



Green and Ethical Investment

A Course for Financial Advisers

**Based on
'Investing Responsibly: A Toolkit for Financial Advisers'**



From UK Social Investment Forum (UKSIF)

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Introduction

A Learning objectives

The aim of this course is for you to learn:

- What green and ethical investment consists of. It is also known as 'responsible investment', 'sustainable investment' and 'socially responsible investment'. It covers investments that use some social, ethical and/or environmental investment criteria.
- Why you as a financial adviser should consider offering advice about green and ethical investment.
- How to identify clients who may want to consider green and ethical investment by asking all clients an appropriate initial question in the fact finding process.
- How to understand clients' motivations, concerns and goals through effective additional fact finding.
- The approaches and terminology used for green and ethical investment.
- The issues involved in investment performance of green and ethical investment.
- How to match client needs and wishes with investment solutions that make good financial sense.
- Where to find further information about green and ethical investment.

What will be tested?

After completing this course, you will be given the opportunity to complete an online test about green and ethical investment. This tests your understanding of the information covered in the course. After passing the test, you will be able to print a certificate of course completion.

When registering for the test, you will also be able to request further resources to assist you in advising on green and ethical investment.

In the course of explaining the key issues, we have included case studies and additional information that should illuminate the subject, but will not be directly tested. These areas are contained in boxes within the main text like this one.

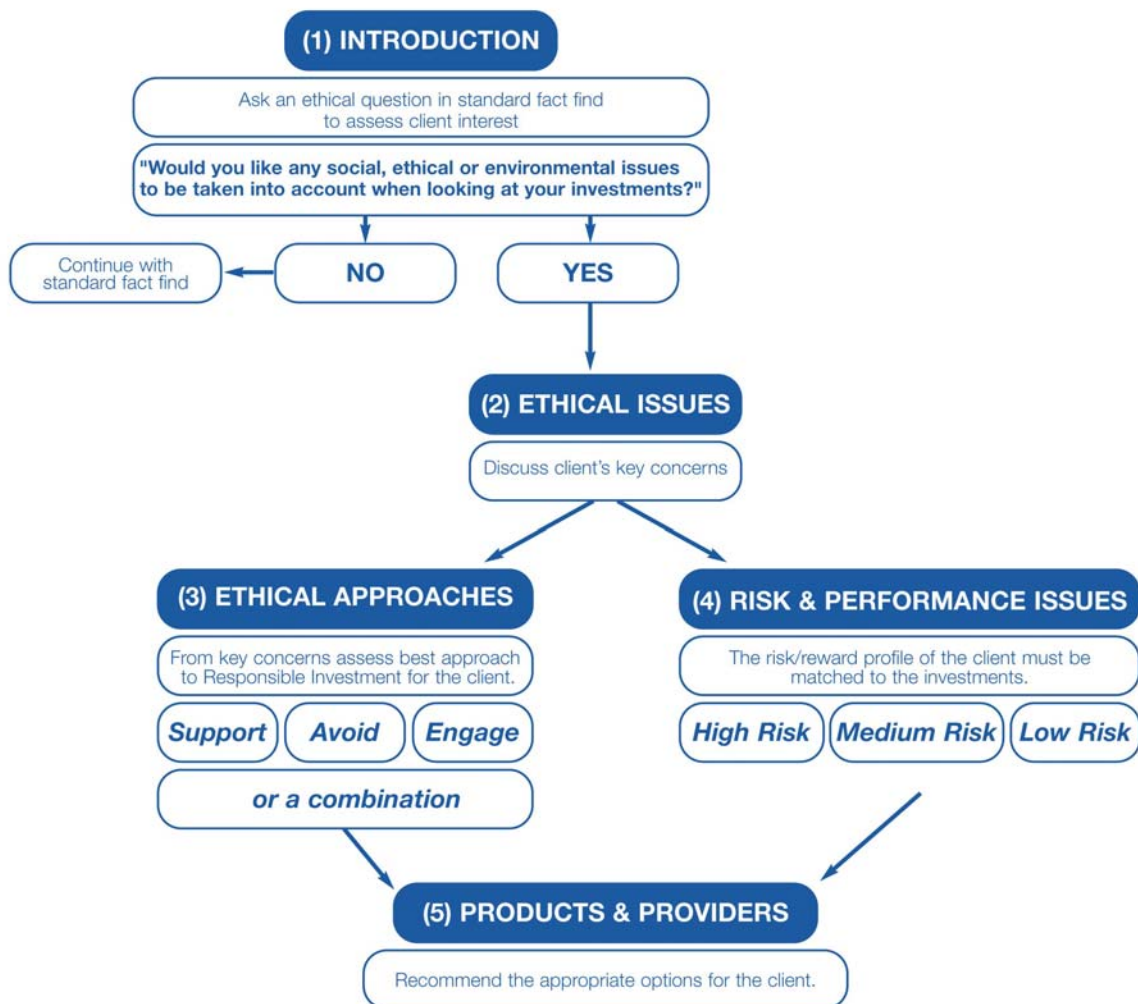
B How this course is organised

The course is structured around the five key steps of advising on green and ethical investment laid out in the UKSIF Toolkit 'Investing Responsibly: A Toolkit for Financial Advisers'. The five learning steps that you will follow correspond to the five step advice process:



Introduction

The five step advice process

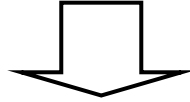




Step 1

Getting started with fact finding on green and ethical investment

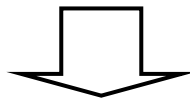
Decide to offer clients advice on green and ethical investment, and start to explore whether a client is interested as part of your standard fact finding process.



Step 2

Fact finding about green and ethical investment issues

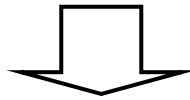
Explore these issues in more depth with interested clients.



Step 3

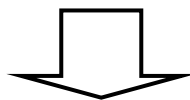
Deciding on the choice of ethical investment approaches

Help the client to decide on the choice of approaches: positive screening/support, negative screening/avoidance, engagement or a combination.



Step 4

Using the client's risk profile, consider risk and performance issues



Step 5

Selecting the appropriate providers and products

C What is green and ethical investment?

Green and ethical investment covers a wide range of investments that use some social, environmental or ethical (SEE) investment criteria.

In the investment world, the expressions 'ethical investment', 'environmental investment', 'green investment', 'responsible investment' and 'socially responsible investment' (SRI) are often used interchangeably. Occupational pension funds and other institutional investors often prefer the term 'responsible investment'. The retail market tends to use 'ethical investment' or 'green investment'.



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In this online course, we will use the term 'green and ethical investment' to cover all kinds of investment that use SEE criteria. We will also use the term 'investing responsibly' to describe the use of green and ethical investment.

Religious belief can sometimes be a motivation for choosing green and ethical investments. This course covers the use of SEE criteria. Several of these have their roots or origins in religious beliefs. However, the course does not cover advising on specialist Islamic finance products.

In general, the main type of green and ethical investments described and considered in the learning material are pooled equity and bond funds. These are typically open-ended investment companies (OEICs), unit trusts, investment trusts or life or pension funds, although some other types of green and ethical investments are also covered.

There are several different approaches to green and ethical investment for portfolios or funds, and these are set out in greater detail in Step 3. Briefly, the main ways to invest responsibly boil down to the following:

- **'Positive screening'** or **'support'** involves investing in companies that have a responsible approach to business practices, products or services. For example, some funds focus on investment in those companies that have the best practice in their industries, while others focus on particular themes, such as environmental technologies.
- **'Negative screening'** or **'avoidance'** means not investing in companies that do not meet the ethical criteria that the fund sets. This is the oldest and best known approach to responsible investment.
- **'Engagement'** uses the active influence of shareholders to support and encourage more responsible behaviour by businesses. Fund managers mainly use dialogue with the management of the companies in which they invest on issues of concern, and may also use their voting powers as well. This approach could extend to a fund manager's entire equity portfolio, and may include life, pension or other collective investments.

Many funds combine these approaches.

D A brief history of green and ethical investment

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.

Recent social and economic developments

In the last twenty-five years, the rise of green and ethical investment has also been closely linked to major changes in society, especially in such key social movements as the environment, human rights and animal welfare. Important economic trends have helped to drive green and ethical investment forward. These include:

- The increasing financial independence of women and young people.
- The growth of employment in the voluntary sector.
- Globalisation and the increasing power of multinationals.





- The diminishing power of democratic governments.
- A massive increase in share ownership by unit trusts, pension funds and insurance companies.

Landmarks in the development of green and ethical investment in the UK included:

- Initiatives for a UK ethical unit trust, which were 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), which was set up in the previous year by ethical investment enthusiasts who wanted a common source of research on company activities.
- The formation of the UK Social Investment Forum (UKSIF) in 1991, which brought together key figures across the full range of responsible investment to co-operate in sharing knowledge and advancing the agenda.

In the UK, nearly half of all people asked now say that they are interested in green and ethical investment.¹

E International perspective on green and ethical investment

Green and ethical investing is not an isolated UK phenomenon. In many parts of the world (for example, the US), the market for green and ethical investment is arguably even more developed in some respects than it is in UK. In the US, a fund was first launched in the 1970s for investors who were opposed to companies involved in the Vietnam war.

Worldwide, both institutional and individual investors are increasingly adopting green and ethical investment approaches. Driven by the pressure for sustainable or environmentally-conscious development, there have been several United Nations initiatives to support and encourage responsible investment.

Examples of international developments

Recent key developments worldwide include:

- The United Nations Principles for Responsible Investment, which were endorsed at their launch in May 2006 by institutional investors representing over \$4 trillion in assets. By January 2007, the Principles had over 150 signatories.²
- The United Nations Environment Program Finance Initiative's (UNEP-FI) 2005 report on fiduciary responsibility prepared by leading law firm Freshfields Bruckhaus Deringer.³

In Europe, the socially responsible investment (SRI) market has grown considerably since 2003. The Broad SRI market across Europe is now valued at over €1 trillion. There are signs of robust SRI strategies, increased mandates from institutional players and the growing involvement of more traditional financial services.⁴

¹ 72 Point Ltd for F&C Asset Management Plc, December 2006.

² See www.pri.org.

³ A legal framework for the integration of environmental, social and governance issues into institutional investment, October 2005. See http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.

⁴ See http://www.eurosif.org/media/files/eurosif_sristudy_2006_europe.



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In the US, nearly one out of every ten dollars (9.4%) under professional management is involved in socially responsible investing. SRI assets have risen more than 258% over the last decade from \$639 billion in 1995 to \$2.29 trillion in 2005, while the broader universe of assets under professional management increased by just under 249% from \$7 trillion to \$24.4 trillion over the same period. In the final two years of this period, green and ethical investing enjoyed healthy growth, increasing from \$2.16 trillion in 2003.⁵

F The size of the green and ethical investment market

In terms of the funds under management and the total number of funds, green and ethical investment funds still constitute a relatively small part of the total market, although this is growing rapidly. There were nearly 90 UK retail green and ethical investment funds in January 2007, according to EIRIS.⁶

Most investors who invest responsibly only do so for a proportion of their funds. One investor survey found that just over half (51%) invest a quarter or less in green and ethical investments⁷, while another found that over half held some other investments. The reasons for this may be to achieve diversification and also the wish to retain existing investments.

In terms of value, green and ethical screened funds currently represent over 1.5% of total retail funds.⁸ Over 4% of retail funds are screened.⁹ Over £480bn in assets are subject to engagement undertaken by UK fund managers on behalf of their clients.¹⁰

Self test question

What does SEE stand for?

⁵ 2005 Report on Socially Responsible Investing Trends in the United States, Social Investment Forum. See <http://www.socialinvest.org>.

⁶ See www.eiris.org.

⁷ Research by Friends Provident Stewardship and Henderson Global Investors.

⁸ According to the Investment Management Association, investment funds under management as December 2005 stood at £347bn. See <http://www.investmentuk.org/press/2005/stats/stats1205-00.pdf>. According to EIRIS, ethically screened funds at end December 2005 accounted for about £6.1bn. See www.eiris.org.

⁹ According to the Investment Management Association, the total number of consumer retail funds in the UK stood at 2,035 in January 2007. See <http://www.investmentuk.org/press/2007/stats/stats0107-00.pdf>. According to EIRIS, there were over 90 ethically screened funds as at January 2007. See www.eiris.org.

¹⁰ See http://www.eurosif.org/media/files/eurosif_sristudy_2006_uk.





Green and Ethical Investment

A Course for Financial Advisers

Introduction – Key learning points

- Green and ethical investment (incorporating ethical, environmental, responsible and socially responsible investment) describes investments that use some social, environmental and/or ethical (SEE) investment criteria.
- Green and ethical investment is well established, having started at the beginning of the last century.
- Green and ethical investment is a worldwide phenomenon.
- Green and ethical investment has both retail and institutional clients. Institutional clients often prefer to use the term 'responsible investment' instead of green and ethical investment.
- There are three different basic approaches to green and ethical investment – see Step 3.



Step 1

Step 1: Getting started with fact finding on green and ethical investment

Advisers should be raising the issue of green and ethical investment in the fact finding process with all clients as a matter of course.

1.1 Basic fact finding

In order to 'know your client', advisers undertake some form of fact finding. This enables an adviser to explore the client's personal objectives and concerns. As such, the initial fact find should include an open-ended question about whether a client is interested in integrating social, environmental and/or ethical concerns into their financial decisions. 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?"

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. This is the essential first step towards getting involved in this area.

There are several different ways to raise the issue of green and ethical investment. But it is normally less productive to ask a closed or leading question, such as:

"Do you want ethical investments?"

Some clients have not heard of ethical investment or may not have defined themselves as 'ethical investors', even if they do have concerns about issues like the environment or are interested in the business opportunities that social or environmental challenges may offer.

Public awareness of the existence of green and ethical investment is still low

According to consumer research in December 2006¹, less than half of the UK public (46%) are aware of stock market funds that allow them to invest ethically.

1.2 The case for asking all clients an initial question during the fact finding process

There are several very strong commercial and other reasons why advisers should offer their clients the opportunity to buy green and ethical investments.

If you do not already ask an ethical fact find question, you should consider the following:

- Does your current fact finding process tell you everything you need to know about your clients?
- Can you give appropriate advice if you have not asked clients about their personal values and interests?

¹ 72 Point Ltd for F&C Asset Management Plc, December 2006.





- If you are competing with other advisers for a client, is there any disadvantage to being the only one who asks an ethical fact find question? Would you have a competitive advantage if other advisers raised the issue of the client's values or beliefs regarding green and ethical issues and you did not?
- How might your clients feel if they learned about green and ethical investment from a source other than you?
- If a client returned to you after six months saying that the investment you sold them was inappropriate because they should have been offered a green/ethical investment fund, what would you say and what action would you take?

These aspects are explored further below.

1.3 You should 'know your client'

There is currently no strict legal obligation for advisers to offer green and ethical investment advice, or for product providers to offer green and ethical investment.

However, every financial adviser has an obligation under the FSA conduct of business rules (COB) to know their customer. As a financial adviser, the FSA also requires you to treat customers fairly. These are broad principles, but understanding the needs and wishes of your clients, and not ignoring any ethical concerns they might have, would seem to be part of the process of providing appropriate advice.

You should not pre-judge client views and attitudes.

Some advisers take the view that 'our clients are not interested in this type of investment'. Opinions regarding who might be a stereotypical ethical investor are not hard to come by. But while it may be simple 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 green and ethical investment.

It is not safe to assume that all of your clients share exactly the same views and assumptions as you, their adviser. Even if your views are generally aligned, it is highly improbable that they are identical, especially regarding such matters as society, the environment or ethical issues.

It is also not safe to assume that a client's attitudes remain fixed over time. People change their views, as we can see with the rising interest in such issues as global warming. So when reviewing a client's portfolio and revisiting the fact finding process, it is important to check their attitude to green and ethical investments, even if they expressed a view about them last time you spoke.

A survey² in 2003 found that there were no substantial age, sex, geographic or socio-economic differences between responsible investors and other investors. Anybody might be interested in green and ethical investment, and it is not possible to make assumptions without asking.

The experience of an IFA who offers advice on green and ethical investment

'The experience among 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 who have assets on which they seek independent advice.'

² NOP World/Friends Provident, between 1-3 August 2003.



Step 1

1.4 You should protect yourself against possible complaints

Some people who have concerns about environmental or social issues have strong opinions. Unless you ask about, recognise and note a client's interest as part of the fact finding process, you are unlikely to know that you are dealing with a person with such opinions, and you could risk giving inappropriate advice. Clients who fall into this group may even move to specialist 'ethical' advisers once they find out that green and ethical investment exists.

The failure to ask an ethical fact find question is unlikely to trigger an immediate complaint, but if an adviser has failed to ask the question, it 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 received training in this particular area.

1.5 You can benefit from new opportunities and protect your client base at the same time

Advisers who do not explore with their clients whether they would be interested in green and ethical investment are increasingly likely to be missing valuable business opportunities. The ability to understand and discuss the main issues surrounding green and ethical investment can give you an important competitive edge.

(a) Many clients are interested in green and ethical investment

There is a great deal of evidence that a large and growing number of people are interested in green and ethical investing.

Recent market research³ has found that:

- Just under half of the public want to invest ethically, and just under one in five would be prepared to see some sacrifice in their investment returns in order to invest ethically.
- About nine out of ten people questioned believe that it is important for companies to take social, ethical and environmental issues seriously.
- Under half of those questioned were aware of the existence of green and ethical investment funds.

An increasing number of people are looking for advisers who will advise them on green and ethical investment.⁴

There is also substantial and growing media interest in green issues, such as global warming, which both reflects and stimulates public interest in such matters.

³ 72 Point Ltd for F&C Asset Management Plc, December 2006.

⁴ IFA Promotion, see <http://www.unbiased.co.uk/media/media-resources/press-releases/demand-for-ethical-investment-advice-up-100/>.





Examples of evidence of public interest in green and ethical investment and related issues

In December 2006, consumer research⁵ found that:

- 87% of respondents believe that it is important for companies to take social, ethical and environmental issues seriously. This view is held throughout the UK, but is especially strongly held in London and the South East – suggesting that it is more widely believed by more affluent sectors of society.
- Nearly half (48%) of the UK public would like to invest ethically.
- Nearly one in five (18%) would be keen to invest ethically, even if it meant a slightly lower return.

IFA Promotion, the organisation promoting the benefits of independent financial advice, says that consumers are increasingly seeking to invest their money ethically. It found that more than twice as many people searched for an ethical investment independent financial adviser in the summer of 2006, compared with the same period in 2005.⁶

Market research has shown that clients are looking to financial advisers to raise the issue:

- 65% of people said that 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.⁷
- 83% of the public believe that 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 green and ethical investment from a financial adviser.⁸

Know your client

"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

(b) The market for green and ethical investment advice

Potential green and ethical investors include:

- Those investors who have already started to invest part of their funds in green and ethical investments or are looking to invest more in ways that are consistent with their beliefs. Such clients are actively seeking advice in this area.

⁵ MORI/Friends Provident, 10-15 June 2004.

⁶ IFAPromotion – see note 4.

⁷ MORI/Friends Provident – see note 5.

⁸ NOP World/Friends Provident, between 1-3 August 2003.



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- The even greater number of investors who have taken an interest in buying ethical products (eg Fairtrade products, where Fairtrade has 20% of the UK ground coffee market⁹), but have not yet considered applied this interest to buying investments and financial services.

(c) The advantages for advisers of offering advice on green and ethical investment

Advisers have found that the benefits include:

- **Improved relationship with existing clients** If a client considers that their adviser is taking into account their values and proactively 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.
- **Increased referrals** Clients are more likely to be happy with their investments if these are aligned more closely to the rest of their personal values. This regularly translates into increased referrals as well as good client retention.

Case Study

You never know who will be interested – there's no harm in asking

Evidence from an IFA who offers green and ethical investment advice:

Following a presentation to accountants representing celebrities, a green and ethical investment specialist IFA was approached to advise one of the accountant's clients. The particular celebrity is a famous international female recording artist. Green and ethical 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 has invested 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, this is a win-win situation all round.

- **Protection of the existing client base** Offering green and ethical investment can protect against increased competition from other advisers. IFA Promotion reported in August 2006 that 840 (10%) IFA Promotion member firms included a focus on ethical investments, compared to 633 (8%) one year previously, and just 593 (6%) three years previously.¹⁰

⁹ Jean Marie Krier: Fair Trade in Europe 2005 – Facts and Figures on Fair Trade in 25 European countries, published by the Fair Trade Advocacy Office in Brussels. See <http://www.ifat.org/downloads/marketing/FairTradeinEurope2005.pdf>.

¹⁰ MORI/Friends Provident – see note 5.





Case Study

If you can't offer green and ethical investment advice, your clients might go to someone who can

A client with over £200,000 accumulated in PEPs and ISAs approached a specialist ethical investment IFA after hearing about green and ethical investment on the radio. None of their existing portfolio was invested ethically, the client had never asked for green and ethical investment and their IFA had never mentioned the option.

The ethical IFA confirmed that while 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% pa fund-based commission on over £200,000, the earlier IFA lost over £1,000 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 that the IFA had offered advice suitable to their requirements.

- **New marketing opportunities** Advisers should be able to identify affinity and niche marketing opportunities. People who are interested in social, environmental and/or ethical issues are often unaware of the existence of green and ethical investments.
- **Improved product persistency rates** Green and ethical 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. So ethical investors are widely believed to be more persistent than other comparable investors.

1.6 You can prepare yourself for future changes to the green and ethical advice environment

It is looking increasingly likely that future legal, regulatory or professional standards changes may make an awareness of green and ethical investment an increasingly important factor for adherence to professional standards or even compliance.

For example:

- The Financial Services Skills Council has published an exam syllabus that includes ethical investment for the first time. Both the Chartered Insurance Institute (CII) CF2 and Institute for Financial Services (IFS) CeFA exams now have modules on ethical investment. All new advisers will therefore have a basic knowledge of ethical investment and the provision of advice in this area.¹¹
- The British Standards Institution (BSI) launched a new international standard for competence in personal financial planning, ISO 22222, in 2006. Financial advisers will soon be able to use the prestigious BSI kitemark for achieving this standard. However, it requires that the client data requested by a financial planner should normally include "attitudes to social, ethical, environmental and religious considerations". In their draft guidance on compliance, the BSI said that financial planners should have adequate processes in place to give appropriate advice where

¹¹ See <http://www.fssc.org.uk/public/downloads/AES1RetailInvestmentAdvice310504.pdf>.



Step 1

a client expresses interest in these areas. It highlights UKSIF's 'Investing Responsibly' toolkit, which forms the basis for this course, as an aid to help meet the standard's requirements.¹²

- The 2006 government Pensions White Paper *Personal accounts: a new way to save* said that the government expects that the new system of personal accounts will include SEE investment options.¹³

By identifying whether or not the issues behind green and ethical investment approaches are important to a client and developing skills in advising on this area, an adviser can be prepared for these types of future changes.

1.7 You can deliver added value for clients seeking green and ethical investment

There are a number of specific technical issues surrounding the provision of green and ethical investment advice. A number of your clients may not have enough knowledge and experience about this area or general investment issues to be able to make appropriate decisions without advice.

Along with knowledge of asset allocation, risk and reward, tax and choice of appropriate tax wrappers for clients, the ability to provide green and ethical investment advice is therefore an important part of every financial adviser's skill set and requires specific competencies.

Need for guidance

Some clients seem to assume that all investment funds screen their underlying investments for ethical issues. One market research study found that 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.¹⁴

1.8 Advice opportunities – pension funds must provide a 'Statement of Investment Principles' (SIP)

Most advisers are involved in pension fund advice.

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 scheme's approach to ethical and socially responsible investment.

The rules, which were originally introduced by a regulation under the 1995 Pensions Act, state that trustees of occupational pension funds are to disclose the following in their SIPs:

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

¹² Press release at <http://www.uksif.org/cmsfiles/uksif/uksif-ISO22222-PR.pdf>.

¹³ See http://www.dwp.gov.uk/pensionsreform/pdfs/PA_Chapter5.pdf.

¹⁴ NOP World/Friends Provident, between 1-3 August 2003.





The legislation did not oblige pension fund trustees to adopt responsible investment policies, but it has increased their transparency on the issue, and so has driven change.

Techniques for implementing responsible investment by occupational pension funds include 'engagement-only' approaches (see Step 3), thematic investment (eg in green private equity) and the introduction of screened green and ethical investment options where members can exercise individual choice, eg for defined contribution schemes.

Advising on pension fund investment

Advisers helping to select stakeholder pension products should request SIPs from stakeholder providers before making recommendations, so that they are able to advise any interested or potential members on this aspect of the scheme.

1.9 Advice opportunities – charities

Some financial advisers provide advice to charities. Like other institutional investors, charities often prefer the term 'responsible investment' to 'green and ethical investment'.

Responsible investment can help a charity to align its investments with its charitable objectives. 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 in *Investment of Charitable Funds* states that "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".¹⁵ It highlights that, as with any other investment strategy, trustees must discharge their duties with respect to investment. This includes having regard to the suitability of the particular investment. It goes on to say that "Where a charity has an ethical or socially responsible investment policy, the duty to consider suitability involves recognising the need for consistency with that policy".¹⁶

The Charity Commission recognises that an ethical investment policy may be entirely consistent with the fiduciary duty of maximising return on investment. It outlines three situations where trustees can allow an investment strategy to be governed by considerations other than pure investment return:

1. Where investment in a particular type of business would conflict with the aims of the charity.
2. Where certain investments might hamper its work by alienating supporters or beneficiaries.
3. On moral grounds, provided 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*¹⁷ 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'.

¹⁵ Section F of Charity Commission. *Investment of Charitable Funds*. See <http://www.charity-commission.gov.uk/supportingcharities/cc14full.asp>.

¹⁶ Paragraph 56 of Charity Commission. *Investment of Charitable Funds*. See <http://www.charity-commission.gov.uk/supportingcharities/cc14full.asp>.

¹⁷ Statement of Recommended Practice (SORP) 2005, *Accounting and Reporting by Charities*. See <http://www.charity-commission.gov.uk/Library/publications/pdfs/sorp05text.pdf>.



Step 1

Advising on charitable investment

Useful sources of further information for advising specifically on charitable investment are:

- *Investment of Charitable Funds*, particularly Section F.¹⁸
- The guides produced by the EIRIS/UKSIF Charity Project.¹⁹

1.10 The financial performance of responsible investments

There is a theoretical view of investment performance which holds that by limiting the range of possible investments, green and ethical investment strategies will lead to underperformance. Some advisers cite this view as a defence for offering investment strategies solely aimed at maximizing returns.

Performance issues are covered in greater depth later, but some of the key arguments against this are that:

- There are now many years of practical experience demonstrating that green and ethical funds need not underperform. "Investing ethically does not mean that you have to sacrifice investment performance", according to the Investment Management Association in their *Guide to Ethical Investment*, July 2006.²⁰
- A significant number of investors may not want profit maximization at all costs. As described earlier, nearly one in five members of the public surveyed stated that they would be "keen to invest ethically, even if it means a slightly lower return", according to December 2006 consumer research.²¹
- Companies that improve their corporate social responsibility and sustainability (eg with regard to climate change) may perform more profitably in the long run.²² Investor engagement may encourage this.
- Green and ethical investment funds can give investors the chance to get involved with emerging social and environmental investment themes at an early stage, before many conventional investment funds have identified the investment opportunity. This happened with environmental technologies such as solar power and fuel cells.

¹⁸ Charity Commission – see note 15.

¹⁹ The guides, all available at www.eiris.org, are:

Investing Responsibly: A practical introduction for charity trustees (2005), a joint publication of EIRIS, UKSIF and NCVO. This explores current practices and suggests five steps for charity trustees considering a responsible investment policy.

Responsible investment approaches to non-equity investments: An introduction for charity trustees (2006).

The Responsible Investment Approaches of Common Investment Funds – A guide for charity trustees (2006).

²⁰ See <http://www.investmentfunds.org.uk/FactSheets/EI/default.asp>.

²¹ 72 Point Ltd for F&C Asset Management Plc, December 2006.

²² See research at www.sristudies.org, such as *Corporate social and financial performance: a meta analysis*, 2003, at <http://www.sristudies.org/html/bibliography.html#Orlitzky>.





Self test question

What types of pension scheme are required to provide a 'Statement of Investment Principles'?

Step 1 – Key learning points

Getting started with green and ethical find finding

- Financial advisers should ask all their clients during the fact finding process whether they would like green and ethical investment issues to be considered.
- A significant proportion of clients are actually or potentially interested in green and ethical investments for at least some of their holdings.
- There is a strong business case for advisers to offer green and ethical investment advice as part of their normal activities.



Step 2: Fact finding about green and ethical investment issues

Once you have established a client's interest in and concern about green and ethical investment issues in the general fact finding process, it is important to probe and explore further. This may take place while you are carrying out your standard fact find, or you may want to develop the conversation later. There is no single method that suits all advisers. But whatever approach you decide to take, your aim should be to understand:

- **The client's areas of concern** These will indicate the main investment themes to be favoured and/or to be avoided in the choice of investment funds.
- **The client's level of concern and degree of commitment to green and ethical investment** These will help to indicate the proportion of the investor's funds that might be held in green and ethical investments, and the extent to which such factors should be considered in the context of pure investment issues of risk and return.

2.1 Using informal discussion or a supplementary green and ethical investment fact find

Advisers should be used to introducing new investment concepts to clients, such as the general characteristics of different asset classes, the relationship between risk and reward, and the importance of tax issues. Green and ethical investment issues need to be dealt with in a similar way through one of two main approaches:

- An unstructured informal discussion, possibly using diagrams, lists and other aids to understanding.
- Using a specially designed supplementary fact find.

The use of a list of different issues, or possibly a briefing paper, can help to focus the discussion and can aid understanding.

The aim of additional fact finding is to help the adviser choose funds that meet the client's green and ethical investment views/attitudes.

Some experienced ethical investment IFAs recommend that the easiest way to capture the exact views and wishes of clients is to use a specialist green and ethical investment supplementary fact find. This provides an agenda and aide-memoire to organise the client's green and ethical objectives. Two examples are available from the UKSIF website. You could use these or develop your own.

Discussions and fact finds will help to provide a transparent audit trail and documentation of your client's opinions. The client may be considering issues for the first time (at least in the context of investment), so give them space and time to develop their understanding and views. Taking time to discuss these issues with the client will also help the adviser to build a strong relationship with them.

While some clients will wish to explore a range of green and ethical investment issues or feel passionately about specific ones, it is important to recognise that some clients may want to 'do their bit' by choosing green and ethical investments, but may not wish to engage in a detailed selection of issues. The adviser's role here is to respond to this requirement, drawing out broad themes and any issues of particular concern, but avoiding the suggestion that the client should necessarily have more detailed views.





The discussions may or may not lead to a recommendation for a screened or engagement product solution for the client. Any such recommendation will depend on other standard advice issues, such as the availability of appropriate products or funds, and what impact those issues might have on performance with reference to the client's risk profile. This aspect is discussed further in Steps 4 and 5.

At any rate, it is important to record not only which issues are of interest to the client but also which are their highest priority and which are less significant.

2.2 Exploring the issues

As a financial adviser, the chances are that your client relationship skills are highly developed and very effective. The discussion of green and ethical issues requires the usual competencies of asking open rather than closed questions, listening carefully and sensitively, and being ready to probe more deeply where required.

It is essential to grasp that, as an adviser, your job is not to argue for one point of view or another, or to impose your opinions on the client. It is to understand the client's feelings and beliefs, and to help them to reflect these in the investment strategy and recommendation. As with estate planning or attitude to risk, it is clearly their views that matter, not yours.

To do this, you do need a general understanding of green and ethical issues of common concern. But you don't need to be any sort of 'green guru' with in-depth expertise on, say, the merits of genetic engineering or the debates around climate change.

Basic knowledge of the main issues that underlie these areas can help you to understand the client attitudes that you encounter. The views expressed may not accord with your own approach to any of these areas of concern, and they are by no means comprehensive or necessarily what you might consider to be balanced. In fact, views are sometimes so diverse that it would be surprising if you did agree with your clients on everything! There is no single 'correct' green/ethical approach, although a fair degree of consensus exists around some issues, such as tobacco.

It can be useful to have access to other advisers who understand green and ethical investment to help you with suggestions about more unusual client views or requirements. Membership of the Ethical Investment Association, the trade body for independent financial advisers in green and ethical investment, is one way to get this type of support.

You also need to appreciate that funds may not use exactly the same definitions of particular issues or treat them in the same way. They compete on their treatment of green and ethical issues as well as on their financial performance. This diversity increases the chance that you will find funds that meet the needs of your clients, but it does mean that you need to be aware of this.

In summary, it is important for advisers to:

- Have a basic high level understanding of key social, environmental and ethical issues likely to be of concern to some clients.
- Provide guidance without leading excessively, and certainly not lecturing or haranguing. Your client may have different opinions and views from your own.

Of course, different family members might have different and possibly conflicting views. This could lead to more than one strategy where you are handling separate portfolios. It could also mean that you will need to reconcile differences where there are joint investments or you are investing for trustees.



Step 2

2.3 Understanding the underlying green and ethical issues

An example list of the main areas of concern is set out below. While each issue appears in only one column, some could easily be classified differently. For example, a client may regard human rights as an ethical rather than a social issue. The table is not intended to be definitive, and there is no need to make a distinction between whether an issue is social, environmental or ethical if this does not feel comfortable for you or for your client.

Social, environmental, ethical (SEE) or environmental, social, governance (ESG)?

Some aspects of corporate governance are now widely accepted as contributing to effective business management and protection of shareholder value, as well as being a green and ethical investment issue. For this reason, some product providers will talk about environmental, social and governance (ESG) criteria rather than social, ethical and environmental (SEE) criteria.

Examples of social, ethical and environmental fund criteria

(Those in bold are described further later)

Social	Environmental	Ethical
Access to medicines Bribery and corruption Child labour Community initiatives Conflict Corporate governance (including excessive executive pay) Equal opportunities Health and safety Human rights Labour standards Military Repressive regimes Supply chain management	Air and water pollution Biodiversity Climate change Energy Environmental management Genetic engineering Mining and quarrying Nuclear power Ozone-depleting chemicals Pesticides Transport Tropical hardwood Waste and toxic chemical management Water management	Alcohol Animal testing and fur Gambling Pornography and adult entertainment Tobacco

The following is a brief and necessarily incomplete summary of some of the views held on some of the key issues. Bear in mind that issues and attitudes change with political, economic, social and scientific developments. These are not 'UKSIF definitions' of particular green and ethical issues and they are by no means definitive. Some sample investor views are also included in boxes to provide an indication of the range of some of the attitudes you might encounter.





One aspect to be aware of is that in many areas, there are both negative and positive aspects to a given ethical issue. For example, oil and gas companies may be the leading source of emissions of carbon dioxide, a major greenhouse gas – but they may also hold the key to more environmentally friendly future energy solutions.

If you want to understand more about these issues, the internet is a very good source of information, as are the press and the many books written on these subjects, or industry organisations offering green and ethical investment.

If you are familiar with concepts and terms around social, environmental and ethical issues, you may wish to go straight to the end of this section. But do note that this part of the course may be covered in the test.

(a) Social issues

Social issues where some companies cross the line into unacceptable behaviour can be found in a range of activities, both in the UK and (more often) overseas.

Access to medicines

A criticism of some large healthcare and pharmaceutical companies is that they make few concessions to the economic position of most of the populations of developing countries, and aim to charge them the same prices for much needed drugs as they achieve in advanced markets. Proponents of greater access to medicines argue that pharmaceutical companies could supply drugs at their marginal cost of production, or licence generic drug manufacturers to produce low-cost drugs. Some say that this would protect rather than damage the companies' business model.

An investor's view

"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'."

Bribery and corruption

Bribery of government officials and other purchasers, and illegal payments, may take place in some industries, especially in the context of sales of large contracts to developing countries. This can perpetuate poverty and is often linked to human rights abuses.

Corporate governance

Shortcomings in the way that certain companies are run have sometimes derived from the structure of their organisations and in particular their boards. In such egregious cases as Enron, criticisms have included insufficient effective checks or balances on management action, especially by independent non-executives or auditors.

Health and safety

Companies that put short term profitability above safety are of concern. Some companies have excellent safety records while others have poor attitudes and procedures.



Step 2

Human rights

Basic human rights – which we take for granted in most developed countries – are lacking under some regimes round the world. Some companies supply products and services to regimes that do not respect human rights, or operate or buy goods in countries where human rights violations are common (Burma is an example of a country of concern).

An investor's view

"I would like to see someone addressing the issues of sale of aircraft, etc to oppressive regimes, but otherwise it doesn't bother me..."

Labour standards

Some companies operate very high standards in their treatment of employees. Other companies allow lower standards, particularly when the employees are in developing countries or work for suppliers.

Military

Some companies are overtly involved in the production and supply of arms and military equipment. Some investors are keen to avoid any involvement whatsoever, while others may want to avoid the ownership of armament suppliers. However, other investors are happy to invest in this sector.

An investor's view

"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?"

Another investor's view

"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) Environmental issues

With the increase in concern about global warming, environmental issues have come to the fore among ethical investment issues. Sustainable development is development that "meets the needs of the present without compromising the ability of future generations to meet their own needs", according to the UN-inspired *Brundtland Report*. In addition, there are many specific environmental concerns.

An investor's view

"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."





Biodiversity

Companies can damage the diversity of plant and animal life, especially those involved in the extraction industries, agriculture or construction. There are also opportunities for companies in these and other industries to make positive contributions to encourage biodiversity.

Climate change

The emission of greenhouse gases is widely agreed to be the cause of climate change. We all contribute directly and indirectly to this, but some industries are major generators of greenhouse gases. Most notable are the transport and energy sectors. There are business opportunities for some companies to develop or promote more efficient technologies or to remove carbon dioxide from the atmosphere.

An investor's view

"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."

Energy

The generation and use of energy involves such major issues as the depletion of resources (like oil) that cannot be renewed, contribution to climate change, and the use of nuclear energy that has long term dangers for the environment. The positive contributions that companies can make include the use of renewable resources in energy generation.

Environmental management

Some companies follow general policies about 'avoiding environmental damage' or promoting environmentally friendly policies. Certain companies aim to follow specific environmental policies relating to particular areas of activity, eg pollution, use of certain sorts of timber, use of pesticides, etc. Some companies that manufacture and use chemicals lead the way in initiating managerial strategies in how chemicals are produced and used, while others tend to make do with meeting the minimum requirements.

Genetic engineering

Genetic engineering involves changing the DNA of the cells of plants, animals or other organisms with the aim of introducing new characteristics, eg making a crop resistant to a herbicide, or introducing a novel trait. Genetically modified organisms (GMOs) are increasingly used in agriculture and medicine. Many people have concerns about the environmental impact of this, and some people are concerned about the possible medical uses of these techniques.

Mining and quarrying

The extraction industries can cause major environmental damage. Some companies take great care to minimise damage both during and after the mining or extraction process. Minerals are often located in countries ruled by oppressive and corrupt regimes.

Tropical hardwood

The hardwood trees in tropical rainforests take decades to replace. The use of this material for furniture, building and other uses puts the trees and the forests themselves in danger, and accelerates the destruction of the forests, which are in turn important for countering global warming.



Step 2

Water management

Water is a scarce resource in many parts of the world, especially where populations are growing rapidly. The main issues around water management (aside from the long term political, economic and social impact of a diminishing resource) concern waste, pollution and use for non-essential purposes.

(c) Ethical issues

Alcohol

Investor concerns about alcohol may include health impacts, responsible marketing and their own religious values. Some may see this as a social issue rather than an ethical one. Some investors may be concerned only about the manufacture of alcoholic drinks. Others may wish to exclude businesses that generate a certain level of their turnover from distribution. Some investors may want to exclude supermarkets and other retailers because they distribute alcohol, while others may be concerned only about business activities like running bars and public houses where the proportion of turnover attributable to alcohol is higher.

An investor's view

"I'd like to avoid any company involved in the 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."

Another investor's view

"What I'd like to see is someone who is dealing with serious issues such as irresponsible marketing to children. Selling alcopops, for example, is really not on... is it?"

Animal testing and fur

Views about the use of animals in product testing can vary greatly. Some people object to them being used in testing cosmetics and other household products, while others dislike the use of tests on animals in the development of pharmaceuticals.

An investor's view

"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 other than have their products tested on animals."

Another investor's view

"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."

Pornography and adult entertainment

Definitions of pornography vary. Some mainstream media companies as well as specialist companies might be regarded as producers of material to which some investors might well object. Distributors, such as newsagents and other retailers, cinemas and television companies, may also be regarded as a part of the industry.





Tobacco

Many people who are interested in ethical investment are keen to avoid investing in tobacco manufacturers. They might or might not be concerned about retailers – and particularly supermarkets – that are responsible for the sale of tobacco products.

Self test question

What is the green/ethical investment issue implied by the expression 'biodiversity'?

Step 2 – Key learning points

Fact finding: discussing the issues

- A supplementary ethical fact find questionnaire can help identify clients' social, ethical and environmental (SEE) concerns to assist product selection.
- Advisers should take time to get a broad sense of their clients concerns to establish what issues are of most concern to them.
- A client's views on green and ethical issues may differ from the adviser's own. Advisers should not impose their own views on ethical issues on the client.
- An adviser should be able to give advice that encompasses a client's values and interests as well as their financial objectives.
- 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.



Step 3: Deciding on the choice of ethical investment approaches – ‘positive screening’, ‘negative screening’ and ‘engagement’

Once you have identified the key social, environmental and ethical issues that are of concern to a client, the suggested next step is to work out the approach to green and ethical investment that will best suit the client’s needs and wishes. We break these down into three main approaches.

3.1 The three approaches

In addition to covering a diverse range of issues, different funds/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 main types of green and ethical investment approaches are:

- Positive screening – or support.
- Negative screening – or avoidance.
- Engagement.

Many funds combine all three approaches (support, avoidance and engagement), while others only use one or two. Product provider literature should make it plain which of the three approaches apply to which of its products or funds.

This information should be set out clearly in a provider’s marketing material, as is encouraged by the Eurosif Transparency Guidelines for the Retail SRI Fund Sector.¹ This is explored further in Step 5.

(a) Positive screening or support

Positive screening or support seeks to invest in those companies with a commitment to responsible business practices, positive products and/or services. This is often a less visible approach than the other main techniques but can manifest itself in a number of ways. Broadly:

- 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 necessities of life such as food, clothing, electricity, water or housing.
- Funds may favour companies with positive policies and practices (perhaps irrespective of the company’s line of business), such as good equal opportunities policies, 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 in a particular ‘positive’ industry to the exclusion of all others – for example, a fund that focuses on environmental technology.

¹ See http://www.eurosif.org/media/files/eurosif_transpguidelines.





Other funds prefer not to exclude entire sectors and so adopt an alternative approach. Rather than blanket exclusion, companies are selected on a 'best in class' or 'best of sector' basis.

This approach is a technique that fund managers use to rate companies according to a green and ethical investment policy. Fund managers apply the policy guidelines where they can, and they bias their investment decisions towards higher rated companies. Fund managers select investments or portfolio weightings that take into account how closely a company meets the policy.

This approach allows fund managers to mix ethical and financial criteria. If several companies have a similar rating according to the conventional financial criteria of risk and return, the manager can rate them against the chosen responsible investment criteria and then select the company with the better all-round performance. So, for example, a fund manager who invests in oil stocks may adopt a 'best in class' approach and select the oil company with the best environmental management.

(b) Negative screening or avoidance

The most commonly recognised form of green and ethical investment is negative screening or avoidance. 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, do 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 (eg they may allow 3%, 5% or 10% of a company's turnover to comprise the questionable activity). The fund's *de minimis* limit may or may not follow the stances outlined by research agencies or other commentators.
- Companies may be excluded by virtue of the industry in which they operate (eg financial services, mining, making or selling pornographic material), or because of the way they do business (eg poor relations with suppliers or employees, pollution-related convictions, offensive advertising). Although there is a degree of commonality, different funds consider different issues and exclude companies in accordance with their own policies.
- There is no single, correct 'black and white' approach to any issue. Approaches may vary between being very strictly against something, 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.

Fund managers or product providers should publish their exclusion criteria, and the details should reflect how the fund is run in practice, and in particular the stock selection practices.

(c) Engagement

Engagement aims to encourage and support more responsible business practices. It may also seek to improve investment returns by encouraging companies to manage social, ethical and environmental risks or to address new social or environmental business opportunities.

Engagement relies on the influence of investors and the rights of shareholders as owners of companies. It mainly takes the form of dialogue between fund managers and companies on issues of concern and may also extend to voting practices.



Step 3

Historically, there has been a degree of dialogue between ethical funds and the companies in which they invest. However, activity levels have increased substantially over recent years, to the extent that some providers and fund managers now offer this as a 'stand alone' approach – ie without an overlay of positive or negative screening.

Different fund managers engage on different issues, sometimes operating unilaterally and sometimes in collaboration with other fund managers – for example, through the Institutional Investors Group on Climate Change.²

The issues covered tend to be less contentious than some screening issues. Examples include:

- Climate change.
- Access to essential medicines.
- Inappropriate executive remuneration.
- Labour standards.
- Bribery and corruption.

Engagement may be separate from screening or may be combined with it. It may apply to screened and unscreened funds.

Engagement may also apply across a product provider's entire equity portfolio and may therefore apply automatically, no matter what fund is purchased from that company. In instances where a fund manager is committed to engagement with companies on behalf of all their equity assets, the manager may not specifically highlight this for all their retail funds under management.

Normally, engagement with a company only takes place when there is a business case for change. In general, a company would not comply if there were no business benefit.

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 – sometimes takes place.

Engagement is less frequently employed across non-equity holdings, but it sometimes applies to bonds and property investments.

It is increasingly being adopted by occupational pension funds.

3.2 Approaches in practice – support, avoidance and engagement

Many screened funds combine all three approaches (support, avoidance and engagement), while others only use one or two. An engagement-only fund will, as it implies, apply the third approach only.

- **Screening** Within screened ethical funds, the issues tend to be relatively static, because funds have to be mindful of their existing client base. However, additional criteria may sometimes be added and some policies may change over time as the fund manager seeks to stay up to date with what is happening in the world. For example, one of the earliest exclusion areas was 'Companies with operations in South Africa' – a criteria well worth reviewing in the post-apartheid world. Screened funds tend to be referred to as 'ethical' or 'green' funds. Funds described as 'ethical' normally address a diverse range of issues, although it is obviously important to

² See www.iigcc.org.





understand the criteria for each. Funds described as 'green' may range from a general ethical fund, perhaps with an emphasis on environmental criteria, through to a fund with a thematic environmental solutions proposition and no additional negative screening. Journalists and other commentators may sometimes use the terms 'ethical' and 'green' completely interchangeably.

- **Engagement** 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 therefore not 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. Funds that use an engagement approach but do not screen stocks in or out of their portfolio are not traditionally marketed as green or ethical funds, although this has recently started to change to some degree.

Step 5 describes how to understand the application of screening and engagement by particular funds.

3.3 Other investment and savings options

Buying collective investments is not the only route to green and ethical investment. There are a number of other possibilities that clients might want to consider.

(a) Ethical banking

Some smaller banks have specialised and differentiated themselves as 'ethical banks' by using social, environmental and/or ethical criteria for their lending and other activities. As with green and ethical funds, they may focus on investing positively in certain areas or emphasise instead the activities or operations not permitted for their business customers; they may also offer a combination of these.

Major banks are increasingly aware of the social and environmental impact of their lending activities, particularly in the developing world, as some have come under criticism for their involvement in controversial projects (for example, the construction of dams for hydroelectric power). It is becoming increasingly common practice for banks to have 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'³, is a framework that banks can use to manage environmental and social issues in project financing and is supported by some leading high street banks.

(b) Cause-based investments

Many investors wish to back individual projects or causes through carefully directed investments. The sector is currently dominated by authorised financial institutions such as the smaller specialist banks, although it also includes ethical companies who raise money directly from stakeholders.⁴

(c) 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 (CDFIs) to develop and create wealth in disadvantaged communities and under-invested markets.

³ See <http://www.equator-principles.com>.

⁴ See www.eiris.org.



Step 3

CDFIs are sustainable independent financial institutions that provide capital and support to individuals and/or organisations that cannot obtain mainstream finance. They aim to help social enterprise create local jobs, develop services and reverse downward spirals of under-investment in under-served communities. Some are specialist banks, while others do not hold banking licenses and may be industrial and provident societies or use other legal forms.

Financial returns are mainly provided through a special tax incentive available to investors in accredited CDFIs, but this is sometimes complemented by interest from the CDFI. By investing in the CDFI sector, investors can gain a reasonable return and know that their money is being used directly to achieve social gains.

Size of community development finance in the UK

The report *Inside Out 2005 – the state of community development*⁵, published by the Community Development Finance Association (www.cdfa.org.uk), found that CDFIs now have a total loan and investment portfolio of over £181m. The value of CDFI loans and investment written in 2005 increased to over £77 million.

The tax incentive for investment into accredited CDFIs is called community investment tax relief (CITR). Its key characteristics are:

- The CITR reduces the investor's income tax (or corporation tax) liability.
- The tax relief is spread over five years (5% a year) and is worth an annual 8.33% gross for higher rate taxpayers.

(d) Venture capital

Venture capital, or private equity, provides long term, committed share capital to help unquoted companies grow and succeed. Most venture capital is not undertaken on a responsible investment basis, but there is a small portion which does adopt responsible investment principles.

Self test question

Which of the three main approaches to green and ethical investment is definitely practiced by a 'best in sector' fund?

⁵ See <http://www.cdfa.org.uk/documents/InsideOut05Keyfindings.pdf>.





Step 3 – Key learning points

Different approaches: positive screening or support; negative screening or avoidance; engagement

- Various approaches exist to suit different needs. Those which are offered by life, pension and investment product providers break down into 'positive screening' or 'support', 'negative screening' or 'avoidance', or 'engagement'.
- Funds may employ only one approach or several.
- 'Support' and 'avoidance' 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.
- Advisers need to understand a client's motivations in order to match them to the solutions that are available.



Step 4: Using the client's risk profile, consider risk and performance issues

Having completed your standard fact find, you should have a thorough understanding of your client's attitude to risk. For those clients who are interested in green and ethical investment, it is worth spending a little while on risk and performance issues relating specifically to such funds.

As with any other investment, advisers have a responsibility to make sure that their recommendations are suitable for the client and match the client's risk profile and other strictly financial objectives, as well as meeting their green and ethical investment aims. It is therefore very important that during the fact finding process the adviser should discuss the normal investment criteria of:

- Risk and reward – choice of asset classes.
- Timescale.
- Liquidity.
- Income and capital growth.
- Tax.

There are now many investment funds, tax wrappers (OEICs, ISAs, CTFs, pension funds, onshore and offshore bonds), financial products and other types of investment from which to choose to meet the financial and green/ethical investment requirements of almost any investor.

Nevertheless, it is very important that clients understand the implications of their investment decisions. The adviser has the responsibility to explain to clients what impact the decision to invest in a particular fund (or other type of green and ethical investment) could have on the investment's financial performance.

Performance and risk issues are different for screened funds, which select stocks and make exclusions specifically on SEE grounds, and 'engagement-only' funds which generally do not. These are therefore covered separately below.

4.1 The case against screened green and ethical investment funds

The conventional view is that screened green and ethical investment funds typically lead to substandard returns. The theory can be simply stated as follows:

- If a fund has a reduced investment universe, this will lead to underperformance.
- Excluding sectors increases tracking error from the benchmark index, and thus increases portfolio risk.
- Consequently, responsible investment is not mainstream and is only suitable for ethical investors who are prepared to accept some underperformance.

For example, where a fund does not invest in tobacco companies, and the tobacco sector is doing well, it is missing an investment opportunity and increasing risk. The fund will therefore underperform.

The well-established arguments against this view are described in section 4.2.





In Step 5, you will learn what to find out about specific screened funds so that you can assess how (and how well) the particular fund you are considering manages these aspects.

4.2 The case for screened green and ethical investment funds

The case for screened funds that follow green and ethical investment criteria is as follows:

- Green and ethical investment funds vary greatly. It is inappropriate to generalise about them.
- The argument against green and ethical investment is confused with the argument against active management, as all active fund managers have to hold a manageable number of stocks in their fund.
- There may be long term financial advantages in some green and ethical investment strategies.
- There is considerable evidence against the underperformance view.

(a) The wide variation in screened funds

Green and ethical investment funds invest in a wide range of asset types and offer different screening and/or engagement approaches. Any attempt to treat them as a homogenous group is misguided. This is because their strategies are diverse, although there is some bias among them towards growth rather than value investment, and medium and smaller companies rather than the FTSE100 or the equivalent. Approaches are diverse because they attempt to meet the needs of different investors.

Some commentators mistakenly view green and ethical investment as a separate asset class. This view, while attractive for its simplicity, is also misleading, as there are many different approaches (both ethical and investment) adopted by different screened funds.

Both actively and passively managed green and ethical investment funds are available.

(b) Active fund management and screened green and ethical investment funds

For actively managed green or ethical investment funds, success or failure is primarily a function of:

- Fund management skill.
- Asset allocation.
- Stock selection.
- Risk control.
- The accuracy of the analyst's views.
- The overall quality of resources of the fund management house.

In this respect, they are like any other active investment approach.

The view that restricting investment choice by removing the possibility of investing in certain companies leads to underperformance is really an argument against active fund management rather than green and ethical investment.



Step 4

All active managers screen out stocks for various reasons. This is the nature of active fund 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 management approaches than for passive management.

Screened green and ethical investment funds simply exclude or favour stocks based on long term environmental, social, ethical and corporate governance concerns – and thereby reduce the risks or maximise the benefits associated with these areas. This leaves a fund manager with a set of stocks from which he or she can select investments, and to which he or she can apply mainstream portfolio construction techniques – which is exactly what most screened fund managers do.

Screened funds are no different from other actively managed funds in using different sector weightings relative to mainstream benchmarks (extreme index-huggers excluded). The degree to which a particular green and ethical investment approach has a beneficial or a detrimental impact on performance will primarily rest with the skill of the fund manager and their team – and in particular their stock selection abilities.

(c) The long term view of the impact of green and ethical screening

There is a case for saying that green and ethical investment strategies can lead to long term outperformance and competitive advantage over conventional fund management approaches. For example:

- Fund managers focus on the longer term views of trends that conventional analysts have typically ignored in their company valuations, eg climate change, human rights and brand value. The advantage can be particularly marked where fund managers are supported by an experienced team that is able to identify possible valuation impacts of long term social, environmental and corporate governance concerns.
- A specialist focus on particular sectors or technologies could lead to outperformance, though possibly at the cost of higher risk.
- Corporate governance is often an important factor in corporate success or failure. When corporate collapses such as Parmalat, Enron, WorldCom and Ahold can have such a serious economic impact, any additional information about the governance of a firm, and its approach to and management of social environmental and ethical issues, could provide invaluable insight.

(d) Practical evidence about the performance of screened funds

There is considerable evidence that funds that meet green and ethical investment criteria can perform at least as well as, and sometimes better than, other equivalent investment funds. The evidence is based on more than two decades of performance figures in the UK and other markets.

Recent assessment and evidence includes:

- A report from the Investment Management Association in July 2006 that said, "Investing ethically does not mean that you have to sacrifice investment performance. As with any investments, some perform better than others".¹
- Several fund managers of green and ethical investment funds are rated as AAA or AA by Citywire, and a 2005 Lipper Citywire All Stars Award was won by an ethical investment fund manager. According to Citywire, "fewer than 5% of all UK fund

¹ See <http://www.investmentuk.org/FactSheets/EI/performance.asp>.





managers achieve an AAA rating... If they do, it means that they have performed very well and are among an elite."²

- According to Money Management in March 2007, "the amount of negative and positive criteria has no definite effect on the performance of an SRI fund. But with a number of different kinds of SRI funds sitting at the top of the charts, there should be something to suit every kind of ethical investor."³
- A joint study on Corporate Environmental Governance by Innovest Group and the Environment Agency, published in November 2004, found that "better financial returns can be obtained from investing in companies which integrate environmental considerations into corporate governance and processes."⁴
- *Investment Life & Pensions Moneyfacts* wrote in August 2006: "It is possible to profit without sacrificing your principles... there are still plenty of examples where ethical funds have performed at least as well as, and sometimes better than, their conventional counterparts... Just like any other sector, it would appear that ethical and SRI funds have their own fair share of good and bad performers."

4.3 Passive management and the use of index trackers

For advisers who favour the lower cost and possibly lower risk approach of passive investment, there are green and ethical investment index trackers.

A tracker approach can be used with screening or preference to track the universe of companies, and may reduce management costs while meeting other financial criteria.

A green and ethical investment index tracker fund may mean a narrower underlying list of stocks than conventional index trackers. However, some indices are relatively broad, eg FTSE4Good.

If used by a particular fund, some passive techniques could reduce the variation in performance between a responsible universe of stocks and a conventional index.

4.4 Exploring fund characteristics which may lead to performance variations

Although there are many arguments to refute the case against screened green and ethical investment funds, it is still important for an adviser to understand the characteristics of funds which may be recommended and to discuss the investment implications of certain strategies with the client. This is necessary both to select funds suitable for the client's financial objectives and to ensure that the client understands and accepts any differences from other funds.

Of course, you need to take account of what you already know about the client's risk profile so that you can tailor the discussion appropriately.

Typical characteristics that may need to be understood and, where relevant, explained are:

- Implications of the types of investment style adopted by some green and ethical investment funds, which may be more likely to be biased towards growth rather than value investing, or may be a thematic investment proposition based on

² See <http://www.citywire-fmi.com/CFI/About.aspx>.

³ Survey: *How ethical are ethical funds?* in Money Management Green Investments Supplement, March 2007.

⁴ See http://www.innovestgroup.com/pdfs/2004-11-09-Environmental_Governance.pdf.



Step 4

emerging social and/or environmental changes or opportunities. Of course, if you expect to recommend screened equity income or bond funds, then this will alter what you need to discuss.

- The size of the companies held in different types of funds. Some funds may have a bias towards smaller companies in order to meet avoidance criteria, while others may focus more on larger companies by using a 'best of class' approach. Some thematic funds may have a small company bias inherent in their investment proposition.
- The techniques used by the fund to manage, and where necessary mitigate, any short term performance issues from the effect of differing sector weightings or other consequences of its screening criteria.

These characteristics can make a particular screened fund perform differently from common benchmarks in certain market conditions, although, as described above, not necessarily less successfully over the medium to longer term.

These aspects are very similar to those you will be used to considering for non-screened funds.

4.5 Engagement-only approaches and performance

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

An engagement-only approach to green and ethical investment management can yield long term benefits to fund holders:

- Using engagement, shareholders aim to behave like responsible owners of companies, to look to the longer term and to encourage better business practices where it is believed to be to the benefit of all.
- Improved corporate responsibility, supported by investor engagement, may result in corporate benefits such as improved reputation, happier employees, and an ability to attract and retain quality staff.
- Engagement with a company can also help to inform fund manager opinions. 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 shareholder value over the long term.

The Investment Management Association's third annual survey of fund manager engagement with companies, covering the year ending June 2005, involved 35 UK fund managers⁵ and identified 27 managers who had made their policy statements on engagement public (by publishing them on their websites), compared to 21 in 2004 and 14 in 2003, with more planning to do so.

Of the 35 managers, 33 employ staff dedicated to engagement and corporate governance and/or SRI issues. Fund managers' clients are one of the key drivers for engagement – 13 managers now consider that engagement is a key factor or influences whether they are selected.

⁵ See <http://www.investmentfunds.org.uk/press/2006/20060621.asp>.





Self test question

What is the case for saying that green and ethical investment strategies can lead to long term outperformance?

Step 4 - Key learning points

Risk and performance issues

- There is a wide range of green and ethical investment funds. Advisers should consider the merits of individual funds rather than generalising about the field as a whole.
- Fund manager skill is likely to be one of the most important factors in determining performance.
- The arguments against screened green and ethical investment funds are essentially arguments against actively managed funds, as, in practice, these also focus on a restricted investment universe and make investment decisions which deviate from benchmarks.
- There is much evidence that investing responsibly can be done without accepting underperformance.
- Advisers should understand the characteristics of funds that may be recommended, and should discuss the investment implications with clients.
- Most engagement-only funds do not exclude stocks on social, environmental or ethical grounds.
- Engagement encourages better business practices that seek to build shareholder value over the longer term, and can provide additional company information for fund managers.



Step 5: Select the appropriate providers and products

The final step in advising on green and ethical investment is to recommend the specific providers and funds for the client in the light of their financial and green and ethical investment needs and wishes, as discussed in the fact finding process.

The suitability letter should reflect the client's wishes and needs with respect to both the financial criteria and the green and ethical investment criteria. The client should understand the potential risks and returns.

5.1 Transparency guidelines for green and ethical investment funds

In most cases, transparency of information about what the fund does is a key issue. This ensures that a client can understand what they are buying. It helps advisers and clients to compare products more easily and to understand what is available, so that a solution can be found that matches a client's needs as closely as possible.

The Eurosif *Transparency Guidelines for the Retail SRI Fund Sector* have been created to improve standards in the area of greater transparency, ie encouraging product providers to be more open about what they do and how they do it.

The guidelines were produced by the European Social Investment Forum (Eurosif) with support from some of the leading European green and ethical investment fund providers and the European Commission.

As of January 2007, over 40 fund managers were signatories to the guidelines. Signatories are encouraged to disclose information on their green and ethical investment research processes, their green and ethical investment criteria and the fund's approach to voting and engagement.

The guidelines, a list of signatories and the information they have disclosed are all available on the Eurosif website.¹

5.2 Understanding the providers – transparency and responsibility

For some clients, considering how responsibly a product provider itself behaves will be just as important as looking at which companies are held in a particular fund – if not more important.

(a) The main issues

The importance of transparency has already been described. Clients who are concerned about the product providers themselves may also want reassurance about such issues as:

- **The institution's general approach to being a responsible shareholder**

Clients may want to know whether a fund manager or product provider engages with companies (and if so, what resources are devoted to this).

¹ See http://www.eurosif.org/publications/retail_transparency_guidelines.





They may also 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.

- **How the institution runs its own business**

Clients may well be interested in the product provider's own approach to corporate governance, corporate responsibility, voting practices and the FSA's initiative 'Treating Customers Fairly'.

- **The institution's contribution to developing a responsible finance sector**

Clients could be concerned about such issues as the institution's membership of organisations such as UKSIF, Eurosif, the Institutional Investors Group on Climate Change (IIGCC), or specific leadership initiatives on SEE issues in financial services or cross-industry.

(b) Available information

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 in such areas. The level of activity, as well as company's openness about what it does (or does not do), can be a useful indicator of its level of commitment to wider issues related to responsible investment.

Information of this kind may be available from a company's website, and should be easily accessible to advisers if available.

Opinions expressed by external commentators may be equally important indicators, such as membership of FTSE4Good Index (quoted companies only) and assessments made by Standard and Poors (eg regarding corporate governance), Business in the Community and others.

5.3 Understanding the products

In addition to the transparency disclosures described above, 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 none has a monopoly on ethical standards. Different approaches suit different clients. Terminology and methods of publicity vary.

In addition, be aware that issues change within the companies in which funds invest, 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' or 'aim to'. However, this may not be an indication of the seriousness with which a provider views an issue.

5.4 What to find out about specific screened funds

As an important part of selecting the correct funds that answer a client's needs, an adviser should understand the following issues about specific screened funds, asking the product providers to supply further information if necessary. For example:



Step 5

(a) In what sectors is this fund substantially underweight relative to its peers?

Typically, this might include defence, oil and gas, pharmaceuticals and perhaps financial services, because of concerns about armaments manufacture, pollution and climate change, animal testing and support for activities that the fund aims to avoid.

However, some green and ethical funds have exposure across almost all sectors, as stocks are picked on a 'best of class' basis.

(b) How does the fund manager mitigate the impact of being underweight in a particular sector?

The product provider's response might be that the fund manager aims to replace key sectors or stocks with:

- Less commonly held smaller or medium-sized companies that are often under-researched and may show similar performance characteristics to those being replaced.
- Stocks that are believed to be likely to give similar longer term performance because of positive attributes that may be unrecognised by others, such as emerging technologies.

Some product providers may say that although a fund may be unable to fully mitigate some risks because of its allowable universe of stocks, it has benefited from avoiding some major collapses thanks to the additional ethical investment research.

(c) If this fund is underweight relative to its mainstream peers in large cap stocks, how does the fund manager handle any disadvantage this might present?

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

(d) Other useful information

In addition, the adviser may wish to review:

- A list of the fund's top ten holdings to gain an understanding of how the green and ethical investment criteria are applied to the fund in practice. This may be available from the fund or product provider's website.
- The relative size of the sectors in which the fund is substantially underweight or overweight. This will help you to gauge how important this position might be. Information regarding the relative size of each sector is published in the *Financial Times*.

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

5.5 Green and ethical investment products and providers

A wide range of green and ethical investment funds is available today in many of the main fund sector categories.

As with other funds, green and ethical funds are available as ISAs and through life and pensions platforms.





Green and Ethical Investment

A Course for Financial Advisers

According to the Investment Management Association, investment sectors with ethical fund options include:

<ul style="list-style-type: none">• Active Managed	<ul style="list-style-type: none">• Specialist
<ul style="list-style-type: none">• Balanced Income	<ul style="list-style-type: none">• UK All Companies
<ul style="list-style-type: none">• Balanced Managed	<ul style="list-style-type: none">• UK Corporate Bond
<ul style="list-style-type: none">• Europe excl. UK	<ul style="list-style-type: none">• UK Equity Income
<ul style="list-style-type: none">• Europe inc. UK	<ul style="list-style-type: none">• UK Other Bond
<ul style="list-style-type: none">• Global Growth	

Bespoke green and ethical investment portfolios for clients with sufficient funds are available from a range of providers.

When you register to complete the course test, you will be offered the opportunity to receive further information about the green and ethical funds and providers in the market, and about the tools available to help you to select from among them.

Further information on green and ethical investment products and providers

The Eurosif *Transparency Guidelines for the Retail SRI Fund Sector* are available on the website of the European Social Investment Forum (Eurosif).

Information about members of the UK Social Investment Forum is available on the website of the UK Social Investment Forum. This includes product providers for collective investments, managers of bespoke green and ethical investment portfolios, and research/support organisations.

An online database of green and ethical funds will be available from April 2007 from Ethical Screening.

Synaptic Systems offers an ethical investment module within the Synaptic Fund Manager suite.

The Ethical Investment Research Service (EIRIS) provides a range of information for financial advisers, and will launch a new guide to UK ethical retail funds in April 2007.

Self test question

In what sectors is a screened fund likely to be substantially underweight relative to its peers?



Step 5

Step 5 – Key learning points

Selecting products and providers

- Standardised disclosure of information using, for example, the Eurosif *Transparency Guidelines for the Retail SRI Fund Sector* aids comparison between funds or companies, thereby helping to identify the best solution to meet a client's needs.
- Many clients are interested in the corporate responsibility behaviour of the product provider itself, and this may be as important as the fund's green and ethical investment approach.
- A substantial number of products with different approaches are available, offering a range of options for investors.
- In selecting funds, advisers should understand the fund characteristics and how these are managed – in particular, the implications of sectors underweight and overweight, and market capitalisation/size of companies held in the fund. This should help you to understand when a fund's short term performance may vary from that of an equivalent unscreened fund.
- A range of tools is available to assist you to advise on green and ethical investment.





Answers to self test questions

Introduction

Answer: Social, environmental or ethical responsible investment criteria.

Step 1

Answer: Occupational and stakeholder pensions must provide a SIP.

Step 2

Answer: Affecting the variety of plant and/or animal life. Company activities can do this in a positive or negative way.

Step 3

Answer: Positive screening or support.

Step 4

Answer: Fund managers focus on the longer term views of trends that conventional analysts have typically ignored in their company valuations: climate change, human rights and brand value. A specialist focus on particular sectors or technologies could lead to outperformance, though possibly at the cost of higher risk. Corporate governance is often an important factor in corporate success or failure.

Step 5

Answer: Typically defence, oil and gas, pharmaceuticals and perhaps financial services.

