Selecting funds for ethical and sustainable investment

By Quintin Rayer | Jan 11, 2018

Previously, Dr Quintin Rayer introduced sustainable (environmental, social and governance, or ESG) investing [1], and looked at different approaches [2], [3]. This article considers the selection of ethical funds, outlining some of the challenges investors face. A future article will explore performance issues.

Introduction

Beyond conventional portfolio construction considerations, ethical investors must select companies and monitor their performance in ethical and sustainability terms. Whichever ethical approach is used, environmental issues, social responsibility and governance quality are not readily measurable. Consequently, many investors employ the skills of specialist fund or portfolio managers.

Ethical Funds

Several fund management houses run ethical strategies, while some are specialists, others include ethically-orientated funds as part of their wider offering.

A concern for investors is whether fund managers lack ethical investing experience or commitment, but want to ‘jump on the bandwagon’, launching a fund to appeal to the ethical market. Although promoted as such, a fund's ethical credentials may be slender, potentially including holdings that would make clients uncomfortable.

Inexperienced providers may launch new ethical funds, but fail to reach required asset targets to make them commercially viable. Insufficient investment in resources or appropriate staff could result in an inability to deliver the performance expected, with a gradual erosion of interest. Consequences could include merger with a conventional fund, closure, or dropping ethical objectives.

Fund selection should explore how deeply embedded ethical investing culture is in the organisation. Managers may find clients like to hear them talk positively about ethical investing, doing so for marketing benefits. Examining staff experience and qualifications can help detect superficial commitment since only serious providers are likely to have invested in individuals with proven knowledge and skills.

Portfolio Construction

It is useful to appreciate the challenges facing managers constructing ethical portfolios. When considering a company for inclusion, apart from return, risk and diversification aspects, ethical requirements must be considered. Although some criteria might be straightforward, others are more complex.

Managers are assisted by corporate standards, covering diverse areas. Many are voluntary, confirming that particular activities have been conducted meeting defined standards. The sheer number of different standards can be challenging, and requirements vary. However, some standards provide more symbolic than real value [4]. The many initiatives encouraging companies to behave more responsibly include auditable quasi-official standards, initiatives encouraging companies to publicly report emissions, achievements and progress to motivate improvement, or are purely aspirational.

Companies' annual reports and accounts can reveal ethical, sustainability, social, environmental objectives and standards, and also information about corporate governance [5]. Governance can explore the nature and composition of the board, including roles of NEDs, turnover, expertise, independence, ability to challenge executives, and the remuneration committee.

Investors must dig beneath ostensible statements regarding achievements, since many companies desire a 'green makeover', while reluctant to absorb the costs and challenges required for genuine change [6]. The complexity means that advisers may benefit from support by wealth managers knowledgeable in this area. Skills within the financial sector give it a crucial role in developing sustainable investment.

How this helps Advisers

Clients increasingly wish to invest ethically and often have specific concerns in mind. Younger people may give this a higher priority than older generations with twice as many 18 to 34-year-olds feeling their pensions should be invested ethically, compared with those above 45 [7]. The Investment Association reports £14.9 billion assets in the UK ethical funds sector in October 2017, a yearly increase of £2.7 billion [8].

Advisers will wish to know how to best meet clients' needs either by selecting the most appropriate ethical funds or, when necessary, accessing the skills of wealth managers who can support them in this important and growing area.

Did you see? P1 Investment Management is now ISO 14001 Certified

P1 Investment Management are proud to have been awarded the ISO 14001 Certification. This standard demonstrates that P1 meet the standards required for a 'best practice' Environmental Management System and it illustrates their commitment to acting in an environmentally responsible way. It includes a wide range of environmental management principles, including environmental audits, measuring performance, communication and environmental challenges.

References

[1] Q. G. Rayer, An introduction to ESG investing (for advisers with ethically minded clients), DISCUS, 23 August 2017.

[2] Q. G. Rayer, Approaches to ethical & sustainable investing: screening and best-in-class, DISCUS, 26 October 2017.

[3] Q. G. Rayer, What is 'Tilting' and 'Influence and Engagement' in sustainable investing?, DISCUS, 20 November 2017.

[4] P. Shrivastava and S. Berger, Sustainability Principles: A review and directions, Organization and Management Journal, vol. 7, no. 4, pp. 246-261, 2010.

[5] R. Monks and N. Minow, Corporate governance, Oxford, England: Blackwell Publishing, 2011.

[6] C. Krosinsky, N. Robins and S. Viederman, Evolutions in sustainable investing: strategies, funds and thought leadership, John Wiley & Sons, 2012.

[7] BBC, More young savers 'want ethical pensions', 8 October 2017. Online, Accessed 10 September 2017.

[8] PDF ARCHIVE OF STATISTICS, The Investment Association, October 2017. Online, Accessed 12 December 2017.

This article was written by Dr Quintin Rayer, Head of Investment research at P1 Investment Management and also published on the DISCUS website.