

Ethical Investing

- an introduction

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Businesses and other organisations operating within an economy, need capital to finance their activities. Investors supply that capital via the cash, bond, property and share markets. Having set an investment strategy by combining cash, bond, property and shares, to reflect the investor's liabilities, the traditional goal is to secure an appropriate financial return.

For some investors, having a focus that goes beyond the financial return and looks at the wider social or community impact, or the activity that is the source of the return, is also important. Having a social focus can be a way for investors to use their capital to obtain an appropriate financial return and to promote the ideas and values what are important to them. This is known as "ethical investing".

This naturally raises a range of questions - what does ethical investing mean? How is it implemented and does it reduce returns short-term, or long-term?

Market terminology

Within the industry there is a range of expressions adopted that are often inter-changed. For example, "socially responsible investing" (SRI), "responsible investing" (RI) or investing by reference to "environment, sustainability and governance" (ESG) considerations. Each involves ethics, social responsibility and future sustainability to different degrees. Each can mean different things to some people, but often cover similar concepts. In this article we will call this approach "ethical investing".

While "ethics" typically incorporate values, morality and human rights, responsibility will extend these factors to include how individuals and businesses act in the wider community (local or global) across a range of social issues. Sustainability, on the other hand, incorporates environmental and business sustainability, along with "good governance" practices.

While there has been a trend in some areas to define business sustainability and good governance as a "responsible investment" it is probably better to view these factors as sensible investment considerations and part of risk management, rather than ethical investment in the true sense. Would any investor wish to take on blindly, the risk of investing in a company with poor governance?

Investor definition

Having a clear understanding and agreement of the ethical objectives and standards is important, if an ethical approach is to be successfully adopted.

While individuals may have little difficulty in defining their personal beliefs and what is important to them, the same is not always clear cut for an organisation. There can be a significant difference between an individual investor's values and an organisation's, e.g. a trust, where a group of trustees (individuals) are making collective decisions for that trust and its principal purpose. Distinguishing between what trustees may do as individuals and what they should do, as trustees, is important.

What constitutes one person's values, is not necessarily the same as another's. This is true even if they have the same end goals. For example, one person might choose to invest in an alcohol manufacturing company that has a positive stance on promoting responsible drinking practices. Another might choose not to invest in that same company, because they oppose alcohol use at all levels. Both investors aim to reduce the adverse impact of alcohol abuse on the community.

"Ethical" investing integrates an investor's personal beliefs and values, with traditional financial and economic considerations, when making investment decisions. It does so by incorporating "belief" criteria into the buy/sell decision process. It shifts, from the single goal of "maximising the return for the level of risk", to also having regard to the social impact.

The ethical investment policy of an investor will be evidenced by actions and behaviours and not seen by words and intent

Manager implementation

How an investor ethically invests will depend not only on values but also on what is practical and achievable. It typically involves the use of an investment manager and/or a specialist SRI researcher. Having an understanding of how managers incorporate ethical considerations into their research and decision process becomes important.

When investment managers select stocks for an ethical fund, they need to look at the stated ethical elements of the investment relative to the investor's objectives, at the same time as they look at the financials. They must do this while recognising that they still need to produce competitive or explainable returns.

A manager typically does this, with a number of additional steps and resources. Firstly, companies must meet the standard investment criteria (e.g. quality management, business advantage, appropriate debt levels, growing earnings etc.).

Without being sound financially, the potential to produce competitive and prudent returns is compromised and it doesn't matter how ethical the company is.

After passing the initial investment criteria tests, companies are then assessed on a range of social and ethical issues to determine their potential suitability. This will overlay a filter process of various negative and positive ethical "screens".

Negative screening will look to exclude defined investments depending on the interest area or ethical objective. For example, companies whose business activity include some of alcohol, gambling, uranium mining, weapons, animal testing, genetically modified organisms, human rights violations and environmental degradation might be excluded.

Positive screening may be applied to emphasise certain investments. For example, companies that make a positive contribution, or set a standard, in areas such as the environment, human rights and philanthropy and may include areas like good accounting, corporate governance and marketing practices.

Having established the list of investments that meet both the investment criteria and ethical criteria, further research to identify the "best" of the group is required. Alternatively, the investor might simply, at this stage, adopt a passive approach. After that, the portfolio can be constructed.

Ethical investing therefore introduces a new research layer to the overall selection process. It then also introduces further requirements to the ongoing monitoring process. Both of these will lead to additional costs.

A manager's ethical investment process may also involve "engagement". Under engagement, the investor actively promotes ethical behaviours and looks to establish discussions to encourage the company to improve its practices.

Using a manager to implement ethical investing may involve compromise. To obtain economies of scale, a manager will have to adopt ethical standards that will have broad appeal. For some investors, this will exclude investments that they might otherwise be happy with. This will be the price of being able to implement what is important to them in an efficient, more cost effective way than doing it themselves.

Do we really know if an investment is "ethical"?

If we're focused on a particular issue - say environmental sustainability - we can promote this cause by buying shares in a company that also values the environment in the same way and, at the same time, by choosing not to invest in a company that damages the environment.

What should be the investor's policies in the areas of:

- Alcohol?
- Animal welfare?
- Arms/weapons/defence?
- Community citizenship?
- Corporate governance?
- Employment practices?
- Environment?
- Gambling?
- Human rights?
- Mining?
- Tobacco?
- Uranium?

What causes should be supported?

But do we know for sure what the specific practices of a company are and can we be confident that it will do what it says and will continue to do so consistently over time. If we're not confident, we could indirectly support a company that compromises our values. Ethical investing therefore requires a constant review of a company's practices, based on all new information as it becomes available. It also involves additional research to verify the claims of the organisation. This will involve costs and may inevitably involve additional turnover of assets and transaction costs, as investments are sold, not for investment reasons, but on ethical considerations.

Will ethical investing reduce performance?

The answer is probably "yes", because of higher fees and costs. However, supply/demand considerations and market trends will mean that this is not always the case and it may take time to evolve.

Long-term, the average return achieved must correlate to the return a company achieves on its equity and the price investors are willing to pay for a dollar of future earnings and earnings growth.

The questions therefore are which companies will achieve, long-term, a higher return on capital, have a more efficient balance sheet and have greater potential growth? Will it be ethical companies?

From an ethical point of view, companies fall into three categories:

- **Excluded investments** - those that are screened out because of the sector they are in say, for some, tobacco.
- **Favoured investments** - those that are emphasised because of the sector they are in say, for some, environmentally friendly.
- **Neutral investments** - those that are not screened out nor favoured. This category can then be subdivided into those that have better "ESG" practices and those that don't.

The questions that arise are:

- Will the excluded investments underperform favoured and neutral investments?
- Will favoured investments outperform excluded and neutral investments?
- Will better ESG practices of neutral investments outperform companies with lesser ESG practices?

Unless the answers are "yes" an ethical approach will not, long-term, outperform. Likewise unless they are "no" it shouldn't underperform on average either.

However, there is no simple answer to these questions and it is unlikely that there will ever be sufficient evidence to be able to conclude one way or another. Many of the studies to date are short-term and time period dependent - the returns incorporate the impact of the increased demand for ethical investing as opposed to simply higher sustainable returns.

While ethical investing may not alter the average gross return achieved, because of supply/demand changes and general cyclical factors, it will change the year-by-year pattern over the long term. By screening out some potential investments, an investor may change the potential year-by-year return. However, to argue that it will alter the long-term average return requires evidence, for example, that a soft drink company will consistently underperform a water company i.e. have a lower return on capital. If this occurred for one or two years the price of the soft drinks company should reduce to improve the expected future returns for a new investor, otherwise the soft drink company will not attract new capital.

If companies that adopt ethical practices achieve a higher return on equity, all other companies will eventually follow suit as it is in the shareholder's interests for the company to do so. Alternatively, the price of a company without ethical practices will fall to increase the future return to a shareholder.

Logic therefore suggests that the gross returns will be similar, provided the remaining universe of investments is sufficiently large.

Provided therefore, that the remaining range of investments (after excluding any for ethical reasons) is sufficiently large, there should remain sufficient high quality investments to ensure appropriate diversification and a competitive long-term gross return. The actual return over shorter periods will probably vary more, because of the exclusion of some investments, though this is also not certain.

However, the additional layer of research and monitoring required will in most cases lead to increased management costs. Given similar returns from the companies themselves, higher costs must result in lower long-term net returns to investors.

Consumer demands have already placed pressure on companies to operate in an increasingly ethical way. So companies are now valuing social responsibility together with their financial bottom line. By default, more companies are "moving" into the "ethical" sector. This provides a wider and more diverse group of investments and should bring the potential returns of ethical and non-ethical investments closer. It will ultimately reduce the need for significant ethical screening.

An ethical policy should stem from at least one of four aspects:

- ★ Purpose;
- ★ Reputation;
- ★ Belief, or
- ★ Expectation.

Purpose

What investment restrictions & policies will help meet the investor's purpose? What should be restricted? What should be supported?

Reputation

What restrictions/policies need to be applied to protect the investor's reputation?

Belief

What investment belief might improve the return outcome or mitigate risk? For example, might companies that adopt sustainable environment policies, or better human rights policies, be more profitable long-term? Policies that are based on belief may be opinion or evidence-based.

Expectation

What are the reasonable expectations of the beneficiaries (if any) in terms of what are appropriate investments?

The Global Compact's Ten Principles

The Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment, and anti-corruption: The Global Compact's ten principles in these areas are derived from:

- The Universal Declaration of Human Rights
- The International Labour Organisation's Declaration on Fundamental Principles and Rights at Work
- The Rio Declaration on Environment and Development
- The United Nations Convention Against Corruption.

Human Rights

Businesses should

- Principle 1: support and respect the protection of internationally proclaimed human rights; and
- Principle 2: make sure that they are not complicit in human rights abuses.

Labour Standards

Businesses should uphold

- Principle 3: the freedom of association and the effective recognition of the right to collective bargaining;
- Principle 4: the elimination of all forms of forced and compulsory labour;
- Principle 5: the effective abolition of child labour; and
- Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

Businesses should

- Principle 7: support a precautionary approach to environmental challenges;
- Principle 8: undertake initiatives to promote greater environmental responsibility; and
- Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

Businesses should

- Principle 10: work against corruption in all its forms, including extortion and bribery.

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*The real return
is a better
community*

The UN Principles for Responsible Investment (UN PRI)

The UN believes that institutional investors have a duty to act in the best long-term interests of their beneficiaries. In this fiduciary role, environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). The UN also recognises that the application of the UN PRI may better align investors with the broader objectives of society. Therefore, where consistent with fiduciary responsibilities, the UN PRI asks its members to commit to the principles of:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.