

This paper outlines a little of its varieties and history and then focuses on approaches now available to endowed funds who wish to align where they invest with their fundamental objectives.

### **Some history**

Ethical investment, or social and responsible investment, or more simply nowadays, responsible investment, has been around for a long time, but it has had a particular active development over the last 30 years or so.

As regards listed investments, it has gone through three broad stages:

|                                 |   |  |
|---------------------------------|---|--|
| Ethical investment              | · Almost entirely exclusionary                              | Mid 1970's to end 1980's                       |
| SRI                             | · Some exclusionary   | 1990's to today and into the future            |
| socially responsible investment | · Best of sector<br>· Some positive sectors                 |  |
| RI                              | · Limited exclusionary                                      | Last few years, current with much interest now |
| responsible investment          | · Strong engagement<br>· Identification of superior returns |  |

We are now entering probably the most interesting period as the approach reach some maturity and as a much wider group of funds start to adopt some sort of environmental, social and governance (ESG) monitoring of their portfolios. Recent polls show that the majority of fund managers believe most funds will incorporate some ESG considerations within the next 5 – 10 years. And the recent establishment of the UN Principles of Responsible Investment (UNPRI) has created a substantial amount of interest and seen many funds signing up to it. From being more of a specialist concern, it looks like RI, in some form, is well on the way to becoming mainstream.

New Zealand is a little behind the curve. A study I undertook for the MfE in 2004 suggested that the amount of funds managed under some sort of SRI mandate was about 10% of that to be found in the UK and Australia *per capita* – ie, smaller because New Zealand is small, of course, but actually smaller by a factor of 10 per head of population. I suspect that this may be changing and that the change may well be led by funds such as foundations and the CFIs.

### **Motivations**

There are multiple roots to the responsible investment movement and many competing claims and points of view. It's not a single thing. There is some commonality in the view that decisions about investment cannot be decided by financial risk and return alone: risks are not only financial and it matters how the return is earned. ESG factors are relevant. Beyond that, there is a wide range of different approaches. This is partly because it's still in development but also because there are genuinely differing objectives. So it is hard to categorise it in a simple way.

However, there are perhaps four main motivations, and these are useful reference points if you are considering some form of responsible investment for your fund. Which of them apply to you? Very often, it will be more than one.

- A. keeping clean  
want to avoid investments which don't align with your, or your stakeholder or your investment mandate's, values
- B. changing the world  
want to use the power which being an investor gives you to change what companies do
- C. unlocking activity  
want to make funding available for activities which are held back by insufficient funds
- D. seeking superior returns  
want to take advantage of possible superior returns by making an early move into, say, new environmental technologies

### *Keeping clean*

This was particularly taken up in the 1970's by church groups who realised that they were investing in activities they found to be unethical. These were typically gambling, alcohol, tobacco and armaments. How could you be a pacifist, for example, while your church's income came in part from investments in companies making armaments?

This is the "sin" stock approach and valid where there is a clear and agreed ethical framework in which a fund operates. But for many funds, such clarity is rather elusive and they have to interpret their legal mandate and also take account of the attitudes of their stakeholders – and stakeholders usually hold a variety of contradictory views which change over time. What then to do?

Today, this is more often an attempt to *mitigate* adverse social and environmental effects – to "do no evil", as Google's company motto has it. Harder than you might think.

### *Changing the world*

A good early example of this was the anti-apartheid movement, again in the 1970's, which sought to put pressure on South Africa by stopping investment and loan capital flows. Especially strong were boycotts of British banks which were major investors in South Africa. Controlling capital, it was thought, would change the political situation more effectively than the directly political campaign.

Today, a much wider range of activities are targeted – labour conditions, environmental despoliation, manufacture of particularly vicious armaments (eg, cluster bombs), corrupt practices. The point is not so much to keep clean – which tends to exclusion and divestment of the investment – but to make companies act clean – active engagement with the company. Indeed, at the more extreme end, some investors buy shares precisely to be able to harass the board of a company at the AGM.

### *Unlocking activity*

There are many activities which require investment and capital but which cannot raise it through the conventional financial sector under normal commercial conditions. This may be

because they simply do not fulfil reasonable commercial criteria but it can also be because of prejudice, because the markets have not yet seen the true potential. Microcredit funds in the developing world are an example of the former: many simply cannot pay a market return even though their activity is hugely effective in alleviating poverty. Some environmental technologies are examples of the latter. The markets don't yet get it and it takes early "value-led" investors to show the way.

Unlocking activity also wants to change the world but by doing new things rather than changing the way existing things are done.

### *Seeking superior returns*

This is perhaps the most recent development. The argument has been for some time that the successful industries of the future will be the ones which face the forthcoming challenges of climate change and the need for new environmental technologies. There's money to be made in them. Some funds have started to look at developing a systematic investment framework to identify those developments which will make money and capitalise on being early investors in these areas.

Generation Investment, set up by Al Gore and David Blood (formerly CEO of Goldman Sachs Asset Management) is one example; Henderson's Future Fund in London, another. Both funds want to be seen as straight investment funds without a particular SRI or responsible investment tag. "We will make more money than others by anticipating how the world is changing," is their claim. They just might.

There's a second sort of classification here which is between investors who invest directly in companies and activities – such as microcredit banks in the developing world, or the European social banks – and those who mainly invest in listed markets – this means stockmarkets and the many related capital instruments. Endowed funds are a part of the second which will be the main focus for this paper but the former is a very fast growing and developing field. It has its examples in New Zealand, in the loan funds which make up Ethical Investment Aotearoa, and in Prometheus Finance, modelled on the European social banks and active for over 20 years.

### **Why do it?**

Funds generally start to look at RI when they think they may have a problem. This has perhaps been stirred internally by the management, perhaps by concerned trustees unhappy with your investment portfolio (people often get a shock when they see where some of their money is invested), or even by stakeholders. The Universities Superannuation Scheme (USS) in London was an example of the latter: it invested to pay the pensions of university staff throughout the UK. The ultimate beneficiaries became unhappy how the money was being earned to pay their pensions. It may even be that your mandate, the legal framework creating the fund, requires you to have account of such matters. The New Zealand Superannuation Fund, for example, is set up under statute which requires it to invest in a way which would not harm New Zealand's reputation as a responsible member of the world community and

requires it to have a published ethical investment policy. The statute, beguilingly, doesn't say what this should be but the requirement is clear.

Whatever the reason, it is essential to get clear *why you want to do it*. Internal and external debates around these issues are frequently fractious and chaotic. There's not much accepted best practice out there. There are numerous approaches clamouring for attention, and there are an enormous number of opinions about what's right and wrong and what works and doesn't. And, unlike debates on the technical implementation of investment mandates, which are considered and well-structured, emotions can run high.

The first step is to calm it down and consider systematically why you want to do it and what factors are relevant. Pay heed to

- what does our formal mandate require of us?
- who are our stakeholders and what do they require of us?
- what are we – the trustees and management – trying to achieve?

Careful evaluation of these and preparation of a policy paper, at least internally, *before* deciding how you will do it provides the framework you will need.

### **Obstacles**

There are two potential obstacles to pursuing a responsible investment framework should you decide, for clear reasons, you want to do so.

#### *Fiduciary duty*

As trustees of a fund, you have a fiduciary duty to maximise the return on its investments without taking undue risk. The argument is that this maximises the benefit for the ultimate beneficiaries.

This has caused a great deal of controversy over the years. For example, could the Church Commissioners, the trustees of the Church of England's very substantial investments, adopt an ethical investment policy in line with what the Church wanted if this ran the risk of lowering returns? Was the UK National Union of Miners' pension fund right to invest in industries which were leading to the demise of the UK coal mining industry and so assisting in the widescale redundancy of miners, the ultimate beneficiaries of the fund? The answer of the UK Courts to the latter, in a case which set the agenda internationally over many years, was, yes, the trustees must so invest as this is in the best interest of beneficiaries as pensioners:

*Trustees may have strongly held political or social views... they may object to any form of investment in companies concerned with alcohol, tobacco, armaments, or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments in 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. (Cowan v Scargill, 1984)*

More recently, there has been an important internationally study undertaken for the United Nations Environment Programme Finance Initiative. This attempted to answer whether environmental, social and governance (ESG) issues are “voluntarily permitted, legally required, or hampered by law and regulations” when investing the funds they are responsible for – ie,

are they allowed to take account of these issues, and even, are they required to do so? The report looked at this under a number of jurisdictions (not including New Zealand). It answered, yes, and even that there was an obligation to do so where the effects of not doing so are material.

I think it's too early to say what the significance of this will be. One view is that this changes the game entirely. Another says it has little legal significance. What it perhaps does do is signal a changing climate within which such issues will be judged in the future. There have been a number of legal cases in the UK and the USA which certainly soften considerably *Cowan v Scargill*, but the precedents are far from clear. What it suggests is that trustees are free to take ESG considerations into account but need to be structured, clear and prudent in doing so.

*Will our returns suffer?*

Of course, if returns don't suffer, then the sting of fiduciary duty is effectively nullified. So, will returns suffer? There have been numerous studies undertaken. However, none are definitive. This is either because the studies poll investment managers' beliefs about whether returns will suffer – the results are generally, no, they won't suffer, and in addition, most funds will in future take account of ESG factors. But this is an anthropological result: what that peculiar species, fund managers, believes. Or, the studies are looking at short data series and amalgamating into one catch-all a heterogeneous group of funds which claim to follow SRI.

For example, most SRI funds have a bias towards small caps as smaller companies are narrower in the range of activities they undertake and it's difficult to find large caps which won't have something in their stable which will be objectionable to a strong SRI investor. In certain market conditions, strong bull markets, small caps tend to do well – the mid 1980's, for example – so SRI funds appeared to do well at that time. Conversely, they do badly in bear markets. SRI funds duly suffered. Is this SRI or small caps? No one really knows.

More systematic and careful study will be needed before the effects of SRI mandates, and then *which* SRI mandates, can be assessed confidently. In the meantime, with suitable health warnings, what the studies suggest is

- hard exclusionary approaches, the older ethical investment approach, reduces performance a little but not always
- SRI seems to matche it providing the mandate is loose enough
- the newer “future funds” approach have the promise of exceeding it – as long as you can pick the winners.

It would seem that, carefully implemented, trustees have little to fear on this score. The evidence is far from definitive, but it suggests that performance is not greatly affected, if at all, and under particular circumstances may confer an advantage. But then the evidence is not clear for all manner of other investment styles and approaches which are embraced without too much concern; ESG factors would seem to be no different.

**Second step: how to do it**

Having established what your motivation and having satisfied yourself that you will be fulfilling your trustee duties in pursuing RI, the question is how to implement it.

*Information*

We are relatively poorly served in specialised services in New Zealand. There is only one fund manager who is offering an SRI fund (Asteron) and one wholesale investment firm who has some specialism in the area (Trust Investments). There is also Prometheus Finance who are direct investors in the social economy, and you might consider placing some cash funds with them, but this is very limited. Australia has quite a lot more to offer with a number of funds – AMP, Hunter Hall and Australian Ethical – offering different approaches and with reasonable track records.

So rather than simply use a fund, you are probably going to have to sign up to an information service – such as SIRI, Innovest or CAER (all Australian based) – who will analyse your holdings and alert you to stocks which may be of concern on a regular basis. Innovest, for example, provides a pre-cautionary analysis of stocks included in the MSCI global index and will alert its subscribers on a traffic light system – green, yellow, red – where there are issues they may want to consider. The others provide similar offerings.

Such information provides a basis for discussion with your fund managers. The key issue will then be whether you want to divest or to engage. The exclusionary approach, divestment, conforms more to the first motivation, A, trying to keep oneself clean. Engagement more to the second, B, trying to change things. In general, where the concerns are not overwhelmingly serious, funds are tending more to engagement. Divestment, unless it is wholesale, makes little difference. The company continues as before. You are simply no longer involved. Engagement, where it is effective, gets the company to change its ways. And this keeps you invested, minimising any possible effect on investment performance.

*Networks*

The second step is to join supporting networks. There are two locally to consider

- Council for Socially Responsible Investment (CSRI) which is New Zealand based and which has focused on campaigning to get, for example, the Crown Financial Institutions, like the NZ Super Fund, to adopt a more aggressive RI policy.
- Ethical Investment Australasia (EIA), founded in Australia but now active in New Zealand. This is more of an industry than a campaigning body offering services to support funds and advisers wanting to be involved in RI. It offers, for example, an independent SRI accreditation scheme which funds can use to confirm to stakeholders what they are doing.

There are also international networks which you can look at. Perhaps the most significant is the UNPRI which, as well as creating standards, is developing a range of services to support those standards. One example is an engagement “clearing house” whereby members can join with other funds to engage with companies on particular issues. The UNPRI’s secretariat will then take up the engagement on behalf of the funds who support it (this is case by case and no member is assumed to have joined on an issue). This is likely to be much more efficient and effective than single funds doing it by themselves.

Both the NZ Super Fund and ASB Trusts locally are now members of the UNPRI and the Super Fund is trying to take some local leadership in this as part of its responsible investment framework.

*Internal institutional framework*

The last and probably most important step is to establish an internal framework for dealing with RI issues. Is this a sub-committee of trustees or will all issues be considered by the full board/trust? Who is responsible for preparing reports when they are needed? What form should this take? How often will they be considered? Who will liaise with the fund managers? What sort of reporting will be expected?

RI, because of its greater emotional loading, can become chaotic. Establishing an internal framework for dealing with the issues it raises, carefully taking these back to the motivations and approaches you have decided upon, should make this a routine, efficient and cost-effective way of aligning values with your investments.

Glen Saunders  
March 2007