Getting the edge with managed funds

Taking an ethical stand

Pick up a newspaper and you don't have to look too hard to find reference to the latest environmental disaster or corporate scandal among the headlines. A growing number of investors are taking note and have decided to follow their conscience on a range of ethical, social and environmental issues. But can the art of mixing ethics and investment really work?

What is ethical investing?

As the term suggests, ethical or socially responsible investing refers to a style of investing that focuses not only on profit potential, but environmental, social and economic consequences. Investing this way allows the integration of personal values and beliefs with financial requirements. For many people, this might include investing in companies that promote sustainable development of the environment, or issues of social responsibility. It could also mean avoiding certain companies such as those involved in gambling, alcohol, pornography, tobacco or the manufacture of weapons. The choices people make every day are frequently influenced by moral and ethical considerations - ethical investing applies the same approach to investing.

Ethical investing dates back to the 17th century when Quakers in North America took a conscious stance not to invest in companies using slaves. More recently, during the 1960s and 70s, people objecting to the US involvement in the Vietnam War refused to invest in companies whose products and services supplied the war effort. Since then, ethical investing has become a growing and significant force in many investment communities.

How it works

The criteria that ethical funds use to make socially responsible investments are called screens. Traditionally, managers used negative screens to rule out companies that produce or invest in enterprises such as nuclear weapons, tobacco or alcohol. Over time, many ethical investment managers moved to selecting securities based on positive or inclusionary screens to find companies that demonstrate, for example, environmental protection.

Common negative screens

Avoid entities that are linked with any of the following:

- Nuclear weapon production
- Exploitation of animals
- Promotion of tobacco
- Environmentally damaging practices

However, the screening process has its drawbacks. What may be ethical to one person might not be ethical to someone else, and it's natural that each ethical fund will arrive at a different portfolio mix based upon its own research methodology. A company that passes some screens may fail others. For example, General Electric (GE) produces energy-efficient light bulbs (good for the environment and global warming) and jet engines (bad for the environment and global warming). While some ethical funds do not invest in companies involved in animal testing of any description, others will allow investment in companies that test animals for medical research but not for cosmetics.

Common positive screens

Seek out and support entities associated with the following:

- Environmental protection
- Pollution control
- Conservation and recycling
- Safety and security
- Ethical employment practices

Ethical funds face significant challenges to determine if a company is "ethically sound". In some cases, funds select companies based on being the best within a sector, so they may not reject a company based on its activities, and select it based on its performance of these activities relative to its competitors in the sector.

Whatever approach an investment manager takes will be set out in their investment charter. An ethical investment charter outlines the range of positive and negative stock screens. Companies that fail to meet the standards of the charter are typically ruled out for investment purposes.

Under the Financial Services Reform Act, ethical funds are now required to explain their research approach and to provide information in plain language about how they select their stocks and review their portfolios. This ruling has been put in place to assist investors to better identify an ethical fund that reflects their own personal values and beliefs.

The legislation also requires that super funds outline the extent, if any, to which labour standards or environmental, social or ethical considerations are taken into account in the selection of their investments. These details must appear in the fund's Product Disclosure Statement (PDS)

A growing segment

Although still small, the Australian ethical investing market is growing strongly, with the number of ethical funds now reaching 89.[1] There are a small number of managers in Australia who only offer ethical options. In addition, more mainstream investment managers are now offering ethical products to their investors.

Australian ethical stats

- Current funds under management equates to $21.5 billion.
- The number of ethical funds has grown from 10 funds in 1996 to 46 in 2001 and 89 in 2004.

Source: SRI Benchmarking Survey, October 2004.

Changes in legislation are also influencing the growth of ethical funds. If you are putting together a financial plan, most financial planners will ask you if social or ethical considerations are important to you when you invest. If so, your planner can provide you with investment choices, in line with your values.

1 SRI Benchmarking Survey, October 2004

Where to find out more

Australia now has a sophisticated range of products and services for individuals wishing to invest in an ethical option, ranging from ethical bank accounts to managed funds. You may also be able to invest in an ethical option in your superannuation fund - check with your super fund provider for details.

You can also speak to a qualified financial planner who specialises in ethical investing to help you align your financial goals with your values and beliefs.

To learn more about ethical investing, including details of ethical fund managers, research on smaller companies held in ethical funds, or details of upcoming conferences and events, visit the Ethical Investment Association's website - www.eia.org.au

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