In contrast, in the environmental category, we excluded Exxon, which had weaker performance, and this actually helped the portfolio. Because Exxon's weight was removed, it was redistributed to other large-cap stocks that remained in the portfolio. Microsoft, Amazon and Meta, for example, increased in weight, and these had strong returns. So not all controversies behaved alike and what's left in the portfolio can be just as important as what's taken out.

Bentley Kaplan

Right, so targeted exclusions of companies with significant social controversies meant dropping some big tech companies out of the portfolio. Companies that despite these controversies performed well. But when Drashti pulled out companies with significant environmental controversies, it not only meant removing fewer companies, but also keeping in these big hitting tech companies that boosted the overall portfolios returns. So how you decide to run your target at exclusions also seems to matter. Now the team could have stopped there, but as Drashti would go on to tell me, market performance has a bit of an indirect connection to a company's controversy. An awful lot happens between an oil spill in Nigeria and what a company's stock is trading at. And that's because controversies point to potential operational or governance risks, risks that should theoretically connect more reliably to company financials rather than their stock price and dividends. Or at least that's the idea.

Drashti Shah

To test this, we looked at companies that lost their green flag, meaning they moved out of the lower risk zone after a significant controversy, and compare their earnings per share growth over the next three years with all other companies. Companies that lost their green flag generally showed slower earnings growth than the rest, especially for social, governance, and the overall controversies. At the same time, the variation was very large. So that tells us that while controversies were often associated with weaker EPS growth, other factors also played a role in driving these results. This opens up room for further exploration. One open question is are there any differences in fundamental performance for different changes in scores? And my co-authors and I looked at EPS growth in this paper, but future studies can also explore other fundamental metrics.

Bentley Kaplan

Right, so at the core of company performance controversies are signaling something. When a company loses its green flag and goes to yellow or orange or red, it dampens the growth of its earnings per share over the next three years, at least on average. That's big. Big because you can make the case that controversies are a backward-looking signal. The event has happened already, no use in crying over spilled oil. These incidents might just be a once-off for a company. A freak

event in what is an otherwise robust risk management system with great oversight and excellent team culture. But what any weather-beaten analyst can tell you is that they might also be the first warning signs of choppy waters ahead. The first slip of a much bigger slide. And Drashti's analysis shows that it's certainly worth entertaining this theory.

Now whether a controversy will ultimately mean negative performance for a company, that's a whole other ballgame. As Drashti explained earlier, there are cases where companies carrying significant controversies went gangbusters anyway. It's not a simple case of divesting from all companies that are facing controversies and calling it a day, because sometimes one of those companies is a tech stock poised to surge. But not always. It's early days in this research, but portfolio managers may be seeing value in the signal that controversies are offering. Whether that's to avoid downside risk or limit exposure to companies that have negative impacts, they could well be wondering how exactly to thread this particular needle.

Drashti Shah

The good news is that there is a clear starting point. Targeted exclusions, removing only companies with the most severe controversies had very little impact on performance, and in some cases, they even added a small positive effect. So investors can act on controversy risks or align their values without drifting far from the benchmark. The challenge comes when exclusions become broader. The portfolio tends to tilt towards smaller companies. But exclusions don't have to stand on their own. Investors can pair them with these other index construction strategies to manage those side effects. For example, if exclusions cause some imbalance, say by removing several large names, the portfolio manager can adjust the remaining weight so the portfolio still reflects the broader market structure or the benchmark. What the right strategy to pair with these exclusions is a whole other topic, though.

Bentley Kaplan

And that is it for the week. A massive thanks to Drashti for her take on the news with the sustainability twist. Her paper, co-authored with Guido Giese and Zoltan Nagy is called *The Return and Risk Characteristics of Controversy-Driven Exclusions*, and it is freely available for download from our website. Do yourselves a favor and download it for something meaty to go with your morning coffee. And I also do want to say thank you very much for tuning in. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice, and tell a friend or a colleague about this very episode. Thanks again, and until next time, take care of yourself and those around you.

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