How green is my portfolio?

Companies earn high marks for morals

Socially responsible investment is providing a clearer focus on previously grey areas of business ethics.

Ethical investment – also called socially responsible investment – is attracting more attention as its proponents show increasing evidence of competitive portfolio performance.

One criticism of the term "ethical investment" is that it implies an inappropriate level of moral judgment on the part of the person or organisation managing the relevant portfolio. Current educational material from the Securities Institute of Australia, however, emphasises the important role ethics plays in modern business. And in the readings for the SIA course "Introduction to Securities Law and Ethics", John Dobson identifies "sound moral judgment" as one of the key elements of ethics in business.

For example, asking a client to choose between a typical retail fund with attractive returns, and a fund with a history of similar returns, but which promises to improve the environment in some way, enables the client to use his or her own moral judgment in making that choice. A consequently enhanced relationship with the client offers a range of benefits to the fund manager including greater loyalty and enthusiasm from the investor and word-of-mouth advertising.

A number of different approaches are taken to ethical investment, although negative and positive screens tend to form the foundation of most of these.

Negative screening excludes companies that offend a given set of criteria. For example, a healthcare organisation might choose to have its portfolio free of any association with the tobacco industry. Likewise, a high-profile human rights campaign organisation could wish to avoid companies involved in armaments manufacture or operating in oppressive regimes.

Positive screening identifies companies that benefit the environment or society. Thus, an investor might choose to invest in companies developing alternative energy schemes, or which offer significant employment opportunities.

Most ethical funds in the UK and the US operate on negative screens with positive overlays. Thus they may avoid investment in tobacco production and uranium mining, but might consider investment in a company that retails tobacco, if that company has a strong policy of corporate giving and excellent employee relations.

Pioneers in ethical investment in Australia have also used combinations of negative and positive criteria. Funds linked with the environment movement may have a bias towards companies operating in the renewable-energy, community-investment or waste-treatment sectors. Funds that have grown out of church-based pools of capital may have strong negative screens against alcohol and gambling.

While several factors can make ethical investment a challenging process in Australia, the main hurdle is market liquidity. An investor in the UK or the US has the luxury of being able to remove a number of companies from the available investment universe, and yet still have hundreds of companies and a deep market to invest in. In Australia, too broad a set of criteria can leave a manager with too few investable companies to ensure an acceptable spread of risk. While this can usually be overcome by careful choice of criteria, some alternative approaches have been developed.

"Best-of-sector" describes an approach in which companies are ranked according to ethical criteria, and the highest-ranking from each sector are selected for investment. This approach enables a large manager to run an index-style "ethical" product which closely tracks market performance.

An inherent danger in this approach, however, is that the "best" companies in a given sector may be at odds with the ethical position of the fund. To illustrate, if a portfolio's commitment was to improved community health, could it invest in the "tourism and leisure" sector, dominated as it is by companies dependent on gambling and alcohol? Likewise, a portfolio marketed as a "green" product might invest in large resource companies with poor environmental records.

Another development has been the "shareholder activist" fund. In this, the portfolio has no major ethical constraints, but closely monitors the actions of companies according to a set of ethical principles. When a company acts in a manner contrary to those principles, the fund uses the authority of its shareholding to change company behaviour, usually by pressure on the directors. This approach offers opportunities for investors with sufficiently large holdings in the company to be taken seriously to make the board aware of some of the non-financial implications of their company activities.

Ethical investment enables investors to apply their own ethical beliefs to a field where the choice previously did not exist. As the sector grows in Australia, new players are offering investors new ways to make their voices heard. It is important that all players are open about the ethics they use, the companies they invest in, and the level to which they enter into dialogue with their investments.

– Duncan Paterson
Australian Ethical Investment Ltd J