

TIM SHARP

Right way to riches

While ethical investment funds still amount to only a tenth of the market, many of the concerns that underpin this sector of the industry, such as climate change, energy and pay levels, are now increasingly being championed by the mainstream

Just as the world had started to pull itself from the wreckage of the credit crunch, the leak of oil from a BP rig in the Gulf of Mexico put corporate behaviour and ethics back in the spotlight. Corporate responsibility is not a universally accepted notion. Free-market economist Milton Friedman called it a “fundamentally subversive doctrine” in a free society. But it has reappeared in the investment lexicon since the financial crisis, when taxpayers across the developed world were forced to pump vast sums into banks to stop their failures pulling down the financial system.

Lord (Paul) Myners, City minister in the then Labour Government, dusted off the term “ownerless corporation” to describe the lack of scrutiny given to companies by the institutional investors who own them. This led to

some companies seemingly being run for their top employees who had the freedom to indulge in all kinds of self-serving behaviour. The Gulf of Mexico spill further emphasised the price that can be paid if companies’ internal controls and external regulation fail.

This would seem to be an ideal environment for ethical funds. One might expect those fund managers who consider the social impact of the companies they invest in to have outperformed their peers. But that is not how it worked out. Ethical funds were hit more than most during the downturn. Some funds negatively screen – cutting out those companies that, for instance, are involved in carbon-emitting industries or deal with dubious regimes. These are at the strictest, or “dark green” end of the spectrum. Others positively screen. They invest in companies that perhaps are developing green technologies. However, this might be just one aspect of a company that is otherwise engaged in polluting activities. Either way, these restrictions tend to stop ethical funds investing in many large companies. But smaller companies, because they have less financial might, are more vulnerable to stock-market movements. This meant that ethical funds struggled during the initial stock market fall that took hold in 2008. These funds performed strongly when markets rebounded, but have ailed again in recent months.

One of the “darkest” green funds on the market is Aegon Ethical Equity which excludes companies involved in areas such as alcohol, gambling, the military or that engage with oppressive regimes. Manager Audrey Ryan plays down the notion that this ethical screening helps her performance: “I would like to say yes and in reality I think it is helpful but is it a strong positive? I do not think so.”

Ms Ryan says that she benefited during the credit crunch from being barred from investing in virtually all UK banks because they ploughed money into companies that did not meet the fund’s criteria. But, she says, it can be difficult for her to get exposure to so-called “defensive” stocks whose earnings stay steady whatever the investment climate. These have been particularly in favour in recent months during choppy stock market conditions - and include the likes of tobacco and pharmaceutical stocks, because people don’t stop smoking or getting ill in a recession.

Instead she looks at the likes of support services companies “to get the kind of earnings

resilience that I cannot get through Imperial Tobacco or Astra Zeneca”.

However, issues traditionally highlighted by ethical investment funds are now being increasingly championed by mainstream investors. In the aftermath of the banking crisis, some of the biggest investors, such as Legal & General Asset Management and Royal London Asset Management became more vocal on issues including excessive executive bonuses. F&C Asset Management, which manages around £100 billion of assets and until recently was controlled by Quaker-founded insurer Friends Provident, has long been at the forefront of engaging with the companies it invests in and has stepped up its work. Last year the fund manager sent 4,000 letters to companies expressing concern about their practices. In the UK, its votes against the board of the companies it invested in doubled from 3 per cent to 6 per cent. It opposed 19 per cent of company pay reports up from 10 per cent in 2008.

Analysis by investor advisory group PIRC based on the disclosures made by companies in the FTSE All-Share, found that the average vote against a remuneration report at a UK listed company last year was 17.28 per cent. That compares with a figure for 2008 of 3.2 per cent. Overall, the number of remuneration reports attracting a vote against of 10 per cent or more increased by 55 per cent from 2008 to 2009.

Issues of wider social interest, such as energy companies’ exploitation of oil sands in Canada have provoked concern on the part of some mainstream investors worried about the environmental impact and the potential reputational damage to those exploiting the resource. Miles Litvinoff, coordinator of the Ecumenical Council for Corporate Responsibility, which has a number of Catholic dioceses among its members, said: “Issues that we have been concerned about for many years have been thrown in to sharper relief particularly in terms of what we mean by risk.” He is now trying to highlight parallels between the financial crisis and what the group sees as a looming ecological crisis.

Separately, the Church Investors Group (CIG), which has 37 members with assets of about £12bn, recently published a report, The Ethics of Executive Remuneration. Much of the report for the group, whose membership extends from the Society of Friends to the Catholic Bishops’ Conference of England &

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Wales and 10 Catholic dioceses, examined the theological basis for investment. It also sought to use these to form clear policies on issues such as what is an acceptable gap in pay between a chief executive and those on the factory floor.

"A maximum multiple of the ratio between the pay of the top executive and that of the average pay of the lowest 10 per cent of employees should be identified and over time the ratio should be set on a downward trajectory. In the opinion of the authors, it would be difficult to justify a ratio in excess of 75 times," it concluded. To put that in context, figures from the Confederation of British Industry show that the chief executives of the UK's largest 100 companies earned 81 times the average pay for full-time workers in 2009, compared with 47 times in 2000. Back in the 1970s, the ratio was closer to 10 times.

The CIG report's conclusions were not knee-jerk bashing of the rich. "Investors should be more concerned with helping the poor than restraining the rich, and therefore even more vigilant about levels of pay at the bottom of an organisation than those at the top," the report said. Pay issues remain at the top of the corporate agenda. A few months ago Royal Bank of Scotland was forced to change executives' bonus targets after shareholder criticism. Familiar names such Marks and Spencer and J. Sainsbury have faced criticism over directors' pay. This changing attitude



The BP oil leak emphasises the price that can be paid if controls and regulation fail. Photo: CNS

seems to be influencing the more thoughtful representatives of corporate Britain. In a recent speech, Richard Lambert, director general of the CBI, warned that top executives "risk being treated as aliens" by the public because their pay is so out of step with the population at large.

Away from pay, companies are increasingly adopting environmental targets because they perceive that investors and customers require them. Telecoms company BT aims to reduce its carbon footprint by 80 per cent by 2016. Marks and Spencer

wants to achieve carbon neutrality by 2012.

Some improvements in investor oversight have been institutionalised. The Financial Reporting Council has issued a Stewardship Code that encourages investors to be more proactive, more organised and more transparent in the way they engage with board directors. The Bribery Act, which was passed under the Labour Government, comes into force in the autumn and will make companies liable for payments made by third-party fixers in foreign countries.

Nevertheless, while there are 54 ethical funds for investors in the UK, they remain a minority interest. Ethical funds under management rose to £5.9bn at the end of March from £4.1bn a year earlier. But it is still barely a tenth of the market. The increase was mostly due to a rising stock market. Sales lag the wider industry. Over the longer term, growth in ethical funds is better having averaged around 11 per cent a year, against 7 per cent for the wider industry. This suggests that when market conditions improve, investors might think again about the ethical implications of where they put their money. In the meantime the sorts of issues they highlight such as the environment, risky pay structures or engagement with oppressive regimes have stepped a few rungs up the investment agenda.

■ **Tim Sharp is City editor of *The Herald*, Glasgow.**

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