UKSIF

UNITED KINGDOM

KEY FEATURES OF SUSTAINABLE AND RESPONSIBLE INVESTMENT IN THE UK

The UK is widely acknowledged as a global leader in sustainable and responsible finance. Its dynamic cluster of sustainable and responsible investment expertise is spread across a range of institutions, including asset managers, investment consultants, investment banks and independent research houses. It was a pioneer in carbon trading and is now a key centre for the carbon markets.

In September 2010, 13% of the asset managers (57 of over 400 worldwide) and 16% of the professional service providers (26 of more than 150) among the signatories to the UN-backed Principles for Responsible Investment (PRI) were from the UK, as were 10% (22 from about 200) of the asset owner signatories.

In addition to UKSIF, the sustainable investment and finance association, globally significant responsible investment initiatives headquartered in the UK include the UN-backed Principles for Responsible Investment (PRI), the Carbon Disclosure Project (CDP), the Institutional Investors Group on Climate Change (IIGCC) and the Forest Footprint Disclosure Project (FFDP).

Key developments in 2010 include:

- The 10th anniversary of the introduction in the UK of the world's first regulation requiring disclosure by occupational pension funds of their policies on responsible investment. This UK leadership triggered similar initiatives from Scandinavia to Australia and was the first step towards today's wide acceptance of the value of long-term responsible ownership and investment approaches.
- The launch by the UK Financial Reporting Council of the world's first "Stewardship Code" on responsible asset ownership. Asset managers regulated by the UK's financial services regulator will be required to disclose whether or not they implement this principles-based 'comply or explain' code.
- National Ethical Investment Week, which raises awareness among private clients and values-based organisations, takes place for the third successive year. Now being replicated in both Europe and the United States, it was the world's first ever promotional week for sustainable and responsible investment when it was launched in 2008.

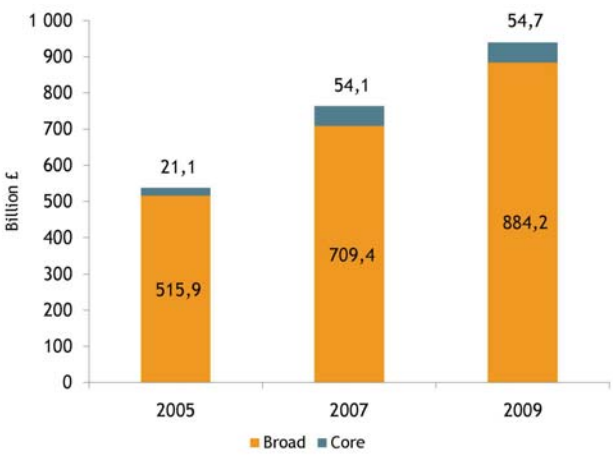
Building on the shocks of the financial crisis, UK public opinion has been shaken by a growing awareness of the financial implications of environmental risks. In particular, the impact on UK dividend income of BP's Gulf of Mexico oil spill has delivered a wake-up call.

Sustainable and Responsible Investment has developed and evolved in the UK in recent years for both institutional and private clients. Today's product and service innovation focuses on investing in solutions to environmental and social challenges or encouraging improved management of associated risks and opportunities.

This study found that the total of SRI AuM in the UK at end December 2009 was £938.9 billion (€1,043.3 billion) with £54.7 billion (€60.7 billion) defined as Core SRI and £884.2 billion (€982.5 billion) as Broad SRI.

Comparing these figures with the total assets managed in the UK by member firms of the UK's Investment Management Association, which remained broadly static at £3.4 trillion at end 2009 compared with end 2007, the 19% increase in total SRI AuM is a positive indication that despite the financial crisis, SRI continues to grow and develop.[1]

FIGURE 1: SRI market in the UK, in Pounds Sterling



Source: Eurosif European SRI Survey and UKSIF, 2010

Main Practices

SRI strategies in the UK may be grouped as:

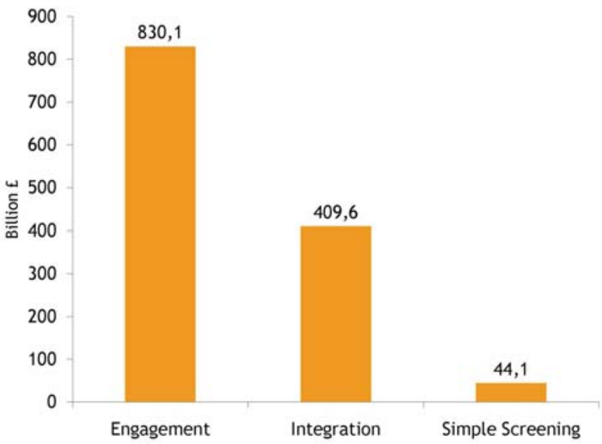
- **Responsible ownership**, where asset managers engage with companies about their ESG performance – voting shares, monitoring corporate behaviour and intervening where necessary. According to this study, £830.1 billion (€922.3 billion) in AuM in the UK are managed under an Engagement policy.

[1] *Investment Management Association Annual Surveys, http://www.investmentuk.org/statistics/fum_survey/default.asp.*

- **Integration** of Environmental, Social and Governance (ESG) issues into investment decision making to deliver improved financial returns. This integration is performed for investors looking purely for improved risk management or greater alpha. Integration is also combined with other SRI strategies to form part of the offer to values-based investors. This study found that in the UK, £409.6 billion (€455.1 billion) in AuM were considered subject to Integration.
- **Thematic investment propositions** based on sustainability themes such as healthy lifestyles or the transition to a low carbon economy. These thematic funds may cover multiple social and environmental issues or may address a more focused theme such as environmental solutions or climate change.
- **Positive or negative screening** to select companies with superior social and/or environmental performance or to avoid particular industries or activities.
- **Impact investing** is emerging as a further investment technique particularly for private and charitable investors. It focuses on investments like microfinance, community enterprise and other areas where the social or environmental impact of the investment is a benefit in its own right, independent of whether it is material to the desired financial return. This study did not gather data on what proportion of investments were classified in this way.

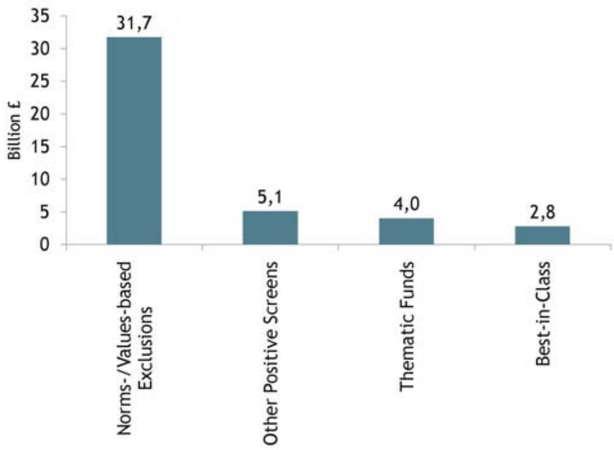
Investments are often subject to some mixture of these strategies. The funds subject to the various Broad SRI strategies are described in Figure 2, while the funds subject to Core SRI strategies are described in Figure 3.

FIGURE 2: Broad SRI strategies in the UK (in Pounds Sterling)



Source: Eurosif European SRI Survey and UKSIF, 2010

FIGURE 3: Core SRI strategies in the UK (in Pounds Sterling)



Source: Eurosif European SRI Survey and UKSIF, 2010

Who are the Main Investors?

Some **insurance companies, banks and asset managers** use integration and/or engagement on ESG issues across all relevant asset holdings to manage risk and enhance investment performance.[2]

Major **occupational pension funds** form a significant force within broad SRI in the UK. As described above, the UK provides some 22% of the asset owner signatories to PRI; most of these are pension funds. In 2009, UKSIF published its second bi-annual study of the Responsible Investment policies of the occupational pension funds of UK listed companies that are corporate responsibility leaders. This found that a group of Responsible Investment champions had started to emerge among pension fund trustees. In addition, those pension funds who had begun to implement Responsible Investment practices by 2007 continued to develop and deepen their activities.

High Net Worth Individuals and ultra high net worth individuals form a significant group within the UK SRI market. In general, their interest has focused particularly on thematic investment propositions. They are also the pioneers in impact investing. The 2010 Eurosif report on High Net Worth Individuals and Sustainable Investment considers this group in more detail.

Mass Market Individual Investors: £9.5 billion (€10.5 billion) was held in the UK's green and ethical retail funds (ie. funds available to the UK general public) at end 2009, according to EIRIS. These were held in approximately three quarters of a million accounts invested across nearly 100

[2] *Investment Management Association Annual Surveys, http://www.investmentuk.org/statistics/fum_survey/default.asp.*

funds.[3] Effectively all of this investment was in Core SRI although the totals do include a very small number of Broad SRI funds. In addition, some fund managers practice engagement on behalf of investments held in unscreened retail funds.

Church and Charity Investors: Church and charity investors remain the largest force in Core SRI within the UK. In recent years, pioneering UK charitable foundations have developed their interest in impact investing although the total charitable assets invested in this way remains small.

What do SRI Fund Managers and Service Providers Offer?

The SRI services provided by UK asset managers may be grouped as

SRI Service	Comments
Engagement on ESG issues to protect or enhance financial return.	This engagement takes place for: • AuM not managed using overtly SRI criteria (including assets managed by investment subsidiaries for their parent bank or insurance company and unscreened pooled funds not marketed as SRI) • SRI funds and discretionary portfolios • 'Engagement overlays' where an 'engagement only' mandate is awarded to a different provider from the asset management mandate
Investment services not necessarily marketed as SRI but which incorporate the integration of ESG issues to some degree.	See the Market Evolution section below for a discussion on the increased availability of financially-oriented ESG research.
Pooled SRI funds for charity investors, pension funds and other institutional investors.	For charity investors, these may be charity-specific funds approved by the Charity Commission (CIFs) or other pooled SRI funds.[4]
Pooled SRI funds for individual investors	Normally such funds either deliver a thematic investment proposition using sustainability themes or are positively and/or negatively screened. In additional to more broadly based options, funds available include 'environmental solutions' and 'climate change' funds. Engagement with companies may take place in addition to stock selection. Index funds are available and exchange traded funds are starting to be added. Funds are available across a range of asset classes. They feature in more than ten of the Investment Management Association (IMA) investment sectors. Fixed income funds and protected funds are among the options available.
Discretionary management services and segregated SRI mandates for institutional investors and high net worth individuals.	This includes SRI and impact investing support from wealth managers and family offices.

In addition, an increasing range of associated services are available including:

Provider	Service
Investment Consultants	Assessment of ESG-related competencies of asset managers for use by institutional asset owners
Investment Banks and Independent Research Houses	Financially oriented SRI research for use by asset managers.
Independent Financial Advisers and their support providers	Assessment of ESG features of green and ethical investment funds – particularly to assess suitability for values based investors rather than to assess ESG-related competencies in effective integration or engagement using material ESG criteria.

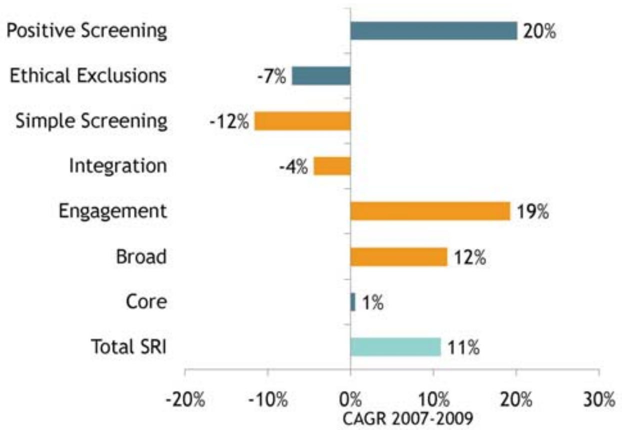
[3] *This policy may be subject to restrictions on grounds such as geography and size.*
[4] *EIRIS, 'UK ethical investment hits record high of £9.5 billion,' News Release, 1 June 2010.*

MARKET EVOLUTION

What is the Growth Rate of AuM?

The compound annual growth rate (CAGR) for Broad SRI was about 12%, measured in Pounds Sterling. In contrast, the total assets managed in the UK by member firms of the UK's Investment Management Association remained broadly static over the same period. Assets managed using Core SRI also remained broadly static, with this study finding a CAGR of about 1% as illustrated in Figure 4. It is most accurate to consider the UK growth rate in Pounds Sterling rather than in Euros so that the effect of exchange rate changes is excluded. The growth in Broad SRI can be largely attributed to a growth in engagement.

FIGURE 4: Growth in the UK SRI Market 2007-2009 (in Pounds Sterling)



Source: Eurosif European SRI Survey and UKSIF, 2010

What Lies Behind This? Have New Trends Emerged?

Global Leadership
The UK has seen increased leadership by Chief Executives of UK investment institutions and other senior city professionals (including fund managers and investment consultants) in championing SRI.

Following the financial crisis, there is a new openness to the limitations of current established valuation and market models. The barriers to SRI have much in common with the factors that led to the financial crisis. They include conflicts of interest, perverse incentives, lack of transparency and other dysfunctional practices within the investment chain.

The range of asset classes has developed, with innovation in fixed income and property particularly notable recently.

Non-SRI investors are now gaining exposure to ESG factors, such as climate change, because these are widely recognised as significant investment issues. The protection and management of natural resources (including forests, water and agricultural capacity) are joining low carbon emissions as key issues. Executive remuneration – while it has always been a concern - has become a very hot topic following the financial crisis and the recession.

Cross-party support has developed for a new UK Green Investment Bank to mobilise the investment needed to support the UK's transition to a low carbon economy.

Increased Capacity
The number of people working in the field continues to grow. The capacity within the sell-side and within major investment consultancies is particularly noteworthy.

One feature of the last two years has been the entry of major investment industry research providers into the market for Environmental, Social and Governance (ESG) research. This has been accompanied by consolidation among the specialist research providers. Bloomberg, MSCI and Thomson Reuters have all entered the market as a result of strategic acquisitions of specialist providers and/or building new internal capacity. EIRIS, the UK's first specialist Responsible Investment research house, remains independent and has developed into a globally recognised organisation. Research houses such as Trucost and other new entrants continue to grow and widen their offerings.

In spite of some shrinkage in the immediate aftermath, most buy-side Responsible Investment research teams remained in place during the financial crisis. While the crisis had significant impact on the sell-side, this was due to the wider contraction within investment banking. In general, Responsible Investment teams suffered less than some other research areas. In 2010, as headcount pressures ease, those investment banks that contracted are rebuilding their UK Responsible Investment research teams.

In one notable new trend, professionals are leaving large investment houses to set up boutiques specifically focused on Sustainable Investment, initially for high net worth clients.

UK Clients
Today, all major asset owners are being encouraged to demand responsible ownership practices from their asset

managers. The UK's new Stewardship Code is a key tool in that process. As a result, it becomes increasingly difficult and meaningless to measure assets subject to SRI practices, compared with those that are not. It is more meaningful to consider the depth of the practice but this is liable to be a qualitative rather than quantitative assessment. Dedicated teams within the major investment consultancies are likely to have an increasingly important role to play in assessing the market as it evolves.

As previously mentioned, UKSIF 2009 research found that a group of Responsible Investment champions had started to emerge among the pension fund trustees of the UK's corporate responsibility leaders and those corporate pension funds who had begun to implement Responsible Investment practices by 2007 continued to develop and deepen their activities.

A wide range of "non-traditional" individual investors are interested in SRI today. This includes younger entrepreneurs and those inheriting wealth. The typical modern green and ethical investment client of a non-specialist adviser will probably want to add some green and ethical exposure to an existing portfolio. This may be to diversify their investments, benefit from new themes or make a difference in the world while achieving their financial aims.

Since 2008, UKSIF has organised an annual "National Ethical Investment Week" to raise awareness and promote discussion of how a greater focus on Environmental, Social and Governance (ESG) issues in investment can help investors to grow and protect wealth and make a positive difference in the world at the same time. Research for National Ethical Investment Week 2009 found that this was not a minority concern. Half of investors were interested not just in making money but also in making a difference in the world through how they save and invest – so long as they can achieve both at the same time.

National Ethical Investment Week has achieved a country-wide reach in its first two years. In National Ethical Investment Week 2009, supporters organised 33 events in 16 towns and cities across the country, including receptions at the Westminster and Scottish parliaments. A national media campaign saw wide coverage in the personal finance and trade press.

MARKET PREDICTIONS

Responsible Investment is reaching a tipping point, both internationally and within the UK. It is now reasonable to assume that it will become the norm for major occupational pension funds, insurance companies and other significant investors worldwide by 2020. It is harder to predict the speed of movement over a shorter timescale like three years. Engagement and integration in particular will grow and the quality of how these techniques are implemented and managed will become a differentiating factor among asset managers. Diversity in both products and asset classes should also continue to develop. However, reaching this tipping point will require activity and commitment from major asset owners, governments and civil society.

The growing international demand for SRI is a significant opportunity for UK asset managers. As sovereign wealth funds and both institutional and retail clients internationally seek SRI solutions, the UK is well placed to respond.

For major UK asset owners, increased demand for Responsible Investment will take place against a backdrop of debate and change in the pensions settlement. Defined contribution pension solutions are likely to become the norm over that time and arguably there may be increasing changes to decision making about accumulated defined benefit assets. Over the next three years, it would not be surprising to see the oversight of investment management of defined benefit assets shift dramatically away from pension fund trustees as part of moves to cap deficits or insure against risks.

Also over the next three years, charitable foundations should continue to deepen their interest in aligning their investments with their mission although it is difficult to predict both whether progress will accelerate and the speed of its diffusion from the leading actors to become the norm for the sector.

An increasing number of private investors are likely to seek SRI options for part of their portfolios. This is likely to be driven by the changing priorities of both "baby boomers" moving towards retirement and the following generation entering their capital accumulation years. It should also be spurred by increased awareness and choice of Sustainable Investment propositions.

With new educational standards for financial advisers and a ban on commission for most products from 2012, private investors may receive advice on a wider range of investment options. On the other hand, some commentators believe that this change may focus advice towards the private investor's personal financial circumstances and limit the investment options recommended.

Within the UK, the coalition government seems likely to focus initially on three Responsible Investment priorities:

1. Encouraging responsible ownership through the Stewardship Code
2. Increasing investment flows to low carbon infrastructure in the UK and developing countries. This includes financing of energy efficiency, renewable energy, smart grid and sustainable transport. A new Green Investment Bank should play a key role in supporting this change.
3. Potentially capitalising social enterprises to deliver public service outcomes in health and social welfare.

In addition, regulators may encourage asset owners to increase their skills in "sustainability governance" so that good ownership and ESG integration practices drive investment mandates. We may also see greater demand for major pension funds to disclose publicly how their Responsible Investment strategies are implemented. Major new pension providers and public sector asset owners may shape industry and public opinion by becoming beacons for responsible ownership and investment.

Non-governmental organisations may build capacity and consumer support for understanding and challenging pension and insurance investment decisions. FairPensions, the NGO campaign, is just one example of this starting to happen.

Trade and professional associations may deepen their support for skills development in Responsible Investment and encourage greater debate on investment timescales and how investment can be aligned more closely with the public interest.

Looking forward, UK employers will be required from 2012 to enrol employees automatically into a pension fund. If corporate responsibility leaders and values-based organisations use this as an opportunity to offer excellent Responsible Investment choices for both default and optional defined contribution funds, this could provide the most significant driver of sustainably and responsibly managed personal investment assets over the coming years.

The data and text above is based on research and analysis conducted by UKSIF.