Ethical Investment:
An Overview Including Challenges

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Ethical/ Socially Responsible Investment is personal; values based investment seeking to make a difference on some societal issue whilst achieving a return on ones investment. It assumes monetary decisions make a difference and as stated in the article below in many cases the returns are competitive with other forms of investment.
In addition for certain institutions a lack of ethical investment policies and actions can result in a risk to reputation. To succeed an organisational ethos reinforcing risk management must be in place. It should not just be seen as a financial activity and it should not be reactive in nature.

Ethical investment has come a long way since the mid eighteenth century, when the Religious Society of Friends (Quakers) prohibited members from participating in the slave trade.

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Ethical investment - also called sustainable investment, responsible investment and socially responsible investment (SRI) - is more popular than ever.

Definitions vary but a simple one is anything that reflects the values of the investor - for example, environmentally-friendly technology or social loans for local communities.

About £12.2 billion is invested in UK green and ethical retail funds, according to Ethical Investment Research Services.

Ethical investment used to be a matter of avoidance. Investors would tell their advisers to avoid putting their money into things such as tobacco, alcohol or arms companies.

But as the market has matured, investment strategies have become more active and less passive.

Investors are picking technologies or industries, such as electric cars, energy-efficient agricultural equipment, or making energy from waste, that make a positive contribution to environmental or social issues.

The attractions for financial advisers and their clients are financial as well as ethical.

Sustainable investment funds generally performed better financially than their mainstream counterparts, according to research published in August 2013 by Moneyfacts.

The average ethical fund delivered returns of 24% over a year, compared with the 18% growth displayed by the average non-ethical fund, the research found.

The Quilter Cheviot Climate Assets Fund has returned 39.9% from launch in March 2010 to March

2014. This compares with the IMA Mixed Investment 40%-85% Shares Sector delivering 32.47% over the same period (Bloomberg).

Which types of ethical investment offer the best potential returns for investors?

Five areas stand out: energy efficiency (or low carbon energy); food; health; resources and water.

These technologies are growing fast and have typically produced good returns for investors over the past few years.

Energy Efficiency

The global population is growing faster than at any other time, with about 800 million more people expected in the next ten years and six out of ten living in urban rather than rural areas.

The energy-efficiency sector – which includes improvements in buildings, such as insulation and lighting, and transport efficiency, such as railways and electric vehicles – is growing at around 10% annually (International Energy Agency / IEA).

It's expected to reach around $1trillion (c.£592 million) by 2020 (Source: Bank of America's Thematic Investing Team)

Transport is growing fast, thanks to strong demand for products such as catalytic convertors, which convert carbon monoxide poisonous gases from car exhaust systems into carbon dioxide.

Demand for this and other green transport technologies is set to increase as governments pass legislation requiring vehicles to reduce pollution.

Lighting is another bright spot for ethical investors. It accounts for 16% of electricity consumption in the UK and 19% globally. Efficient lighting, such as compact fluorescent or LEDs (light emitting diodes), which use less energy than traditional 'incandescent' lighting, is becoming the norm

China will continue to play a vital role in the auto industry value chain. There are already more automotive assembly plants in China than in any other country in the world.

Food

As the global population rises, farmers are having to produce more food.

In the developing world, people are eating more protein – a dietary shift that will further increase pressure on farmers to produce more.

Using less energy can help farmers improve output and cut costs. Energy-efficient machinery can help.

For farmers, a 20% cut in energy costs can be the equivalent of a five per cent increase in sales, according to the UK's Carbon Trust, a publicly funded body that helps businesses cut emissions.

Agriculture is a very thirsty industry. It is currently consuming more than two thirds of the world's fresh water. When growing cereal crops, farmers using conventional ways of irrigation can waste up to 40% of the total water withdrawals, particularly in developing countries.

Better irrigation of farmland - for example, using technology to schedule irrigation and keep soil at the right moisture - can reduce the amount of water that's wasted and reduce costs.

Health

Better drugs and medical treatments are helping people live longer. Meanwhile, governments are putting pressure on drug-makers to lower the price of drugs.

To become more competitive, pharmaceutical companies need to focus on cost effective healthcare and targeted therapies.

These trends make healthcare an attractive market for sustainable investments. Companies providing vaccines, generic drugs no longer in patent (which are much cheaper than branded drugs) new therapies to combat obesity and treat diabetes may be worth investing in. Technology is changing healthcare and creating investment opportunities.

Robotic technology to help doctors do keyhole surgery is becoming more common. So is software allowing hospitals to create electronic-patient records.

The benefits of electronic medical records are obvious: if you're treated in a different hospital, maybe in a different country, your doctor can quickly view your medical history, including any medicines you're allergic to.

Electronic patient records can reduce medical errors. And fewer errors can reduce the risk of hospitals being sued for malpractice -- a major concern in countries including the United States.

Resources

It may not be the most glamorous of industries but waste disposal is thriving. Using and managing resources, recycling them and disposing of them in an environmentally-friendly way can reduce carbon emissions.

Some companies are finding ways to produce energy from waste - for example, extracting methane (a greenhouse gas) from landfill waste and turning it into electrical power.

In the UK alone, recycling food waste for energy and agriculture would save £17 billion a year, avoid the emission of 27 million tonnes of greenhouse gases and power 60,000 homes, according to research published in November 2013 by waste recycling company ReFood.

Water

Whether it's piping it, pumping it, measuring it or checking it is safe to drink there is plenty of liquidity in the water sector. A growing number of companies are offering solutions to preserve and conserve water for business and households.

Behind-the-wall cisterns for the residential and commercial sectors can reduce water flush volume by about a third. Smart meters, meanwhile, can reduce water consumption and improve water usage. They're becoming more common, especially in Europe.

Investors should also keep an eye on 'reverse osmosis' desalination technology, a process for converting salt water to drinking water. It has great potential but may not provide as big returns on investment compared to more established forms of environmentally-friendly technology.

Sustainable investment generates attractive investment opportunities when one understands the global changes taking place with regard to consumer preferences, government spending, energy and food supply-and-security, and the general need for a cleaner and more efficient economy.

In my opinion, shares in renewable energy companies typically haven't performed well in the past five years or so but this is only a small part of the ethical investment sector. A broad investment portfolio can help offset dips in some industries and help investors make good returns with a clean conscience. For example, First Solar Inc. has returned -48.09% (Bloomberg) in the last 5 years as at 31st July 2014.

How does this fit within the 'spectrum of social investment'?

Social investment, as we understand it, covers investment in any business that has a direct impact on the communities in which the business operates. For example, investing in a chain of small supermarkets that only employs workers who live in close proximity to the stores and sources fresh groceries only from local suppliers could be classified as a social investment.

The business creates wealth directly in the community in which it operates. In a way there is a strong focus on how the enterprise does business and earns the right to operate - improving the lives of the chosen demographic.

Sustainable investment covers investment in any business that has a direct impact on improving environmental and demographic challenges around the world, independently of the operation or sourcing location of the enterprise.

For example, investing in companies with technologies, products and services to reduce water shortages or improve the imbalance of food supply and demand. In a way there is a strong focus on what the enterprise does - marketing products and know-how to resolve environmental and urbanisation challenges.

Any challenges?

Over the years we have found that investors were concerned that there was a price to pay for sustainable investing. There was a misperception that the performance of sustainable investment funds would be worse than an unconstrained (mainstream) fund.

However, our own record suggests such a performance penalty does not exist. The Quilter Cheviot Climate Assets Fund has returned +39.80% from launch in March 2010 to July 2014. This compares with the IMA Mixed Investment 40%-85% Shares Sector delivering +34.16% over the same period.

Most of the fund offerings within the sustainability space are mainly equity-only strategies. These have had significant volatility over recent years, as most of their holdings are high beta stocks. These kinds of funds do very well during an economic upturn, but badly in a downturn.

As such, many investors still associate environmental or sustainability markets with high volatility and poor returns.

By taking a mixed-asset approach we, at Quilter Cheviot, aim to smooth the volatility of returns over the economic cycle and offer a decent dividend yield. Additionally, some investors would associate sustainable investing with the solar sector for example, which has had poor performance from 2008 through 2013 due to changes in government subsidy policy, as well as an increased competitive threat to western solar companies from privately owned firms in China.

However, the companies involved in solar power generation are a negligible part of our investable universe. Also, as we only invest in profitable established businesses with attractive valuations, we avoided the solar sector altogether during that period.