

# Investing Responsibly

How do I get started? – I need to know  
more than my clients do!

Which products offer an ethical option?

What issues do ethical funds cover?

I thought ethical investment was all about avoiding companies  
– what is 'engagement only' about?

**Performance**

– what do you mean it may not be an issue?

## A Technical Guide for Financial Advisers

## FOREWORD

We are delighted to introduce our *Technical Guide for Financial Advisers*. The guide should be read in conjunction with our leaflet '*Investing Responsibly: A Practical Introduction for Financial Advisers*' and two example '*Personal Ethical Fact Finds*', which together constitute our '**Responsible Investment Toolkit for Financial Advisers**'.

The UK Government has highlighted that climate change and development in Africa are two major issues of concern to first world nations and their citizens. So much so, that these issues will be key themes for the UK's presidencies of the G8 and European Union in 2005. The recent war in Iraq has been a cause for concern to many and stories of excessive pay-offs and bonuses for corporate executives have hit the headlines many times over the past few years. With 300+ responsible investment products now available to consumers in the UK, all these issues can now be integrated within a client's investment choices, helping them to feel more comfortable with their decisions – and hopefully with you as their adviser.

This business opportunity, combined with the recent inclusion of ethical investment modules in the CII and IFS exam syllabus (resulting from the FSSC Exam Review), indicates the sectors growing interest in this area.

The materials enclosed in this Responsible Investment Toolkit seek to de-mystify responsible investment to enable you to offer advice in this growing market.

To keep up to date with new developments in responsible investment and speak with advisers already offering responsible investment advice, you may wish to consider joining the UK Social Investment Forum ([www.uksif.org](http://www.uksif.org)) or the Ethical Investment Association ([www.ethicalinvestment.org.uk](http://www.ethicalinvestment.org.uk)), which runs regular training on responsible investment for IFAs. In addition, we would encourage you to continue to ask product and service providers to provide you with the information you require to take advantage of responsible investment business opportunities.

Paul Smee, then Director General of AIFA commended the toolkit to IFAs for our Guildhall launch in November 2004 and highlights several benefits of providing advice on responsible investment in his letter enclosed in this pack. We very much hope you will find it a useful resource and we look forward to your feedback.

*Penny Shepherd MBE*

*Chief Executive, UK Social Investment Forum  
June 2005*

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## AUTHORS

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## UKSIF's RETAIL COMMITTEE

We are also grateful to contributions, case studies and comments from other members of UKSIF's Retail Investment Committee. Members serve in their individual capacity and include:

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The full toolkit is available at [www.uksif.org](http://www.uksif.org). For hard copies of the toolkit, free training for IFA's or to provide feedback contact Helen Barnes, UKSIF's Retail Investment Project Manager – [helen.barnes@uksif.org](mailto:helen.barnes@uksif.org) or call +44 (0)20 7440 9718. Additional contacts and organisations are given at the end of this guide on p.22.

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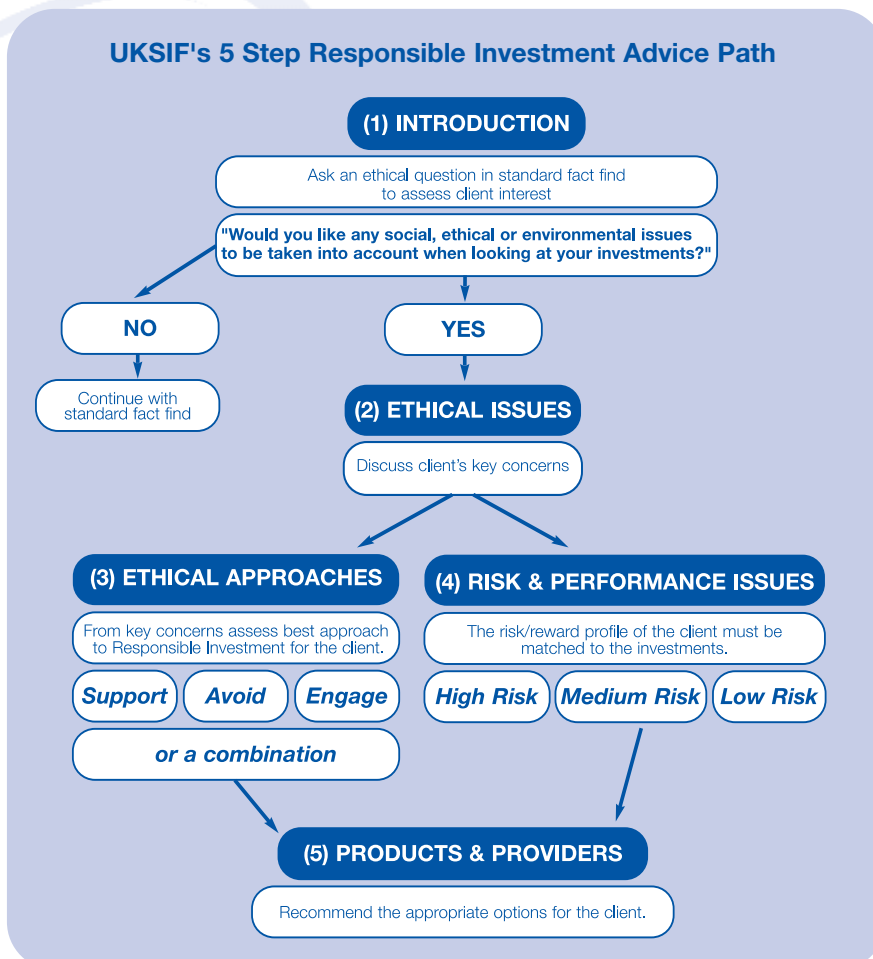
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## INTRODUCTION

### About this technical guide

*This technical guide seeks to explain why financial advisers should consider offering advice on responsible investment (incorporating ethical and socially responsible investment). It explains different responsible investment funds and provider approaches and aims to dispel the myths surrounding performance. In addition it seeks to help advisers to fact find clients and to indicate where further information can be found.*

*It is also our intention to help advisers to understand their clients' motivations, concerns and goals; to match these to product provider terminology; and to help advisers use this information to find an investment solution that makes good financial sense. We aim to help advisers to recognise that whilst a client's attitudes may be different from their own, that for most clients giving appropriate advice means taking such things into account – even if an adviser might not do so for their own investments.*

### What is responsible investment?

Responsible investment covers a wide range of investments that have some form of social, environmental or ethically responsible investment remit. For the purposes of this guide this is normally taken as being pooled equity investments unless stated otherwise.

Different approaches to responsible investment include screened investment funds - which typically include or exclude stocks on social, ethical or environmental grounds. There are also responsible engagement approaches, which use dialogue to influence the behaviour of investee companies and may apply across a fund manager's entire equity portfolio, which may include life, pension or other collective investments. The different approaches are discussed in Step 3. The diversity of options available means there is now a greater than ever range of solutions available for investors today.

### A brief history

From its roots in the religious movements which inspired Victorians concerned with issues such as temperance and fair employment conditions, responsible investment has rapidly grown in recent decades to become a powerful force for social change and now many financial services providers offer responsible investment funds.

At the beginning of the 1900s, the Methodist Church began investing in the stock market, consciously avoiding companies involved in alcohol and gambling. During the twentieth century, more churches, charities and individuals began to take account of ethical criteria when making investment choices.

The rise of responsible investment is also closely linked to major changes in society in the last twenty years. It follows the growth of key social movements such as the environment, human rights and animal welfare. Major economic trends, such as the increasing financial independence of women and young people; the growth of employment in the voluntary sector; the emerging power of multinationals, the diminishing power of democratic governments and a massive increase in share ownership by unit trusts, pension funds and insurance companies have all helped to drive responsible investment forward.

Initiatives for a UK ethical unit trust started in the 1970s and were finally realised in 1984, with the launch of the Friends Provident Stewardship fund. The Ethical Investment Research Service (EIRiS) had been set up the previous year by ethical investment enthusiasts wanting a common source of research on company activities. The formation of the UK Social Investment Forum (UKSIF) in 1991 brought together key figures across the full range of responsible investment to co-operate in sharing knowledge and advancing the agenda.

A growing number of people are now investing in funds both for financial return and to promote positive change in the world.

### Size of responsible investment market

According to the Investment Management Association ([www.investmentuk.org](http://www.investmentuk.org)), investment funds under management as at November 2004 stood at £268 billion. Of these, ethically screened retail funds account for about £4.2 billion i.e. just over 1.5% and include around half a million unit-holders (EIRiS 2003).

The total number of consumer retail funds in the UK stands at 1,968 (IMA, November 2004). There are around 62 screened responsible investment funds (EIRiS) but more than 300 products (Synaptic Systems 2005). The list in the Product and Providers chapter of this guide details product providers who are members of UKSIF. Other lists of responsible investment funds available can be obtained from sources such as EIRiS, Ethical Screening Ltd or Synaptic Systems.

In addition to screened retail responsible investment holdings, over £80 billion of UK equities held by UK occupation pension funds are subject to engagement undertaken by UK fund managers in line with the pension funds' SRI policies. On the supply-side almost £200 billion of UK equity holdings are subject to SRI engagement activities as part of the funds managers own SRI or corporate governance policy/guidelines, (including fund managers owned by insurance companies). (Eurosif 2003).

In the US, one out of every eight dollars under professional management was part of an ethical or socially responsible portfolio according to a 2003 report on socially responsible investing trends in the USA. The report found US\$2.16 trillion being managed by major investing institutions (including pensions funds, mutual fund families, foundations, religious organisations and community development financial institutions). This accounted for roughly 13% of the total \$16.3 trillion in investments assets under management in the US. See [www.socialinvest.org](http://www.socialinvest.org).

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## Key points from Introduction

- Responsible investment (incorporating ethical and socially responsible investment) seeks to integrate clients' values into the financial advice process.
  - Responsible investment is long established starting in Victorian times.
  - Responsible investment has both retail and institutional clients.
  - Responsible investment mainly relates to equity investments at present.
  - There are different approaches to responsible investment – see section 3.
- 

## STEP 1: GETTING STARTED

### 1.1 Ask an ethical fact find question

The first and most important aspect of starting to offer responsible investment advice is to use an ethical fact find question as part of your standard fact find.

There are numerous wordings that can apply, but one used by some advisers is:

*"Would you like any social, ethical or environmental issues to be taken into account when looking at your investments?"*

This chapter of the technical guide builds on the first section of *Investing Responsibly: A Practical Introduction for Financial Advisers* which highlights the above question. The aim of asking this question is to allow an adviser to decide whether or not they should look more closely at this subject with a client. However, before taking this step, advisers may like to consider the following reasons for starting to give advice on ethical or socially responsible investment.

### 1.2 Client demand

*Your clients want you to offer responsible investment*

There is much evidence of public interest, and therefore by implication the investing public, in social, ethical and environmental issues. For example, public opposition to recent international conflicts strongly indicates that many people care

about world issues and many are likely to be uncomfortable investing in armaments companies. In addition, with the current climate of investors campaigning against companies (e.g. against excessive executive remuneration) it may be considered strange that more people are not questioning how they can use their investments to influence companies.

### Case Study 1: Opportunities from media coverage of issues such as "Fat Cat" pay deals

An IFA amended his fact find to include a question asking whether clients would prefer an investment fund that voted against inappropriate executive remuneration. A surprising number of clients not interested in the traditional form of screened responsible investment, responded positively, perhaps because of the media coverage of shareholder revolts. The general consensus from this group of clients was that, whilst they did not wish to screen out companies on social, environmental and/or ethical grounds, they did want the fund managers to talk to companies to encourage better standards of corporate social responsibility, and to exercise their shareholder voting rights to vote against excessive pay deals. In the case of one particular client, the simple fact that the IFA enquired about this issue led to the introduction of friends and relatives too.

Research into public opinion indicates that advisers should be asking clients whether or not they wish to take account of any social, ethical or environmental issues in their investment decisions, for example:

- 65% of people said advisers should ask whether or not they are interested in investing ethically. Only 22% of people questioned said advisers should only mention it if a client requests it.<sup>1</sup>
- 92% of people questioned believe it is important that companies take social, ethical and environmental issues seriously.<sup>1</sup>
- 83% of the public believe financial services companies **should** encourage the companies they invest in to take social, ethical and environmental issues seriously. However only 8% of these people have ever received advice on responsible investment from a financial adviser.<sup>2</sup>
- 9 in 10 UK investors feel they have a duty to challenge both excessive, undeserved directors pay and other un-ethical company practices.<sup>3</sup>
- 78% of investors would like their investment company(s) to have policies related to ethical and environmental issues.<sup>3</sup>

#### *Missed opportunities*

Whilst it seems that the ethical consumer is more knowledgeable about the issues underlying their product choice than the standard consumer, illustrated by the growth in purchasing of Fairtrade products (Fairtrade has >18% of the UK roast & ground coffee market), they do not always transfer their knowledge to their investments. This suggests that advisers are missing opportunities to attract new clients and get closer to their existing clients.

#### *Can you spot the responsible investor?*

Who is the ethical or socially responsible investor? Opinions regarding who is a stereotypical ethical investor are not hard to come by. But, whilst it may be easy to recognise some of the people who are interested in this area, there is a growing recognition that it is not easy to spot everyone who could potentially be interested in responsible investment.

A survey<sup>4</sup> in 2003 found that there was no substantial age, sex, geographic or socio-economic differences between responsible investors and other investors.

We believe for an adviser not to offer responsible investment to their clients because they mainly deal with professional business

people in London or the North West for example is simply wide of the mark. Consider this perspective from an IFA in the business:

"The experience amongst advisers in the market is that although there are those clients that would fall into the "woolly jumper and sandals brigade", the majority of clients are normal, completely average people. They range from socio-economic As and Bs to Cs and Ds. The majority actually fall into the A and B categories. It is usually those in this group that have assets on which they seek independent advice."

*Perspective of an IFA from Gloucestershire*

#### **Case Study 2: You never know who will be interested – there's no harm in asking**

Evidence from an IFA who offers responsible investment advice: Following a presentation to accountants representing celebrities, a responsible investment specialist IFA was approached to advise one of the accountant's clients. The particular celebrity is a famous international female recording artist from the last few years. Responsible investment was something that the client had not considered before, but when asked whether it would be of interest she insisted on moving a significant proportion of her funds to be invested responsibly. Since the first move of funds, there has been a steady increase in the amount she invests responsibly. Importantly, the accountant broached the subject with his client before someone else did. Having done so, the client is extremely happy with the accountant and the accountant is very happy with the IFA – in a market where professional relationships regularly last no longer than a few months it's a win-win situation all round.

#### *Proportions of portfolio invested responsibly*

So how much of their portfolio do responsible investors invest responsibly? Results vary. Research by Friends Provident Stewardship revealed that contrary to common belief many do not invest all of their money ethically – the majority spread their investments like any other investor – in particular with regard to retaining earlier investments. The survey indicated that;

- 51% invested up to 25% ethically
- 20% invested 50% ethically
- 13% invested up to 75% ethically

Another study conducted in 1999 by Henderson Global Investors<sup>5</sup> discovered that just under half of its ethical investors held their entire portfolio in

<sup>1</sup>Source MORI / Friends Provident 10-15 June 2004

<sup>2</sup>Source NOP World/ Friends Provident between 1-3 August 2003

<sup>3</sup>Source NMG Research polled 674 investors mid November 2003

<sup>4</sup>Source NOP World/ Friends Provident between 1-3 August 2003

<sup>5</sup>Henderson Global Investors Ethical Fund Unitholder Questionnaire (1999)

ethical or socially responsible investment. It is possible that ethical and socially responsible investing is, for many investors, their first and perhaps only investment.

The more sophisticated an investor, the more aware they are that their investment portfolios should contain a spread of assets of all the types of investments available. Therefore, a certain level of conventional investment is undertaken to ensure portfolio diversification and to enable a higher degree of confidence that financial requirements will be met.

*Mackenzie and Lewis 1998*

#### *Helping your clients discover responsible investment*

The role of the financial adviser is to help individuals to find and understand what products and funds are most appropriate for them from a financial and a personal perspective.

Using a supermarket as a comparison - if a person would ordinarily prefer to buy Fairtrade coffee, organic fruit and vegetables or free-range eggs or meat for moral or values based reasons they are likely to be interested in ethical and socially responsible investment. But given that financial products are rather less easy to navigate than a supermarket shelf without the help of an adviser they are less likely to be knowledgeable about responsible investment.

In addition, given the magnitude and 'shelf life' of most investment decisions, finding the correct product is rather more important than buying groceries - and all the more likely to cause upset if the wrong decision is made.

An adviser's role is therefore to help clients through the financial services maze and help them to make decisions that are financially sound but still in line with their personal values.

"One in five respondents (22%) was **not** aware that most investment funds put their money into all types of companies irrespective of their social, ethical and environmental policies."

*NOP World Research 2003*

#### **1.3 Client relationships and fact finding**

In order to 'know your client' most advisers undertake some form of fact finding. Fact finding should enable an adviser to explore the client's personal objectives and concerns, and should include whether or not a client is interested in integrating social, environmental and/ or ethical concerns into their financial decisions. Although responsible investment funds may or may not be appropriate for a person's entire investment portfolio, engagement only funds, screened

corporate bond funds and ethical bank accounts go much of the way towards making a 'responsible investment' portfolio possible, so the area should not be ignored for lack of choice. Advisers who do not ask an ethical fact find question already might like to consider following:

- Does your current fact finding process tell you everything you need to know about your clients?
- Can you really give appropriate advice if you have not asked a client about their personal values?
- If you are competing with other advisers for a client, is there any downside to being the only one who asks an ethical fact find question (or what if you are the only one who doesn't)?
- How might your clients feel if they learn about responsible investment from a source other than you?
- If a client returns to you after six months saying the investment you sold them is inappropriate because they should have been offered a responsible investment fund - what will you say - or do?

#### **1.4 Business benefits**

As well as being of benefit to clients, for 'feel-good' or 'performance' related reasons, recommending responsible investment is considered by many to be of benefit to advisers also. The following paragraphs on the benefits of offering advice on responsible investments have been collected from advisers who are active in the responsible investment market.

##### *Protection against complaints*

Many people who have concerns about environmental or social issues have strong opinions. Unless an adviser asks about, recognises and notes a client's interest as part of the fact finding process he is unlikely to know that he is dealing with a person with such opinions and could risk giving inappropriate advice. A client's failure to request advice on responsible investment may not be indicative of their lack of interest. Clients that fall into this group may even move to specialist 'ethical' advisers once they find out that responsible investment exists. Although failure to ask an ethical fact find question is unlikely to trigger an immediate complaint, the fact such a question was not asked may lead to one further down the line. As interest in social, ethical and environmental issues increases the scope for complaints must therefore also be likely to increase. In this vein it is worth noting that the Financial Ombudsman Service has recently received training in this area.

##### *Improved relationship with existing clients*

If a client considers their adviser is taking into account their values and pro-actively taking an interest in them for more than just their money, they

are much more likely to want to do business with the adviser again.

The Consumer's Association recommends that everyone meet at least 3 IFAs before choosing the one that they want to work with. IFAs are unlikely to lose a client through mentioning responsible investment, but they may fail to gain the new client if they don't.

*Increased referrals and protection of client base*  
Clients are more likely to be happy with their investment if they are aligned more closely to the rest of their personal values. This regularly translates into increased referrals as well as good client retention.

"As part of my recommendations I have worked out how best to integrate your personal values as part of the solutions I am recommending in this report..."

*Excellent marketing opportunity*  
Affinity and niche marketing opportunities can be easily identified as most people who are interested in social, environmental and/or ethical issues are unaware of the existence of responsible investments.

*Safeguard against future changes*  
It is looking increasingly likely that future regulatory changes, particularly in the pensions market, may make an awareness of ethical and socially responsible investment a compliance factor. By identifying whether or not the issues behind ethical and socially responsible investment approaches are important to a client an adviser can seek to guard against such changes.

### **Case Study 3: Protecting against Future Regulation Changes**

An IFA active in group pension schemes was concerned that the requirement for a company pension scheme to have a Statement of Investment Principles (SIP), might in the future also apply to group personal pension plans (GPPPS). The SIP requires a scheme to declare the extent to which social, environmental or ethical considerations are taken into account in the managing of investments, and whether associated voting rights are used in this respect. The IFA's choice of pension provider therefore took account of the responsible investment options available under the scheme, and whether the provider had a track record of responsible share ownership. This meant that should the SIP be applied to GPPPS in the future, the IFA's corporate clients will NOT need to replace the existing scheme.

### *Improved product retention rates*

Responsible investors are more likely to be faithful to their investment and hold on to it through market downturns as they may have invested for more than simply performance reasons. As such ethical investors are widely believed to be more 'sticky' than other comparable investors.

### **Case Study 4: If you can't offer responsible investment advice your clients might go to someone who can!**

A client with over £200,000 accumulated in PEPs and ISA approached a specialist responsible investment IFA after hearing about responsible investment on the radio. None of their existing portfolio was invested ethically, the client had never asked for responsible investment and their IFA had never mentioned the option. The ethical IFA confirmed that whilst their existing holdings were in good funds with good companies, equally good investments could have been made in line with their ethical views. The result of the review was that all of their financial arrangements were moved to the ethical IFA, who transferred the investments onto an ethical / socially responsible investment footing. At 0.5% Fund Based Commission on >£200,000, the old IFA lost over £1000 of annual income. The client was not unhappy with the original IFA's advice or service. However, they were not prepared to stay with the original IFA, as they did not feel the IFA had offered advice suitable to their requirements.

## **1.5 The moral case for giving advice on responsible investment**

For advisers who specialise in this field the morality of asking at least one ethical fact find question to gauge whether or not a responsible investment approach may appeal to a client is important. If issues such as tobacco, armaments, nuclear power, animal testing, child labour and pollution are important to a person, why should they be ignored as part of their investment process? Is it right to expect a client to want profit at any cost? Quite possibly not. Many might also comment that share ownership can be every bit as influential to a company as the public's buying power and therefore all the more important to understand.

"No adviser can ever say that every single one of their clients has morals, ethics and values that are identical to their own. Recognising that there are differences here is an important step in completing the 'know your client' process. Rather than imposing your own views on clients you should take steps to find out what your clients think, and take that into consideration when giving advice."

*Ethical Investment Association member*

## 1.6 Other factors to consider

### *Performance reasons*

Performance issues are covered in more detail in the chapter on Risk & Performance in this guide. Whilst performance concerns are often cited, evidence from over 20 years indicates that these are unfounded.

**"Ethical funds have performed more or less on a par with their non-ethical equivalents"**

*Investment Management Association, Guide to Ethical Investment 2003.*

In addition there are a number of positive investment messages that underpin the various approaches to responsible investment. Example opinions include:

- Investors who consider the social, ethical and environmental (SEE) risks and opportunities that companies face could make higher returns from their investments, and, further more, that by encouraging companies to improve their corporate social responsibility (CSR) and sustainability, investors can add value to these companies and, in turn, to their investments. *"Sustainability Pays" Report, Co-operative Insurance Society 2002.*
- Responsible investment funds give investors the chance to get involved with emerging environmental technologies (such as solar power and fuel cells) at an early stage, before many conventional investment funds have identified the investment opportunity.
- Long termism – there is a growing understanding of the long term impacts of SEE issues on shareholder value. For example, pension funds are increasingly recognising that 'environmental' factors such as climate change will affect shareholder value over the long term. The Universities Superannuation Scheme, the UK's third largest occupational pension fund, has a team dedicated to identifying potential SEE risks and opportunities and work with their service providers to manage such concerns and better understand the likely impacts on their portfolio.

### *Pension rules*

There is currently no legal obligation for advisers to offer responsible investment advice or product providers to offer responsible investment.

However occupational and stakeholder pensions are required to have a 'Statement of Investment Principles' (SIP) which must be made available to members on request. The SIP must set out the schemes approach to ethical and socially responsible investment. Advisers should request SIPs from Stakeholder providers before recommending their products so they are able to advise on this aspect of the scheme for any interested or potential members.

The rules, which were originally an amendment to the 1995 Pensions Act, state that trustees of occupational pension funds are to disclose the following in their Statement of Investment Principles (SIPs):

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

Although the legislation did not oblige pension fund trustees to adopt socially responsible investment policies, it has increased their transparency on the issue. In particular, the regulation has fuelled the popularity of 'engagement only' approaches and added pressure on investors regarding the way they vote their shares.

### *Charities & Responsible Investment*

Responsible investment can help a charity to align their investments with their charitable objects. Charities may increasingly seek advice on responsible investment following recent clarifications in the law from the Charity Commission.

For trustees concerned that responsible investment could conflict with fiduciary duty, the Charity Commission states "Trustees are free to adopt any ethical investment policy which they reasonably believe will provide the best balance of risk and reward for their charity"<sup>6</sup>; and "trustees must have regard to the *suitability* to the trust of the investment to be made or being reviewed"<sup>7</sup>. They go on to state that *suitability* includes ethical considerations.

The Charity Commission recognises that an ethical investment policy may be entirely consistent with the fiduciary duty of maximising return on investment.

<sup>6</sup> [www.charity-commission.gov.uk/supportingcharities/cc14full.asp#24](http://www.charity-commission.gov.uk/supportingcharities/cc14full.asp#24)

<sup>7</sup> See OG 86 B1-8 February 2002 on the Trustee Act 2000

Furthermore, they outline three situations where trustees can allow an investment strategy to be governed by considerations other than pure investment return<sup>8</sup>:

- *Firstly, where investment in a particular type of business would conflict with the aims of the charity;*
- *Secondly, where certain investments might hamper its work by alienating supporters or beneficiaries;*
- *Thirdly, on moral grounds, provided that the trustees are satisfied that this would not involve "a risk of significant financial detriment".*

In line with pension fund disclosure, the amended Statement of Recommended Practice (SORP) 2005 for Accounting and Reporting by Charities states that charity trustees should explain as part of the financial review section of their annual report "where material investments are held, the investment policy and objectives, including the extent (if any) to which social, environmental or ethical considerations are taken into account"<sup>9</sup>.

For advisers providing advice to charity trustees we would suggest reading CC14, Section F and 'Investing Responsibly: A practical introduction for charity trustees', a recent joint publication with NCVO, EIRIS and UKSIF available at [www.eiris.org](http://www.eiris.org). The booklet explores current practices and suggests five steps for charity trustees considering a responsible investment policy.

#### *Financial Services Skills Council Exam Review*

The Financial Services Skills Council has published an exam syllabus, which includes responsible investment for the first time. Both the Chartered Insurance Institute CF2 and Institute of Financial Services CeFA exams now have modules on ethical investment. All new advisers will therefore have a basic knowledge about ethical investment and the provision of advice in this area.

#### *International Standard for the Competencies of a Personal Financial Planner*

At the end of 2005, financial advisers will be able to seek assessment against this standard. The draft standard presently requires financial advisers to ask clients when fact finding whether they want to consider ethical or socially responsible investment. The draft standard also requires the financial adviser to include a client's concerns on social, environmental and/or ethical issues in their analysis and evaluation of the client's status and the development of a financial plan. The client's concerns should also be borne in mind when the financial plan is reviewed periodically in the future.

<sup>8</sup>See CC14 - Investment of Charitable Funds - [www.charity-commission.gov.uk/supportingcharities/cc14full.asp#24](http://www.charity-commission.gov.uk/supportingcharities/cc14full.asp#24)  
<sup>9</sup>[www.charity-commission.gov.uk/publications/pdfs/sorp05text.pdf](http://www.charity-commission.gov.uk/publications/pdfs/sorp05text.pdf)

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## Key Points from "Getting Started"

- Ask an initial fact find question such as: "Would you like any social, ethical or environmental issues to be taken into account when looking at your investments?"
  - Interest in social, environmental and ethical issues is widespread amongst the public and it is inappropriate to attempt to 'stereotype' responsible investors.
  - An adviser's attitude to responsible investment may differ from that of his client. A key aim of this guide is to help advisers recognise this and to give advice that takes a client's values into account as well as their financial objectives.
  - Responsible investment provides an excellent marketing opportunity for advisers, but there is a need to recognise that clients views may differ from the advisers own. Appropriate advice means finding a solution that matches clients' needs and attitudes.
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## STEP 2: SOCIAL, ENVIRONMENTAL AND ETHICAL (SEE) ISSUES

This chapter builds on the second section of our leaflet *Investing Responsibly: A Practical Introduction for Financial Advisers* which suggests discussing a client's key concerns

In order to give advice on responsible investment an adviser must be aware of the different approaches and issues covered by different ethical funds. Different approaches are discussed in the next chapter. This section introduces many of the social, environmental and ethical issues that screened funds in particular tend to cover and therefore the kinds of concerns that can be matched to client attitudes.

### 2.1 Discussing the client's key SEE concerns

After establishing whether a client might be interested in responsible investment, it is important to discuss and identify the main issues they are interested in and to get a broad sense of their key concerns. These concerns may be different to the advisers own.

Finding out which issues are important to a client is an essential first step towards identifying which fund, product provider or approach (see Step 3) will suit a client's needs.

The client's concerns can be explored in an informal discussion or with the help of a more complex supplementary fact find, in addition to the adviser's standard fact find. Two supplementary ethical fact finds accompany this technical guide within the responsible investment toolkit. However, different advisers will find different approaches work for them. The discussions and fact finds will help to provide a transparent audit trail and documentation of your client's opinions. Taking time to discuss these issues with the client will also help the adviser build a strong relationship with them.

The discussions may or may not lead to a recommendation for a screened or engagement product solution for the client – dependent on other standard advice issues such as the availability of appropriate products or funds and how those issues impact on performance with reference to the client's risk profile. However, given the range of options available today a request to consider ethical issues is more likely to help the adviser to offer solutions that suits the client's needs more effectively than ever before.

### *Diversity of funds reflects different public opinions*

Ethical funds were created for people who were interested in more than the simply traditional financial aspects of investment. For example the first US fund had its roots in the anti Vietnam War movement in the 1970s. The first UK fund, Friends Provident Stewardship, initially focused on issues from the Quaker and Methodist faiths – such as the avoidance of alcohol, armaments, tobacco, pornography and a strong concern for social issues - notably business involvement in South Africa during the Apartheid years. The fund coupled these with a will to support companies which had a positive benefit to society so that the fund could be used to incentivise better practices.

Since then, the range of issues has broadened and deepened to meet the diverse needs of the investing public – though some client's requirements will be impossible to satisfy completely. Different approaches to different issues have also developed and are discussed further in section 3.

Some of the key social, environmental and ethical issues are outlined in Table 1.

Two supplementary ethical fact finds accompany this technical guide within the responsible investment toolkit. Available at [www.uksif.org](http://www.uksif.org).

**Table 1:**  
**Examples of social, environmental and ethical fund criteria**

Social	Environmental	Ethical
Access to Medicines	Air & Water Pollution	Alcohol
Bribery & Corruption	Biodiversity	Animal Testing & Fur
Child Labour	Climate Change	Gambling
Community Giving	Energy	Genetic Engineering
Community Initiatives	Environmental Management	Human Rights
Conflict	Mining & Quarrying	Military
Corporate Governance	Nuclear Power	Nuclear Power
Equal Opportunities	Ozone-Depleting Chemicals	Pornography & Adult Entertainment
Health & Safety	Pesticides	Repressive Regimes
Human Rights	Transport	Tobacco
Labour Standards	Tropical Hardwood	
Supply Chain Management	Waste & Toxic	
	Chemical Management	
	Water Management	

**Table 2: Example client attitudes**

	<b>Example of client concern</b>	<b>Example of client concern</b>	<b>Example of client concern</b>	<b>Example of client concern</b>
<b>Environmental Pollution</b>  (focusing on oil and gas companies)	"I don't want to invest in any oil and gas companies. Climate change horrifies me and I want to avoid contributing to the problem where possible".	"I want to invest in the 'better' oil and gas companies, because we can't just switch away from fossil fuels overnight - so I'm happy making money from those that really take environmental issues seriously".	"I want to invest with an investment provider that is trying to make oil and gas companies more 'environmentally friendly', but don't really care which ones are in my fund".	"I'm more worried about the way oil companies are involved in countries that have poor human rights records - to be honest..."
<b>Tobacco / Alcohol</b>  (production, sale and marketing issues)	"I'd like to avoid any company involved in production of such products, but am not too bothered about companies that 'retail' them - so long as it is not a big part of their business".	"I have a real bee in my bonnet about tobacco companies and people who sell cigarettes - all too often to children. I don't want anything to do with them, they cost the NHS a fortune..."	"Alcohol and Tobacco are 'personal choice issues'. People can make their own minds up - live and let...live. I'm quite happy to invest in them."	"What I'd like to see is someone who is dealing with the serious issues such as irresponsible marketing to children, selling alcopops for example is really not on...is it?"
<b>Armaments</b>  (from aircraft sales to national defence).	"The arms industry is also known as 'defence', and this is the way I see it...why should I worry about investing in companies that allow us to defend ourselves?"	"I'm only really bothered about companies that make strategic military weapons, planes, ships etc . Building barracks and the like is going too far for me – and are not a problem."	"I would like to see someone addressing the issues of sale of aircraft etc to oppressive regimes, but otherwise it doesn't bother me..."	"Any involvement -from selling food, water or electricity right up to the production of weapons of mass destruction are all 'out'. I don't want to invest in any companies with any military involvement at all."
<b>Pharmaceutical</b>  (focusing on animal testing issues)	"It's not that I'm not bothered about animals, I just put people first. Some testing is required by law and until that changes companies can't do anything different than have their products tested on animals."	"I love animals, if a company tests on animals or gets others to do tests for them I don't want anything to do with them."	"I am keen to invest in pharmaceutical companies, my brother had a serious illness and is only alive today because of the drugs he was given – and they will have been tested on animals."	Animals – who cares? I want to see these companies starting to be more responsive to issues like access to medicines in poor countries. I would invest in any fund that concentrated on getting companies to 'do the right thing'."

**2.2 Degrees of Support or Avoidance**

Within each of these issues it is also possible to cover different areas in different ways and to different degrees. A fund or strategy may focus, for example, on either what a company actually does, or makes – or the way it operates namely the 'way' it does things. Different investors may favour different approaches in line with their diverse concerns, and in some cases client concerns may not be able to be met.

**2.3 Useful information – terminology and methods vary; Transparency is key**

Terminology and methods vary. Product providers publish marketing and other material to set out which areas are covered by the approach or approaches they offer and the degree to which they screen, either positively or negatively for an issue. Some also publish detailed policy statements that set out their approach to various

issues and their rationale for doing what they do. It is important to remember that no one set of issues, or approach is 'correct', as no one has a monopoly on ethical standards. In addition, be aware that issues change within investee companies (a company whose shares are held by a fund), in particular when mergers or acquisitions take place. This leads some providers to err on the side of caution in marketing literature and the use of words like 'seek to / aim to...' this may not however be an indication of the seriousness with which a provider views an issue.

In most cases the more important issue is transparency of information about what the fund does so that a client understands what they are buying. Two Eurosif initiatives, the 'Transparency Guidelines for Retail SRI Funds', and the pilot 'Transparency Guidelines for Engagement and Voting' are working with some of the leading

European socially responsible investment (SRI) fund providers to improve standards in this area ([www.eurosif.org](http://www.eurosif.org)). The aim of both projects is to encourage retail and institutional responsible investment providers to be more open about what they do and how they do it. This will help advisers and clients to be able to compare products more easily and understand what is available; so that a solution can be found that

matches a client's needs as closely as possible. As ever the role of the adviser is to match the client's needs to the most appropriate product solution – and ethical issues may or may not be a deciding factor, but should in any event be taken into account.

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## Key Points from "Social, Environmental and Ethical (SEE) Issues"

- Advisers should take time to get a broad sense of their clients concerns to establish what approach would be most suitable to them.
  - Different funds cover different issues – some specialise in particular areas.
  - There is no perfect formula for which issues should be considered, or to what extent.
  - A supplementary ethical fact find questionnaire can help identify investors SEE concerns to assist product selection (two are provided in the UKSIF toolkit).
  - There are no rights and wrongs; more important is transparency of information from product and fund providers (see Transparency Guidelines for Retail SRI Funds at [www.eurosif.org](http://www.eurosif.org)).
  - Different investors have different concerns, and clients' opinions may differ from the adviser's own. The investors personal values should lead the debate and the search for an appropriate solution.
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### STEP 3: DIFFERENT APPROACHES: SUPPORT, AVOID, ENGAGE

This chapter refers to step 3 in our leaflet Investing Responsibly: A Practical Introduction for Financial Advisers.

Having identified the key social, environmental and ethical issues that are of concern to a client, the suggested next step is to work out the best approach to responsible investment that will best suit the need of the client. We break these down into three main approaches.

#### 3.1 Three main approaches

In addition to covering a diverse range of issues different funds or fund management houses and product providers employ different approaches or 'tactics' that aim to meet the needs of their respective investor bases and/or target markets. The following is a break down of the main types of responsible investment approaches as described in marketing material. Many funds combine all three approaches (support, avoid and engage), others only one or two. Product provider literature should make it clear which of the three approaches apply to which of its products or funds. This information should be clearly set out in a provider's marketing material as is encouraged by the Eurosif Transparency Guidelines for Retail SRI Funds (see [www.eurosif.org](http://www.eurosif.org)).

##### *Avoidance or negative screening*

The most commonly recognised form of responsible investment is avoidance or negative screening.

- This approach involves avoiding companies, or industries that do not meet the social, environmental or ethical standards by which the fund is run.
- Most funds, for example, will not invest in tobacco, alcohol or armaments production.
- The degree to which an industry or a particular behaviour is avoided may vary from fund to fund (e.g. allow 3%, 5% or 10% of turnover) and may or may not follow the stances outlined by research agencies or other commentators.
- Companies may be excluded by virtue of the industry they are in (e.g. financial services, mining, making or selling pornographic material), or by virtue of the way they do things (poor relations with suppliers or employees, pollution related convictions, offensive advertising). Although there is a degree of commonality, different funds will consider different issues and exclude companies in accordance with their own policies.
- There is no single, correct approach to any issue. Approaches may vary between very strictly 'anti', to having no concern about a given issue. However where there is a wide public consensus about an issue, the approach adopted by different funds may be very similar.
- Exclusion criteria should be published by fund or product providers and should reflect how the fund is run in practice, in particular stock selection.

### *Support or positive screening*

An often less visible approach is positive screening, which seeks to invest in those companies with a commitment to responsible business practices, positive products and/or services. Many of the issues here are in common with the above points, but broadly –

- This approach can manifest itself in a number of ways.
- Funds may want to support companies that sell positive products - for example educational materials, safety products, products for the renewable energy sector or products that are essential necessities of life such as food, clothing, electricity, water or housing.
- Funds may favour companies with positive policies and practices (perhaps irrespective of what the company actually does) - such as good equal opportunities, supply chain management, environmental management practices or community involvement and charitable giving.
- Approaches and their impact on stock selection vary, but a notable variation is themed or thematic investment, where a fund might major on a particular 'positive' industry to the exclusion of all others – for example a fund that focuses on environmental technology.

### *Engagement, dialogue and shareholder activism*

Historically there has always been a degree of dialogue between ethical funds and investee companies. However the activity levels have increased substantially over recent years, to the extent that it is now offered as a 'stand alone' product by some providers and fund managers.

- Engagement may be separate to, or in combination with, screening. It may apply to screened and unscreened funds.
- Engagement may apply across a product provider's entire equity portfolio and therefore apply automatically, no matter what fund is purchased from that company.
- Engagement entails using rights relating to share ownership as a means to encourage more responsible business standards.
- Engagement only funds may not always be branded or marketed as ethical investments.
- In instances where a fund manager is committed to engagement with companies on behalf of all their equity assets, they may not specifically highlight this for all their retail funds under management.
- Normally this is carried out only when there is a business case for change – largely because if there was no business benefit a company would not comply.
- Engagement itself does not normally alter stock selection and mainly takes the form of

dialogue, negotiation and gentle persuasion. This is often conducted away from the public eye, although voting at AGMs and EGMs, and in extreme cases using the media to 'shame' a company is becoming increasingly common.

- Engagement is less prolific across non-equity holdings, but sometimes applies to bonds and property investments.
- Different fund managers engage on different issues, sometimes operating unilaterally and sometimes in collaboration with other fund managers (e.g. through the Institutional Investors Group on Climate Change - see [www.iigcc.org](http://www.iigcc.org)).
- The issues covered tend to be less contentious than some screening issues. Example issues include: climate change; access to essential medicines; inappropriate executive remuneration; labour standards; and bribery and corruption.
- Engagement is increasingly being adopted by pension funds.

### **3.2 Approaches in practice**

Many screened funds combine all three approaches (support, avoid and engage), others only one or two. An engagement only fund will apply the third approach only. Different providers will commit different levels of resources to these areas and have different views on their respective levels of importance.

Generally, the issues within screened ethical funds are fairly static, because funds have their existing client base to keep happy. However, some policies may change over time as the fund manager seeks to stay up to date with what is happening in the world e.g. new policies may have been developed in relation to GMO's; and funds will have removed any screens relating to apartheid in South Africa. Engagement programmes tend to be more fluid, changing as issues in the news and of concern to fund managers change. An engagement only fund should not therefore be sold on the basis of engagement on a particular issue unless the fund manager has agreed to continue that engagement on an ongoing basis.

Further information on the application of screening and engagement should be available from the product providers website or from research providers including EIRiS ([www.EIRiS.org](http://www.EIRiS.org)) and Ethical Screening Ltd ([www.ethicalscreening.co.uk](http://www.ethicalscreening.co.uk)).

### **3.3 An investor's perspective – useful terminology**

Considering avoid, support and engage from the view-point of the investor the following terminology may be more appropriate:

1. Investors attracted to a **'conscience decision'** – this represents the original responsible investor. The main motivation of these investors is to ensure that wherever they invest, they must not have holdings in companies involved in activities they do not approve of such as animal experimentation or armaments, or other areas in accordance with their religious beliefs. Some investors are conscience investors on single issues such as tobacco whilst others will have a range of issues or dislikes - but their main motivation is to avoid the issues that concern them.
2. Investors attracted to the idea of supportive or **'themed investing'** - namely investing in sectors that seek to combine financial rewards with support for themed business or services – such as finding commercial solutions to issues like climate change or in companies who provide basic human necessities e.g. healthcare.
3. Investors attracted to the idea of **'responsible corporations'**. They are typically more interested in promoting corporate accountability. They like Corporate Social Responsibility (CSR) practices and want to see visibility on these issues. Their primary motivation is to challenge the excesses of big business and they want to see institutions use engagement or voting shares as a force for change.

### 3.4 Other investment options

#### *Cause based investments*

Responsible investment isn't always confined to shares traded on the stock exchanges. Many investors may prefer to back individual projects or causes. Over £186 million (2002) is invested in the UK in cause-based investments. The sector is currently dominated by authorised financial institutions such as Triodos Bank and the Ecology Building Society, although it also includes ethical companies who raise money directly from stakeholders. To find out more about this area please see [www.eiris.org](http://www.eiris.org).

#### *Community development finance and Community Investment Tax Relief*

Community development finance is the term given to the range of approaches taken by community development finance institutions (CDFI's) to develop and create wealth in disadvantaged communities and under-invested markets. CDFIs are sustainable independent financial institutions that provide capital and support to individuals and/or organisations, which cannot get mainstream finance. They seek to help social enterprise create local jobs, develop services and reverse downward spirals of under-investment in under-served communities. Community Investment Tax Relief (CITR) is a tax

incentive for investment into accredited CDFI's. The CITR reduces the investor's income tax (or corporation tax) liability. The relief is worth up to 25% of the money invested, spread over five years (5% a year) and is worth 8.33% gross pa for higher-rate taxpayers, 6.41% pa for standard-rate taxpayers, and 7.14% pa for main-rate corporation tax payers. Financial returns are mainly provided via tax relief, but they can also be complemented by interest from the CDFI, such as Charity Bank which offers interest up to 2%pa. By investing in the CDFI sector, investors can gain a good return and know their money is being used directly to achieve social gains. For more information see [www.cfda.org.uk](http://www.cfda.org.uk).

#### *Venture capital*

This area provides long-term, committed share capital to help unquoted companies grow and succeed. Venture capitalists invest in shares of private companies, often at a very early stage, providing the equity finance necessary to enable the business to grow rapidly. Unlike loans, venture capital is provided in exchange for a stake in the company and as shareholders the investors' returns are dependent on the growth and profitability of the business. For further information on this type of investment please see [www.uksif.org](http://www.uksif.org) and [www.susten8.com](http://www.susten8.com)

#### *Ethical banking*

Several banks are making increasing efforts to act as responsible businesses and some have recognised the impact of who they offer their finance and banking services to - and under what conditions.

Some of the larger banks are signed up to a UK initiative backed by the Department of Trade and Industry and the British Bankers Association; the Forge Group. They work on Corporate Social Responsibility guidance for the financial services sector. Barclays, HBOS and Royal Bank of Scotland are working with the FORGE principles to promote good CSR practice within the financial services industry as well as implementing the principles themselves. For more information on this see [www.abi.org/forge](http://www.abi.org/forge). Recognised leaders in the ethical banking area include The Co-operative Bank, which gives customers a say in how their money is used and encourages their input into its Ethical Policy. Other organisations with established reputations in this area include the Ecology Building Society, Triodos Bank and Unity Trust Bank.

Banks are increasingly aware of the social and environmental impact of their lending activities, particularly in the developing world, as banks have come under criticism for their involvement in certain projects, including the construction of dams for hydro-electric power for example. Many ethical issues, such as the environmental conduct of business customers, are now part of the

standard risk assessment. It is becoming increasingly common practice for banks to have established guidelines for their staff and customers on major ethical issues that arise during lending, such as Third World debt, the arms trade, human rights and oppressive regimes, environmental issues, and support for the community. A global initiative, the 'Equator Principles' is a framework for how banks can manage environmental and social issues in project financing. It has been signed up to by the HSBC, Royal Bank of Scotland and Barclays. For more information on this project see [www.equator-principles.com](http://www.equator-principles.com).

Banks are also increasingly recognising their responsibilities in improving financial literacy and facilitating access for excluded sectors of the community to appropriate financial products. Many banks have also improved their performance in community support, charitable giving and in managing the impact of their own operations on the environment.

Banks and buildings societies generally have a fairly good record in offering equal opportunities to employees, but they have come under recent scrutiny for outsourcing call centre work to India and other offshore locations and this may be an issue of concern to some of your clients.

#### *Child Trust Funds*

Access to screened funds and providers with active engagement and corporate governance policies is available to parents investing in CTF's. A list of CTF's with responsible investment options can be found on UKSIF's consumer website [www.investability.org](http://www.investability.org).

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### **Key Points from Ethical Approaches: Support, Avoid, Engage**

- A range of approaches exist to suit different needs. Those which are offered by life, pension and investment product providers break down into Support, Avoid or Engage.
  - Funds may employ only one approach or several.
  - 'Support' and 'Avoid' apply to specific funds and have an impact on where the fund can invest.
  - Engagement can apply to a specific fund or across a company's entire fund or product range. It does not normally alter stock selection and therefore might be more appropriate than screening for some clients.
  - Engagement only funds may not always be branded or marketed as ethical investments.
  - Different providers select different engagement priorities and the resources committed to engagement vary.
  - Transparency about all three ethical approaches is encouraged in the Eurosif Transparency Guidelines for Retail SRI Funds - see [www.eurosif.org](http://www.eurosif.org).
  - Advisers need to understand a client's motivations in order to match them to the solutions that are available.
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## STEP 4: RISK & PERFORMANCE ISSUES

This chapter relates to step 4 in our leaflet *Investing Responsibly: A Practical Introduction for Financial Advisers* covering risk and performance concerns.

Whilst risk and performance issues should be carefully considered with the client, as with all investment decisions, there is now a wide range of responsible investment options, including screened ethical funds and unscreened 'engagement only funds', available to suit different client needs.

Historically some advisers have had concerns about the performance of responsible investments relative to conventional funds. This has resulted from fears about the impact of reducing a fund manager's investment universe by excluding certain companies or industries through screening.

Firstly, advisers should be aware that the performance issues for screened and engagement only funds are quite different as funds adopting an engagement only approach are unlikely to make exclusions purely on SEE grounds. Secondly, with reference to screened funds, there are now over 60 screened ethical funds available, including trackers funds, some of which have more than two decades of performance history. In addition research from sources such as the Investment Management Association, has indicated that ethical and socially responsible investment funds have performed more or less on a par with their non-ethical equivalents.

Below, we outline the performance and risk issues in more detail for both screened and engagement funds separately. We hope the information will serve as useful guidance.

### 4.1 Screened funds

Although some similarities exist within screened responsible investment funds, for example a propensity to follow a growth bias, an adviser would be well advised to view with a degree of scepticism any attempt to generalise about the performance of responsible investment funds given a wide range of approaches and performance exists.

It is our view that a fund should be considered on individual merit and that it is more the combination of industry trends and fund manager skill that will dictate performance – as with other investments.

Another area cited by some as a reason for dismissing screened funds, is different sector

weightings relative to mainstream benchmarks. Yet screened funds are no different from other actively managed funds in this respect (extreme index huggers excluded). The degree to which a particular responsible investment approach will have a beneficial or a detrimental impact on performance will primarily lie with the skill of the fund manager and their team - and in particular their stock selection skills.

### 4.2 Reported research on performance of screened funds

- According to the Investment Management Association over the period 1993 - 2003, ethical and socially responsible investment funds **performed more or less on a par with their non-ethical equivalents.**
- The Daily Telegraph recently reported "Within the UK All Companies sector there are 19 [ethical] funds that have a three-year performance track record. Of these, **five are in the top 25 per cent of funds, while a further eight have produced above-average returns**". (Daily Telegraph, 4 May 2005).
- An independent report by WestLB Panmure in November 2002- 'More Gain than Pain' - commented that there was: **"No sign of a systematic performance disadvantage"** and: "Although the observation period is not long enough to be able to draw final conclusions, a simple performance comparison already shows that the frequently voiced hypothesis of a **systematic return disadvantage of socially responsible investment is clearly not supported by the present data.**"
- A CIS report Sustainability Pays in 2002 reviewed many studies of performance and concluded that **"the use of social, environmental and ethical screens does not impact negatively on share performance"**.
- Another performance study carried out by ABN Amro Asset Management in September 2001 found that responsible investment **"has generally not led to a long- run risk-adjusted under performance"**.
- "After controlling for investment style, we find **little evidence of significant differences in risk-adjusted returns between ethical and conventional funds for the 1990-2001 period.**" International Evidence on Ethical Mutual Fund Performance and Investment Style; Bauer, Koedijk, and Otten 2002 Winner of the Moskowitz prize for reporting on socially responsible investment.

- A comprehensive report by an analyst at UBS Warburg in 2001, showed that **returns are no more affected by an SRI style than for any actively managed fund driven by an investment style** (Chen; 2001, pp. 13-15). It is these active style and factor bets, which have determined the performance of such funds rather than any SRI logic per se. The report points out that most actively managed funds under-perform their passive benchmarks and SRI funds are no different in this respect (Chen; 2001, pp. 14).

### 4.3 Screening and Active Fund Management

#### *The Usual Story*

The conventional view is that ethical and socially responsible investment funds typically lead to sub-standard returns. The theory goes something like this:

'If a fund has a reduced investment universe, for example by excluding or being underweight in particular sectors, this will inevitably lead to underperformance when these sectors are 'in vogue'. This also increases tracking error and thus portfolio risk. Consequently responsible investment is a flawed investment approach with no foundation in mainstream portfolio construction disciplines. This suggests responsible investment is only for the 'ethical' investor and will forever be a niche investment market which 'mainstream' advisors can afford to ignore, unless they have ethical investors as clients.'

These arguments may be backed up by fund performance tables which show a basket of ethical or socially responsible investment funds which have underperformed a given benchmark or sector average. However enticing these arguments may appear, there is normally another study available which shows the opposite to be true. Performance tables can equally be used to show that responsible investment funds do produce returns in line with mainstream funds or a given benchmark. But this misses the point.

#### *Active Fund Management*

The key issue to concentrate on is active fund management. If an investor objects to responsible investment on the grounds that it is synonymous with screening, and they assume that removing companies from an investment choice leads to underperformance, then it is active fund management that they are really objecting to, not responsible investment. All active managers screen out stocks – for a variety of reasons - as this is the nature of active management. Markets are generally efficient, but it is possible to derive additional performance from taking active market bets, which is why investors pay more for active than passive management. All screened funds do

is to exclude, or favour, stocks based on long term environmental, social, ethical and corporate governance concerns – thereby reducing the risks, or maximising the benefits, associated with these areas. This leaves a fund manager with a group of stocks from which he can select his investments, and to which he can apply mainstream portfolio construction techniques, which is exactly what most screened fund managers do.

#### *Not a different Asset Class*

Some commentators mistakenly view responsible investment as a different asset class. This view, whilst attractive for its simplicity, is also misleading as there are almost as many different approaches to ethical funds as there are mainstream funds. Ethical funds invest in different asset types and offer different screening and/or engagement approaches. Any attempt to treat them as a homogenous group is misguided, as their strategies are too diverse to be comparable. Whilst they may differ from their mainstream counterparts these differences are less substantial than the differences between ethical funds (see 5.2). This is of course intentional, as providers of ethical funds aim to offer products that meet the needs of the widest possible range of investors.

***Like any other active investment management approach, success or failure depends upon the ability of the fund manager, the accuracy of the analyst's views, and the depth and breadth of resources of the fund management house overall.***

#### *The long term view*

The big advantage that responsible investment potentially provides (particularly if supported by an experienced team that is able to quantify the valuation impacts of long-term social, environmental and corporate governance concerns) is a longer-term view of trends that have typically been ignored by analysts in company valuations: Climate Change, Human Rights and Brand Value for example. In addition corporate governance is often integrated. When corporate collapses such as Parmalat, Enron, WorldCom and Ahold can have such a big economic impact, any additional information about the governance of the firm and its approach and management of social, environmental and ethical issues could provide invaluable insight.

#### *The perception of risk*

Screened equity responsible funds will tend to hold a larger proportion of shares in small to medium size companies and a smaller proportion in larger companies than their non ethical equity equivalents because the larger a company is the

more likely it is to breach screening criteria. This can make them perform differently from other funds. Although tracking error is likely to increase at least one EIRiS study has shown that responsible investment funds may have lower volatility.

#### *In Conclusion*

As with all equity funds, investment carries risks. Short term investment is normally regarded as undesirable and, investing for the medium to long term is a preferred approach. In practice, over the longer term performance is primarily a function of fund management skill, asset allocation, stock selection and risk control just like any other fund. However this is substantially different from saying that investing responsibly leads to poor performance.

#### **4.4 What to ask screened fund managers**

Further information an adviser may like to enquire about from screened ethical fund managers;

- What sectors are you substantially underweight in relative to your peers?

Typically this might include Defence, Oil and Gas, Pharmaceutical and perhaps Financial Services - respectively due to concerns about armaments manufacture, pollution and climate change, animal testing and support for activities that the fund aims to avoid. (Note - alternatively some ethical funds have exposure across almost all sectors as stocks are picked on a 'best of sector basis').

- What do you do to mitigate the impact of being underweight in a particular sector?

Typically a response might be that they aim to replace key sectors or stocks with often under researched smaller or medium sized companies which are likely to show similar performance characteristics - or by looking for stocks that are believed to be likely to give longer term out performance because of their positive attributes that may be widely unrecognised - such as emerging new technologies. Some funds may have benefited from having avoided some major collapses.

- If you are underweight relative to your mainstream peers in large cap stocks - how do you manage any disadvantage this might present?

A response might state that the medium to longer term impact has been - and may in future be - neutral as the performance of larger caps versus smaller caps tends to be cyclical.

In addition:

- Ask for a list of top ten holdings to gain an understanding of the depth of screening and how ethical criteria are applied by the fund managers.
- Consider the relative size of the sectors in which the fund is substantially underweight or overweight to gauge how important this position might be. Information regarding relative sizes of each sector is published in the Financial Times.
- Unscreened funds (e.g. with engagement remits) show no measurable performance impact as they do not exclude companies on social, environmental and/or ethical grounds alone.

Further information on these issues is available in published fund fact sheets and investment bulletins and through independent research and software providers.

#### **4.5 Engagement Only approaches and performance**

The issue of a restricted investment universe is less relevant for engagement only funds as engagement tends not to effect stock selection or alter portfolio allocation decisions. Engagement usually takes place with the stocks that are in the fund, rather than in advance of stock selection.

Using engagement, shareholders aim to behave like responsible owners of companies, to look to the longer term and encourage better business practices where it is believed to be to the benefit of all. An example of such a win-win situation is demonstrated by BP- see Case Study 5.

Improved corporate responsibility, supported by investor engagement, may result in company gains such as resource management, improved reputation, happier employees, an ability to attract and retain quality staff.

#### **Case Study 5: BP<sup>10</sup>**

One of the world's largest energy companies, BP looked into targeting reduced emissions back in 1998. They achieved this by integrating emissions caps into managers' performance targets, and by developing an internal carbon trading system that makes lowest cost reductions first, and encourages business units to seek out innovative strategies to cut emissions. The financial benefits of these actions have been a saving of US\$650 million over the three years to 2001, from an estimated outlay of US\$20 million. In addition to the financial benefits, BP has achieved a leadership position on emissions trading, strengthening relationships with policymakers.

*Source: The Climate Group 2004.*

<sup>10</sup>Quoted from 'A climate for change: A trustee's guide to understanding and addressing climate risk': a publication from the Carbon Trust & IIGCC, written by Mercer Investment Consulting

Dialogue and engagement with a company can also help inform fund manager opinions about the Directors, company strategy etc – all of which may be considered when valuing the potential of a company. Indeed, sell-side brokers at investment banks are increasingly researching social, environmental and ethical concerns to enable integration into their company analysis.

Engagement may highlight potential future issues to companies to encourage them to build and protect shareholder value over the long term. This approach may be employed by an occupational pension fund looking for growth over a 30-40 year time frame for example – a similar timescale to many individuals investing for retirement. Whilst the long-term nature of the relationship between responsible business practices and shareholder value can be complex – e.g. some issues may take many years to surface and it can be difficult understanding their likely impact on the bottom line - this should not be an excuse for fund managers or financial advisers to ignore or dismiss SEE concerns.

Many more fund managers now have engagement policies linked to their equity funds and exploring an engagement only approach may be more appropriate for some clients.

The IMA (Investment Management Association) conduct an annual survey on fund managers' engagement with companies<sup>11</sup>. For the year 2003-2004 they identified 34 fund managers, from their c.140 strong membership, who undertook engagement. The report highlighted that 21/34 firms published their engagement policies on their website and all bar one fund manager employed staff dedicated to responsible investment or corporate governance. The 34 firms represented 55% of UK equities managed in the UK, demonstrating that responsible investment practices are far from niche activities.

<sup>11</sup>Investment Management Association Survey of Fund Managers' Engagement with Companies June 2004

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## Key points from "Risk & Performance Issues"

- Risk and performance concerns are commonly overstated. All other issues being equal, the impact of screening is as likely to be positive as negative.
  - Fund manager skill is likely to be one of the most important factors in determining performance.
  - Screened funds – active fund managers are accustomed to managing a smaller investment universe as this is essentially how actively managed funds operate.
  - Advisers should seek information from fund providers regarding excluded sectors and stocks and ask how this is managed – in particular focus on sectors underweight and overweight and market capitalization / size of companies held in fund. This should help you to understand when performance will be stronger or weaker than unscreened funds.
  - Engagement only funds do not exclude stocks on social, environmental or ethical grounds.
  - Engagement encourages better business practices which seek to build shareholder value over the longer term.
  - Engagement and dialogue with a company should provide additional company information for fund managers.
-

## STEP 5: SELECTING PRODUCTS & PROVIDERS

This chapter refers to the fifth and final process-step in our leaflet *Investing Responsibly: A Practical Introduction for Financial Advisers* which should help you to recommend appropriate providers and product options for your client.

### 5.1 Provider issues: transparency and responsibility

For some clients considering the responsibility of the product provider will be just as important as looking at which companies are held in a particular fund – if not more important.

For such clients, issues such as whether a fund or product provider engages with companies (and if so their resources devoted to this) may be very important. They may also be interested in the product provider's own approach to corporate governance, corporate responsibility or voting practices. Furthermore, they may like to know whether a fund provider votes their shares at AGMs (Annual General Meetings) and EGMs (Extraordinary General Meetings) or whether they publish how they voted on issues such as board structure, directors pay or concerns that are making that month's headlines.

The amount of information a company publishes on these subjects (and others) varies greatly but there is a trend towards greater transparency and increasing activity across such areas. The level of activity, as well as their openness about what they do, or do not do, can be a useful indicator of their level of commitment to wider responsible investment related issues.

Information of this kind may be available from a company's website and should be easily accessible to advisers if available. Signatories to the Eurosif Transparency Guidelines for Retail SRI Funds are encouraged to disclose information on their responsible investment research processes, responsible investment criteria and the fund's approach to voting and engagement - see [www.eurosif.org](http://www.eurosif.org).

Opinions expressed by external commentators may be equally important indicators such as membership of FTSE4Good Index (quoted companies only), assessments made by Standard and Poors (e.g. regarding Corporate Governance), BiTC (Business in The Community) and others.

### 5.2 Responsible investment products & providers

A wide range of screened and unscreened equity funds are available today.

The following investment sectors have screened fund options:<sup>12</sup>

- Active Managed
- Balanced Managed
- Cautious Managed
- Europe ex UK
- Europe inc UK
- Friendly Societies
- Global Equities
- Global Growth
- Protected Growth
- Specialist (including property)
- Stockmarket Managed
- UK All Companies
- UK Corporate Bond
- UK Equity Income
- UK Other Bond

Unscreened funds with a responsible investment bias include options offered by product providers with across the board engagement strategies (although engagement is primarily equity orientated) and may cover all equity based investment sectors.

The following list is intended to help you identify UKSIF-member product providers who offer responsible investment products. Many UKSIF members offer screened equity-based Responsible Investment funds, including:

- Aberdeen Asset Management
- Aegon Asset Management
- Co-operative Insurance Society \* +
- Allchurches / Ecclesiastical Insurance Group
- Friends Provident / F&C Asset Management \* +
- Henderson Global Investors \* +
- HSBC (Amanah Fund)
- Impax Group
- Insight Investment \* +
- Jupiter Asset Management \*
- Legal & General Investment Management
- Norwich Union / Morley Fund Management \* +
- QUADRIS (sustainable forestry investments)
- Skandia
- Standard Life Assurance Company \*

Most of these funds are available as ISAs, and some of them are available through the provider's own, or a third party's, life and pensions platforms.

The providers marked \* are signatories to the Eurosif Transparency Guidelines for SRI Retail Funds, and those marked + are currently piloting Eurosif's Transparency Guidelines for Engagement & Voting (for further details about these EC-funded initiatives to encourage greater transparency see [www.eurosif.org](http://www.eurosif.org)).

In addition to some of the providers above, and the private banking subsidiaries of the main high street banks, UKSIF's private client banking and broking members can provide bespoke SRI portfolios for clients with sufficient funds:<sup>13</sup>

- Cazenove
- Gerrard
- Rathbones (incl Rathbone Greenbank Investments)
- Schroders +

<sup>12</sup>Source: Synaptic Systems, April 2005

<sup>13</sup>In 2004 Cazenove, Gerrard, Henderson, Jupiter and Rathbones provided detailed figures for UKSIF's first exercise to size the UK private client market for bespoke responsible investment portfolios: in total they managed £20bn of private client assets, of which £1.2bn (6%) was managed in bespoke responsible investment portfolios.

### 5.3 Further information on responsible investment products & providers

For further information about the above UKSIF member organisations please see UKSIF's membership directory at [www.uksif.org](http://www.uksif.org).

Additional fund information is also provided on the back page of IFA, Lee Coates' Personal Ethical Fact Find – also included in the Responsible Investment Toolkit.

Further information about approaches and products should be requested from providers. In addition, research tools, such as the Synaptic Systems ethical module which sits within their Fund Manager suite also gives further details and adviser orientated information sources may follow in due course. Detailed information regarding responsible investment approaches is also available from EIRIS and Ethical Screening Ltd, although these research providers do not integrate financial/product information.

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#### Key points from "Selecting Products & Providers"

- A substantial number of products integrating different approaches are available, offering a range of options for investors.
  - Provider 'issues' such as transparency and the way they run their own business, may be important to clients. Information on such issues should be available from product or fund providers.
  - A number of providers are signatories to the Eurosif Transparency Guidelines for Retail SRI Funds - see [www.eurosif.org](http://www.eurosif.org). Standardised disclosure of this information aids comparisons between funds or companies, thereby helping an adviser to match the right solution to the right client.
  - Software and research tools including responsible investment data can make product research and selection simpler.
- 

#### FURTHER INFORMATION: USEFUL ORGANISATIONS

##### UK Social Investment Forum

UKSIF is the UK's membership network for socially responsible investment (SRI). UKSIF's primary purpose is to promote and encourage the development and positive impact of SRI amongst UK based investors. UKSIF believes that all material social, environmental and ethical (SEE) issues should be integrated into standard investment practice and that individual investors should be able to reflect their values in their investments. [www.uksif.org](http://www.uksif.org).

##### Ethical Investment Association

The EIA is an association for independent financial advisers working in Ethical Investment. Membership offers quarterly training meetings to stay up to date on product and sector developments, reduced subscriptions to Ethical Performance magazine and access to ready made client marketing literature. [www.ethicalinvestment.org.uk](http://www.ethicalinvestment.org.uk)

##### Ethical Investment Research Service (EIRiS)

The Ethical Investment Research Service provides the independent research into corporate behaviour used by ethical investors to make informed decisions. Their website also has an extensive personal finance section detailing all the different products. [www.eiris.org](http://www.eiris.org).

##### Ethical Screening Ltd

Ethical Screening is a company of dedicated socially responsible investment specialists. They conduct detailed research and analysis into a wide range of corporate social responsibility issues, from human rights to environmental exploitation. [www.ethicalscreening.co.uk](http://www.ethicalscreening.co.uk).

##### Synaptic Systems Ltd

Synaptic Systems provide software solutions for financial advisers. Synaptic Systems has developed an ethical module within their Fund Manager tool. The system enables advisers to compare screening policies used by funds and providers' approaches to engagement. Advisers can create reports for clients, including performance graphs to compare funds against recognised indices or other funds. A supplementary questionnaire is provided with the module and is available within the UKSIF toolkit. [www.synaptic.co.uk](http://www.synaptic.co.uk)

##### Association of Independent Financial Advisers (AIFA)

AIFA is the trade association representing the IFA. They represent 70% of the IFA market. Recognised by regulators and the media as the focal point for finding out the views of IFAs, they help keep IFAs informed about developments which affect their business. [www.aifa.net](http://www.aifa.net).

##### Investment Management Association (IMA)

The Investment Management Association (the IMA) is a trade body for the UK's asset management industry. They publish a consumer leaflet on ethical investment as well as having ethical fund information on website. [www.investmentuk.org](http://www.investmentuk.org).

Invaluable support and/or funding for the Toolkit was provided by the following organisations;

- **Friends Provident**  
[www.friendsprovident.com/sri](http://www.friendsprovident.com/sri)
- **Co-operative Insurance Society**  
[www.cis.co.uk](http://www.cis.co.uk)
- **Henderson Global Investors**  
[www.henderson.com/sri](http://www.henderson.com/sri)
- **Insight Investment**  
[www.insightinvestment.com](http://www.insightinvestment.com)
- **Jupiter Asset Management**  
[www.jupiteronline.co.uk](http://www.jupiteronline.co.uk)
- **Morley Fund Management**  
[www.morleyfm.com/sri](http://www.morleyfm.com/sri)

Please also see these websites for further information on the funds and services they provide and the innovative work they are doing.

# Appendix 1

Whilst this guide discusses three key approaches - support, avoid and engage - other categorisations exist. Advisers should be aware of this and may find the different categorisations useful. We have included one example below from HSBC:

Name of approach	Description	Impact on environmental & social performance of company	Impact on financial performance of fund
<b>Status quo</b>	The status quo adopted by all conventional fund managers who claim to take envi and social considerations into account, in so far as they affect immediately the price of a company's shares.	As no specific effort is made to focus on the envi and social impacts of companies this approach has no impact on sustainable development (SD).	No different from conventional fund management.
<b>Ethical and Negative Screening</b>	The original approach to SRI, involving avoidance of companies undertaking 'unethical activities' such as armaments or tobacco manufacture, animal testing on cosmetics etc. Adopted by most retail funds but few institutional funds.	Contrary to the perceptions of many investors, ethical screening has a negligible influence on the envi or social performance of companies because, with under 1% of total money invested in the stock market, ethical screening funds can neither materially affect the price nor the liquidity of a company's shares.	While intuitively the exclusion of companies and sectors should have a negative impact on the performance or risk of a portfolio, in practice costs for this has often been found in the virtues of increased focus. As a result, over the long term ethical screening funds have neither under nor out performed the market materially.
<b>Best in Class/ Positive Screening</b>	'Best in class' involves investing only in companies that lead their peer groups in respect of envi and social performance. SRI indices fall into this category.	As with ethical screening this approach has limited impact on the price or liquidity of a company's shares. However, the Best in Class research process and the publication of any results or the creation of SRI indices often prompts companies to improve their policies and practices.	Although the ethical screening arguments broadly apply, BIC funds have additional claims to: <ul style="list-style-type: none"> <li>• Some of the performance benefits from focusing on envi tech stocks.</li> <li>• Uplift from any truth in the argument that sustainable mgmt is a proxy for good mgmt.</li> </ul>
<b>Environmental Technology Investment</b>	A specialist form of investment that invests in companies developing technologies to solve envi issues such as alternative energy and water treatment. In some instances the definition stretches to include envi services companies.	When applied to unquoted envi tech companies, this type of investment may provide otherwise unavailable access to capital for small companies and enhance the liquidity of their shares. However, it can have little impact on influencing the behaviour of quoted companies.	The investment rationale for envi tech investment lies in the growing market for technologies that solve envi problems. Benefiting from legislation but often volatile there is a clear investment case to be made for these specialist funds on financial grounds alone.
<b>Engagement / Advocacy</b>	Engagement is an approach that involves dialogue with company management to encourage them to improve the impact they have on the envi and/or society.	Effectively practiced engagement can have a significant impact on SD by actively sending messages from shareholders to company mgmt about the importance of sustainability issues.	Engagement is the preferred approach of institutional pension funds as it does not limit the universe of stocks available to fund managers.
<b>Integrated assessment</b>	An approach which involves "integrating envi, social and financial considerations into a holistic investment mgmt process". Although an ultimately 'sustainable' approach to investment, current legal and economic parameters mean that the approach is likely to remain theoretical for some time to come.	'Integrated assessment' would fundamentally raise the importance of envi and social issues in the management of companies.	The view that there is a correlation between strong envi/ social and strong financial performance is supported by some statistical evidence and more anecdotal evidence. However, as discussed elsewhere there are also compelling arguments against it.

(key: envi = environmental, SD = sustainable development, mgmt = management)



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