

Introduction

Shareholders sometimes group together to campaign against certain issues, such as excessive director remuneration. This could be considered as **the engagement approach** to ethical investment issues.

Those who invest in ethical funds are, in effect, also voicing their concerns by **using their money to influence the behaviour of companies**.

As of the end of 2007, there was a record £8.9 billion invested in UK ethical funds. That represents **almost 750,000 accounts in ethical funds**, up from around 137,000 accounts in 1997.

2008 saw the first **National Ethical Investment Week** (www.neiw.org). Running from 18-24 May, it encouraged investors to consider ethical options.

Ethical, green, environmental and other 'socially responsible' funds now tend to be referred to under **the generic name of ethical funds**.

There are, however, **differences which can be very important for particular investors** and we will begin by outlining those differences.

Having done this, we will, in the rest of this Guide **simply refer to ethical funds** and mean that to include all of the types of funds.

"What do we mean by ethics? In simple terms, *morality* is the right or wrong (or otherwise) of an action, a way of life or a decision, while *ethics* is the study of such standards as we use or propose to judge such things. Thus abortion may be moral or immoral according to the code we employ but ethics tells us why we call it so and how we made up our minds. As a result, ethics is sometimes called *moral philosophy*; we use it to criticise, defend, promote, justify and suggest moral concepts and to answer questions of morality."

An Introduction To Ethics by Paul Newall

Ethical funds

Funds that call themselves 'ethical' or 'socially responsible' **tend to apply negative criteria** when deciding which stocks and shares to invest in. This could be considered as **the avoidance (ie negative screening) approach**.

They may, for example, avoid investment in companies which are involved in the production of **alcohol, tobacco, pornography**, or in the **supply of armaments**, or operate in countries with **oppressive regimes**. They may also avoid companies which **exploit animals** or are involved in **nuclear power**.

The degree to which the criteria are enforced varies considerably from fund to fund. For example, some funds will buy shares in companies which sell alcohol but do not produce it.

"From its roots in the religious movements which inspired Victorians concerned with issues such as temperance and fair employment conditions, ethical investment has rapidly grown in recent decades to become a powerful force for social change and is now entering the investment mainstream."

Penny Shepherd - Executive Director
UK Social Investment Forum

Green funds

Funds that call themselves 'green', as their name suggests, concentrate largely on what has become known as **'green consumerism'**. For example, in many green funds you will find stocks such as Marks & Spencer and Tesco because they sell 'friendly' detergent and organically grown vegetables.

In the main, **the green funds are passive**, investing in companies which they believe are not damaging the environment 'too much'. This could be considered as **the support (ie positive screening) approach**.

"The modern roots of socially responsible investment can be traced back to the 1920s when the Methodist Church wished to start investing in the stockmarket while avoiding companies involved in alcohol and gambling. The Quakers soon followed, avoiding weapons manufacture."

Penny Shepherd - Executive Director
UK Social Investment Forum

Environmental funds

Funds that call themselves 'environmental' do not apply ethical criteria as such - although they would not usually invest in major polluters, for example.

Their main aim is to invest in companies involved to a significant extent **in improving or maintaining the quality of the environment**.

The history of ethical funds

The philosophy of ethical investment is not a new concept. The first American ethically screened unit trust (or mutual fund) predated the launch of ethical unit trusts in the UK by more than a decade.

In 1971, the Pax World Fund was set up in response to the demand for investments which did not benefit from the Vietnam War. In the 1980s, opposition to South African apartheid fuelled the ethical investment movement both here and in the US.

Friends Provident was the first investment group in the UK to launch an ethical fund, the Stewardship Fund, in 1984, and in 2006 this fund became the first ethical fund to reach the £1 billion mark. A growing number of other investment groups are making a serious contribution to the range of choice for investors.

"When the first UK ethical trust was launched in 1984, informed City observers estimated that the ethical investment market in the UK would eventually reach a maximum size of around £2 million. Yet by the spring of 2000 it had grown in value to reach some £2.6 billion - more than 1,000 times the original estimate - and the growth shows no signs of slowing."

Penny Shepherd - Executive Director
UK Social Investment Forum

Ethical investment received a boost in 1998, when Pensions Minister John Denham announced that he was "minded to require trustees to disclose to what extent, if any, they have taken account of social responsibility considerations in their investment strategy". His proposals become law in 2000 and now **all occupational pension funds have to consider formally** whether or not to develop policies on social, ethical and environmental issues.

The following numbers of ethical funds were listed by Financial Express company, TrustNet (www.trustnet.com), on 01.11.2008.

	Ethical	Green	Environmental
Unit Trusts	31	25	12
Investment Trusts	0	4	2
Pension Funds	57	5	13
Insurance Funds	61	7	12
Offshore Funds	4	6	12
VCTs	0	2	0
Totals	153	49	51

You can now have the option of an ethical fund **when considering a wide range of investment decisions.**

The relative performance of ethical funds

A Cooperative Insurance Society Report in 2002 reviewed many studies of performance and concluded that **screening for ethical criteria resulted in no negative effect on performance.** Another study carried out by ABN Amro Asset Management (whose funds are now part of Artemis) backed this up.

However, it is important for individual investors to be aware that **such studies may be made over very long periods of time.** The comparative performance of ethical funds with the rest of the market may be quite different when considering periods of less than, say, ten years.

We believe it is important for investors in ethical funds to realise that nearly all such funds are **heavily invested into smaller companies.** This is because the screening process has tended to drive ethical funds away from many large capitalisation stocks. Although it has to be said that a 'smaller company' is usually defined as one with a capitalisation of less than £50 million.

As a consequence **some funds are now adopting a neutral approach,** that is they are allowing investment in companies that are neither positively harmful, nor positively beneficial.

If you are thinking of making an investment into one or more ethical funds it is important that you appreciate **the impact that investing predominantly in smaller companies could have on the short term performance** of your investment.

It is also the case that because of this emphasis on smaller companies the funds are **predominantly suitable for growth investments rather than producing income.**

Smaller companies have **tended to under perform the market during times of recession.** During falling (bear) markets investors naturally tend towards investing in larger household name companies for security. In such times, **you may pay a heavy price, in terms of lower returns,** for your socially responsible stance.

On the other hand smaller companies have **tended to do better coming out of a recession** than larger companies.

During rising (bull) markets investors tend to let their natural conservatism slip away from them and invest in smaller companies which seem to be growing faster than their larger counterparts.

Over the longer term of ten years or more smaller companies as a group tend to perform as well as, if not better than, larger companies.

The general view, therefore, is that investing in ethical funds over the long term **should present no noticeable cost to you.**

In the short to medium term, that is less than ten years, however, you should be prepared to pay a price in terms of lower overall growth in your investment.

EIRIS

The Ethical Investment Research Service (www.eiris.org) is an **independent body** which was launched in 1983 to **provide information for ethical investors** and research ethical issues.

EIRIS can provide details of which UK investments meet the criteria which a specific unit trust, for example, is trying to achieve. In other countries established sources of environmental information are drawn upon to determine the eligibility of shares for a particular trust.

Arch Financial Planning Limited is registered with EIRIS and in this way we are kept up to date with information on socially responsible issues and funds. You may wish to visit the EIRIS website to view the **EIRIS Green and Ethical Funds Directory.** This enables you to navigate between the different ethical policies and approaches offered by a diverse range of UK ethical funds.

Whether your main concerns are environmental improvement, animal testing, engaging with companies on issues relating to the third world or a host of other criteria, the directory has been launched to help investors find out which funds' criteria match their own concerns.

Investor subjectivity

It is important to be aware of the **subjectivity which investors bring to any particular fund.** The trust managers may interpret the basic criteria of the fund in a different way to that of the investor.

Take, for example, a supermarket chain that is being considered for inclusion in a share portfolio. The group offers ozone friendly deodorant sprays, recycled toilet paper, washing powder in bags, organic vegetables and one pence for every plastic carrier bag that customers re-use. It sells cigarettes, however, and apples from an African country with a known oppressive regime, plus a range of wines and alcoholic beverages. **Can this stock be included in an ethical fund?** Some funds will certainly consider investing in such a stock and some will not.

From your point of view it will depend on whether you are inclined towards environmental issues and enjoy the occasional glass of wine, or whether tobacco is anathema to you.

What of the ordinary investor?

People are gradually becoming aware that even a small change of lifestyle can, over the years, have a dramatic effect upon the world in which we live.

"I have found no greater satisfaction than achieving success through honest dealing and strict adherence to the view that, for you to gain, those you deal with should gain as well."

Alan Greenspan
Chairman of the US Federal Reserve 1987 to 2006

The number of people now using unleaded petrol in their cars and driving diesel cars is evidence of the fact that many people are prepared to make an environmentally friendly choice **if the decision to do so does not cost more money.**

The rates of **vehicle excise duty (VED)** have recently changed and this is likely to persuade some people to look again at their choice of car.

The 2.5 litre petrol driven Lexus IS250 is a good looking car but its CO₂ emissions of 231 g/km means that it is in **Band G with a VED of £400 pa**. Whilst not quite so sporty, the 2 litre diesel BMW 118d with its CO₂ emissions of 119 g/km means that it is in **Band B with a VED of less than a tenth of the cost at just £35 pa**.



The saving is, of course, not just in the pocket of the driver, but the lower emissions are good for the environment too.

Once people are made aware of the fact that they can make an ethical, green or environmentally friendly choice when purchasing their pension or savings plan then there is no doubt that many more investors will wish to do so.

As a first step when taking out a new investment product **you may wish to designate that a percentage of your investment** be allocated to an ethical fund.

Whilst you may feel that this will restrict you as to the choice of life or pension office to be used, there is a growing number of household name product providers offering an ethical fund choice. The **really big improvement for ethical investors**, however, is the availability of fund platforms.

Ethical savings and investment are not just limited to those with a lump sum to invest. A number of product providers now offer **regular savings plans and investments with an ethical fund option**.

The advantages of a fund platform

Individual investment or pension companies may offer a choice of just one or two ethical funds. Ethical investors should seriously consider **moving their investments and pensions onto a fund platform** where a much wider choice of ethical funds will be available.

We use the **Nucleus Wrap** for clients with a total of more than £20,000 to invest (including existing investments which can be re-registered to Nucleus) and the **Cofunds Fund Supermarket** for small investments.

Choosing an ethical fund

Investors should **not seek to choose a fund in isolation** because what might be a good fit for one investor might be totally inappropriate for another. When choosing any fund it is best to follow a process as follows:

- **Can you afford to invest?** This may seem like a funny question but it is important to settle this at the outset. For example, it is generally advisable to pay off any debt that you have before investing as the cost of your debt may well exceed the returns on your investment, net of charges and tax.
- **What is your attitude to investment risk?** This is the foundation question of any investment that you wish to make. After all, if you are a defensive investor whose main priority is the security of your capital, then you probably will not want to stray much beyond keeping your money on deposit or in short term UK government securities (gilts).

We use **five definitions of attitudes to investment risk** prepared by AKG consulting actuaries. These are defensive, cautious, balanced, moderately adventurous and adventurous. In each case the asset allocation we use will be affected by whether the investments are to be medium term (up to 10 years) or long term (in excess of 10 years).

- **What do you want the investment to do?** Do you require income from your investment, or do you simply require the prospect of long term growth? Do you want a long or short term investment? Are you investing for yourself or for someone else, such as a child?
- **What assets do you want to hold?** It is advisable to spread your risk by investing across a range of different asset classes, fund managers, investment styles and geographical regions, rather than placing all your money in one type of investment.

The main asset classes are cash, bonds, equities and property. These can be **broken down into different markets**, for example, how much in the UK, how much in emerging markets? There are also alternative asset classes, such as commodities, private equity and hedge funds that can also be considered, as these have become more readily available to retail investors

- **What is your tax situation?** Investments can be held in different 'wrappers', for example ISAs, VCTs, pensions, life assurance bonds; or be 'unwrapped' and simply held as unit trusts or OEICs (Open Ended Investment Companies). Different wrappers, or the absence of a wrapper, will affect the tax liability on your investment in different ways.

A higher rate tax payer will particularly benefit from holding investments in an ISA or a pension. **A basic rate tax payer** may find that an unwrapped investment is suitable for his or her needs. **A non tax paying spouse** of a higher rate tax payer may benefit from holding his or her investment in an offshore life assurance bond.

- **What are your ethical concerns?** You may simply want to feel that your investments are doing more good than harm. On the other hand you may have very specific requirements as to the type of ethical screening that you wish to see. In this case you will want to look at the funds in depth using the **EIRIS Green and Ethical Funds Directory**.
- **What about the relative performance of the funds?** It is important for you to be aware of what the funds you are considering have achieved in the past. At the same time you need to remember that past performance is not a guide to future performance. For example, the past performance **may have been achieved by a particular fund manager who has now left**, or by a few investments when the fund was small.

We use *Aequos Engage* which is fund research software provided by Defaqto (www.defaqto.com) which provides **timely and accurate financial information on a wide range of ethical funds**. Defaqto has been the leading independent provider of financial services research since 1994 and is the sole supplier of data to the Financial Services Authority for use in its Comparative Tables service.

We also use the **SRI Funds Service** which combines performance and risk measures of the European SRI fund universe with basic information regarding SRI fund selection criteria. The fund's financial information is sourced from Morningstar Europe, a leading provider of fund performance and risk data. The financial data is updated on a daily basis.

Finally we refer to **the normal research information that we use for comparing all types of funds**. The main sources that we use are TrustNet, Citywire, Lipper and OBSR Fund Ratings.

Our practice

We consider it is **a matter of good practice** to bring the availability of ethical investments to the attention of each potential new client, and from time to time with existing clients considering further investments.

Our Confidential Questionnaire, which all new clients are asked to complete, includes the statement, 'Would you like any social, ethical or environmental issues to be taken into account when looking at your investments?'

Other useful organisations

You might also like to look at the websites of the UK Social Investment Forum (www.uksif.org), the Ethical Investment Association (www.ethicalinvestment.org.uk), Ethical Performance (www.ethicalperformance.com) and Clear Profit (www.clear-profit.com).

For your ethical banking needs you might like to look at the Co-operative Bank (www.co-operativebank.co.uk), Triodos Bank (www.triodos.co.uk) and the Ecology Building Society (www.ecology.co.uk).

If you are an active member of your local church you might also like to look at The Ecumenical Council for Corporate Responsibility (www.eccr.org.uk) and the Christian Ecology Link (www.christian-ecology.org.uk).

For a great introduction to introducing socially responsible issues to your local church and your own lifestyle, you might like to use the free resources of the Eco-Congregation (www.ecocongregation.org).

For those local to Guildford the Guildford Baptist Church organisation, GodsAcre (www.godsacre.co.uk) provides some excellent ideas and activities.

Risk Factors

- All investments carry an element of risk. Where past performance is mentioned please note that the past is not necessarily a guide to future performance.
- An investment into an ethical fund such as a unit trust, OEIC, ISA, or other collective investment scheme, is intended as a long-term investment. Both capital and income values may fall as well as rise and are not guaranteed. You may not get back the full amount you invested.
- These notes do not replace the full product specification that accompanies each investment recommendation. Each fund has its own objectives and risk factors. These are detailed in the Key Features document. Before you decide to invest in any ethical fund you must read this document.
- The tax efficiency of any investment depends on individual circumstances and tax rates and laws may change in the future.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether an ethical investment is suitable, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

For personal advice

If you would like to discuss whether an ethical investment might be appropriate for you please ask your usual Arch adviser or contact us via one of the following:

Tel: 0845 3700 661
Email: enquiries@arch-fp.co.uk
Online: www.arch-fp.co.uk

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