BANISHING THE **ETHICAL INVESTING MYTH** OF UNDERPERFORMANCE

The focus on ethical investing surrounds the opportunities it omits, but casting the net wider is not always the best option, as uncontrollable circumstances can affect non-ethical investments

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When it comes to ethical investments, advisers find themselves struggling with their own moral dilemma. While many advisers and clients believe ethical investments matter, an overarching fear of underperformance has a tendency to cloud their judgement.

In challenging underperformance concerns, reasons why ethical investments perform better than previously thought have come to light.

ADAPT AND CHANGE

Advisers are under pressure to adapt to a changing world. Human actions have generated a number of threats, including climate change and its environmental consequences. An ageing population is another potential issue, as certain demographics will affect healthcare and pension costs.

The average lifespan is increasing, so individuals will demand an improved standard of living as less developed countries modernise. These are a number of factors that show how unsustainable the current way of living is.

Corporations are ubiquitous and powerful, so they need to end unsustainable behaviours and tackle future challenges, including environmental and social issues. Through the means of share pricing and an ability to raise funds, financial markets help to direct and control corporate behaviours.

This includes the market rewarding originality, efficiency, and productivity, thereby valuing companies. Firms tackling these problems will benefit in the short and long term, making them valuable investments.

CORE STRATEGIES

There are three central factors that measure the sustainability and effect of ethical investment; environmental issues, social responsibility and corporate governance. Methods for implementation include negative screening (avoiding non-ethical companies), positive screening (investing only in ethical companies), best-in-class (selecting the least bad companies in a sector), portfolio tilting (slanting a portfolio towards ethical investment), and engaging with companies to influence their behaviours.

Many of these strategies can be accessed through funds, although this can be a complex area. In addition to the usual investment process, due diligence and analysis into the ethical strategies is required, to confirm they meet client needs.

In this respect, advisers may benefit from support from wealth managers, who possess specific skills and expertise in this area.

One approach, which could be referred to as light green on the ethical scale, is portfolio tilting. The majority of this type of portfolio is invested conventionally, allaying underperformance fears, while the remainder is invested ethically.

CONFRONTING FEARS

The main argument against ethical funds is that ethical investment requires a screening process, reducing the number of companies available for investment, which in turn lowers diversification. This limitation is blamed as a contributing factor for lower returns and higher risks. In addition, fund providers may only have a superficial commitment to ethical investing to override a client issue.

> *Non-ethical companies have risks that are not well reflected in share prices*

However, exploring underperformance using an historical analysis raises questions about the ethical strategies implemented and periods of time covered. Fundamental arguments suggest ethical investing can generate superior returns, with a focus on risk and competitive advantage.

Harmful corporate behaviours lead to negative consequences, harming growth and share price. These can include sector emissions constraints, community opposition to projects, increased insurance premiums, decreased access to capital markets, damage to reputation, and litigation threats. Non-ethical companies have risks that are not well reflected in share prices.

Ethical companies have a competitive advantage by avoiding these problems. A good reputation hands a number of advantages to a business. It is attractive to customers, draws in the best staff, and enhances trust with similarly ethical trading partners. These positive aspects reduce costs and increase business opportunities, opening new revenue streams from fresh environmental technologies and providing access to capital markets on better terms. ■