

What is ethical investment?

Every day we are able to make decisions to choose to actively support or avoid causes as diverse as human rights, climate change and genetically modified foods.

We all have some idea of what it means to be ethical in our approach to others, to animals, to the environment. But what is ethical investing and will it produce good returns as well as salving my investment conscience?

Ethical investment combines the social or environmental considerations of the investor with their financial objectives.

Traditional ethical funds follow a positive and negative selection process. This is where money is invested in companies that make a positive contribution to the world and withheld from companies that do not. This strict screening method has perhaps fuelled the idea that ethical funds have been unable to compete with their non-ethical counterparts in terms of performance, but it is not true to say that following your conscience will mean poor performance and ultimately poor returns on your investment.

The background

Green and ethical investment has grown rapidly in recent decades. Its roots were in religious movements dating back to Victorian times, when the key issues included temperance and the conditions of employment in work places.

At the beginning of the 1900s, the Methodist Church began investing in the stock market, and consciously avoided companies that were involved in alcohol and gambling. As the twentieth century progressed, more churches, charities and individuals started to use ethical criteria when they were making their investment choices.

In 1985 Friends Provident launched the first ethically screened investment fund with criteria which excluded tobacco, arms, alcohol and oppressive regimes. Since 1985 over 90 investment funds have launched offering a wide range of investment criteria; both negatively screened and with positive investment criteria i.e. investing into companies involved in promoting sustainability.

According to the Ethical Investment Research Service (EIRIS) over 700 000 people in the UK now invest in green and ethical investment funds with almost £9 billion invested in the funds.

What investment strategies are used?

Broadly there are three main strategies used by fund managers for both identifying the universe of companies from which stocks can be selected and then aiding the decision on which stocks to select. These strategies are used either singly or in combination:-

Negative Screening:

The most commonly recognised form of ethical investing. Negative screening involves avoiding companies that do not meet the ethical standards by which the fund is run. For example, a fund might exclude companies that participate in the arms trade or the tobacco industry. The fund manager can then select stocks using normal financial analysis from the resulting pool of companies that have passed through the negative filter.

Positive Selection:

Positive Screening seeks to invest in those companies with a commitment to responsible business practices, products and/or services. This commitment can come in a number of forms, such as the adoption of more sustainable environmental principles or a strong programme of community involvement and ethical supply chain management in developing nations.

The fund manager identifies those companies meeting the positive criteria, before going on to select stocks for the fund out of the resultant pool. The fund might invest in areas such as environmental technologies, environmental protection, pollution control and recycling.

Engagement or Dialogue:

This strategy looks to shareholder activism as a method of influencing corporate behaviour. Fund managers enter into a dialogue with a company with the intention of improving the company's ethical activities and status.

This may not alter stock selection and mainly takes the form of dialogue between major investors and companies, and may extend to voting practices. This approach can be done separately to or in combination with screening. Fund managers will engage on areas such as inappropriate remuneration and climate change. This approach is also known as active shareholding.

It will be apparent that a fund manager must possess the normal skills required in stock selection and fund management (based upon macroeconomic and more detailed company financial analysis) but also the requisite knowledge of the social, ethical and environmental arenas. In any event, careful selection of the best fund managers is necessary.

It is increasingly clear that ethical funds can perform very well as the scope of ethical and environmental concerns widen and regulation increases. Companies will have to adapt to these new pressures or face increasing unpopularity. Furthermore, at the cutting edge of the ethical and environmental processes, companies are more likely to be smaller, offering potentially higher returns as they grow and their processes are recognised as sustainable.

Risk

Understanding the risks associated with this type of investment is equally as important to some investors as identifying the ethical areas in which you want to invest.

Traditional ethical investing, because of its negative screening methods, is often perceived as a risky investment. These funds tend to exclude larger companies from their portfolio, such as oil and pharmaceuticals, areas that have been known to provide good growth or tobacco stocks which are renowned for paying strong dividends.

Funds using negative screening, also invest a higher percentage in shares of small to medium sized companies, sometimes considered unpredictable investments. All collective investment funds both ethical and non-ethical have an element of risk. It can alter with your investment choice and the length of time you invest.

New ideas and approaches are changing the way in which ethical funds are perceived. Fund managers may also take advantage of market trends, offering better potential for higher returns. Past performance suggests that some ethical funds have equalled or beaten their conventional counterparts. Although past performance is not necessarily a guide to the future, the new developments to the industry may strengthen this record.

There is the risk that ethical funds might have commonality in their underlying investments so reducing the level of diversification within a wider client portfolio. It is necessary therefore to take care in ensuring an ethical portfolio is balanced and not overly concentrated.

As with all collective investment funds (pooled investments that invest in equities) there is some risk involved. It depends upon the length of time you hold the investment and the fund you choose.

Well-run companies with strong ethical and environmental principles face less risk of regulatory fines, environmental clean-up costs or shareholder backlash and are more likely to be the companies delivering the products and services required by today's investing community.

Shades of green

Ethical investment can be confusing as there are many shades of "green" funds available

Ethical funds have many different investment objectives. To make your investment choice easier many groups use a system to categorise their investment style. The main categories are dark green and light green, some groups also refer to a fund as medium green.

Dark green funds use the strictest investment criteria. Suited to investors with strong ethical beliefs, investment usually excludes the largest companies in the UK. This type of fund shuns companies involved in such activities as animal testing, tobacco and arms manufacture. Investment in oil, pharmaceuticals and banking is also very limited. Fund managers of dark green funds would employ a negative screening process. The Aegon Ethical Fund is an example of a dark green fund.

Light green funds use a positive approach to portfolio selection. Although these funds are still opposed to those companies involved in areas such as animal testing and tobacco, they do consider investment in mainstream companies that have shown an improvement in their environmental or social policies. For example, an oil company, rejected by a dark green fund could be considered for a light green portfolio if the company had taken positive action to help the environment, such as the use of solar power. This approach is commonly termed 'best of sector' or 'best of class'. These funds are considered a less risky investment due to the increased number of companies available to light green fund managers to choose from when investing.

How do I choose an ethical fund?

Ethical investing begins with your ideas and principles; what issues you believe to be important.

Just as different people have different views on the definition of ethical, not all funds have the same objective. Each fund should state clearly its policies on exclusions and inclusions, so that we can help you find the right funds for you.

In addition to these specific ethical concerns, consideration of the preferred investment approach is necessary in the normal way including more general investment objectives (for example whether or not an income is required). This involves an understanding of the above approaches to ethical investing and in turn being comfortable with funds that adopt specific approaches.

Further, the degree of risk and need for diversification within the overall portfolio must be taken into account when selecting ethical investments. The more limited fund choice arising from the wish to make ethical investments does inhibit the extent to which risk and diversification can be controlled, as well as the ability to select the best performing funds.

To find out more contact your adviser on 0161 835 2266.