# The ethical tipping point

From public opinion to regulatory pressure and adviser attitudes, Richard Eagling reports on the continuing progress of the ethical and SRI fund market

**From the recent photo of huskies pulling a sledge through a sea of melted ice water in Greenland to footage of baby turtles struggling to swim through plastic pollution in Honduras, there is no shortage of striking imagery to highlight the damage being done to our planet. For many years some scientists have been warning that the world is fast approaching a tipping point, whereby rising global temperatures could push our climate system past the point of no return. Urgent action is needed, a message that is seemingly striking the right chord with the growing number of individuals that are asking questions about where their money is invested, the causes that it is supporting and the impact that it is having.**

## Tipping point 1: public opinion

"The Blue Planet 2 series appears to have flicked a switch in many people's minds," says *Julia Dreblow, Director at SRI Services and Founder of www.FundEcoMarket.co.uk*. "The constant flow of news about plastic waste, climate change, biodiversity loss, air pollution, the discrediting of climate sceptics and the success of shifting to cleaner sources of energy, mean that the backdrop to client conversations has changed dramatically."

The extent to which public opinion around ethical/socially responsible investing (SRI) is changing and individuals are increasingly seeking investments that reflect their own values, is reflected in the Investment Association (IA) statistics detailing net retail sales of ethical funds and total ethical fund assets under management. Last year, net retail sales of ethical funds reached a record £1.29 billion, more than double the volume of sales just two years previously. 2019 has seen further healthy demand, with net retail sales of £178 million in April 2019 (the most recent month for which statistics are available), a significant uplift on sales of £110 million in April 2018. "Fund inflows are increasing rapidly and many fund managers have new funds planned, so there is no sign of this slowing down," adds Julia Dreblow.

Meanwhile, total ethical fund assets under management have more than trebled over the last decade to £18 billion, with their share of industry funds under management creeping up from 1.2% to 1.5%. "Purely 'ethical' investing, i.e. those focussed on ethical exclusions from their portfolios, is around 1.5% of the UK market, but, this is only a small and niche part of the 'responsible and sustainable' investment market as a whole," points out *Neville White, Head of RI Policy & Research at EdenTree Investment Management.* "Funds with integrated environmental, social and governance (ESG) risk or sustainability strategies are becoming far more widespread and mainstream among retail and institutional clients, and we believe this will only continue to grow."

The ethical/SRI fund market has come a long way over the last 10 years, but it is the decade ahead that is causing the most excitement. There is a firm belief that demand for ethical and SRI investing is at a tipping point and about to embark on a period of accelerated growth. Indeed, according to research by Triodos Bank, the SRI market could be worth

£48 billion by 2027. Other industry experts share this optimism. “We feel the sector is breaking ground and see it growing to 20% of global AUM over the next decade,” predicts *Wayne Bishop, Head of Ethical Investing and CEO of King & Shaxson Asset Management.* “The availability of options is increasing and as all asset managers are now jumping on the bandwagon we see a number of barriers coming down. On top of this, recent conversations with advisers have shown they see a growing demand from younger generations, so the wealth shift from baby boomers to millennials will likely boost ethical/SRI flows.”

While acknowledging that further demand for more ethical investment opportunities will come from existing investors, the Triodos Bank research also highlights the rise of a new generation of socially conscious millennial investors as an important trend. Its research found that a fifth of UK investors are planning to invest in a socially responsible investment in the coming years, rising to almost half (47%) among younger investors aged 18-34. The research also points to a new level of ‘resist investing’ particularly among this younger group. A third of investors said that they are motivated to invest in ethical funds because of negative events in the news, rising to 56% of investors aged 18-34. Among this age group, climate change-related disasters, the 2008 financial crisis and the fossil fuel divestment movement were cited as the biggest stimuli.

The 2019 Deloitte Global Millennial Survey, paints a similar picture suggesting that millennials and Gen Z, will support companies that align with their values, but not hesitate to lessen or end a relationship where they disagree with a company’s business practices or values. Indeed, 42% said that they had started or deepened business relationships because they believe a companies’ products or services are having positive impacts on society or the environment, while 37% have stopped or lessened a business relationship because of the company’s ethical behaviour.

“Bad management and business practices such as tax avoidance or poor environmental practices have made people more aware of the behaviour of companies they are invested in,” says Wayne Bishop. “While some would say this is generational, we would disagree as we see investors of all ages. What these people realise is that their investment choices can make a difference. The fact that many companies now try to “green” themselves shows how far we have come in the last decade, when ethical and SRI was on the fringes of the investment universe to now being front and centre.”

### Tipping point 2: Financial regulators

It is not only among investors that the ethical/SRI fund debate has seemingly reached a tipping point – financial regulators have also woken up to the need to take climate change seriously. It is now widely acknowledged that climate change is likely to have a significant impact on the global economy and financial services markets. The Paris Agreement and UN Sustainable Development Goals have significantly raised international awareness of the financial impact of climate change placing increasing pressure on financial regulators and trade bodies to understand these risks.

“Rule makers are increasingly focused on sustainability issues and climate change in particular as the situation we find ourselves in becomes more pressing,” says Julia Dreblow. “This is feeding through from the EU – via ESMA and MiFID II – and UK regulators, most notably driven by the Bank of England which is working to reduce climate-related risks to the stability of the financial system. Other key bodies include the Department for Work and Pensions (DWP), Financial Conduct Authority (FCA) and Investment Association (IA) who are all effectively looking to improve client understanding of, and access to, investments with sound sustainability and ESG credentials.”

Interest in the financial risks posed by climate change has been building for some time among central banks, with Governors Mark Carney of the Bank of England and Villeroy de Galhau of the Banque de France warning that financial institutions need to adjust to the new world of climate change, or “they will fail to exist”. However, a new report from the Network for Greening the Financial System has recently claimed that while the world’s leading central banks are doing an excellent job of ringing the alarm bells and raising awareness of the risks climate change poses to the financial system, there remains a disconnect between words and action. The report ultimately argues that central banks need to lead by example, by incorporating climate risks into their own day-to-day monetary policy operations.

“Central banks – thanks in no small part to the work of the Bank of England that helped launch the TCFD initiative at the Paris Climate conference in 2015 – are indeed starting to make real progress on climate change,” argues Julia Dreblow. “But it is early days and lending policies are unlikely to change overnight – but I believe things will change quite rapidly in the banking sector (and also the insurance sector). The FSB’s TCFD initiative (the Financial Stability Board’s Taskforce for Climate Related Financial Disclosure), is rapidly gaining traction and cited by investors. Its aim is to improve transparency for climate-related financial disclosures – however its most recent report (June 2019) comments that much work is still necessary – as companies still do not publish sufficient information for investors and others to fully assess climate-related risks.”

While the Bank of England has been at the forefront of the debate around the financial

## Key ethical/SRI fund talking points

There is so much going on. The UK moving towards net zero carbon emissions by 2050, thanks to the work of the Climate Change Committee, is probably the biggest news as it sets a direction of travel that investors can respond to. The EU taxonomies work is a further big topic as are growing fears around greenwashing. For advisers, the biggest topic now seems to be ‘how do I do this?’ – which marks a major change from the ‘why bother?’ conversations that have dominated conversations for the last two decades.
**Julia Dreblow, Director SRI Services and Founder**
**www.FundEcoMarket.co.uk**

We are seeing attempts to define the different areas of investment such as impact and ethics. In some cases this is for clarity, but others are seeking to commoditise the market – we feel it’s more complex than that. We have also noted the growing awareness around ‘impact’ and we continue to see a rise in the reporting from fund houses to showcase to investors the results of their investments. We feel this is key to swaying more investors to open up to the idea of sustainable investing, however beware ‘greenwashing’ of reports.
**Wayne Bishop, Head of Ethical Investing and CEO,**
**King & Shaxson Asset Management**

We are seeing strong interest in ESG integration and a rise in funds and strategies entering this market. Confusion around terminology and the potential for product mis-selling is galvanising some commentators to warn of these dangers, including ourselves. Elsewhere, we continue to see interest in how the Sustainable Development Goals can be applied to portfolios, and some demand for measuring the impact of investments. The issue of climate change is now really exercising investors, and there is considerable emphasis on participating in climate change-related investor initiatives.
**Neville White, Head of RI Policy and Research,**
**EdenTree Investment Management**

risks presented by climate change, there has been a sense that the FCA has been lagging behind. However, there are signs this is changing, with the publication of the FCA Discussion Paper on Climate Change and Green Finance in October 2018 seen as a particularly significant development. "We welcome the FCA's involvement and its appreciation of how climate change will impact finance," says Wayne Bishop. "We see this as very forward-thinking and an important step".

In its Climate Change and Green Finance discussion paper, the FCA argues that there are a number of areas in which climate change can potentially impact its role as a regulator and that could warrant greater regulatory focus. These include ensuring that where pensions are concerned, those making investment decisions take account of risks including climate change, enabling competition and market growth for green finance, ensuring that disclosures in capital markets give adequate information to investors of the financial impacts of climate change and assessing the scope for the introduction of a new requirement for financial services firms to report publicly on how they manage climate risks.

A key development emanating from this discussion paper has been the creation of the Climate Financial Risk Forum, whereby the Prudential Regulation Authority (PRA) and FCA have joined forces to co-ordinate action and share best practice to help the financial sector manage the financial risks from climate change and support innovation for financial products and services in Green Finance.

"I very much welcome the recent FCA climate change paper – although when I first read it I did not think they had recognised the magnitude of the risks climate change presents," says Julia Dreblow. "My impression now is that they are upskilling in this area and recognise the benefits of encouraging a greater focus on sustainability and climate change. The new FCA/PRA Climate Change Forum should help bring a focus to their work as the PRA is tasked with maintaining the stability of the financial system that climate change threatens. It is hard to tell how significant this will be to the ethical/SRI sector as, in my view, the FCA's work needs to go far beyond focusing on funds that are mostly pretty good in this regard. Their activity should therefore focus on those who pay scant attention to climate risk – and I believe we are seeing movement in that area already. My understanding is that most institutional investors now mention ESG as part of their RFP pitches, although their skill sets are pretty mixed. The FCA's attention should therefore be focused on raising the bar across all areas of investment and guarding against greenwash."

### Greenwash concerns

A major issue expressed by all of the commentators that we spoke to for this feature was greenwashing – where companies market their products, activities or policies as producing positive environmental outcomes when this is not the case. Here there are fears that funds that employ a very loose definition of socially responsible investing or sustainability could undermine the progress that the SRI fund sector has made. As more such funds launch and investment houses become keener to offer a presence in this market, so the dangers of greenwashing become more acute. "Investors need to be alert to greenwash as new entrants come to market, but again, education over the coming years will ensure advisers and consumers are aware of this practice," says Wayne Bishop.

Indeed, greenwashing is already a client concern. According to Triodos Bank, 45% of investors are worried that some investment funds labelled as SRI are in fact still investing in companies that have a negative impact on society or the environment. As a result, over a third (39%) said SRI funds need to have tighter criteria.

"The problems with ethics is that they differ," says Wayne Bishop. "What some investors would regard as acceptable, others would not accept. There will always be light and dark green approaches. However, even some light green funds seem to push the envelope too far and are guilty of greenwash. The concept of greenwash does go some way to damaging the sector's reputation, which is why it is important for advisers and consumers to be educated on the topic. We note from past experience that clients tend to be truly passionate about the outcomes of their invested capital, so to avoid greenwash is essential in order to ensure we are fulfilling our mandates."

### Tipping point 3: Definitions and labels

One of the biggest challenges facing advisers and consumers is understanding all of the different ethical/SRI options and styles and the terminology that is used. The growing number and variety of recently launched sustainability themed funds has added to this complexity.

"Sustainability themed funds have increased in number faster than any other retail SRI fund style but they vary substantially, says Julia Dreblow. "Some are heavily weighted towards pure play, 'impactful', solutions companies whereas others focus more on ESG risk mitigation or 'best-in-sector' companies. Both groups may or may not also have ethical policies that bring additional clarity to where they will or will not invest – however this is normally not their main focus. Both of these strategies are perfectly legitimate – as are the many variations between these extremes. Each can contribute to both improved performance outcomes and the transition towards more sustainable lifestyles – but they suit different clients."

Given the growing potential for confusion, it is perhaps unsurprising that the IA launched the first industry wide consultation on sustainability and responsible investment at the start of the year. The consultation sought the views of asset managers on key aspects around sustainability and responsible investment, with the aim of bringing greater clarity to help savers and investors navigate this area.

The consultation covers three key areas, the first of which is to look at proposed definitions for the different sustainable investment approaches, including commonly used terms such as ESG integration, impact investing, and negative screening, with the aim of agreeing on an industry endorsed set of standard definitions.

"We believe that this is an issue that needs addressing, which is why we responded to the IA consultation and have been very public in our views that as market interest grows, there needs to be more of a focus on definitions so that clients understand what they are buying," says Neville White. "The multifarious terminologies used and language around responsible and sustainable investment has largely been what has created this confusion – but so too has the generally vague way in which sustainability is used as an investment approach."

The second area of focus is the potential development of a voluntary UK product label, designed to assist retail investors and their advisers to easily identify funds that have adopted a sustainable investment approach.

"We have expressed caution on the viability of the IA providing a label," warns Neville White. "We would prefer a stronger emphasis on honing terminology used, with more focused descriptions of the different fund strategies available – ethical, ESG, sustainability, impact etc - and what the strategy, process and objectives of each of these are. We would prefer for regulation to be centred on removing the confusion from this space rather than on limiting strategies – in our view, the IA consultation paper gave too little attention to ethical and responsible strategies in favour of sustainability and impact."

Other commentators remain equally as sceptical of the IA's approach. "I am not sure how this will best serve the client," suggests Wayne Bishop. "Ethics are different and therefore ethical products will differ depending on the intended market. We suspect attempts to produce UK product labels and standardise definitions are about commoditising products. This is an area we are watching with interest."

The third area of focus for the IA will be a 'stock-take' of reporting frameworks: This will involve a review on reporting frameworks used by asset managers to disclose how they embed ESG considerations into their investment process and the impact that their investments have had on wider sustainability indicators.

### Treading carefully

One of the most useful resources for advisers highlighting the full spectrum of ethical, sustainable and responsible investment strategies that are currently available is the Fund EcoMarket SRI Styles Directory. This segmentation system groups funds according to what they are designed to do – from an 'ethical or SRI' perspective. The eight different SRI styles are: Ethically Balanced Funds, Negative Ethical Funds, Faith Based Investments, Sustainability Themed Funds, Environmentally Themed Funds, Social Themed Funds, Responsible Ownership and ESG Integration.

"Based on the experience of running our own labelling system for the last eight years, I'd encourage people to recognise the magnitude of the challenges faced by the IA in this area," says Julia Dreblow. "Our system works because it is retail-intermediary focused. Funds are grouped according to their similarities (and differences) with the aim of helping financial advisers to find funds that meet their clients' aims – by explaining policies and strategies in words that pretty much anyone can understand. The IA's position is more complex. They need to reconcile the opinions of a diverse membership with often conflicting opinions, business objectives, motivations and clients. They, like the EU with their similar projects, are tasked with also being careful not to stifle innovation, facilitate misselling or cause bubbles. The reality is that their work could significantly impact the way people see SRI, ESG, ethical and sustainability themed funds. Given the size and nature of their membership and the rapid growth this area is now enjoying, they should tread carefully."

The wide range of funds and approaches to sustainability means that the IA faces a difficult task, but this does not mean that it should abandon it altogether. A measure of realism as to what can best be achieved, however, may be in order. "My view is that they should keep their output relatively high level, using fund policies and objectives as their starting point – and avoid being that into details which will inevitably shift over time. Nonetheless, they will have to set minimum standards so that their labels are credible – and that will require them to help users differentiate between lighter touch and often highly nuanced strategies as opposed to strategies that appear to promise far more than they deliver (i.e greenwash). This will be a tough balancing act as some of their members are highly experienced and deeply passionate about this area - whereas others are neither."

### Tipping point 4: Performance

One area in which the ethical/SRI fund market has arguably already reached a tipping point is in respect of its performance credentials. There is a growing body of evidence proving that ethical/SRI funds can outperform their peers and that it is possible to profit from your beliefs. "We have always maintained that the integration of environmental, social and governance risks makes for better performance over the long-term and for more responsible businesses," suggests Neville White.

**Figure 1: Ethical funds versus non-ethical funds (percentage growth)**

| | 1 year | 3 years | 5 years | 10 years | 15 years |
|---|---|---|---|---|---|
| All ethical funds | 3.98% | 34.86% | 45.58% | 163.09% | 211.33% |
| All non-ethical funds | 1.96% | 30.61% | 40.13% | 148.27% | 226.08% |
| **IMA sector performances** | | | | | |
| Ethical £ Corporate Bond funds | 3.95% | 12.20% | 25.74% | 90.68% | 103.54% |
| Non-ethical £ Corporate Bond funds | 4.34% | 12.17% | 22.17% | 86.40% | 91.86% |
| Ethical Mixed Investment 40-85% Shares funds | 6.55% | 43.77% | 62.17% | 191.04% | 248.26% |
| Non-ethical Mixed Investment 40-85% Shares funds | 2.12% | 28.15% | 35.32% | 126.37% | 185.76% |
| Ethical Global Funds | 6.76% | 50.81% | 64.26% | 176.06% | 269.10% |
| Non-ethical Global funds | 5.22% | 51.52% | 69.47% | 208.22% | 282.31% |
| Ethical UK All Companies funds | 0.32% | 29.82% | 34.17% | 171.91% | 206.74% |
| Non-ethical UK All Companies funds | -3.40% | 27.28% | 31.83% | 169.36% | 209.35% |

Source: Lipper Investment Management. % growth as at 20 June 2019, total return, UK net, no initial charges

The ability of ethical/SRI funds to deliver on both a moral and financial level is backed by the findings of our latest survey. It found that over the past year, the average ethical fund returned 3.9%, more than double the growth of 1.9% posted by traditional funds (see **Figure 1**). Ethical funds also have the edge after three years, returning average growth of 34.8% compared with 30.6% from the average non-ethical fund. It is a similar story over five years, with the average ethical fund delivering growth of 45.5% compared with 40.1% from the average non-ethical fund.

While the performance of ethical/SRI funds over the short to medium term is impressive, it is over the longer term that they will ultimately be judged and here the results are more balanced. Over 10 years, the average ethical/SRI fund return (163%) has now eclipsed non-ethical funds (148%). For the first time, we have also introduced a comparison over 15 years, although it is important to note that only 26 ethical/SRI funds have performance figures over this period so a degree of caution is needed. Here non-ethical funds have posted the superior performance, returning 226% compared with growth of 211% from the average ethical fund.

Overall, ethical funds outperformed their non-ethical rivals in 18 out of the 25 scenarios analysed. However, although ethical/SRI funds currently hold the bragging rights when it comes to performance, this can quickly change. "Years of experience has taught us that performance differs as a result of the tracking difference, i.e. not having certain underperforming shares that have a large influence on the index," says Wayne Bishop. "Note the large exposure of the FTSE to oil, gas and finance, which can lead to ethical/SRI fund outperformance when these sectors move lower. Therefore, in some years ethical funds will outperform and in other years underperform, and it is this very point that needs to be communicated to advisers and clients."

### Tipping point 5: Adviser attitudes

In the past, adviser attitudes to ethical funds have not matched growing consumer enthusiasm, but there are signs that more advisers are now incorporating ethical/SRI considerations into their advice processes.

"This is not an easy topic, but when advisers get it right it enhances their relationship with the client," says Wayne Bishop. "We see adviser education as essential in managing expectations and ensuring the client's ethics are truly understood alongside the traditional investment process. We are seeing a surge in adviser interest, not only for our model portfolio service, but also for white labelling our adviser support material, such as our values-based questionnaire or tailored screening reports."

While progress is being made in encouraging advisers to get to grips with the ethical/SRI market there are still some calls for making it a regulatory requirement for advisers to build a consideration of their client's ethical, social and environmental opinions into the advice process. "Although I am well aware that advisers do not want additional regulation, I do believe that it will be in everyone's best interest for advisers to be required to discuss this area with clients," says Julia Dreblow. "My fear is that if this does not happen, retail investors will be left behind and suffer financial loss as a result of a failure to factor in climate risk when others are doing so."

### A tinge of regret

The ethical/SRI fund market has evolved considerably in the three decades since the first ethical fund was launched back in 1984, a time when cynics laughably dismissed such funds as a passing fad. With issues such as climate change and plastic pollution firmly in the public eye, it seems inevitable that the SRI market will continue to thrive.

"In general, like most in this area, I see sustainable, responsible and ethical investment as going from strength to strength now," concludes Julia Dreblow. "It is a hugely exciting time, but somewhat tinged with regret that this could not have come earlier. Investors should have started playing a far greater role in addressing climate change far sooner."