A greener future

Richard Eagling reports on how a renewed focus on climate change and the strong performance of ethical funds could see more advisers grasping the opportunities offered by SRI

The ultimate aim for any investor is to generate a healthy return on their investment, but this does not have to come at a cost to the environment or society. Fuelled by constant media coverage of corporate greed and Government debate around environmental issues, more and more investors are waking up to the realisation that profit and principles are not two mutually exclusive concepts and that companies who adopt sustainable practices are well placed to be tomorrow's commercial winners.

The extent to which ethical and Socially Responsible Investing (SRI) is permeating society is reflected in last year's strong sales of ethical funds. According to the Investment Association, ethical funds enjoyed net retail sales of £460 million in 2014, their highest figure since 2007. But although the UK has already become Europe's largest Sustainable and Responsible Investment market, there remains a sense that the sector has a long way to go before it reaches its full potential, with ethical/SRI funds still only accounting for around 1.1% of the total investment funds under management.

"It is enormously encouraging that many businesses are taking environmental, social and governance (ESG) factors seriously, and this can be seen in the number of businesses that are now signatories of the UNPRI - clearly there is increased demand in this area," says *Peter Michaelis, Head of Equities at Alliance Trust Investments.* "There is still, however, an enormous amount of growth potential for those of us who specialise in Sustainable and Responsible Investing, with the sector small in comparison to the wider market."

A higher profile

One of the main reasons to be optimistic about the future of the SRI sector is that ethical issues look set to gain an even higher profile. Indeed, there are plenty of developments that should ensure ethical and socially responsible issues remain at the forefront of investors' minds over the coming months and years.

"Whether it is discussion about air pollution in our cities, the type of economic growth we want to see, where cuts to welfare should fall and how the food and goods we buy are produced, social, environmental and ethical issues are central to public debates," argues Peter Michaelis. "2015 is also an important year for climate change with a new global agreement likely to be signed in December in Paris."

The issue of climate change in particular has risen up the political agenda and could prove a big driver for discussions around SRI. There has been a renewed interest around climate change in recent weeks, sparked by a spate of important announcements and activity.

Last month the leaders of the G7 group of industrialised nations committed themselves to a carbon-free future, having backed a plan to phase out fossil fuels by the end of the century. A global target for limiting the rise in average global temperatures to below 2°C was also agreed. Closer to home, in a letter sent to Prime Minister David Cameron, 80 UK companies including the likes of BT, E.ON, John Lewis Partnership, Sky and Tesco urged the PM to take more decisive action on climate change and to build a low-carbon economy.

Further ensuring that climate change remains in the spotlight is the publication of a new report by the New Climate Economy, which suggests that the decarbonisation of the global economy is possible given international cooperation from policymakers, businesses, investors and other stakeholders. An important element of its plans to close the emissions gap by 2030 is the proposal that “financial sector regulators and shareholders should require companies and financial institutions to disclose critical carbon and ESG factors and incorporate them in risk analysis, business models and investment decision-making”.

“The biggest issue in the SRI community, as I see it, is climate change,” says *Julia Dreblow Director at sriServices.* “With the forthcoming IPCC meeting in Paris (COP21) in November, minds are focused on both how to reduce emissions and the implications for investors. This year has seen shareholders becoming increasingly active (e.g. at the Shell and BP AGMs), concerns about companies involved in areas such as fracking and arctic exploration, and the Bank of England (among others) endorsing the view that ‘stranded assets’ are a genuine risk for investors with exposure to fossil fuel companies.”

The fossil fuel divestment campaign

Indeed, the debate around whether investors should be re-assessing their exposure to companies that extract fossil fuels and potentially divest has been intensifying. The case for considering fossil fuel divestment stems not only from concerns about their impact on climate change but also the financial risks associated with exposure to fossil fuel stocks.

It is feared that stricter regulations on carbon dioxide emissions and lower future demand for fossil fuels could significantly reduce the value of such reserves and potentially leave them ‘stranded’ and worthless. Indeed, Carbon Tracker has already calculated that only 20% of the proven reserves of fossil fuels can be burned unabated if global temperature rises are to be limited to below 2°C, leaving up to 80% of assets in the ground.

In a ‘stranded assets’ scenario, carbon intensive industries would naturally become less attractive and investors would see these share values fall fast. As a result, there is a growing belief that investors should reduce the risks posed by exposure to fossil fuel stocks by repositioning their portfolios away from fossil fuels towards low carbon-energy, such as renewables.

“The ‘divest’ campaign has set the cat among the pigeons in the SRI community,” suggests Julia Dreblow. “Not all SRI investors agree that avoiding oil and gas or even coal is necessarily useful - but it is certainly raising the profile of the need to move away from fossil fuels and towards renewables. Even among those who feel there is still money to be made from what are seen as the ‘less negative’ areas of fossil fuels (e.g. gas), the risk of assets becoming stranded is believed by many to be real. Funds that are promoted as ‘responsible’ or ‘ethical’ are unlikely to want to find themselves in the wrong place if, or when, a big sell-off happens. The alternative investment area is, of course, renewable energy (most notably wind and solar), which have become increasingly competitive over recent years. Most SRI funds therefore have at least some exposure to cleaner, greener technologies and recognise this as a growing opportunity.”

Other SRI experts agree that climate change remains the overriding concern for responsible investors. “Much collected activity is focused on lobbying business to improve emissions management and reduce overall climate change impact,” says *Ketan Patel, Senior SRI Analyst at EdenTree Investment Management.* “The debate on fossil fuel divestment has therefore come to the fore over the last 12 months with several high profile investors contributing to an increasingly polarised dialogue. Our Amity Funds do not specifically exclude fossil fuels, but on environmental, human rights and climate change grounds we do not have any investment exposure to mining in the Funds and only minimal direct exposure to oil and gas. In terms of power generation, we recognise the need for reliable energy generation and where we do invest, we prefer companies that have a mixed inventory that combines renewables with gas, which have a lower carbon footprint than coal."

At the moment the SRI community appears to be split on the fossil fuel divestment and 'stranded assets' debate, perhaps reflecting the diverse range of opinions that exist on these issues among the general public. "Given that our funds have a generally low exposure to the heaviest fossil fuel companies and the complexity of the issue, we have not taken a formal position on the divestment campaign, although we are cognisant of the arguments offered in support - and against," comments Ketan Patel.

Instead, Mr Patel argues that the key driver for EdenTree Investment Management is what companies are doing to manage and reduce their climate change impact over the medium to long term. "We would also point out that while commentators focus on framing fossil fuel natural resources as a fuel source, a significant proportion of oil and gas assets are used by the chemicals, food and pharmaceutical sectors (among others). Looking for companies that are managing their carbon footprint is imperative in order to ensure that emissions are not only kept in check, but are reduced over the long term. This can only be achieved by investing and engaging in companies that are committed to stewardship of the environment, regardless of what sector/s they operate in."

Water resources

Water-related issues are another big talking point in the SRI sector at the moment. In 2013 the World Economic Forum identified water supply crises as one of the top five global risks, while the World Resources Institute suggests that more than a billion people currently live in water scarce regions. Consequently, some SRI providers are integrating water into their investment decisions by analysing how companies manage this critical resource.

"Second to climate change we are seeing increased awareness and action taken in respect of water related impacts," adds Ketan Patel. "Most analysis accepts that water will become a major risk for businesses operating in water intense sectors such as electronics, energy, retail supply chains and food and beverage manufacture. Measuring water footprints is therefore becoming a key issue for business and investors are focusing dialogue with companies on how they can reduce use and impact while ensuring water as 'a shared resource' does not lead to communities withdrawing business license to operate owing to failure to share limited water resources adequately."

Table 1: Top 15 ethical unit trusts/OEICs performance over 1 year - as at 18 June 2015

Fund Name	1 year % growth
Alliance Trust SF UK Ethical A Acc	17.93
Alliance Trust SF UK Growth SC1	15.75
F&C Responsible Global Equity 1 Acc	15.58
Premier Ethical A Inc	15.50
First State Asia Pacific Sustainability A GBP Acc	15.45
Kames Ethical Equity B Acc	14.87
Standard Life Inv UK Ethical Ret Acc	13.81
Henderson Global Care UK Income A Inc	13.56
FP WHEB Sustainability A Acc	12.94
Legal & General Ethical R Inc	12.41
F&C Responsible UK Income 1 Inc	12.26
Henderson Global Care Growth A Inc	12.17
CIS Sustainable World Trust A Inc	12.01
Kames Ethical Cautious Managed Acc B	11.91
F&C Responsible UK Equity Growth 1 Inc	11.55
Total ethical fund average	7.89

Source: Lipper Investment Management. Figures are based on total return with no initial charges applied. Net income reinvested at XD date.

A maturing market

For those clients looking to grasp the ethical/SRI opportunity, there is now a wider choice of investment options than ever before. As a result, most investors who want their investments to reflect their principles should be able to find a fund with an acceptable ethical/SRI stance.

"Advisers and clients can now build a diversified ethical/SRI portfolio covering all

Table 2: Ethical funds versus non-ethical funds (percentage growth)

	1 year	3 years	5 years	10 years
All ethical funds	7.89%	45.60%	54.07%	94.24%
All non-ethical funds	6.55%	35.46%	42.51%	100.07%
IMA sector performances				
Ethical £ Corporate Bond funds	5.83%	22.53%	38.45%	52.53%
Non-ethical £ Corporate Bond funds	5.05%	19.03%	30.39%	52.26%
Ethical Mixed Investment 40-85% funds	10.06%	48.25%	60.60%	98.74%
Non-ethical Mixed Investment 40-85% funds	6.79%	34.27%	42.08%	94.11%
Ethical Global Funds	7.42%	43.94%	41.13%	104.57%
Non-ethical Global funds	9.88%	48.68%	55.20%	111.24%
Ethical UK All Companies funds	10.46%	59.19%	77.90%	108.03%
Non-ethical UK All Companies funds	7.63%	53.63%	73.40%	113.92%

Source: Lipper Investment Management. % growth as at 18 June 2015, total return, UK net, no initial charges

asset classes (including fixed interest and property) and geographies," explains Ketan Patel. "The concept of socially responsible investment is maturing all the time. The number of UK products that are 'ethical' or 'responsible' has now passed 100, with funds to suit all types of investor. These range from the traditional 'negative screened' funds to those embracing positive screened criteria and positive engagement, such as the Amity range, to the more thematic focused funds centred on technology such as water, waste and renewable energy. More recently, impact, social and peer-to-peer investing are adding new dimensions to the responsible investment space that make this a genuinely vibrant and exciting market."

According to Eurosif's 2014 European SRI Study, the most practised SRI strategy in the UK by assets under management is engagement and voting, with this strategy covering £1.434 trillion. ESG integration and exclusions are the second and third most practised strategies respectively.

"The highest levels of interest in the intermediated market still appear to be in the middle ground of SRI options where funds offer a combination of diverse 'ethical' exclusions (e.g. tobacco, armaments and major polluters) alongside 'positive themes' such as sustainability, health and safety, and sound governance practices," claims Julia Dreblow. "Investors today seem to want a bit of everything. They typically like to invest in well managed, positive, 'future-proof' companies while avoiding key 'nasties' - but also strongly approve when fund managers encourage better practices through responsible engagement and voting."

Powerful performance

As well as the social and environmental case there is also a compelling performance argument for using ethical/SRI funds. The average ethical fund has enjoyed a productive 12-month period returning 7.8% compared with 6.5% from the average non-ethical fund.

Furthermore, of the 60 ethical unit trust/OEIC funds surveyed, over a third (21) posted double-digit growth over the last 12 months, while only six suffered a loss. **Table 1** shows the top 15 ethical/SRI fund performers over the last year. Alliance Trust Investments have enjoyed a particularly productive 12-month period, boasting the top two ethical/SRI performers: Alliance Trust Sustainable Future UK Ethical (17.9%) and Alliance Trust Sustainable Future UK Growth (15.7%).

"A focus on higher quality businesses allied to good fund management discipline has been the basis of our success," explains Peter Michaelis. "The outperformance in these particular examples (Alliance Trust Sustainable Future UK Ethical and Alliance Trust Sustainable Future UK Growth) can be attributed to the positive selection of companies benefiting from sustainable investment themes. For instance, one of our largest holdings, Kingspan, has benefited from increasing demand for energy efficiency in construction and consequent rapid growth in sales of their insulation products. As well as this, we can't deny that the fall in oil prices has helped given that we do not invest in this sector."

The strong performance of ethical/SRI funds is also reflected in **Table 2** which shows how they have fared within the four Investment Association sectors that house the most ethical funds. In the £ Corporate Bond sector and Mixed Investment 40-85% Shares sector, ethical funds have outperformed non-ethical funds over all of the terms surveyed (1, 3 , 5 and 10 years), while in the UK All Companies sector, they only lag behind their conventional counterparts over 10 years.

Overall, ethical/SRI funds have continued to perform favourably, outpacing the returns generated by their traditional fund rivals in 14 out of the 20 different investment scenarios we surveyed.

Given that companies that focus on sustainability are more likely to better manage environmental, financial and reputational risks, issues that could prove detrimental to a company's share price, it should come as little surprise that ethical/SRI funds have delivered such impressive returns. "The integration of ethical/SRI factors into financial analysis helps to reveal the full risk profile of a potential investment, which over the long-term will help deliver superior or outperformance," says Ketan Patel. "There has been a shift by companies and investors in viewing ethical/SRI as a profit centre and not just a cost centre. CEOs have grasped the idea that ESG factors, if managed well and for the long term, can deliver reputational value as well as reduce costs."

Grasping SRI opportunities

So if there is a healthy appetite among consumers for ethical/SRI options and the funds themselves are delivering on their profits and principles promises, what could be holding the SRI sector back?

"Investors continue to face barriers to investing responsibly, such as information deficit, or IFAs failing to ask investors about their interest in investing ethically at the outset," claims Ketan Patel. "Given the size of the market, the range of opportunities and the projected growth, the industry needs to be able to sell itself more visibly to specialist and mainstream investors alike."

One of the problems in addressing these adviser attitudes is that discussing ethical/SRI options with clients is not a regulatory requirement. However, advisers who are aiming to achieve the best practice adviser ISO standard (ISO 22222) are required to ask an SRI fact-find question.

"It is 'best practice' to build consideration of clients' 'ethical, social and environmental' opinions into the advice process," says Julia Dreblow. "If an adviser does not discuss SRI or ethical issues with their clients, there is simply no way to identify who is and is not interested. Failure to do so could lead to inappropriate investment recommendations being made.

"There are definitely more advisers who ask clients if they are interested in ethical options than there were, say, 10 years ago, but my concern at present is the quality and objectivity of this process," continues Julia Dreblow. "If all advisers were to offer at least a neutral view of this area and give a flavour of its diversity, the SRI sector would have advanced further than it has. Retail SRI significantly lags behind the institutional market so something is not right. My personal view is that many advisers lack the skills and confidence they need in this area."

Ultimately, there is a strong business case for incorporating SRI into the advice process. In doing so, advisers can add value to their client service proposition and get to know their clients better. "Offering clients the option to consider this area is an opportunity for advisers," concludes Julia Dreblow. "Finding clients who are interested in this area can help deepen the adviser/client relationship and also help position a person's portfolio to benefit from future trends. It also lends itself well to the kinds of 'one-to-one' advice that advisers are so well placed to offer."