

VALUES-ALIGNED INVESTING

UNDERSTANDING EXCLUSIONARY SCREENING, ENVIRONMENTAL, SOCIAL, AND GOVERNANCE TILTS, AND POTENTIAL IMPLICATIONS

Values-aligned investing continues to reshape the investment landscape, with \$6.5 trillion in US assets under management (AUM) explicitly marketed as Environmental, Social, and Governance (ESG) or sustainability-focused investments according to the US SIF Trends Report 2024/2025. This approach extends beyond financial returns by incorporating investors' personal values into portfolio construction.

For investors seeking to align their public equity portfolios with their values, two common approaches have emerged and have been utilized separately or combined:

1. Exclusionary Screening: Removing companies that conflict with specific values.
2. ESG Tilts: Allocating more capital to companies with stronger ESG characteristics.

Exclusionary screening is one of the oldest, most accessible, and widely implemented values-aligned investment strategies. Its roots trace back to the 18th century, when Quakers avoided investments linked to the slave trade. Today, this approach involves systematically avoiding companies engaged in activities that conflict with specific social values. While exclusionary screening was among the earliest tools for expressing social values alignment, modern strategies have evolved to address a broader range of concerns, including sustainability and climate-related issues.

Another commonly employed approach, applying ESG tilts, aims to reallocate portfolio weights toward companies or sectors that better align with ESG practices and values. For example, rather than entirely excluding carbon-intensive industries, an ESG tilt might significantly reduce exposure to the highest emitters while increasing allocations to companies with lower carbon footprints or credible transition plans. This method allows for some values expression in the portfolio while maintaining exposure across the full spectrum of market sectors.

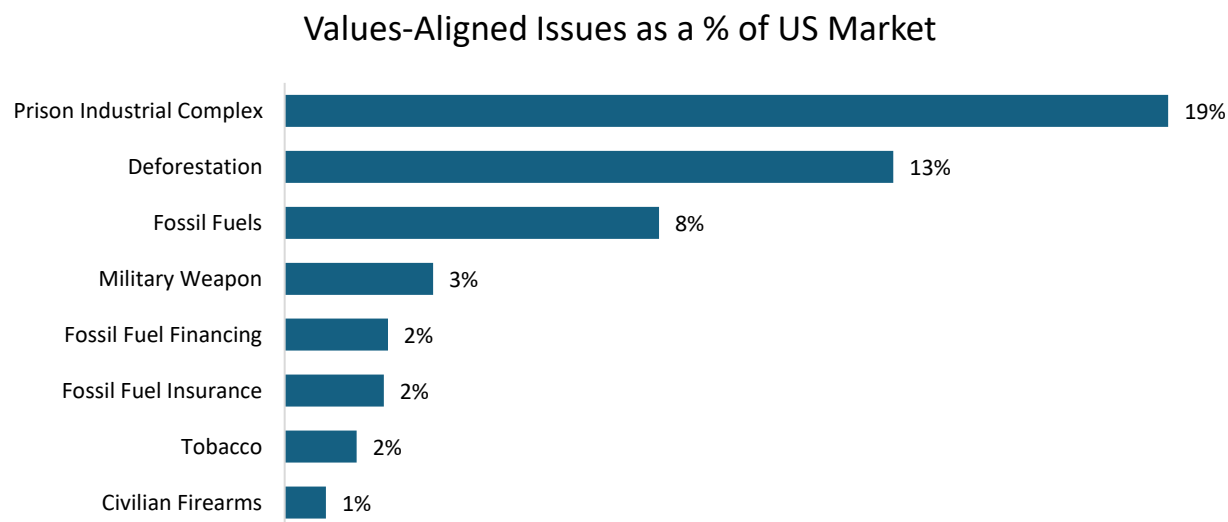
While distinct in their implementation, both approaches share common portfolio construction considerations and can be used standalone or together to create values-aligned investment portfolios. However, these approaches generally lead to portfolios with inherent composition differences compared to the broader market and may produce

different return experiences relative to passive market-tracking portfolios due to several structural factors. Thus, awareness of portfolio construction is critical when striving for values alignment and market rate financial returns.

EXAMPLES OF STRUCTURAL CHALLENGES IN EXCLUSIONARY SCREENING AND ESG TILTS

Depending on the exclusions and ESG tilts applied, the investable universe may be reduced, and the portfolio could become predisposed to underweights and overweights in certain sectors. This is especially common in portfolios with fossil fuel-related exclusions, which tend to reduce exposure to energy and utility companies. Utility companies are traditionally considered defensive and value-oriented due to their stable cash flows, consistent dividends, and lower volatility. Energy companies, while sensitive to commodity price fluctuations, often have lower valuations and consistent dividends. From a financial standpoint both sectors could provide a source of diversification within the portfolio, over time. Excluding these sectors may lead to portfolio diversification decrease, and as byproduct, may potentially leads to a higher concentration in growth-oriented companies within the investable universe to offset that decrease.

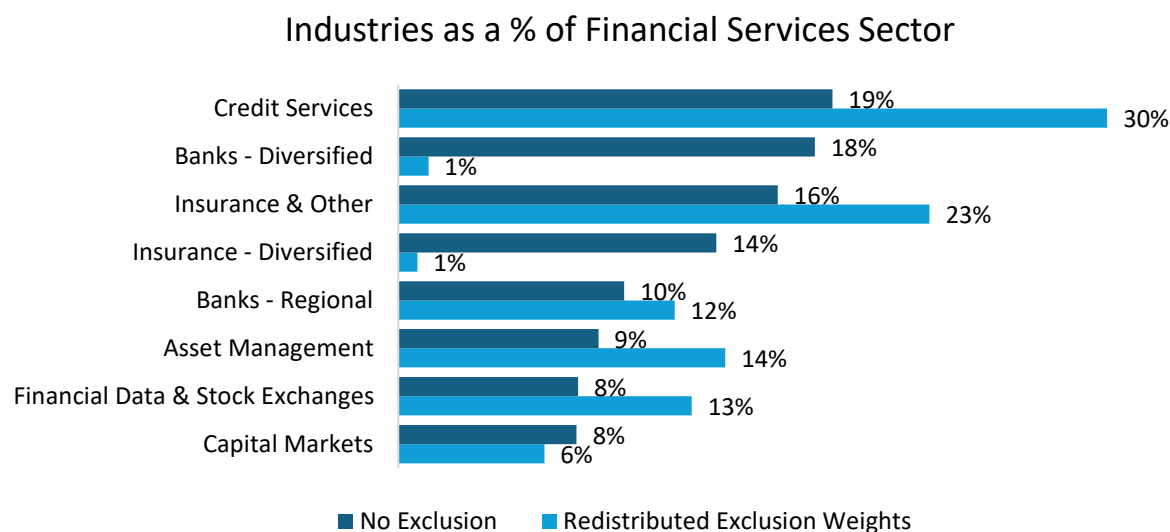
It is also important to recognize that not all values-aligned issues have the same level of representation in the broad market. For example, using the Russell 3000 Index as a proxy for the U equity market, companies involved in civilian firearms account for just 0.9% of the index, while companies involved in fossil fuels represent 8.1%.



Source: As You Sow, Morningstar, Syntrinsic, Data as of 2/27/2025

To continue along with the fossil fuel exclusion theme and to take it one step further, financial institutions play a key role in providing capital to businesses involved in fossil fuel projects.

According to FossilFreeFunds.org and BankingOnClimateChaos.org, 13 financial services companies, representing 5.6% of U.S. equities, have been identified as providers or facilitators of financing to fossil fuel-related companies. Notably, many of these are among the largest U.S. companies (e.g., Wells Fargo & Co.) and collectively account for 39% of the financial services sector.



Source: Morningstar, Syntrinsic, Data as of 3/31/2025

Excluding these companies leads to lower exposure to large-capitalization companies and greater exposure to mid- and small-cap companies. It also causes a significant shift in industry composition within the financial services sector, as the weight of diversified banks declines and is redistributed to other industries.

Thereby, excluding fossil fuel companies and related activities could result in meaningful changes to underlying portfolio exposures in a portfolio and should be considered when implementing a values-aligned investment portfolio. Over the longer-term this approach could potentially reduce the perceived risk of a portfolio and/or influence the capital markets to create changes with regards to climate-related issues but in the short-term,

portfolios can meaningfully deviate from the broader underlying market indices and investors need to take that into consideration.

APPROACH TO PORTFOLIO OPTIMIZATION

As mentioned above, exclusions can result in meaningful changes to underlying portfolio exposures, particularly in a market capitalization-weighted portfolio construction approach as shown in the examples above.

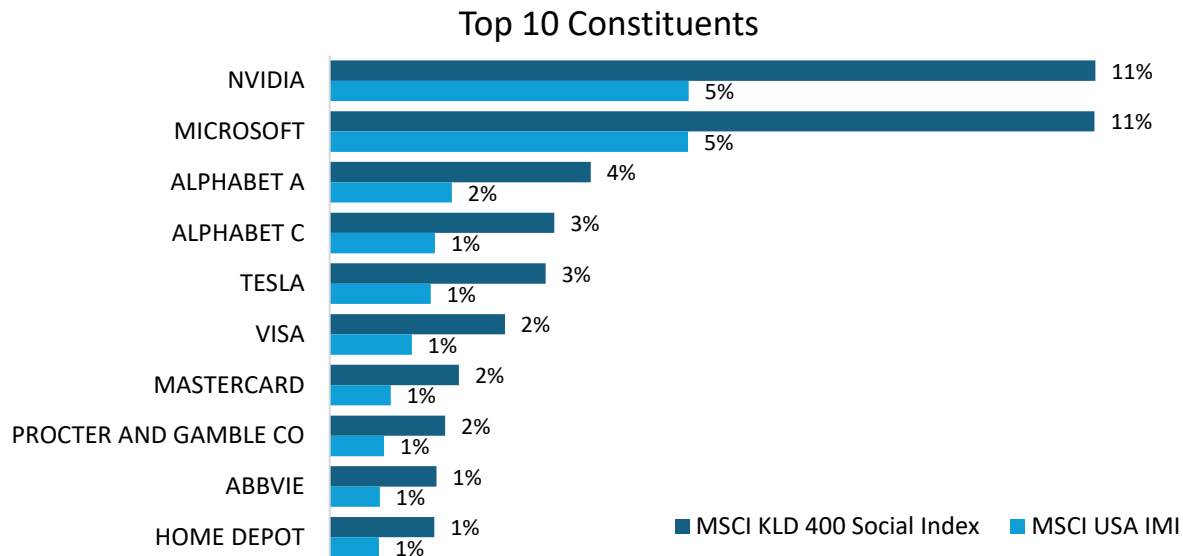
An alternative approach in portfolio construction is optimization. This method can help with building a diversified, values-aligned portfolio while also minimizing deviations relative to a broad market index. However, a smaller investable universe inherently introduces constraints during portfolio construction and portfolio optimization can't solve for that underlying factor. Moreover, optimizing to a market index is a zero-sum game. That is, when one sector or a company is taken out, another sector or company will be overweight relative to the index.

Returning to the fossil fuel financing exclusion example, only two diversified banks meet the criteria to eliminate fossil fuel financing from the portfolio. As a result, the portfolio's financial services company exposure may lean heavily toward regional banks or become concentrated in the few eligible large institutions—demonstrating the practical limitations that can arise when the number of values-aligned companies are limited.

ENVIRONMENTAL, SOCIAL, & GOVERNANCE INDICES

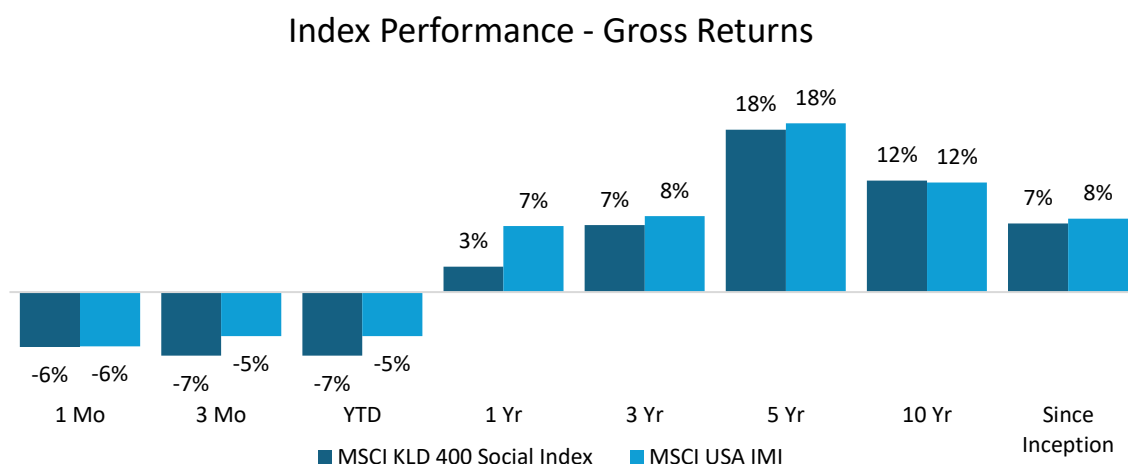
Structural portfolio challenges also exist within ESG indices, which are often used in passive investment products and viewed as off the shelf solutions. ESG indices typically apply predefined exclusions, ESG tilts, or both, and are constructed relative to a broad market parent index. While they provide a standardized approach, investors do not have control over how values are implemented or how resulting risks are managed.

For example, the MSCI KLD 400 Social Index illustrates this point. The methodology tilts allocation to companies with strong ESG scores while excluding those with negative ESG impacts. As of March 31, 2025, the index's top 10 holdings made up approximately 39% of the total weight, compared to 18% in its parent index, the MSCI USA IMI. Nvidia and Microsoft together accounted for 22% of the index, more than double their combined weight in the parent index. The MSCI KLD 400 Social Index also showed a higher allocation to the information technology sector at 35%, versus 28% in the parent index.



Source: MSCI KLD 400 Social Index Factsheet, Data as of 03/31/2025

Portfolio composition differences reflect the same structural issues seen in custom values-aligned portfolios, including increased sector and company concentration, periods of elevated tracking error, and the potential for return deviations. For instance, over the trailing one-year and year-to-date periods, the MSCI KLD 400 Social Index returned 13% and -1%, respectively, while its parent index returned 18% and 1%. Even when using off the shelf ESG index tracking products, it is essential to understand how the index is constructed and how its methodology may influence portfolio characteristics and performance outcomes.



Source: MSCI KLD 400 Social Index Factsheet, Data as of 03/31/2025

CONCLUSION

In aggregate, exclusionary screening, ESG tilts, or a combination of both, are practical approaches to values aligned investing. When implemented thoughtfully and with appropriate expectations, these strategies can support personal or institutional values across a range of market environments.

At the same time, it is important to recognize the structural portfolio challenges, such as company concentration, sector imbalances, and tracking error, whether that be in custom built strategies or off the shelf ESG products. Having a clear understanding of the construction methodology, and the tradeoffs they may introduce, is essential when striving for values alignment while generating market rate financial returns.

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SOURCES:

- i. [US Sustainable Investing Trends 2024/2025 | US SIF](#)
- ii. [iShares Russell 3000 ETF | Fossil fuel investments | Fossil Free Funds](#)
- iii. [Banking on Climate Chaos 2024 - Banking on Climate Chaos](#)
- iv. [MSCI KLD 400 Social Index](#)
- v. [MSCI USA IMI](#)

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