

## Social Responsible Investment Comes Of Age

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### A historic date

History may record the 3rd July 2000 as a momentous day in the evolution of investment management in the UK. From that date all UK private sector pension funds will be legally obliged to consider socially responsible investment (sri) and voting rights as part of their overall investment policy. (New regulations are currently being drafted which will apply similar obligations to public sector pension funds.) This has come about by a regulation issued under section 35 of the 1995 Pensions Act, which provides a statutory obligation for all pension funds to have a Statement of Investment Principles (SIP). These statements must cover the types of investment, the balance between investments, risk, return and realisations. The new regulation requires all trustees to add the following two considerations to their fund's SIP:

- i. 'The extent (if at all) to which social, environmental or ethical considerations are taken into account by trustees in the selection, retention, and realisation of investments; and
- ii. the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments.'

At first sight these clauses do not look particularly dramatic. It is important to stress that pension funds are *not* being forced to invest along sri lines; the new rules simply oblige them to consider it and disclose their policy about it. However, this appears a major watershed in the evolution of investment management even from a global viewpoint. Socially responsible investment has become a major force for change in the US, as will be shown later, and is growing rapidly in Canada, Australia, and from a low base in Europe. Yet to the best of my knowledge the new measure is the first time that any government anywhere in the world has obliged pension funds to consider environmental and social factors in their investment policy.

It is worth repeating that the regulation is about consideration and disclosure, not about compulsion. However, it seems likely that it will cause rapid growth in the proportion of pension funds which consider socially responsible investment to be a normal part of their investment strategy. Similar shifts occurred in the attitude of most pension funds to investment in emerging markets around 1990, or to venture capital in the early 1980s. The point being that the regulation provides a vehicle for scheme members to translate their increasing awareness and interest in social investment into investment policy.

Up to now pension fund trustees and their professional advisers have been able to resist growing pressure for their funds to invest along sri lines on the grounds that this contravenes the requirements of fiduciary duty. However, the Government's imposition of the new regulation gives an implicit suggestion that this cannot be true, otherwise the Government would be forcing pension funds to consider potentially unlawful acts. In other words, the 3rd July 2000 will see socially responsible investment *come of age* as it moves from fringe to mainstream in the investment community. (Older texts tended to use the phrase 'ethical investment', rather than 'socially responsible investment'; for the purposes of this article I shall treat them as being identical in meaning.)

### **Growing public awareness**

My aim here is to put on record the process which led to this significant development. One of main forces underlying the Government's new initiative is easy to identify: popularity. This regulation was first mooted by the Pensions Minister John Denham in a speech to the UK Social Investment Forum (UKSIF) AGM in July 1998. His speech included the following:

'As a politician I am interested in what people think about ethical and green issues. There have been a number of surveys over the years. In 1996 analysis of regular Mori polls identified that 41% of British adults qualified as "green consumers". In the same year Ogilvy and Mather reported that 67% of adults consider a company's ethical stance when buying a product. The EIRIS survey last year showed that over 70% of those interviewed wanted their pension scheme assets invested ethically.'

Denham was referring to an opinion poll carried out by NOP for the ethical investment research service EIRIS in September 1997. 44% of the 700 adults questioned stated that their pension scheme should operate an ethical policy if that could be done without any reduction in financial return. Interestingly, a further 29% of the sample argued for their pension scheme to adopt ethical policies even if this led to reduced returns, making 73% wanting ethical pensions. (19% of the survey thought that pension schemes should ignore ethics and concentrate on financial return, while 8% didn't know.) Following a Government reshuffle in 1998 Denham was succeeded as Pensions Minister by Stephen Timms. When he introduced the new sri regulations in Parliament on 1st July 1999 Timms followed a similar line of argument:

'There is undoubtedly a significant groundswell of public interest in socially responsible investment. Ordinary people want to know what is being done with the money invested on their behalf.'

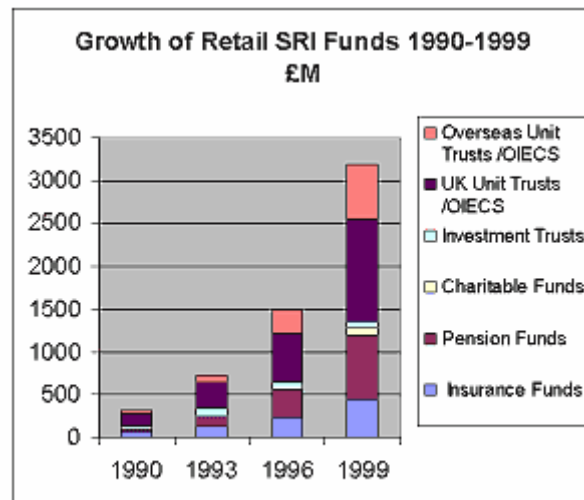
The campaign *Ethics for USS* is a good example of the pressure brought to bear by scheme members on a large pension fund. The Universities Superannuation Scheme (USS) is one of the largest pension schemes in the UK, with £22bn in assets. *Ethics for USS* was set up in 1998 to persuade USS to adopt a comprehensive ethical and environmental investment policy. The campaign was supported by 3,500 individual members as well as the Association of University Teachers, and seems to have been

successful. USS is now recruiting two sri advisers: 'to assist with the formulation of socially responsible policies and to engage effectively with companies to promote socially responsible policies that will be of benefit to USS's membership'.

### Rapid growth in ethical unit trusts

The most visible sign of public interest in sri is probably the continuing strong growth in the number and size of socially responsible funds available to the public. This includes unit trusts and OIECS and related pension and insurance funds. In 1994 *Professional Investor* published an article 'The Rewards of Virtue' in which I demonstrated the rapid growth of ethical unit trusts in their first ten years of life, following the launch of Friends Provident Stewardship in June 1984. (This article has just been reprinted in *Double Takes*, by John Wiley & Sons).

'The Rewards of Virtue' showed that the universe of retail ethical funds was doubling in size every three years. Despite its much larger size, the industry is still demonstrating the same extraordinary growth rate, as shown by the chart below:



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To summarise the data:

Year	1990	1993	1996	1999
Total £m	321	728	1480	3197
Total Funds	30	41	45	60

There are a couple of points arising from the chart that I would like to highlight. The first is the growth in general fund products such as OEICs and exempt unit trusts aimed at the charity market. This sector did not exist in 1990 or 1993, and was minuscule in 1996, but reached £106m by the end of 1999. The second is the actual decline in ethical and green investment trusts, which showed little growth from 1993, and actually shrank in 1999 when one 'green' trust reorganised itself to become a general fund. Lastly, that the period 1998-1999 saw sri product launches by many of the heavyweight names of the UK insurance industry: Legal & General; Norwich Union; Scottish Amicable; Sun Life, and Standard Life. Many of these new funds are therefore relatively immature and may be expected to see significant growth over the next few years.

This is, in fact, a highly attractive sector of the financial services market to be in. Surveys repeatedly show investors in ethical unit trusts as consisting largely of professionals with above-average financial status. (Some data suggests a gender bias, with a distinct preponderance of women, but this is less certain.) In fact, the growth in retail sri products is hardly surprising. The last twenty years has seen a steady erosion of public support for political parties and the established churches, combined with continued growth in support for environmental and social campaigning groups such as Greenpeace, Friends of the Earth, and Amnesty International. Retail ethical funds offer a vehicle for supporters of such groups to ensure that their investments mirror the values that they feel are crucial.

### **The road to the new regulation**

While the growing popularity of sri may have prompted the Government to act, the conventional wisdom among most pension advisers argued against it for superannuation funds. Ethical investment was seen by the pensions industry as based upon a high level of negative exclusion, leading to poor returns and thereby falling foul of the rules on fiduciary duty. The new Labour Government's plans for social security reform meant a lot of challenges for the DSS (the parent department of the pensions ministry). Nevertheless, plans for pension funds to be able to consider ethical investment were high up the political agenda. According to one civil servant who worked on the measure:

'We started work on the project in October 1997, and after discussions with lawyers and pensions consultants, we reported back that it was impossible. Financial returns on ethical unit trusts were described as sub-optimal- which ruled them out under the Scargill case. However the Minister was not satisfied with this answer, and instructed us to look further.'

The legal reference is to the classic judgement in trust law which places severe restrictions on the extent to which pension trusts may adopt non-financial objectives in their financial policy. However, *Cowan vs Scargill* took place in 1984. Many leading law firms (Simmons & Simmons; Herbert Smith; Linklaters & Paines) have gone on record in recent times to express their view that the 'climate of legal opinion' regarding the ability of pension funds to consider social and environmental factors has 'moved on' since the Scargill case. According to Charles Scanlon of Simmons & Simmons:

'Pension scheme trustees need not feel constrained by trust law to ignore ethical investment. On the contrary, provided that they take into account only the legally relevant considerations, trustees can fairly regard an ethical investment policy as a modern expression of the traditional principles of trust law'.

In fact the 1993 Goode Committee report on pension funds which led to the 1995 Pension Act made a clear statement of the rights of pension funds to consider socially responsible investment:

' As trustees they are perfectly entitled to have a policy on ethical investment and to pursue that policy, as long as they treat the interests of the beneficiaries as paramount and the investment policy is consistent with the standards of care and prudence required by law. This means that they are free to avoid certain kinds of prudent investment which they consider the scheme members would consider objectionable, so long as they make equally advantageous elsewhere'

Nevertheless, while legal thinking may have moved on, the Government new measure faced considerable opposition from many established players within the pension consulting/ investment management community. The public face of this opposition was probably the National Association of Pension Funds, led by its Director-General Ann Robinson. In June 1999, shortly before the new Regulation was due to be put before Parliament, the NAPF warned:

'An artificial restriction on the investment strategy of pension fund trustees could have a major detrimental effect on important sectors of British industry....it is quite likely that some pension funds will say "I don't like tobacco, I don't like drinks, and I don't like aerospace". This could be very bad for UK plc.'

The regulation was passed on the 1st July 1999. The DSS reassured the NAPF that the new regulation was about disclosure and consideration, not compulsion. The *Financial Times* subsequently reported that: 'Pension funds yesterday reversed opposition to rules requiring disclosure of their ethical and environmental stance...the NAPF withdrew a stark warning...that the regulations could damage share prices and the British economy'.

### **Pensions ministry climbed a steep learning curve**

The pensions ministry carried out a considerable amount of consultation before the regulation was passed, and they seem to have climbed up a steep learning curve whilst developing the sri disclosure policy. The term 'ethical investment' was dropped: 'we came to the conclusion that the phrase "ethical investment" came with too much negative baggage, and switched to "socially responsible investment" instead'. A clause about voting rights was added.

It is clear that ministers and their officials also turned their attention from retail unit trusts, in Denham's words : 'relying heavily on relatively simplistic negative techniques', to finding examples of a more sophisticated approach better suited to pension funds.

(They were pleased to discover that church investors such as the Central Finance Board of the Methodist Church had a track record of successful institutional fund management whilst using sri constraints.) Denham's original speech saw the basic sri approach for pension funds as that of a 'tie-breaker', i.e. something allowing a choice to be made between two otherwise equal potential investments. By the time Timms introduced the regulation, the government's thinking had moved on. He stressed the role of pension funds to 'engage' in dialogue with company managements on social and environmental issues, and to assert them through the use of their voting rights.

### **Joined-up Government**

Reviewing this regulatory process I have been struck by how keenly the Government pursued this aim despite a crowded legislative agenda and in the teeth of some negative publicity. It should also be noted that reshuffles at the DSS meant that three ministers (John Denham; Stephen Timms; Jeff Rooker) have been in charge of pensions over the last two years, yet the sri policy has been consistently supported. Does this not suggest that this policy objective had the blessing, and probably the active support, of the highest level of government? Socially responsible investment dovetails naturally with Tony Blair's statement that:

'It is surely time (that) we shift the emphasis in corporate ethos from a company being a mere vehicle to be traded, bought and sold as a commodity, towards a vision of the company as a community or partnership in which each employee has a stake, and where a company's responsibilities are more clearly delineated.'

In any case, I suspect that this measure will be listed among the genuine achievements of the Blair Government when the history books are written. Socially responsible investment also fits naturally into the Government's overall policy towards corporate social responsibility and the environment. It therefore reflects what the Prime Minister has described as 'joined-up Government', i.e. that all parts of Government should adopt a consistent set of attitudes and policies. Examples include: the major review of company law, which is due to report in 2001; the announcement in April 2000 of the appointment of a minister for corporate social responsibility, and the DETR's commitment to sustainability by encouraging all local authorities to adopt the principles of Local Agenda 21. In a recent speech the new Pensions Minister Jeff Rooker stated that while the Department of Social Security drafted the new SRI pensions regulation:

'the inclusion of a requirement to state policy on the exercise of (voting) rights is there because the DTI (Department of Trade and Industry) wanted to move that issue forward but didn't have a legislative vehicle of its own available- an example of "joined-up Government" '.

Lastly, the new regulation also fits the bill as part of the Government's desire to increase transparency and disclosure. In Stephen Timms' words:

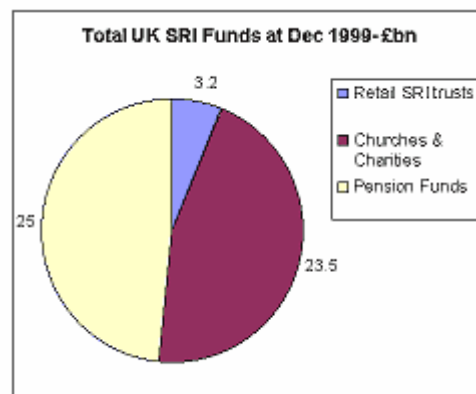
'We, as a Government, look to the future with confidence. It is clear that many companies and those who invest in them, including pension funds, can reap substantial benefits from meeting market and consumer demands for greater transparency, greater democracy. Increasingly, people do want to know how their savings are being applied- it is wholly reasonable that they should do so, and our proposal will make it possible.'

## The Future

One commentator, Barchester Green Investment has forecast that the *retail* market for sri products could reach £10bn by 2003. That figure seems a little high, but a continuation of the recent growth rate would see a figure of £7.5bn by December 2002. Perhaps the most interesting question is the extent to which the *institutional* market for pension and charity sri funds develops. At the moment public perception of socially responsible investment is still dominated by the public awareness of retail ethical products with a strongly negative, exclusionary bias. This is not surprising, given that these products are sold directly to the public and thereby receive a considerable amount of media attention.

However, it does seem helpful to make a clear distinction between such ethical unit trusts and institutional funds operating a sri policy within a framework of fiduciary duty. The main purpose of ethical unit trusts as I see it is to allow as many people as possible to invest in shares without being involved in some activity they detest, within a pooled fund offering the benefits of some diversification, and at a reasonable cost. Return is a secondary factor, as investors in such funds are willing to accept a performance penalty. For pension and charity funds, the primary aim is quite distinct, to generate good investment returns within a sri framework.

It is also worth noting that despite all the attention they get, retail funds only account for a small proportion of the £51.7bn total of sri funds invested in the UK. The chart below shows that at the end of 1999 retail ethical funds accounted for less than 10% of all UK sri funds under management. The figure for pension funds would have been much greater if I had included recent developments such as the £22bn USS scheme, and the £29bn BT Pension Scheme's adoption of a sri policy.



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The UK often follows the example of the US in social matters. There the total universe of sri funds grew 82% from 1997 to \$2,159bn (£1,380bn) in 1999, which amounted to 13% of all funds under management. A civil servant who worked on the new regulation has little doubt about the eventual outcome:

'You cannot take away knowledge. This measure will enable scheme members to push for their pension funds, those great capital engines of the financial markets, to actually get involved in social and environmental issues. I suspect that within three to five years it will be *unthinkable* for pension funds *not* to invest their funds in socially responsible ways.'