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A GUIDE TO ETHICAL INVESTING

Socially conscious investing, whereby companies are evaluated not only by their investment potential but also by their environmental and social impact, is one of the fastest growing investment strategies in the world as investors strive to align their portfolios with their conscience.

The investment community generally identifies ethical investments by evaluating companies on environmental, social and governance (ESG) factors. Examples of ESG issues include:

Environmental — impact of business on the environment: environmental degradation, pollution, climate change, sustainability, water/energy efficiency, animal testing, clean energy.

Social — impact of business on society: human rights violations in supply chain, exploitation of cheap labour in developing countries, supply of armaments to military, poor labour relations, provision of socially undesirable goods such as tobacco and gambling.

Governance — management structure and behaviour: undue political influence, lack of diversity on the board, large gender pay gap, lack of board independence, abuse of market share, corruption, use of tax havens.

Different ethical funds focus on different ethical issues. While this means that socially-conscious investors have a wide range of options to choose from, it also increases the chances of an investor choosing a fund with ethical principles incongruent to their own.

Many of the top performing ethical funds invest heavily in big banks and miners, but won’t invest in industries such as tobacco, alcohol and gambling. Is it more unethical to invest in a wine distributor than a big bank or miner? Would someone wanting to invest in an ethical fund expect it to include banks and miners? It depends on what their ethical beliefs are.

What is ethical?

Before we can delve into the world of ethical investing, we need to define what is ethical in order to differentiate between ethical and non-ethical investments. This presents a challenge, since every individual has their own beliefs about what is right and wrong, and often what one thinks is perfectly ethical may be seen as morally reprehensible by someone else.

Ethics refers to the discipline dealing with what is good and bad, and with moral duty and obligation. However, what constitutes ethical behaviour is often ambiguous. What is considered to be ethical can vary wildly, especially in situations where what constitutes moral behaviour is unclear. Therefore, it is essential for socially-conscious investors to understand the ethical framework underpinning the investment strategies of ethical funds. One environmentally-conscious fund might invest in nuclear energy as a clean alternative to fossil fuels, while another environmentally-conscious fund might deem nuclear energy unethical due to the environmental effects of nuclear waste.

There may be no right or wrong answer, only the preferences of the investor.
Screening socially responsible investments

Socially responsible investing (SRI) is the practice of constructing portfolios aligned with the ethical beliefs of an investor. There are three main ways to achieve this:

1. **Negative screening**—avoid any company that engages in business activities seen as unethical by the investor.
2. **Positive screening**—increase weights in companies that engage in business activities that are deemed to have a positive impact on society.
3. **Impact investing**—target specific social or environmental outcomes along with financial returns.

Negative screening is where an investor identifies companies that they will not invest in due to their ethics. For example, an individual might choose to not invest in companies involved in alcohol, tobacco or gambling because this does not align with their religious beliefs.

Positive screening involves adjusting portfolio weights to increase the portfolio’s exposure to companies with strong ESG factors. An investor can either attempt to maximise the overall ESG profile of the portfolio, or they can try to maximise the portfolio’s profile in one ESG factor (e.g. representation of women on the board, carbon emissions, etc.).

Impact investing refers to the targeting of a specific social or environmental outcome as well as financial return. For example, a wealthy investor concerned about factory farming could invest in a company that develops cultured meat.

Choice of investment product

There are three common approaches to building a socially responsible portfolio:

- **Exchange traded fund**—a screening process is used to create an index of ethical stocks to invest in. A portfolio is then constructed with the aim of matching the performance of that index. These investments can be bought or sold like an ordinary share on the ASX.

- **Managed fund**—a screening process is used to create a universe of stocks to invest in. The fund manager then constructs a portfolio from this universe with the goal of outperforming a predetermined benchmark (e.g. ASX 300).

- **Direct investing**—investors undertake their own analysis and construct a portfolio of stocks based on their ethical preferences.

Managed funds and ETFs offer exposure to ethical portfolios managed by investment professionals; however, the onus is on the investor to ensure that their beliefs are aligned with the ethical framework of the fund.

Management fees and ethical incongruence can be avoided if one constructs their own portfolio of socially responsible investments. Although this strategy is cheaper, most investors have neither the time nor expertise required to build a sound portfolio.

Effective portfolio management requires constant reviewing and adjustment, and the ongoing analysis of investments not only on their own merit but as part of a broader portfolio. Many well-resourced investment professionals are unable to do this adequately, indicating the difficulty of the process.

Choosing an ethical fund manager

When choosing an ethical fund manager, investors need to consider both the manager’s ethical screening process and the historical returns of the fund to ensure that both their ethical and investment objectives are likely to be met adequately.

Empirical performance of SRI funds

Academic research papers on SRI need to be read with a grain of salt, as they often use different definitions of SRI, different benchmarks to measure outperformance, and different data samples of varying length. This complicates the process of empirically determining whether ethical investing affects returns. It should be noted that many ethical investors are willing to accept a level of underperformance in order to have a portfolio aligned to their values.

The bulk of academic research on the performance of ethical share funds suggests there is no meaningful difference between the returns of ethical share funds and conventional share funds. However, a common theme is that both ethical and conventional active funds tend to underperform a passive benchmark.

In 2015 three researchers reviewed more than 2,000 papers and 3,700 study results relating to the performance of SRI funds. The authors found that although there was no meaningful difference in the performance of equity funds, ESG investing generates outperformance for non-equity asset classes such as bonds and real estate.

Since the weight of empirical evidence suggests there is no cost to ethical investing, investors might be able to remove unethical investments from their portfolios with no material impact on their long-term returns.

Social impact bonds

With an ageing population putting an increasing amount of pressure on the sustainability of budgets, governments are increasingly looking to alternative sources to fund their social services expenditure. An area of rapid growth globally is social impact bonds (SIBs), where the money raised from the bonds are used to pay charities to address social ills, and investors receive coupon payments commensurate with the success of the program. The New South Wales and Queensland governments have pioneered social impact bonds, with each government issuing several bonds tackling issues including the neglect and abuse of children, youth unemployment, homelessness and recidivism.

Albeit with a brief track record, SIBs have been resounding successes both socially and financially. The first SIB in New South Wales was issued in 2013 to restore children under age six in foster care to their fami-
families. Since then, more than 60% of families in the program were reunited with their children, compared to the 20% success rate of a control group. This phenomenal outperformance has netted investors a 13.5% p.a. return during a period where global bond yields were near all-time lows.

SIBs are attractive for a number of reasons. Firstly, they increase the efficacy of welfare programs, since only successful programs will receive additional funding from investors. Secondly, they increase the efficiency of welfare programs, as they are not administered by bureaucrats who have little incentive to innovate. Thirdly, they align self-interest with altruism, since investors have a financial incentive to ensure that the program is meeting its goals.

Despite these benefits, the adoption of SIBs in the near future is likely to be slow. The alignment of self-interest with altruism, along with the outsourcing of social services to the private sector, will likely meet resistance members of the community who are sceptical of the motives of the private sector and/or believe it is unethical to make profits off charity. Furthermore, workers in social services departments may resist the rollout of SIBs in the interest of protecting their jobs.

Conclusion
As our society continues to grow wealthier, investors are increasingly foregoing the pursuit of maximising returns, aiming instead on constructing portfolios consisting of companies that are aligned with their core values. Major corporations are responding to this demand by creating large divisions dedicated to corporate social responsibility and sustainability, with the conventional management wisdom of ‘the only business of business is business’ rapidly being replaced by Triple Bottom Line accounting, which places an emphasis on societal and environmental performance as well as economic performance.

Shifts towards corporate social responsibility, plus the potential of sustainable products such as solar energy, should serve as a tailwind for the ethical investors of today as other investors begin to incorporate ESG principles into their portfolios.

The ascent of ethical investing is likely to be a great force for good in the world, as hundreds of millions of dollars will flow from unethical and unsustainable companies to their ethical and sustainable counterparts.

A hurdle that many ethically-inclined investors fail to overcome is the belief that excluding unethical investments is likely to result in underperformance. As mentioned earlier, the consensus from academia is that portfolios constructed with ESG screens have no significant difference in performance or volatility than conventional portfolios.

As more ethical investment products are released, investors will have to be increasingly diligent to ensure that funds that are marketed as ethical are indeed so. We hope that ongoing investor education will help investors to become better equipped to make that judgement, and will spur the sustainable growth of the ethical investment industry for many years to come. FS