

Consider investing in 'ethical' companies

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Investing with a conscience and making decent returns are not mutually exclusive

IF YOU feel sickened by the way public companies, particularly those in the financial sector, have behaved over the past two years and are looking for alternative investment options which will provide adequate returns while not leaving such a bad taste in the mouth, you might consider socially responsible investing (SRI). SRI, ethical or sustainable funds look to invest in companies that have a positive impact on the world and the environment, and their popularity has surged in line with investor disillusionment with mainstream equities.

Across Europe, inflows into ethical and SRI funds are increasing once more, following a fall-off during the financial crisis, while investor maestro Warren Buffet has recently joined the call for long-term responsible investment as part of the “28 strange bedfellows” initiative.

In Ireland, interest in such products is also on the rise, as evidenced by a recent Rabodirect seminar on the topic which was oversubscribed within 24 hours of being launched. In line with this increasing interest, the number and type of products available has also risen.

Friends First's Stewardship fund, which has been running since 1998 and was Ireland's first ethical fund. For a long time, it was the stalwart of the sector, but now most of the major Irish-based investment managers offer either ethical or sustainable funds. Rabodirect has just made three sustainable funds, managed by Sustainable Asset Management (SAM), available to Irish investors.

The key to most ethical, or SRI funds, is that they don't invest in companies which are involved in alcohol, tobacco, pornography, nuclear energy and animal testing. In general, this is achieved by the establishment of a screening committee which identifies companies which should be excluded from the fund, or by following international guidelines.

For example, New Ireland's Ethical Managed Fund offers investors the opportunity to “invest in a socially responsible way, while still aiming to deliver good growth potential” and it has a dedicated Ethical Investment Review Committee, which monitors existing stocks on an ongoing basis and screens new stocks prior to allocation to ensure that they adhere to the bank's ethical criteria, which includes excluding companies associated with the defence industry and environmental damage.

At AIB, the bank's internal research is supplemented by the use of research from EIRIS, a UK-based ethical research provider, while it also has access to the Ethical Reference Group, established in consultation with CORI Justice.

In addition to the rise of SRI funds which invest in companies which meet certain ethical criteria, there has also been a rise in sustainable funds, which also integrate environment factors into their decision-making and, rather than excluding companies from investment, they select companies to invest in.

Sustainable funds are often developed thematically, on themes such as water, renewable energy and climate change.

Julie McDowell, head of SRI with Standard Life, sees this approach as being the next evolution for the industry, and expects that in future there won't be any more separate SRI funds.

The Dow Jones Sustainability Index (DJSI), which is compiled in conjunction with SAM, lists companies which meet certain sustainable criteria. To get on the index, companies have to go through a thorough analysis of corporate economic, environmental and social performance, assessing issues such as corporate governance, risk management, branding, climate change mitigation, supply chain standards and labour practices.

One Irish firm which makes the index is CRH, which was also accorded the distinction of "SAM Sector Mover" this year, which means that it has shown the greatest relative improvement in its sustainability performance in its sector.

Another key to the DJSI is that as well as identifying companies which demonstrate a core ability to manage sustainability issues, the companies included are also deemed to represent an attractive investment opportunity.

Traditionally, SRI funds were seen as the laggards of the league tables, leaving people feeling a bit better, but with not as much money in their bank accounts as their mainstream equity investor counterparts. These days however, SRI and sustainable funds are starting to measure up.

For Ken Owens, a partner with PricewaterhouseCoopers, investing with a conscience and making decent returns are not mutually exclusive, and he says that sustainable funds in areas such as renewable energy are primed for growth.

"It's about looking at who the winners are going to be. There are good commercial reasons why funds investing in companies in these types of sectors should return more money, as they're likely to be the companies which will grow faster. If you get into those companies at the start you can watch them grow," he says.

So far this year, SRI funds have strongly benefited from the bounce in the market. For example, in the year to September 9th, BoI's Ethical Equity fund was up by 23.7 per cent, while its Global Equity fund was up by 23.4 per cent. In the eight months to the end of August, the FTSE4Good Europe advanced by 23.6 per cent, while its mainstream counterpart, the Dow Jones Stoxx 50 Index, was up by only 13.2 per cent.

Thematic funds are also performing strongly. For example, SAM's Smart Energy fund is up by almost 40 per cent in the year to the end of August, while over three years it has returned 4.4 per cent.

However, as McDowell points out, one disadvantage of SRI funds is that they have to avoid defensive sectors, such as tobacco, which means that in a downturn they can perform marginally worse than mainstream funds.

Given the large set-up costs incurred by companies in renewable energy or water sectors for example, investors should also consider allocating money to such funds for the long-term, as they may take some time to come good.

In addition, sustainable funds tend to be over-weight in small and mid-cap firms, due to the size of companies active in renewable energies, water etc, while they can also have a geographic swing towards emerging markets, so like other niche products, investors should only look at allocating about 10 per cent of their investment into such products.

Moreover, while SRI and sustainable funds may salve your conscience, are they really as ethical as they make themselves out to be?

Well, it will depend on what ethical means to you. If avoiding gambling, tobacco and pornography is

enough for you, then you will more than likely be satisfied with the range of funds on offer. If, however, you are looking for companies who are focused solely on improving the environment or on building affordable houses exclusively for the poor or researching cancer without at the same time producing exorbitantly expensive drugs which are then sold on to the Third World, you will find it more difficult.

To some extent, SRI funds are a bit like organic food. Buying organic food sends out an image to the world that you are a caring, health-conscious, environmentally-friendly type of person. However, organic food was recently shown to have limited health benefits and perhaps the same could be said to be true of much of ethical investing.

For example, the top 10 holdings in Bank of Ireland's Ethical Managed Fund includes such esteemed names of the corporate world as CRH, Nokia, Oracle and Nestlé, with a bank, HSBC, even making the top 10. Moreover, Dolmen's Green Effects Fund invests in Starbucks and, while it might surprise you to see an airline included in a SRI fund, given their impact on pollution, Ryanair is one of the top holdings in AIB's Ethical Balanced Growth Fund.

And, while Tesco might be hitting the headlines due its treatment of Irish suppliers, it is one of the main holdings in Friends First's Stewardship fund. The FTSE4Good Europe Index, which measures the performance of companies which meet "globally recognised corporate responsibility standards", includes our beloved banks Irish Life Permanent and BoI, as well as CRH.

Indeed, in many cases it can be difficult to tell an ethical fund apart from a mainstream equity fund.

For example, as well as being the main stocks in BoI's ethical fund, CRH, HSBC, Nokia and Nestlé also all feature in the top 10 holdings of the bank's balanced managed fund.

What about AIB's Managed Fund? The top five holdings in this fund and the bank's ethical balanced fund are almost like for like, with CRH, Ryanair, HSBC and Banco Santander making both lists.

Moreover, like organic food, ethical funds can also be slightly more expensive than mainstream equity funds. For example, if you select Friends First's ethical choice as part of its SmartSaver regular savings scheme, you will have to pay an additional 0.375 per cent on top of its 2.5 per cent annual management charge for the first five years.

In addition, an early encashment penalty of up to 5 per cent is charged if you exit the fund within the first six years. Meanwhile, New Ireland charges 0.25 per cent more in annual charges for its water fund.

So, if you really want to feel like your investment is making a difference, you might be better off investing in a more "pure play" fund, which invests in companies in a particular sector, such as water or alternative energy.

For example, while Dolmen's Green Effects fund is invested in Starbucks, it is largely concentrated on companies which engage in "green" industries such as renewable energy or water technology. Moreover, SAM's Sustainable Climate Fund invests solely in companies which provide technology, products and services designed to alleviate and delay climate change or help overcome the effects of it.

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