

Socially responsible investing

– the choice is yours



A growing number of investors around the world are placing an increasing emphasis on the importance of the environmental, social and economic consequences of their investments. These investors no longer accept that financial performance is the only critical factor for measuring investment success. They want to know what their money is doing and that their personal values are reflected in their investment portfolios.

In the US, it is estimated that as much as 13% of total investment funds are managed according to socially responsible principles. Socially Responsible Investment (SRI), also known as Ethical Investment, represents a small fraction of the Australian investment market but is growing rapidly as more and more superannuation funds decided to adopt socially responsible investment practices.

What is SRI?

There is no strict definition of SRI. In practice it varies greatly depending on the ethical viewpoint of the investor or the rules applied to a SRI fund. Broadly speaking SRI tends to exclude the purchase of securities of companies in industries that are regarded as harmful to people or the environment. Such industries may include gaming, alcohol, tobacco, uranium mining and armaments.

Perspective

Professional investors typically use one of two techniques to construct a portfolio of SRIs. These techniques are known as negative and positive screening. Negative screening filters out investment in companies or industries deemed to be ethically undesirable. Positive screening actively favours investment in companies that make products or engage in activities expected to benefit people or the environment.

Negative screening is less demanding than positive screening as fund managers simply avoid investing in specified sectors. These fund managers are then free to invest in the universe of other stocks according to another set of performance criteria.

Positive screening requires more rigorous investigation of investment options. For example an SRI fund could favour companies with sound corporate governance, environmental or labour policies. This investment process can be difficult as companies are constantly changing their operations. An SRI fund manager using this technique needs to be up-to-date with all aspects of a company's operations.

According to a survey commissioned by the Ethical Investment Association (EIA), investment in Australian funds using SRI principles grew 70% to \$7.67 billion* in the year to June 30, 2005. Much of this growth was driven by large super funds adopting SRI policies for existing portfolios.

In the five years from 2000 through to 2005 Australian SRI funds grew from \$325 million to \$7.67 billion, an increase of 2360% (almost 24 times). The EIA estimates that Australian superannuation fund managers now offer more than 300 SRI investment products. Although this sector of the market is growing rapidly it still represents a tiny fraction of the total Australian investment market.

Relative performance of SRI funds

Clearly a major concern for investors interested in SRI is whether this type of investment produces comparable returns to regular investment. It seems logical that ethical investment may result in lower returns because investment options are restricted. However research has shown SRI funds can outperform regular funds.

For example the EIA survey compared the performance of Australian equity SRI funds to their mainstream counterparts in the year to June 30, 2005. The survey found the average SRI fund outperformed the average mainstream manager. This was despite a higher than average level of fees.

Proponents of SRI argue there is no disadvantage investing in SRI funds as their screening processes eliminate companies that engage in unsustainable business practices. They argue the companies filtered out will be less profitable in the long term. While there is not enough evidence to suggest this investment philosophy is better in the long term, there is growing evidence that there is little or no performance disadvantage in investing in SRI funds.

SRI hurdles

There is now more information about SRI available to Australian investors compared to even a few years ago. For example there is a specific SRI index. The RepuTex SRI index is calculated daily by Standard & Poor's. It measures the share market performance of a portfolio of public companies listed on the Australian Stock Exchange that demonstrate a required minimum level of socially responsible performance and management of social risk. In addition a number of independent research houses actively analyse and compare the relative performance of Australian SRI funds.

However, a concern for investors is a study that revealed SRI funds are not clear about the ethical standards they apply. This makes it very difficult for investors to assess how SRI funds measure up on such issues as environmental and labour standards. The study, funded by the Australian Council of Super Investors, Macquarie University and RepuTex, found that more than half of Australia's SRI funds failed to meet the ethical disclosure requirements contained in the Corporations Act.

The Corporations Act requires a product disclosure statement to include the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the fund's investments.

Perhaps the biggest hurdle for both individual and professional investors is the complexity of the ethical issues themselves. For example a number of SRI funds faced a big dilemma when Australian-listed mining company BHP Billiton acquired WMC. WMC had uranium mining assets and many SRI funds filtered out uranium mining companies. The issue was that BHP Billiton was one of the best performing stocks in 2004–05. Some SRI funds sold their BHP Billiton stock while others argued that uranium mining was not material to BHP Billiton's operations.

Ways to invest in SRI

Individual investors who don't want to rely on the wide discretion of SRI fund managers and want to take on the challenge of SRI have a couple of alternatives. They can set up an account with a stockbroker and select stocks that meet their ethical standards or they can open a separately managed account (SMA) with a fund manager.

The key benefit of some SMA vehicles for ethical investors are that they allow the investor to customise their portfolio by prohibiting certain stock or substituting one stock for another.

In an SMA, investor funds are allocated across one or more existing investment models. These investment models have been designed by investment specialists and vary in focus depending on the risk and return objectives of the investor and can be modified in keeping with the investor's ethical viewpoint.

If you are considering making SRI choices, as with any investment decision, it is important to seek professional advice first. Talk to your financial adviser to ensure that the choices you make fit your ongoing needs and objectives, as well as your ethics.

*Socially Responsible Investment in Australia 2005 Survey – Commissioned by the Ethical Investment Association, October 2005.

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