



White paper

# Nordic sustainability exclusions – assessing the financial effects

An analysis of the impact of standard Nordic sustainability exclusions on a global equity portfolio (MSCI AC World index) from 2019 to 2024.

## EXECUTIVE SUMMARY

Today, a range of sustainability-related exclusions are widely implemented by most asset managers and institutional investors as part of their responsible investment strategies. However, the effectiveness of these exclusions continues to be a subject of intense debate.

Opponents of excluding companies point out that exclusions limit the universe of stocks, thus minimizing investment opportunities and reducing diversification effects, consequently impacting the risk and return characteristics of a portfolio. Proponents of excluding companies due to their association with questionable business practices argue that such exclusions do not necessarily result in lower returns but rather the opposite, improve returns.

In this paper, we examine the ex-post financial effects of standard Nordic sustainability exclusions on a global equity portfolio based on the MSCI AC World index from 2019 to 2024. Nordic asset managers and institutional investors typically exclude companies linked to tar sands; thermal coal; controversial weapons; and tobacco, as well as companies failing to uphold good governance principles. We have applied these exclusions in our study, using historical data throughout the period.

Using the MSCI AC World as our starting benchmark, we have excluded the relevant companies and rescaled the remaining holdings in the portfolio with the same rescaling factor, ensuring an agnostic approach where no company is rescaled differently.

### These are the key findings:

- The performance effects of exclusions can vary considerably from year to year in terms of both size and direction.
- The impact of exclusions becomes more significant during periods of substantial events such as Covid-19, Russia's invasion of Ukraine and the artificial intelligence (AI) rally in financial markets.
- The performance effects of exclusions are mainly a result of pronounced sector tilts in the exclusion-adjusted portfolio compared to the benchmark. Most notably, the energy, industrials, and utilities sectors make up a smaller part of the exclusion-adjusted portfolio.
- Exclusions at times produce factor tilts towards factors such as Quality, Growth, and Momentum, which have historically often contributed to positive performance.



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## ANALYSIS

Our analysis shows that the effect of standard Nordic sustainability exclusions on a global equity portfolio varies from year to year, measured by the simulated performance of the exclusion-adjusted portfolio relative to the benchmark (MSCI AC World). The impact differs across the years in terms of both size and direction. While the exclusion-adjusted portfolio outperformed the benchmark in 2019, 2020, 2023 and 2024, it was outperformed by the benchmark in 2021, 2022. In 2021, the exclusion-adjusted portfolio and the benchmark achieved virtually the same returns (see Fig. 1). Overall, the exclusion-adjusted portfolio has outperformed the benchmark by more than 4% during the period from 2019 to 2024 (see Fig. 2). However, we should be mindful of the six-year time period used in this analysis. As it is a relatively short period, six years may not capture full market cycles, structural changes (such as regulation, macro policy, etc.), and longer-term trends, potentially leading to biased or incomplete conclusions.

The differences in returns between the two portfolios are primarily due to the fact that standard Nordic sustainability exclusions affect the sector composition in the exclusion-adjusted portfolio relative to the benchmark. Most notably, the energy, industrials, and utilities sectors make up a smaller part of the exclusion-adjusted portfolio relative to the benchmark as a consequence of exclusions of companies within these sectors. Hence, strong performance in these sectors could lead to underperformance of the exclusion-adjusted portfolio relative to the benchmark. Furthermore, the exposure to consumer staples and materials is slightly smaller relative to the benchmark.

Conversely, the exclusion-adjusted portfolio has a larger allocation to the other sectors – communication services, consumer discretionary, financials, health care, information technology, and real estate. Strong performance in these sectors could lead to outperformance of the exclusion-adjusted portfolio relative to the benchmark. Fig. 3 illustrates the sector tilt dynamics between the exclusion-adjusted portfolio vs benchmark.

### Substantial events impacted sector performance

The period from 2019 to 2024 was marked by several substantial events that, in some years, had a considerable impact on the performance of the exclusion-adjusted portfolio compared to the benchmark.

- 2020 was characterized by the global outbreak of Covid-19, which had significant effects on equity markets. These effects varied across sectors, generally benefiting the exclusion-adjusted portfolio which outperformed the benchmark by 1.85%. Information technology was the best-performing sector in 2020, while energy was the worst-performing sector, strongly affected by lower demand due to Covid-19's negative impact on economic growth.
- In 2022, the Russian invasion of Ukraine was the main reason for an underperformance of 1.61% relative to the benchmark: Firstly, the energy shock that followed the invasion meant a steep rise in energy prices and price volatility, which provided tailwinds for the energy and utilities sectors. Secondly, the invasion also prompted a strong demand for military equipment which subsequently benefited arms manufacturers, a part of the industrials sector.
- In 2023, AI emerged as a major theme in financial markets following the launch of ChatGPT by OpenAI. This heightened focus on AI significantly drove the performance of the information technology and communication services sectors, which were the top-performing sectors. In contrast, utilities exhibited the weakest performance among all sectors. With an outperformance of 1.27% relative to the benchmark in 2023, the exclusion-adjusted portfolio benefited from these developments. Strong performance for the information technology and communication services sectors has also contributed to the outperformance of 0.73% relative to the benchmark in 2024.

### FIGURE 1: YEAR-TO-YEAR EXCLUSION-ADJUSTED PORTFOLIO PERFORMANCE

Year-to-year simulated performance of the exclusion-adjusted portfolio relative to the benchmark (MSCI AC World) from 2019 to 2024. Simulated past performance is not a reliable indicator of future results that can be negative.

	2019	2020	2021	2022	2023	2024
Benchmark	29.22	6.31	27.52	-12.86	18.40	25.38
Exclusion-adjusted portfolio	29.73	8.16	27.44	-14.48	19.66	26.11
Total	0.51	1.85	-0.08	-1.61	1.27	0.73
Allocation (Sector)	0.17	0.89	-0.18	-0.63	0.44	-0.01
Selection (Sector)	0.34	0.96	0.11	-0.98	0.83	0.74
Allocation (Region)	-0.02	-0.02	0.06	-0.03	0.05	0.00
Selection (Region)	0.53	1.88	-0.13	-1.58	1.22	0.73
Currency	-0.08	0.14	-0.06	0.06	-0.03	0.01

Source: Factset.

In 2020, 2022, and 2023, the differences in returns between the exclusion-adjusted portfolio and the benchmark were significantly larger than the estimated deviation. An Estimated Tracking Error of 0,38 for the ESG excluded portfolio indicate a performance deviation in the range of +/-0,38% compared with the MSCI AC World. It is likely that the extraordinary events previously described have contributed to these larger-than-expected deviations.

#### The strengths and weaknesses of excluding specific companies

While the adjusted sector allocation of the exclusion-adjusted portfolio relative to the benchmark explains the majority of the return differences between the two portfolios, it is not the only determining factor. Stock selection across sectors also plays a crucial role.

The exclusion-adjusted portfolio tends to favour companies with higher ESG scores, as many companies with lower ESG scores are excluded from the portfolio. This may in periods lead to better-or worse-performance within individual sectors compared to the benchmark. In 2020, 2023, and 2024, stock selection within sectors

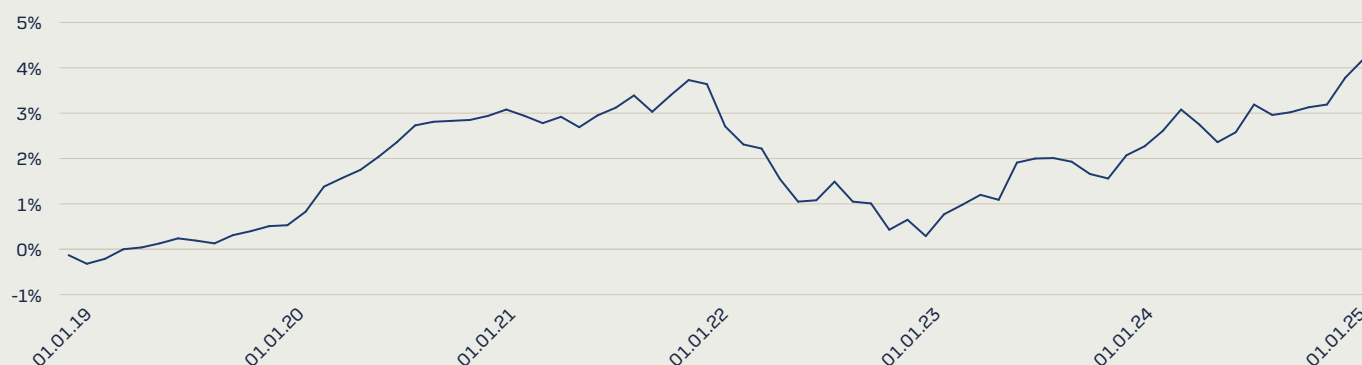
contributed positively to the outperformance of the exclusion-adjusted portfolio relative to the benchmark, while in 2022, stock selection contributed to underperformance relative to the benchmark (see Fig. 1). In addition, Fig. 3 highlights the tilts towards certain sectors of the exclusion-adjusted portfolio relative to the benchmark

There can be several reasons why stock selection within sectors leads to deviations in returns.

On one hand, companies with high-quality ESG profiles often perform well financially. Data for the exclusion-adjusted portfolio indicate that it is tilted towards several quality factors, such as return on equity (ROE) and net margin, relative to the benchmark (see Fig. 4). Historically, these quality factors often have "supported" strong performance. Similarly, the exclusion-adjusted portfolio is also tilted towards other factors such as Growth and Momentum, which, during recent years, have also often contributed to better performance. Therefore, tilting a portfolio towards these higher-quality ESG companies, rather than lower-quality ones, might be beneficial.

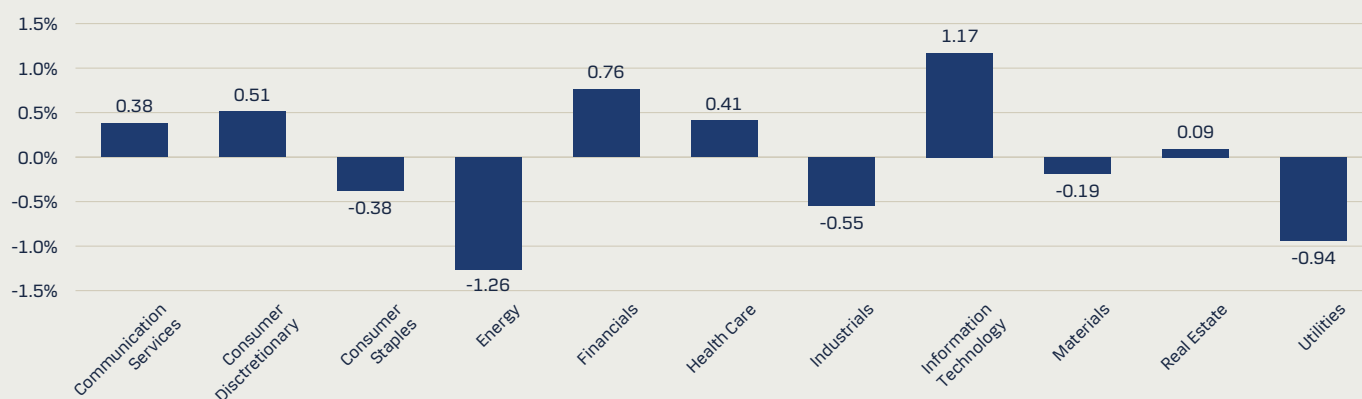
**FIGURE 2: ACCUMULATED EXCLUSION-ADJUSTED PORTFOLIO PERFORMANCE**

Accumulated simulated outperformance of the exclusion-adjusted portfolio relative to the benchmark (MSCI AC World) from 2019 to 2024. Simulated past performance is not a reliable indicator of future results that can be negative.



Source: Factset, as per 31.12.2024.

**FIGURE 3: SECTOR TILTS IN THE EXCLUSION-ADJUSTED PORTFOLIO COMPARED TO BENCHMARK**



Source: Factset, as per 31.12.2024.

On the other hand, excluded companies might offer higher expected returns because investors demand compensation for their exposure to lower-quality ESG companies. Furthermore, exclusions can lead to less efficient diversification. A smaller investment universe entails greater (unsystematic) risk. Particularly in sectors or sub-sectors dominated by a few large players, exclusions can result in a significant concentration of risk.

As one might expect, the outperformance of the exclusion-adjusted portfolio has also come with higher risk, measured in terms of volatility. The annualized volatility of this portfolio has been slightly higher compared to the benchmark: 13.43 for the exclusion-adjusted portfolio versus 13.28 for the benchmark portfolio.

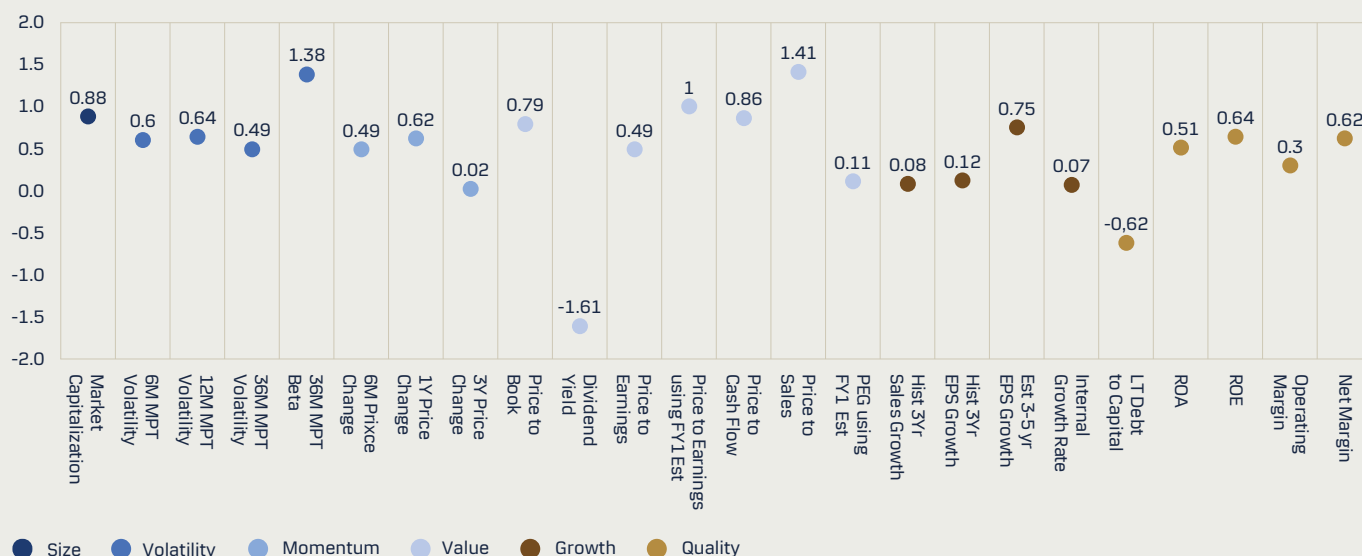
#### Limited effect from adjusted regional allocation

It is also worth briefly commenting on regional exposures, even though the adjusted regional allocation of the exclusion-adjusted portfolio relative to the benchmark has had a limited effect on the return differences between the two portfolios (see Fig. 1).

In the exclusion-adjusted portfolio, we observe a slight bias towards certain markets compared to the benchmark, most notably in countries such as France, Japan, Switzerland, and Taiwan (see Fig. 5). Conversely, Canada, for example, is the most significant underweight in the exclusion-adjusted portfolio due to the exclusion of companies engaged in oil extraction from tar sands.

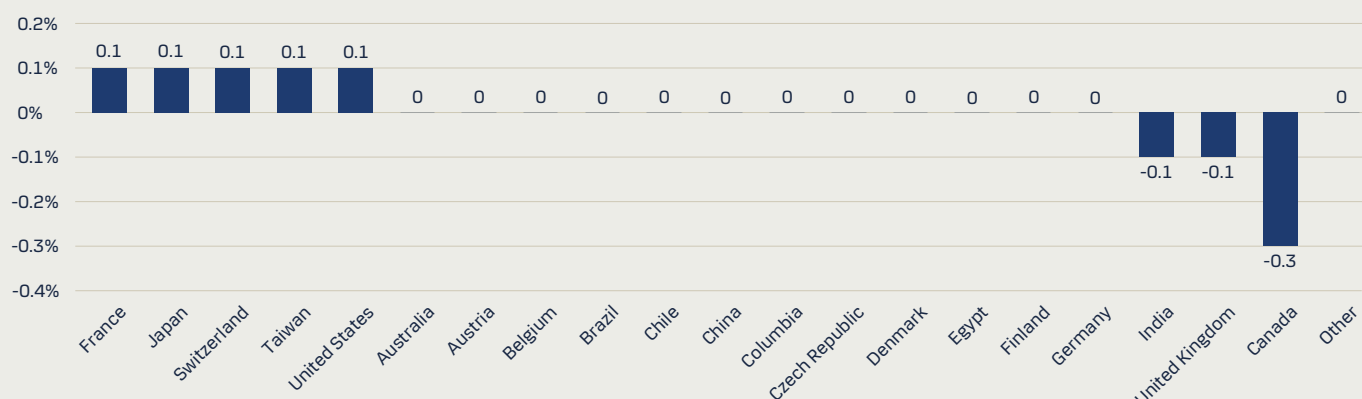
**FIGURE 4: CHARACTERISTICS TILTS IN EXCLUSION-ADJUSTED PORTFOLIO COMPARED TO BENCHMARK**

The Characteristics Tilt illustrates whether there is a significant deviation of a particular style factor compared to the benchmark. The larger the value, the more the portfolio values differ from the benchmark.



Source: Factset, as per 31.12.2024.

**FIGURE 5: COUNTRY OVERWEIGHTS/UNDERWEIGHTS IN EXCLUSION-ADJUSTED PORTFOLIO COMPARED TO BENCHMARK**



Source: Factset, as per 31.12.2024.



## CONCLUSION

As initially mentioned in this paper, the use of exclusions in portfolios is a “hotly” debated topic. The key question is whether exclusions positively or negatively impact the performance of an equity portfolio.

Our analysis shows that basic standard sustainability exclusions do not invariably result in lower or higher returns. Therefore, investors should be aware that these exclusions can lead to notable deviations from the benchmark – both positively and negatively. Furthermore, it is important to note there are certain limitations in using short periods, as this may lead to cyclical biases or disproportionately affect outcomes due to one-off events. A possible extension to this analysis would be to use a longer-term horizon and incorporate certain mitigation approaches, such as a sensitivity analysis across longer historical data.

Major international events and trends can significantly impact the performance of the exclusion-adjusted portfolio relative to the benchmark. This is largely because the exclusions lead to a slightly different sector allocation in the exclusion-adjusted portfolio compared to the benchmark portfolio. Furthermore, the exclusions lead to a slightly different stock selection – among other things, the exclusions can unintentionally tilt a portfolio towards certain factors that may be beneficial for investors.



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