Keywords: ethical investment, socially responsible investment, ESG, portfolio screening.

RETAIL INVESTORS AND ETHICAL INVESTMENT

Ethical and responsible investment markets have experienced phenomenal growth around the world in recent years and were relatively unaffected by the global financial crisis. This paper provides an overview of the framework for, and key issues involved in, ethical investing at the retail level in Australia. Ethical investment in Australia primarily involves screened portfolios, with limited activity occurring in community finance and shareholder advocacy.[1]

HOWARD PENDER is a Director of Corporate Analysis Enhanced Responsibility (CAER) and Australian Ethical Investment. He has been a Director of Australian Ethical Investment for 20 years. Email: hpender@autralianethical.com.au

MARIE BROCCHETTO was an intern at Australian Ethical Investment. She recently completed her Masters degree in Finance & Strategy at Sciences Po Paris in France. Email: marie.brocchetto@sciences-po.org

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Terms

Ethical or Socially Responsible Investment (SRI) is a generic term covering 'investment processes that combine investors' financial objectives with their concerns about ESG issues'.[2] It is also known as ethical, sustainable or socially conscious investment, but these various terms cover different practices across the world. *Ethical investment* is generally defined to encompass three activities — portfolio screening (with regard to ESG issues), community finance and shareholder advocacy. Responsible investment encompasses engagement and activism (again, with regard to ESG issues), and integration (see Figure 1).

Figure 1: Ethical or Socially Responsible Investment (SRI)

Ethical Investment	**Responsible Investment**
> Screening portfolios	> Engagement
> Values based	> Integration
> Norms based	
> Community finance	
> Shareholder advocacy	

ESG stands for Environmental, Social and Governance issues. There are usually two key motivations for people seeking to understand these issues: they may want to impose an ethical screen on their investments or they may be concerned about the future price impact of such issues.

Screening is about restricting a stock universe. It can have two quite different motivations. A 'Greenie' may want to screen out coal miners due to concerns about the carbon emission externality. A fund manager may want to screen out coal miners because of concerns about the impact (on the value of the stock) of government action to address the externality.

Portfolio screening for ethical investment purposes is about deliberately including or excluding companies or sectors based on moral, ethical or religious concerns. The companies excluded must be legally open for investment.[3] It may involve absolute 'lexicographic preferences', e.g. 'no nuclear power plant operators whatsoever', or materiality trade-offs, for example, 'I'll own electricity suppliers provided nuclear isn't more than x percent of revenue'.The best-of-sector screening approach limits the companies that managers can include in their portfolios to those identified as the top performing in their sector, with regard to ESG criteria and challenges specific to their industry group.

On the other hand, negative screening — also known as exclusion — refers to an approach that excludes certain companies or even whole sectors from a portfolio on the grounds that they are involved in harmful activities such as tobacco, arms manufacture, publication of pornography, animal testing or gambling.

Norms-based exclusion is a specific form of negative screening. It involves excluding from a portfolio companies that are not compliant with international norms and standards such as those issued by the Organisation for Economic Co-operation and Development (OECD), the International Labour Organisation (ILO), the United Nations (UN), and the United Nations Children's Fund (UNICEF).

Engagement refers to long-term dialogue with companies, with the aim of influencing their practices. The style and approach used vary significantly between different actors and in different countries. Engagement usually involves private negotiations. *Shareholder advocacy* is engagement plus filing and public support for resolutions with a view to improving returns and/or improving performance on ESG issues.

Community finance is the practice of making loans to or deposits with banks, deposit-taking institutions and finance companies that specialise in environmental or socially responsible lending.

Responsible investment as defined by the UNPRI (The United Nations-backed Principles for Responsible Investment Initiative) is 'based on the premise that ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk-adjusted returns. It is therefore firmly within the bounds of investor fiduciary duties'.[4] Responsible investment involves engagement (see above) and *integration*. *Integration* is the explicit inclusion of ESG risk into traditional financial analysis, which is often combined with engagement.

Legal background

Situation of retail investors versus trustees

In secular Western society, there is little to stop individuals from managing their finances according to their own ethics or whims, and as they see fit. There may be activities which it is illegal to finance and profit from

An individual's situation needs to be distinguished from that of a person who acts as a trustee of an investment fund. Trustees are not able to exercise their own whims in making decisions about donations and investments or when choosing between investment opportunities.

(e.g. prostitution, illicit drugs, manufacture of cluster munitions). But otherwise, an adult of sound mind is free to make their own choices about: donations and investments; differing investment opportunities; and the extent to which they will free ride on other investors, e.g. taking dividends but not voting at AGMs.

Anglophone countries

An individual's situation needs to be distinguished from that of a person who acts as a trustee of an investment fund. Trustees are not able to exercise their own whims in making decisions about donations and investments or when choosing between investment opportunities. For example, in Australia, the SIS Act requires a trustee:

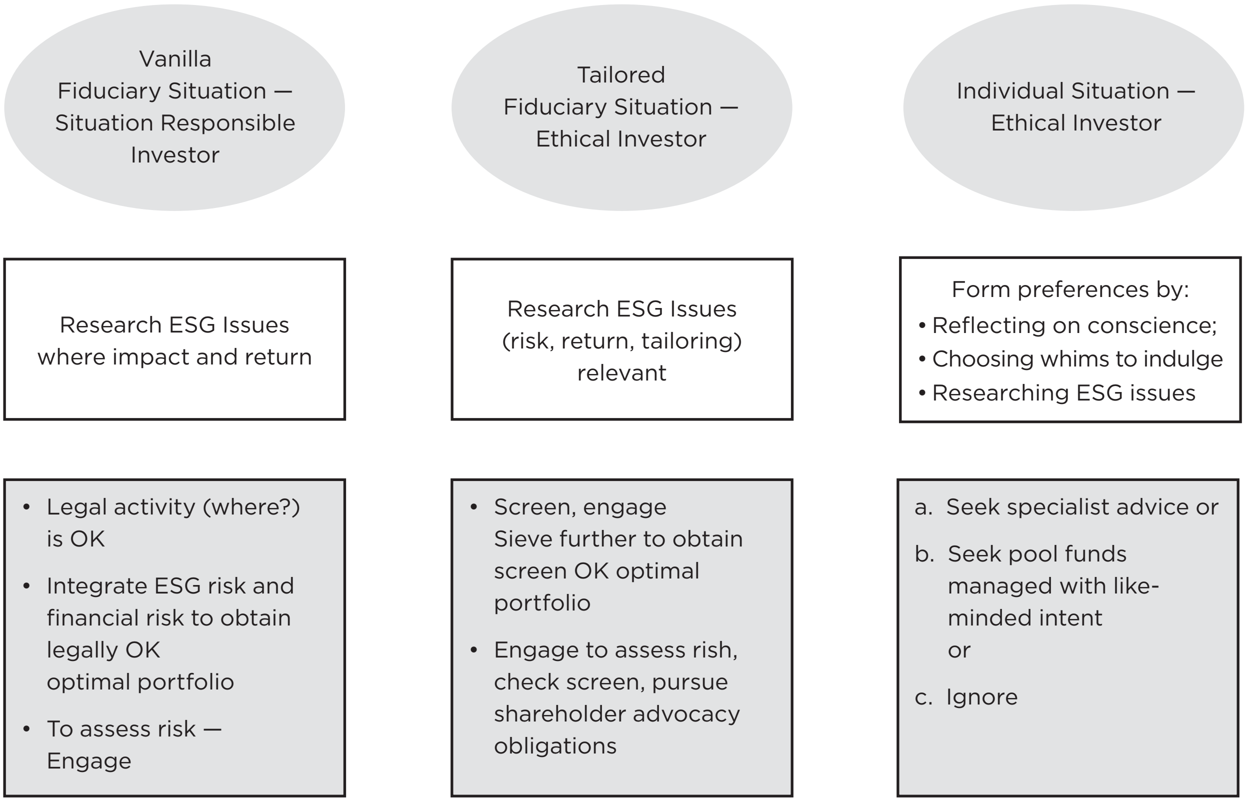
> 'to formulate … an investment strategy that has regard to …

> the composition of the entities investments as a whole including the extent to which investments are diverse or involve the entity in being exposed to risks of inadequate diversification.'

Similarly, in the United States, the *Employee Retirement Insurance Savings Act* (ERISA), passed by Congress in 1974, provides that: 'A fiduciary shall discharge his [or her] duties solely in the interest of the participants and their beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan' (section 404(a)(1)(A)).

Is ethical or responsible investment consistent with these obligations? Does the law make it acceptable for a trustee to finance the construction of a nuclear plant on top of a major geological fault, right next to the beneficiaries' houses, as long as it provides them with a great financial return?

Figure 2: Distinction between the individual situation and two variants of the fiduciary situation



A famous UK court case addressed this question (Cowan v Scargill, 1984). Trustees appointed by the National Union of Mine Workers wished to prohibit the scheme from investing overseas or in energy stocks in competition with coal (e.g. oil, gas, nuclear).

In finding against these trustees, the judge made two important points:

Firstly, though trustees '… may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. Yet if under a trust, investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold'.

Nevertheless, the judge did not assert that 'beneficial' must be construed solely from a financial perspective even if the only object of the trust is to provide financial benefits.

The distinction between the individual situation and two variants of the fiduciary situation is set out in Figure 2. On the left-hand side of the diagram is the vanilla fiduciary situation of a 'Responsible Investor'. The middle of the diagram depicts the ethical investment situation where the members have gathered together defining their interests (e.g. a foundation or specialist ethical investment fund). In the vanilla situation, the equivalent of the ethical screen is 'legal.' Of course, the tailored fiduciary situation might focus on whim but mostly it will focus on

If you're a trustee in a vanilla fiduciary situation it isn't relevant whether you think: climate change is a genuine issue; food manufacturers are responsible for obesity; it's OK or not OK for businesses to deal with oppressive regimes. What is relevant is the risk that all these sorts of issues pose. If you're an individual it's no-one else's business.

externalities which the law hasn't got to yet. The individual situation is shown on the right-hand side of the diagram. An adult of sound mind is free to apply whim, ethics, morals as they see fit and, if they choose, inconsistently from one day to the next.

If you're a trustee in a vanilla fiduciary situations it isn't relevant whether you think: climate change is a genuine issue; food manufacturers are responsible for obesity; it's OK or not OK for businesses to deal with oppressive regimes. What is relevant is the risk that all these sorts of issues pose. If you're an individual it's no-one else's business.

As a consequence of the very different legal situations facing individuals and 'institutional' trustees, the two markets have developed very differently.

European countries
In Europe, at least eight countries have specific SRI regulations that cover their pension systems.[5] However, despite the major step forward that these regulations represent, enforcement is still rather weak.

In France, two laws concerning SRI and pension systems were introduced in 2001, both inspired by the British SRI-disclosure regulation. Consumer protection and a desire to strengthen SRI-investments were the main reasons for the legislation. The February 2001 law changed many features of the French Employee Saving Plan laws, notably introducing an obligation that a fund's internal rules and annual reports specify the way social, environmental or ethical considerations are taken into account. The second law requires the executive board of the *Fonds de Réserve des Retraites* (Retirement Reserve Fund) to report to the supervisory board on the investment policy guidelines and how these take into account social, environmental and ethical issues (Article L135-8, French Social Security Code).

Similarly, in Germany, in January 2000, the Parliament decided to establish an ethical, environmental, and social disclosure regulation in the new pension law. Newly conceived private pension schemes now have to fulfil a number of obligations — including the disclosure of SRI policies — in order to be certified and hence qualify for tax deductions.

In Norway, the size of the ethical investment market increased dramatically in 2004 with the introduction of ethical guidelines on the Norwegian Government Pension Fund, the largest pension fund in Europe and the second largest pension fund in the world. The fund's guidelines are based on a combination of engagement, negative screening and exclusion.

And, in Sweden, since 2001, the five largest state-controlled pension funds have been forced to include environmental and ethical criteria in their investment policy 'without relinquishing the overall goal of a high return on capital'.

Disclosure obligations on financial advisers and product vendors selling to the retail market
It's common in the Anglophone countries for financial services law to insist upon accurate and complete disclosure including in the area of ethical investment.

It's very rare to hear of any litigation or regulatory action in relation to such requirements. The only case the authors are aware of where a manager has been sanctioned for violating representations in relation to ethical screens involved a US company called PAX, which was fined US$500,000 for failing to screen its portfolio in accord with representations in its prospectuses.

Company law attitude to shareholder engagement and advocacy
One form of ethical investment is shareholder advocacy. The significance of this activity as part of the 'ethical and responsible investment scene' in a particular country depends a lot on the requirements set out in the corporation's law of that country with regard to shareholders putting resolutions to meetings. These arrangements also determine the importance of retail investors in engagement and advocacy.[6] In some countries, one shareholder is entitled to put a resolution. Evidently this encourages a degree of retail involvement in this activity. In other countries, only very big money interests can put resolutions.

The United States has the healthiest corporate democracy in this respect. Much of the resolution activity is coordinated by the Interfaith Centre for Corporate Responsibility (ICCR). The ICCR started as a non-denominational faith-based organisation. However, its membership now spans state governments, large institutional owners, investors who manage money on behalf of retail investors, as well as the core founding religious organisations. Each year, hundreds of resolutions are put to US companies on a wide range of ethical, social, moral, religious and environmental issues.

History of the development of ethical investment in Australia

This section describes the history of ethical investment in Australia focusing on retail participation.

Shareholder advocacy
Shareholder advocacy has virtually no history in Australia. Today there is one fund, 'The Climate Advocacy Fund', managed by Australian Ethical Investment, which has an advocacy mission. It is primarily a retail fund and was launched last year. It 'lead-filed' (developed and co-ordinated lodgement of) four resolutions in the 2010–11 AGM season. In almost every year dating back to 1996, surveys of ethical investment in Australia have contained a sad sentence to the effect that, 'Yet again this year, there have been no specific shareholder resolutions related to environmental and social responsibility'. The few resolutions that have been dealt with at Australian listed companies' AGMs have been 'side show' parts of union or green activist issue campaigns.

There are two reasons for this absence of shareholder advocacy history in Australia. One reason for this is the requirement of the *Corporations Act* that resolutions must have the support of 100 members or members holding at least five per cent of the votes.

The second, more significant reason for the absence of development of a culture of shareholder resolutions and democracy is the failure of intellectual leadership on the part of the Australian churches by comparison with the US churches. Just a decade ago, religious organisations were by far the largest identified ethical investors. They had the money, but in stark contrast with the United States, an ecumenical 'universal owner/shareholder advocacy culture' wasn't established in Australia. Today, entirely unlike the situation in the United States, shareholder advocacy has a 'ratbag' connotation to some Australians.

Figure 3: Ethical/responsible investment markets in selected countries (a)

			Total SRI (bn)	Total SRI (€ bn)
United States (2010)	Total SRI	US$3,069	US$3,069	2,141
Canada (2008)	Core SRI	Cnd$54.2	Cnd$609.2	405
	Broad SRI	Cnd$555.0		
Australia / NZ (2010)	Core SRI	Au$18.2	Au$93	58
	Broad SRI	Au$74.8		
Japan (2009)		¥579	¥579	4
Europe (2009)	Core SRI	€1,150	€4,986	4,986
	Broad SRI	€3,836		
TOTAL WORLD				€7,594

Source: European SRI Study, Eurosif, 2010.

a. The core/broad SRI distinction in this table corresponds broadly with the ethical/responsible investment distinction in Figure 1. Core SRI is ethical/broad SRI is responsible.

Community finance

Also, unlike the situation in the United States, community finance has never been a substantial portion of the Australian ethical investment marketplace. The main reason for this is that Australia has always been a well-banked society. Currently, community finance represents about seven per cent of the total core ethical investment market. It is almost entirely retail and it has grown rapidly in recent years.[7]

Screened portfolios

To many Australians, ethical investment and screened portfolios are synonymous because community finance and shareholder advocacy have been fairly minor parts of the Australian ethical investment marketplace. The main features of the screened portfolio/ethical investment marketplace over the past two decades have been: rapid growth; significant broadening in the range of screening 'styles' on offer; increased significance of retail products; and continued disinterest on the part of mainstream adviser firms.

With regard to screening processes, there are no norms-based investment screens operating in Australia. In 2010, ethical exclusions and positive screening approaches each accounted for about one-third of the marketplace. Best of sector accounted for 14 per cent of the market and thematic investment accounted for 20 per cent. [8]

In total, screened portfolios amounted to $15.4 billion in Australia in June 2010. That's about 1.7 per cent of the total managed funds market. It is very difficult to split this into retail/wholesale. The bulk of it is 'retail' driven.' For example, into a number of super funds offer their members an ethical responsible investment option, though the money may be invested in a 'wholesale' pool. As a general proposition, wholesale offerings are less stringent in their approach as compared with retail offerings. For example, while there is a retail super fund available that focuses solely on avoidance of cruelty to animals, there's no similar wholesale offering. Broad responsible investment is much larger — about $75 billion in June 2010, accounting for 8 per cent of the market.

International comparison

Ethical/responsible investing has become a fast-growing worldwide phenomenon in the past 10 years and it is increasingly linked into mainstream fund management. However, the global ethical investment market is far from homogeneous, as a combination of cultural and legal differences deeply influence the shape of domestic markets. Ethical investment 'marketplaces' vary considerably in terms of size, growth, market share and strategy across the world.

Europe represents by far the biggest Socially Responsible Investment (SRI) market in the world, with close to five trillon euro under management,[9] compared with a little over two trillion dollars in the United States (see Figure 3). Other significant markets — although far smaller — include Australia, New-Zealand and Japan. Interestingly, some emerging economies such as South Korea, Malaysia and South Africa have also recently seen a rise of investment in ethical funds.

Ethical/responsible investment markets have experienced phenomenal growth around the world in recent years and were relatively unaffected by the financial crisis; some markets even kept growing. The market grew at about 13 per cent in the United States from 2007 to 2010,[10] now representing 12.2 per cent of the assets under management in the country. The fastest growing area in the US market is community finance, which has grown over 60 per cent over the past three years. Likewise, 17 per cent of European assets are managed through a socially responsible approach, as a result of the European market growing at an average annual rate of 37 per cent between 2008 and 2010.

Retail ethical investment still accounts for a much smaller part of total ethical funds than institutional ethical investment across the United States (81 per cent[11] institutional) and Europe (92 per cent). The split varies a lot between countries — in Germany and Switzerland retail represents about half the market.

One of the reasons that make the global ethical investment market hard to describe is its rapid evolution. It is becoming increasingly hard to define and segment. Terms such as 'best of sector' and 'screening' cover different practices across the world, making cross-country comparisons a challenge. Nonetheless, some long-run trends are clearly discernable. For example, the Swiss prefer best-of-sector and thematic funds, whereas Norway and Sweden are the countries where norms-based exclusions are the most widely used,[12] and engagement is mostly practiced in the United States and, to a smaller extent, in the United Kingdom and Norway. Interestingly, the gradual development of integration — as defined by the inclusion of ESG risks into traditional financial analysis — has become a global trend.

These national and regional differences in strategy, market share and growth of ethical investment can partly be explained by the diversity of political and financial traditions. The greatest difference is probably the long tradition of investment and application of ethical criteria to equity investment in the United States and the United Kingdom, compared with countries such as Spain, where stock markets are less significant. As a result, ethical investment markets are small and more oriented towards community finance in Southern Europe. Ethical financial products are mainly based on environmental criteria in Scandinavia and Germany, where environmental movements have long had credibility and access to political power. Investors in predominantly Catholic countries tend to favour exclusion strategies, screening out entire sectors such as alcohol, tobacco and weapons.[13]

Beyond 'cultural' particularities, differences in legal contexts go some way towards explaining these differences. The adoption in European countries of a series of laws making it mandatory for pension funds to disclose how they take ethical criteria into consideration has coincided with a strong growth in the market. Shareholder activism still remains infrequent in Continental Europe and Australia, mainly because of the legal hurdles that make it more difficult for shareholders to lodge a resolution at a company's general meeting whereas, in US law, one shareholder is all that is required to lodge a resolution.

Conclusion

Ethical investment has three dimensions — screened portfolios, community finance and shareholder advocacy. Responsible investment has two dimensions — engagement and integration.

Responsible investment is a more recent development. In Australia, ethical investment is primarily screened portfolios. Community finance and shareholder advocacy are fairly minimal.

The development of screened portfolio options in Australia have been substantially driven by retail investors with some impetus from church groups. The Australian situation is quite different from that in the United States where shareholder advocacy has been an important feature of ethical investment largely driven, initially, by church funds. The ethical investment market in Australia is also quite different from that in Europe, where the market is proportionally much larger, and more institutionally based. ■

Notes

1. The views expressed are the author's own. Howard would like to thank Damien Lynch, the pioneer of ethical investment in Australia for his inspiration. Further detailed information is available as appendices to the original paper presented to the 16th Melbourne Money and Finance Conference, see www.australiancentre.com.au.
2. European SRI Study 2010. There is a lot of variation in nomenclature in this area. In Europe it's more common to refer to 'Sustainable and Responsible Investment' (SRI) and distinguish 'Core' and 'Broad' SRI which roughly correspond to 'Ethical' and 'Responsible' investment as described in Figure 1. The term 'Ethical' and the term 'Responsible' are also sometimes used as umbrella terms to encompass both ethical and responsible investment practice.
3. For example, in Belgium it is illegal to be indirectly involved in financing a company which produces cluster munitions. So, avoidance of companies involved in cluster munitions production isn't 'ethical investment' in Belgium. This is further discussed in Attachment B to the original conference paper (available at www.australiancentre.com.au).
4. See www.unpri.org/faqs/
5. See www.belsif.be
6. Attachment A to the original conference paper (available at www.australiancentre.com.au) sets out these requirements in various western countries
7. Average growth over the three years to June 2010 has been 25 per cent per annum.
8. See *RIAA Benchmark Report*, November 2010.
9. *European SRI Study* 2010, Eurosif.
10. *Report on Socially Responsible Investing Trends*, Social Investment Forum, 2010.
11. *Report on Socially Responsible Investing Trends in the United States*, Social Investment Forum Foundation, 2010.
12. The ethical approach of the Norwegian pension fund is described in Attachment C to the original conference paper (available at www.australiancentre.com.au).
13. A country-by-country description of the development of ethical investment markets is provided in Attachment D to the original conference paper (available at www.australiancentre.com.au).