# SRI takes a giant step forward

## A slow process, but ethics is becoming legitimate

***Ethical investment, now more commonly known as socially responsible investment, has been slow to gain acceptance in Australia. It has now received major impetus with the publication of an analysis of its status and potential.***

"Socially Responsible Investment (SRI) in Australia is on the verge of a transition from being a niche activity to having a place in the mainstream investment options." So begins the executive summary of a report published by the Allen Consulting Group as the result of a review carried out on behalf of the Ethical Investment Working Group, a group of individuals and organisations from the philanthropic sector seeking to further develop ethical investment in Australia.

The report, titled "Socially Responsible Investment in Australia", describes the current status in Australia of ethical investing. The aim was to investigate recent thinking and developments in a framework that would enable investors and the finance sector to identify options for advancing this form of investment. The highlights of the report were presented at a recent conference of the Ethical Investment Association in Sydney.

The size of the market in socially screened investment is estimated at around $1 billion, including community and church-based investment funds. This represents about 0.7% of equities in managed funds. Until recently in Australia, the market has not had the benefit of wholesale players providing options to investors. There are now larger players active in this sector, which has the effect of "legitimising" it in the eyes of the mainstream market. A viable, interrelated and informed network of expert services is now emerging, including independent researchers, informed asset consultants, financial planners, stockbrokers open to SRI, and supportive education providers. This is part of the necessary infrastructure to grow this form of investment, along with the fundamental requirement of confidence in the market. Two key questions regularly put to proponents of SRI are: how are companies selected, ie, how is "social responsibility" or "ethical soundness" determined; and how well do SRIs perform?

### SCREENING TECHNIQUES

Screening is the practice of including or excluding publicly traded securities from investment portfolios or managed funds based on social and/or environmental criteria, in addition to applying the usual financial screens. Negative screens exclude companies that do not meet the agreed SRI criteria (examples are companies that produce tobacco or derive revenue from gambling or alcohol), while positive screens allow selection of stocks of companies whose activities make a positive contribution to society.

The underlying premise is that, as social and environmental standards continue to become more exacting, certain industries will profit from the changed market environment and be sustainable in the longer term. A best-of-sector approach provides a fund manager with the opportunity to diversify a portfolio across the entire economy, thereby reducing the financial risks associated with investing in only specific sectors.

The different screening techniques may throw up some contradictory findings, because a company may perform well on one criterion that is central to the concerns of one group of investors, such as environmental improvement, but may not perform well on other criteria, such as labour relations. Another concern is that of contested or incomplete data. Ratings constructed from such data may unnecessarily antagonise companies, work against the development of more robust and cooperative assessment techniques and generally inhibit credibility and growth in the area.

### PERFORMANCE

Perceived poor performance of screened investments has been a key reason for the relatively low take-up of SRI in Australia by mainstream financial analysts. This perception arises partly from experience and partly from the logic of the screening process, which would suggest that excluding some stocks from the investable universe of stocks may increase risk, and thus impair risk-adjusted performance.

Increasingly, overseas research is providing counter-evidence, suggesting that such funds are often superior, as they account for additional indicators of a firm's future potential. Reduced operating costs from a more proactive approach to environmental management should lead to a lower perceived riskiness to investors and thus impact on the cost of equity capital and value in the marketplace, as well the company's stock price.
Little performance research has been conducted in Australia, but what has been done suggests that some SRI funds have performed well compared with the mainstream. However, a comparison of a screened fund with the broader market may be misleading; screens tend to increase weightings of "new economy" stocks that have performed better than the wider market over recent years but may not do so in some future periods.

### SHIFT FROM NICHE TO MAINSTREAM

There has been a noticeable shift in the wholesale SRI market from what may be termed first-generation to second-generation funds. First-generation funds have been perceived as being an investment vehicle for "good causes" but "non-financial rewards", specifically excluding some industry sectors and thus not reflecting a diversified portfolio philosophy. However, the risk-unadjusted performance of many of these funds over the past three to five years has been as good as, if not better than, many mainstream funds.

Second-generation funds aim to compete in the mainstream, with greater portfolio diversification and a risk-adjusted performance that is more reflective of mainstream investments. Selection and screening techniques are more explicit, with more systematic use of company performance indicators. Thus potential clients are attracted by both sympathetic social values and positive financial expectations.

### BUSINESS AND POLICY ENVIRONMENT

Three key aspects that are favourable for the growth and expansion of SRI activity are:

- legal advice suggests that the act governing superannuation trustees does not prohibit them from adopting a SRI strategy, subject to reasonable action to investigate investment-related issues and the provision of a SRI fund as one of several options to members;
- the size and growth of superannuation funds (in assets and employee coverage) appears to offer some growth opportunities for mainstream SRI activity; and
- the increasing public disclosure of environmental and social performance (both mandatory and voluntary) will facilitate the development of sophisticated screening techniques and the ranking and analysis of companies.

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### THE WAY FORWARD

The Australian SRI sector has remained relatively small as a result of a lack of (mainly) large wholesale and retail participation in the market, substantially due to high barriers to entry caused by insufficient SRI infrastructure and a perceived lack of demand from individual members and investors: that is, a classic "chicken and egg" situation. Economies of scale require larger players to invest more heavily in the sector, and individual investors need either a better knowledge of finance and/or SRI or to be encouraged to create demand, even with larger institutions, to lead in the longer term to a change in investment focus on the part of the larger funds.

Pointers to the way forward in making SRI more mainstream include:

- challenging the perception of investors and fund managers concerning SRI funds with respect to SRI definition, performance, demand and so on;
- addressing infrastructure needs with respect to the resources, costs and expertise involved in developing a mainstream SRI market;
- building on opportunities for continued growth by focusing on establishing "champions" for the sector, educating "infomediaries" and targeting gatekeepers.

*A downloadable copy of the executive summary, from which these edited highlights are taken, is available at http://www.allenconsult.com.au/focus3.html* J