Retail Investors and Ethical Investment[#]

by

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[#] The views expressed are the authors' own. Further detailed information is available as appendices to the original paper presented to the 16th Melbourne Money and Finance Conference available at www.australiancentre.com.au.

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This paper provides an overview of the framework for, and issues involved in, ethical investing at the retail level in Australia. It contains four sections. The first defines relevant terms. The second deals with the legal background to ethical and responsible investment. The third section gives a brief history of the development of ethical and responsible investment in Australia particularly at the retail level. The fourth section contains a cross country description and comparison of ethical and responsible investment, again focussing on retail.

1. TERMS

*Ethical or Socially Responsible Investment (SRI) i*s a generic term covering "investment processes that combine investors' financial objectives with their concerns about ESG issues"[1]. It is also known as ethical, sustainable or socially-conscious investment, but these various terms cover different practices across the world. *Ethical investment* is generally defined to encompass three activities – portfolio screening (in regard ESG issues), engagement and activism (again in regard ESG issues) and community finance. See Figure 1.

Figure 1: Ethical or Socially Responsible Investment (SRI)

Ethical Investment	Responsible Investment
• **Screening portfolios** - **Values based** - **Norms based** • **Community finance** • **Shareholder advocacy**	• **Engagement** • **Integration**

ESG stands for Environmental, Social and Governance issues. A person might have 2 motivations for wanting understand these issues. They might want to impose an ethical screen or they might just be concerned about the future price impact of such issues.

[1] European SRI Study 2010

Screening is about restricting a stock universe. It can have 2 quite different motivations. A Greenie might screen out coal miners out of concern for the carbon emission externality. A fund manager might screen out coal miners out of concern for the impact on the value of the stock as a result of government action to address the externality.

Portfolio screening for ethical investment purposes is about deliberately including or excluding companies or sectors based on moral, ethical or religious concerns. The companies excluded must be legally open for investment. [2] It might involve absolute "lexicographic preferences" e.g. no nuclear power plant operators whatsoever or it might involve materiality trade-offs e.g. I'll own electricity suppliers provided nuclear isn't more than x percent of revenue.

The Best-of-Sector screening approach limits the companies that managers can include in their portfolios to the ones identified as top performing in their sector, with regards to ESG criteria and challenges specific to their industry group.

On the other hand, negative screening – also known as exclusion – refers to an approach that excludes certain companies or even whole sectors from a portfolio on the ground that they are involved in harmful activities such as tobacco, arms manufacture, publication of pornography, animal testing, gambling, etc.

Norms-based exclusion is a specific form of negative screening. It involves excluding from a portfolio companies that are not compliant with international norms and standards such as those issued by the Organisation for Economic Co-operation and Development (OECD), the International Labour Organisation (ILO), the United Nations (UN), the United Nations Children's Fund (UNICEF), etc.

Engagement refers to long-term dialogue with companies, with the aim of influencing their practices. The style and approach used vary significantly between different actors and in different countries. Engagement usually involves private negotiations. *Shareholder advocacy* is engagement plus filing and public support for resolutions with a view to improving returns and/or improving performance on ESG issues.

Community finance is the practice of making loans to or deposits with banks, deposit taking institutions and finance companies that specialise in environmental or socially responsible lending.

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[2] For example in Belgium it is illegal to be indirectly involved in financing a company which produces cluster munitions. So, avoidance of companies involved in cluster munitions production isn't "ethical investment" in Belgium. This is further discussed in attachment B to the original conference paper (available at www.australiancentre.com.au).

Responsible investment as defined by the UNPRI is "based on the premise that ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk adjusted returns and is therefore firmly within the bounds of investor fiduciary duties". Responsible investment involves engagement (see above) and *integration. Integration* is the explicit inclusion of ESG risk into traditional financial analysis, which is often combined with engagement.

2. LEGAL BACKGROUND

2.1 Situation of retail investors versus trustees

In secular western society there is little to stop an individual managing their finances according to their ethics or their whim as they see fit. There maybe activities it's illegal to finance and profit from (e.g. prostitution, illicit drugs, manufacture of cluster munitions). But otherwise an adult of sound mind is free to make their own choices between:

- Donation and investment;
- Differing investment opportunities;
- The extent to which they will free ride on other investors e.g. taking dividends but not voting at AGMs.

Anglophone countries

The situation of an individual needs to be distinguished from the situation of a person who acts as a trustee. That person isn't free to exercise whim, for example in Australia the SIS Act requires a trustee:

"(J) to formulate…an investment strategy that has regard to …

(ii) The composition of the entities investments as a whole including the extent to which investments are diverse or involve the entity in being exposed to risks of inadequate diversification."

Similarly, in the United States, the Employee Retirement Insurance Savings Act (ERISA), passed by Congress in 1974, provides that: "A fiduciary shall discharge his [or her] duties solely in the interest of the participants and their beneficiaries

and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan" (section 404(a)(1)(A)).

Is ethical or responsible investment consistent with these obligations? Does the law make it acceptable for a trustee to finance the construction of a nuclear plant on top of a major geological fault, right next to the beneficiaries' houses, as long as it provides them with a great financial return?

A famous UK court case addressed the question (Cowan v Scargill, 1984). Trustees appointed by the National Union of Mine Workers wished to prohibit the scheme investing overseas or in energy stocks in competition with coal (e.g. oil, gas, nuclear).

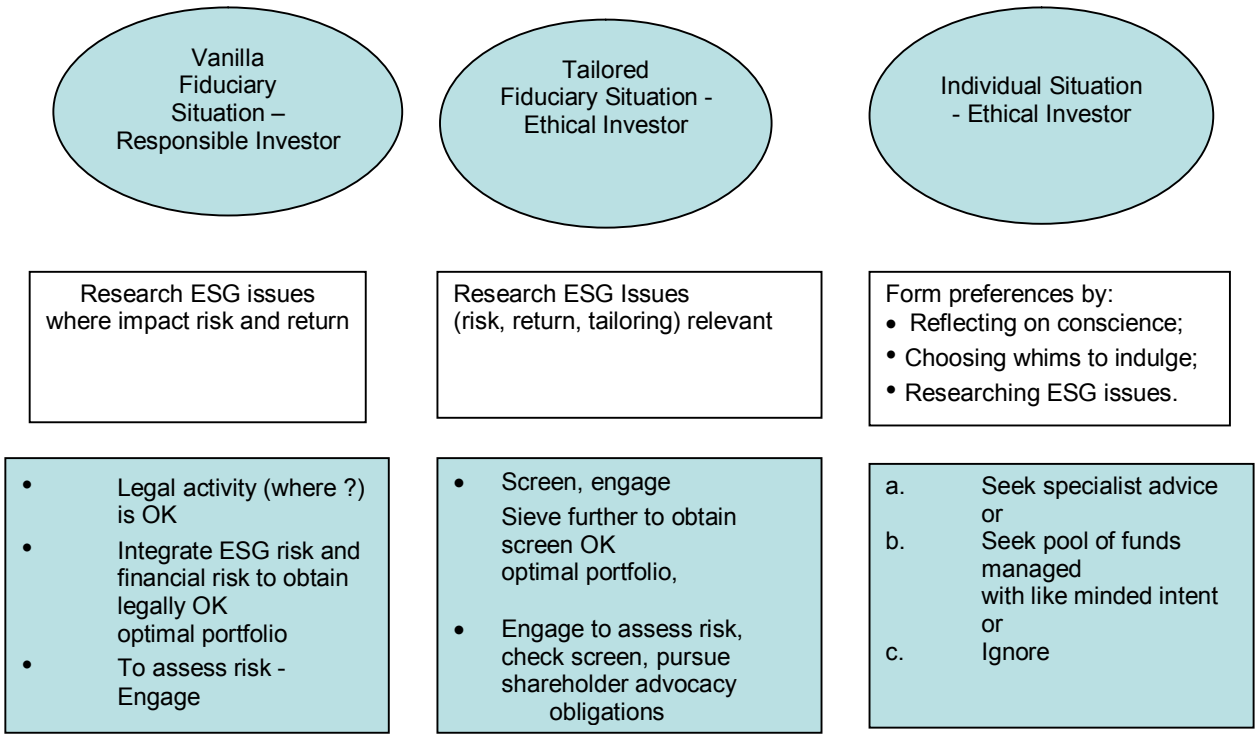
In finding against these trustees, the judge, made two important points:

Firstly, though trustees "…may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. Yet if under a trust, investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold."

Nevertheless, the judge did not assert that "beneficial" must be construed solely from a financial perspective even if the only object of the trust is to provide financial benefits.

The distinction between the individual situation and 2 variants of the fiduciary situation is set out in Figure 2. On the left hand side is the vanilla fiduciary situation of a "Responsible Investor". In the middle the diagram depicts the ethical investment situation where the members have gathered together defining their interests (e.g. a foundation or specialist ethical investment fund). In the vanilla situation, the equivalent of the ethical screen is "legal." Of course the tailored fiduciary situation might focus on whim but mostly it will focus on externalities which the law hasn't got to yet. On the right hand side is the individual situation. An adult of sound mind is free to apply whim, ethics, morals as they see fit and if they choose inconsistently from one day to the next.

Figure 2



If you're a trustee in a vanilla fiduciary situation whether you think climate change is a genuine issue; food manufacturers are responsible for obesity; it's OK or not OK for businesses to deal with oppressive regimes, isn't relevant; What's relevant is the risk all these sorts of issues pose. If you're an individual it's no one else's business.

As a consequence of the very different legal situation facing individuals and "institutional" trustees the two markets have developed very differently.

European Countries

In Europe, at least eight countries have specific SRI regulations that cover their pension systems[3]. However, despite the major step forward that these regulations represent, enforcement is still rather weak.

In France, two laws concerning SRI and pension systems were introduced in 2001, both inspired by the British SRI-disclosure regulation. Consumer protection and a desire to strengthen SRI-investments were the main reasons for the legislation. The February 2001 law changed many features of the French Employee Saving Plan laws, notably introducing an obligation that a fund's internal rules and annual reports specify the way social, environmental or ethical considerations

[3] www.belsif.be

are taken into account. The second law requires the executive board of the *Fonds de Réserve des Retraites* (Retirement Reserve Fund) to report to the supervisory board on the investment policy guidelines and how these take into account social, environmental and ethical issues (Article L135-8, French Social Security Code).

Similarly, in Germany, in January 2000, the Parliament decided to establish an ethical, environmental, and social disclosure regulation in the new pension law. Newly-conceived private pension schemes now have to fulfil a number of obligations – including the disclosure of SRI policies – in order to be certified and hence qualify for tax deductions.

In Norway, the size of the ethical investment market increased dramatically in 2004 with the introduction of ethical guidelines on the Norwegian Government Pension Fund, the largest pension fund in Europe and the second largest pension fund in the world. The fund's guidelines are based on a combination of engagement, negative screening, and exclusion.

As a last example, in Sweden the five largest state-controlled pension funds have been forced to include environmental and ethical criteria in their investment policy "without relinquishing the overall goal of a high return on capital" since 2001.

2.3 Disclosure obligations on financial advisers and product vendors selling to the retail market

It's common in the Anglophone countries for financial services law to insist upon accurate and complete disclosure including in the area of ethical investment.

It's very rare to hear of any litigation or regulatory action in regard such requirements. The only case the authors are aware of where a manager has been sanctioned for violating representations in regard ethical screens involved a US company called PAX which was fined USD500k for failing to screen its portfolio in accord with representations in its prospectuses.

2.4 Company Law Attitude to Shareholder Engagement and Advocacy

One form of ethical investment is shareholder advocacy. The significance of this activity as part of the "ethical and responsible investment scene" in a particular country depends a lot on the requirements set out in the corporation's law of that country in regards shareholders putting resolutions to meetings. These arrangements also determine the importance of retail investors in engagement and advocacy.[4]. In some countries one shareholder is entitled to put a resolution. Evidently

[4] Attachment A to the original conference paper (available at www.australiancentre.com.au) sets out these requirements in various western countries

this encourages a degree of retail involvement in this activity. In other countries only very big money interests can put resolutions.

The healthiest corporate democracy in this respect is in the US. Resolution activity is coordinated by the Interfaith Centre for Corporate Responsibility (ICCR). The ICCR started as a non-denominational faith based organisation. However its membership now spans state governments, large institutional owners, investors who manage money on behalf of retail investors as well as the core founding religious organisations. Each year hundreds of resolutions are put to US companies on a wide range of ethical, social, moral, religious and environmental issues.

3. HISTORY OF THE DEVELOPMENT OF ETHICAL INVESTMENT IN AUSTRALIA

This section describes the history of ethical investment in Australia focussing on retail participation.

3.1 Shareholder Advocacy

Shareholder advocacy has virtually no history in Australia. Today there is 1 fund "The Climate Advocacy Fund" managed by Australian Ethical Investment which has an advocacy mission. It was launched last year,it's primarily a retail fund. It "lead-filed" 4 resolutions in the 2010/11 AGM season. Surveys of ethical investment in Australia which date back to 1996 almost every year have contained a sad sentence to the effect "Yet again, this year there have been no specific shareholder resolutions related to environmental and social responsibility". The few resolutions that have been dealt with at Australian listed companies AGMs have been "side show" parts of union or green activist issue campaigns.

There are 2 reasons for this absence of shareholder advocacy history in Australia. The first less significant reason is the requirement of the *Corporations Act* that resolutions require the support of 100 members or members holding at least 5% of the votes.

The second more significant reason for the absence of development of a culture of shareholder resolutions and democracy is the failure of intellectual leadership on the part of the Australian churches by comparison with the US churches. Just a decade ago religious organisations were by far the largest identified ethical investors. They had the money but in stark contrast to the US an ecumenical "universal owner/shareholder advocacy culture" wasn't established in Australia. Today, entirely unlike the situation in the US, shareholder advocacy has a ratbag connotation to some Australians.

3.2 Community Finance

Also, unlike the situation in the US community finance has never been a substantial portion of the Australian ethical investment marketplace. The main reason for this is that Australia has always been a well banked society. Today community finance represents about 7% of the total core ethical investment market. Its almost entirely retail and its grown rapidly in recent years. [5]

3.3 Screened Portfolios

To many Australians ethical investment and screened portfolios are synonymous because community finance and shareholder advocacy have been fairly minor parts of the Australian ethical investment marketplace. The main features of the screened portfolio/ethical investment marketplace over the past 2 decades are: rapid growth; significant broadening in the range of screening "styles" on offer; increased significance of retail products; and continued disinterest of mainstream adviser firms.

In regards screening processes there are no norms based investment screens operating in Australia. In 2010 ethical exclusions and positive screening approaches each accounted for about 1/3 of the marketplace. Best of sector accounted for 14% and thematic investment 20%. [6]

In total screened portfolios amounted to $15.4b in Australia in June 2010. That's about 1.7% of the total managed funds market. It is very difficult to split this retail/wholesale. The bulk of it is "retail" driven." For example a number of super funds offer their members an ethical responsible investment option, though the money may be invested in a "wholesale" pool. As a general proposition wholesale offerings are less stringent in their approach as compared to retail offerings. For example there's a retail super fund available with its focus solely avoidance of cruelty to animals, there's no similar wholesale offering. Broad responsible investment is much larger – about $75b in June 2010, 8% of the market.

4. INTERNATIONAL COMPARISON

[5] Average growth over the 3 years to June 2010 has been 25% per annum.
[6] See RIAA Benchmark Report Nov. 2010

Ethical investing has become a fast growing worldwide phenomenon in the last ten years and is increasingly linked into mainstream fund management. However, the global ethical investment market is far from homogeneous, as a combination of cultural and legal differences deeply influence the shape of domestic markets. Ethical investment "market places" considerably vary in terms of size, growth, market share and strategy across the world.

Figure 3 - Ethical/Responsible Investment Markets in Selected Countries (a)

			Total SRI (bn)	Total SRI (€ bn)
United States (2010)	Total SRI	US$3,069	US$3,069	2,141
Canada (2008)	Core SRI	Cnd$54.2	Cnd$609.2	405
	Broad SRI	Cnd$555.0		
Australia / NZ (2010)	Core SRI	Au$18.2	Au$93	58
	Broad SRI	Au$74.8		
Japan (2009)		¥579	¥ 579	4
Europe (2009)	Core SRI	€1,150	€4,986	4,986
	Broad SRI	€3,836		
TOTAL WORLD				€7,594

Source: European SRI Study, Eurosif, 2010

a. The core/broad SRI distinction in this table corresponds broadly with the ethical/responsible investment distinction in Figure 1. Core SRI is ethical/broad SRI is responsible.

Europe represents by far the biggest Socially Responsible Investment (SRI) market in the world, with close to five trillon euro under management[7], compared to a little over two trillion dollars in the United States (see Figure 3). Other significant markets - although far smaller - include Australia, New-Zealand and Japan. Interestingly, some emerging economies such as South Korea, Malaysia and South Africa have also seen a rise of investment in ethical funds recently.

Ethical investment markets have experienced phenomenal growth around the world, without suffering much from the financial crisis; some markets even kept growing. The US market grew at about 13% in the US from 2007 to 2010[8], now representing 12.2% of the assets under management in the country. The fastest growing area in the US market is community finance, which has grown over 60% over the past three years. Likewise, 17% of European assets are managed through a socially responsible approach, as a result of the European market growing at an average annual rate of 37% between 2008 and 2010.

Retail ethical investment still accounts for a much smaller part of total ethical funds than institutional across the U.S. (81%[9] institutional) and Europe (92%). The split varies a lot across countries – in Germany and Switzerland retail is about half the market.

[7] European SRI Study 2010, Eurosif
[8] 2010 Report on Socially Responsible Investing Trends, Social Investment Forum
[9] Report on Socially Responsible Investing Trends in the United States, Social Investment Forum Foundation, 2010

One of the reasons that make the global ethical investment market hard to describe is its rapid evolution. It is becoming increasingly hard to define and segment. Terms such as "best-of-sector" and "screening" cover different practices across the world, making cross country comparisons a challenge. Nonetheless, some long-run trends are clearly discernable. For example: the Swiss prefer best-of-sector and thematic funds, whereas Norway and Sweden are the countries where norms-based exclusions are the most widely used[10]; engagement is mostly practiced in the U.S. and to a smaller extent in the U.K. and Norway. Interestingly, the gradual development of integration – as defined by the inclusion of ESG risks into traditional financial analysis – represents a global trend.

These national and regional differences in strategy, market share and growth of ethical investment can partly be explained by the diversity of political and financial traditions. The greatest difference is probably the long tradition of investment and application of ethical criteria to equity investment in the US and the UK, compared to countries such as Spain, where stock markets are less significant. As a result, ethical investment markets are small and more oriented to community finance in Southern Europe. Ethical financial products are mainly based on environmental criteria in Scandinavia and Germany, where environmental movements have long had credibility and access to political power. Investors in predominantly Catholic countries tend to favour exclusion strategies, screening out entire sectors such as alcohol, tobacco and weapons.[11]

Beyond "cultural" particularities, differences in legal contexts go some way explaining these differences. The adoption in European countries of a series of laws making it mandatory for pension funds to disclose how they take in consideration ethical criteria has coincided with a strong growth in the market. Shareholder activism still remains infrequent in Continental Europe and Australia, mainly because of the legal hurdles that make it more difficult for shareholders to lodge a resolution at a company's general meeting, whereas in U.S law one shareholder is all it takes.

5. CONCLUSION

Ethical investment has 3 dimensions – screened portfolios, community finance and shareholder advocacy. Responsible investment has 2 dimensions – engagement and integration. Responsible investment is a more recent development. In Australia ethical investment is primarily screened portfolios. Community finance and shareholder advocacy are fairly minimal. The development of screened portfolio options in Australia have been substantially driven by retail investors with some church group impetus. The Australian situation is quite different to that of the US where shareholder advocacy has been an important feature of ethical investment substantially driven, initially, by church funds. It's also different to Europe where the market is proportionally much larger, more institutionally based.

[10] The ethical approach of the Norwegian pension fund is described in attachment C to the original conference paper (available at www.australiancentre.com.au).

[11] A country by country description of the development of ethical investment markets is provided in attachment D to the original conference paper (available at www.australiancentre.com.au).