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SRI: environmentally, socially and financially useful – and uniquely placed to help build trust

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- Retail sustainable, responsible and ethical investment fund options (SRI) emerged in the 1980s, and have expanded and diversified significantly since 2000 as a result of diverse investor aims, opinions and motivations. Strategies include screened and themed funds options as well as the option to select fund management companies based on corporate level SRI related activities and strategies.
- The market can be simplified by breaking it down into the eight 'SRI Styles' segments: Ethically Balanced, Negative Ethical, Sustainability Themed, Environmental Themed, Social Themed and Faith Based fund options plus Responsible Ownership and ESG Integration corporate level options.
- The clearest indication of the benefits of additional Environmental, Social and Governance (ESG) research is the fact that many of the world's largest investors now integrate ESG issues into risk management and investment analysis across the board.
- SRI offers investors the option to align lifestyle choices, interests, values and opinions into investment planning. Many may also want to reflect their views on emerging mega trends and changing business strategies.
- Shifting the 'conversation' away from purely financial matters and towards opinions and the way in which returns are generated can help to personalise the investment advice experience by adding context and personal relevance.
- 'Conversations' of this kind are becoming increasingly important as issues such as sustainability and climate change are becoming ever more important to both business and investors. By offering people the option to bring their values and opinions into their investment strategy the financial services industry can start to reconnect with investors who have been put off by today's prevailing culture.

The Chartered Insurance Institute

CII Introduction: The sustainable, responsible and ethical investment markets have changed dramatically over the last 15 years, however the enthusiasm seen in institutional markets has only recently started to permeate the individual investor market. Retail 'Ethical and Sustainability themed' fund options achieved their highest ever net fund inflows in 2015, according to the Investment Association. This is a positive signal - however their proportion of total inflows remained in the region of 1.2%, which is where it has been for many years. These somewhat mixed messages point to a sector that is making progress but yet to embrace this area fully. This thinkpiece examines how the retail SRI market got to where it is today and why accelerating the integration of ethical, social and environmental factors into retail investment planning makes sense.

Sustainable, responsible and ethical investment fund options (SRI) today comprise a highly diverse range of issues, approaches, strategies and options. As a result, probably the most obvious challenge presented by this area is terminology - as different terms have emerged at different times to suit different purposes.

The UK's first ethical fund for individual investors was launched in 1984. Most of its policies originated from the values of those who had come together to create it – in particular investment professionals of Quaker and Methodist faith.

Although not the only strategy - its most obvious differentiator was the avoidance of companies that breached its ethical screening criteria, such as tobacco and armaments manufacturers.

The fund's pioneers had battled hard to seek regulatory approval to create a fund they hoped would help make the world a better place – thereby starting a movement that has seen consistent growth ever since.

The late 1980s and early 1990s brought a stream of new fund options and strategies. Many shifted their emphasis to focus on increasingly apparent environmental risks and opportunities - often in combination with ethical screening criteria.

The late 1990s saw a growing dislike of the term 'ethical' in some quarters which triggered the adoption of a wider range of terminology. The more pragmatic 'best in sector' approach gained traction, as did putting an emphasis on positive stock selection - the forerunner of today's many 'themed' options. This included the now widespread Sustainability focused options, which became increasingly popular from the early 2000's.

Institutional investors became more active around 2000 following an amendment to the 1995 Pensions Act, which required additional SRI related disclosure and . encouraged greater consideration of the 'rights and responsibilities of share ownership'.

A number of 'early adopter' fund managers then started to focus on using their position as shareholders to encourage 'win-win' scenarios - where both shareholders and investee companies benefit from more 'responsible', 'longer term' strategies.

This shift marked the emergence of today's 'responsible ownership', 'investor stewardship', 'long termism' and 'ESG integration' strategies which now commonly apply to all or most of a fund manager's assets – in varying degrees.

An indicator of the magnitude of this shift is the UN backed 'Principles of Responsible Investment' which today exceeds $60 trillion of signatory assets.

All of these fund level and corporate level strategies fall within the definition of 'SRI' - Sustainable and Responsible Investment - as options that aim to achieve conventional financial goals whilst paying significant and demonstrable attention to environmental, social and governance issues.

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Different from social impact investment

As well as the growth and diversification of this area amongst major investors - there has also been significant expansion in the 'impact investment' market - also known as 'social impact investment'.

This area has much in common with the SRI fund market and is of interest to many of the same investors. However impact investment places far greater emphasis on the achievement of measurable 'social impact' goals and is commonly only available through somewhat higher risk instruments at present - meaning that it is generally better suited to more sophisticated investors.

The line between impact investment and SRI is in reality however somewhat blurred. Many SRI fund managers do of course aim to have a positive effect on the world, as do their clients. Some have also recently started to measure their positive impacts - however this is in its infancy in SRI.

Given these differences this article leaves the more specialist 'impact investment' market to one side, focusing instead on the more conventionally structured but still highly diverse 'Sustainable and Responsible Investment' (SRI) fund market, which is also somewhat confusingly sometimes called 'Socially Responsible Investment'.

SRI - necessarily diverse

The sustainable and responsible investment market has become increasingly diverse and dynamic as it has expanded over time. One of the main reasons for this diversity is that fund managers have sought to develop strategies that are both 'ethically' and 'financially' attractive for people with different aims and opinions. Most also aim to outperform their 'mainstream' sector peers also - and often succeed.

Funds also frequently evolve over time as, to their credit, fund managers commonly respond to requests and changing situations by updating fund criteria.

It is worth remembering that most SRI options are essentially a fund management company's interpretation of what makes sense when combining their (or their clients') chosen 'issues' of interest (ie areas of research and policies) and preferred 'approaches' (the way in which they will deal with those issues).

There are many different ways to break this area into its constituent parts. Yet although dozens of different strategies exist, it is worth remembering that most strategies are essentially a fund management company's interpretation of what makes sense when combining their (or their clients') chosen 'issues' of interest (ie areas of research and policies) and preferred 'approaches' (the way in which they will deal with those issues).

Issues

The majority of issues covered by SRI options fall within the following broad categories:

- **Ethical** eg armaments, tobacco, gambling, animal welfare
- **Social** eg demographics, human rights, labour standards, health, safety and wellbeing, equal opportunities
- **Environmental** eg climate change, resource scarcity, energy, transport, waste, pollution, nuclear
- **Governance** eg board structures, executive remuneration, bribery and corruption

Approaches

The three basic approaches are:

- **Positive selection:** selecting investments in line with specific criteria or themes
- **Avoidance criteria:** excluding organisations or industries in line with specific negative criteria
- **Influence:** using responsible ownership and investor stewardship strategies (eg shareholder dialogue, voting and resolutions) to encourage mutually beneficial corporate change.

Most the above issues can be subdivided many times, addressed differently and grouped together in many different ways (eg by industry or by theme).

The number of possible combinations is therefore almost limitless.

Although somewhat complex, the diversity we see today is beneficial for both advisers and clients as it enables more client-centric investment planning.

Rules of thumb

Although there is much consensus amongst SRI investors, fund strategies vary significantly.

Some 'rules of thumb' can help explain why this is:

- Things are often more complex than they appear - for example, few issues are entirely 'black or white' and no organisation is entirely 'good or bad'.

- Things change over time, for example companies change and issues can become more (or less) important.
- ‘Negative avoidance’ and ‘positive selection’ criteria can be two sides of the same coin (ie a fund that states it ‘avoids companies with poor employment practices’ may deliver the same outcomes as a fund that ‘invests in companies with sound employment practices’.)
- Deminimis limits (allowable levels) can be used for a range of reasons – including risk management and as a ‘fail-safe’.
- Different people have different, often nuanced, aims and opinions. This includes both fund managers and clients. As such there is rarely such a thing as a single ‘correct’ or ‘perfect’ ethical strategy.

Different responses to climate change

Climate change is a good example of a major issue where strategies differ.

The Governor of the Bank of England, Mark Carney, has warned investors a number of times about the risk of ‘stranded assets’ and since the COP21 Climate Change conference in Paris (2015) it has been increasingly clear that legislative, regulatory and therefore corporate responses will significantly impact investors.

SRI responses include all of the three ‘approaches’ highlighted above, for example.

- Many screened and themed funds **avoid** major coal, oil and gas companies. The increasingly well supported ‘Fossil Free’ and ’Divestment’ campaigns are encouraging further avoidance of high carbon emitting companies and sectors.
- Major investors are increasingly encouraging investee companies to respond to this ‘mega trend’ individually and collectively. The ‘Aiming for A’ investor coalition (and others) are using shareholder voting and resolutions to **encourage** corporate change.
- Approaches vary greatly but many if not most screened and themed SRI funds also look for investment **opportunities** amongst companies that are well (or relatively well) placed to succeed as we transition towards a lower carbon economy.

Example investor initiatives focused on ‘win-win’ benefits

Today, a number of major investors aim to raise investee companies’ environmental, social and/or governance standards in order to help reduce investment risk or maximise opportunities. Investors may work alone or collaboratively depending on the situation.

Work of this kind focuses on generating ‘win-win’ outcomes that aim to improve both longer term company success and improved longer term investor returns whilst also ideally delivering wider societal and environmental benefits.

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‘Responsible investment’ or ‘stewardship’ activity of this kind can relate either to certain areas of a manager’s assets (eg specific funds) or across all assets.

Example collaborative investor initiatives:

- Bangladeshi clothing manufacturers group (following the Rana Plaza disaster)
- Palm oil working group (relating to rainforest clearance, fires and pollution)
- Climate change groups include the ‘Aiming for A’ coalition, the IIGCC (Institutional Investors Group on Climate Change) and ‘Preventable Surprises’
- Other areas of investor activity include sustainable fisheries, forestry, water, forced labour, resource management and transparency.

Although not commonly promoted in the retail market, other than as part of screened and themed funds, work of this kind can of course be of interest to many individual investors.

Identifying client aims

The challenge for the investment advisory community is how to match appropriate investment options to a client’s personal opinions and values once they they have indicated an interest in this area.

Advisers are generally recommended to use a supplementary SRI fact find to identify and record clients' aims - and minimise adviser bias.

The most common method involves presenting clients with a list of issues and approaches from they select their preferences. Experience indicates however that clients often select almost all issues - which can make finding appropriate options difficult.

An alternative method is to discuss the different styles of SRI – focusing primarily on core aims and strategies – although this will require finessing with further questionning for some clients.

Segmentation

One way to simplify this market is to break it down into segments based on the most common combinations of core issues and approaches.

The 'SRI Styles' segments used by the www.Fund EcoMarket.co.uk tool, run by Julia Dreblow, the author of this article - are as follows:

SRI Styles overview

- **Ethically Balanced:** funds that aim to balance the often complex pros and cons of different ethical issues and company strategies.
- **Negative Ethical:** funds that focus on negative screening and avoidance criteria.
- **Sustainability Themed:** funds that focus on sustainability related opportunities and themes, often alongside screening criteria.
- **Environmental Themed:** funds that focus on environmental issues and opportunities, often alongside screening criteria.
- **Social Themed:** funds that focus on social/people related issues.
- **Faith Based funds:** funds that apply screening criteria in line with a specific religion.
- **ESG Integration:** corporate level strategy led research that brings environmental, social and governance (ESG) issues into 'conventional' fund investment analysis.
- **Responsible Ownership:** corporate level strategy led 'investor stewardship' activity, such as voting and dialogue, that encourages more responsible ESG related business practices - often across 'conventional' funds.

These SRI styles are explained further on www.FundEcoMarket.co.uk.

Good practice and best practice overview

Financial advisers are of course required to know their clients, treat them fairly and offer appropriate advice – so although advice rules do not currently specifically require the identification of 'ethical, ESG or SRI related aims or values' this is regarded as 'good practice' by many.

This area also forms part of the international adviser 'Best Practice Standard' ISO 22222 (and BS 8577) accreditation - which requires financial advisers to ask clients if they would like to bring 'ethical, social environmental or faith based issues' into their investment strategies'.

This area is also relevant to pension scheme disclosure, charity guidance (CC14) and the Kay Review. The Pensions Regulator is also currently considering this areas in the context of trustee governance and NEST offers an 'ethical' option.

> *"... institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors which might impact on the performance of a company, or the wider interests of savers, in the long-term."*
>
> Kay Review, 2012

Why highlighting ethical, social and environmental factors make sense

Benefits to individual investors

Of course no single factor drives fund performance. Generic factors such as market swings, pricing and fund manager expertise are major contributors to the relative success of any investment.

SRI specific financial benefits however derive from additional research which enables fund managers to better understand relevant risks, opportunities, trends and company management.

The clearest indication of a shifting concensus in favour of the benefits of extensive (but relavant) ESG research is the fact that many of the world's largest institutional investors now integrate ESG issues into risk management and investment analysis across all their investments.

For funds that focus on increasingly pressing ESG related mega trends such as demographic, societal, environmental and sustainability related themes - the scope for identifying additional performance benefits is clear. (As are the potential risks of a failure to do so.)

Well informed (and managed) options therefore have the opportunity to help future proof portfolios by focusing on relevant issues that relate to changing legislative requirements, business strategies and public opinion.

The performance of many screened and themed funds has also proven that exclusion criteria certainly need not negatively impact performance - particularly over the medium or longer term.

Reflecting people's opinions and values

Not all investors want to leave their personal values at the door when investing. For many investors 'profit at any price' is neither attractive nor sensible.

SRI offers investors the opportunity to find options that align investment planning with lifestyle choices, interests, values and opinions.

Whether a person simply wants to simply avoid a specific company or believes a particular group of issues are important, SRI offers a range of investment options including growth, income, bonds, equities and mixed funds.

The potential benefits of understanding clients' personal needs include; enabling them to bring their personal experiences (and knowledge) into decision making, aligning investments to lifestyles, faith or other values – and also being part of the process of effecting positive change.

Some clients will have opinions that reflect growing challenges such as climate change, resource efficiency, supply chain management and employment practices. Others may regard more 'traditional' ethical concerns as a priority - such as opposition to armaments, tobacco or gambling. Many will require a combination of these.

All such requirements, if met, have the potential to enhance the investment experience - providing clients have access to adequate and appropriate information.

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Enhancing advisory businesses

Integrating clients' personal values, opinions and motivations into the advice process can, in practice, present a challenge for advisers and distributors.

Making this shift can however help build deeper, more loyal and trusting client relationships.

It can also help attract new clients (for example women, charities and pension schemes), enthuse exiting clients whose opinions may have changed over time and be of interest to new recruits and paraplanners.

Benefits to investee companies and wider societal benefits

Retail investors may be a relatively small cog in a big wheel in terms of their ability to influence investment values, however their role should not be understated or overlooked.

Their role in upporting companies (and fund managers) through investment decisions can contribute to business success and impact decision making.

The Financial Services sector and SRI

On a pragmatic level - it is clear that many people do care about ethical, social and environmental issues. So, if a person would like to reflect their views through their investment strategy the financial services community should aim to meet that need.

Moving screened and themed funds from their 1.2% of fund inflows to a more representative proportion, will require change - both culturally and in terms of business processes.

There is little doubt however that such a shift would enhance the reputation of the financial services sector given that today's prevailing 'investment culture is clearly neither acceptable to, nor appropriate for, everyone.

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If widely adopted and executed with care, this area could help shape a very different, more forward looking financial services industry.

It could also help reconnect the financial services market with other insurance markets where the cost of poor ESG related management is felt more accutely.

Looking forward

Embedding SRI into retail business strategies may not be a silver bullet but it has much to offer.

Its diverse but broadly conventional financial strategies, long term outlook and respectable performance track record stand it in good stead for future growth.

The current regulatory situation means that the retail financial services industry has the option to sideline SRI or to recognise the benefits it presents.

To date fund inflows have been neither impressive nor representative of consumer attitudes. Yet in the 20 years I have specialised in this area I have never seen the levels of enthusiasm and optimism that exist today. So this may all be about to change.

My hope is that, based on improved understanding, the retail investment community will soon be as familiar with this area as major investors are.

This would not only benefit individual investors, distributors and our industry - but also potentially those people and places around the world that we may never know - but none the less rely on for our own lifestyles and our wellbeing.

A uniquely useful proposition...

Addendum

It may be that Brexit unsettles markets a while. However the recent vote - for better or for worse - has shone a spotlight on personal values and social differences in a way that we have not seen for many years.

SRI offers a unique way to demonstrate that the financial services community understands that opinions vary - and can be responsive to diverse personal opinions, hopes and aspirations - as well as financial goals.

Julia Dreblow is founder and Director of generic adviser support site SRIServices.co.uk and the free-to-use SRI fund tool **FundEcoMarket.co.uk**. She has worked in financial services since 1989, specialising in sustainable, responsible and ethical investment (SRI) since the mid-90s. A passionate advocate for this area - Julia's work divides into two main areas: SRI consultancy and collaboration, and running the two free to use websites that offer adviser friendly tools and services listed above. Her work was shortlisted in the prestigious Corporation of London 'Sustainable City Awards' (Sustainable Finance category) in both 2015 & 2016 – and Highly Commended (runner up) in 2015. Fund EcoMarket is also an Investment Week 'SRI Research Provider 2016' award finalist.