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HEARTS AND MINDS

Ethical investments Funds under management have doubled in two years and returns are better than other equity funds, writes **Tony Featherstone**.

Green is the new black as billions of dollars pour into ethical funds and a rush of financial products with environmental and social themes targets mainstream investors.

Ethical fund assets grew 62 per cent in 2015 to $52 billion, shows the latest Responsible Investment Association Australasia (RIAA) Benchmark Report. The sector has doubled in two years as responsible investing redefines the investment landscape.

"There's been a massive awakening in ethical investing," says RIAA CEO Simon O'Connor. "Investors have realised they can invest in a way that helps rather than harms the planet, without sacrificing returns. We are heading towards a 'tipping point'."

Growth is being driven by a new generation of investors who are aligning their investment values with personal values; the consistent outperformance of ethical funds on average; and belated recognition that ethical investing reduces portfolio risk.

"Companies with better environmental, social and governance (ESG) practices are more sustainable and deliver higher returns over time," says O'Connor. "Investors are voting with their feet. Growth in ethical investing has a long way to run."

Ethical investing and ESG, although they are related, are different concepts. Ethical funds avoid harmful sectors; ESG, a more holistic investment approach, integrates ESG principles into portfolio decisions.

Ethical investing, technically described as core responsible investing, accounted for 3.8 per cent of total assets under management in 2015. After hovering between 1 and 2 per cent for years, ethical investing's share of managed funds is soaring. Although official 2016 figures are yet to be tallied, ethical investing has, anecdotally, had a boom year.

Industry insiders believe the sector will double in three to five years. In that case, roughly another $50 billion will flow into ethical funds, attracting 700,000 investors (based on an average managed fund balance of about $70,000 in some ethical funds).

Longer term, core responsible investing is expected to account for 10 per cent of all professionally managed assets – or about $134 billion on 2015 numbers.

"We have always believed that ethical investing will come of age and be part of the mainstream rather than a fringe sector," says Australian Ethical Investment managing director, Phillip Vernon. "It's happening. People no longer believe the myth that they have to make sacrifices on portfolio returns when investing in ethical funds."

Vernon believes up to 10 per cent of the Australian investing public, or 1.5 million people, have high ethical convictions that will drive their investment behaviours. "There's a rising social consciousness in the way people consume goods and a growing sense of empowerment as more people express themselves through investing."

Fund managers are lining up to seize the opportunity. Sixty-nine asset managers offered ethical or socially responsible investment products in 2015, from 29 a year earlier. And many super funds have upgraded their ethical investment options.

Lower-cost offerings

Exchange-traded funds (ETFs) are entering the fray. BetaShares in January launched the Global Sustainability Leaders ETF (ETHI) on the ASX and UBS has several ethical ETFs over global sharemarket indices that exclude tobacco and controversial weapons stocks. Russell Investments in April, 2015 launched the Russell Australian Responsible Investment ETF.

> **'It makes no sense to have solar rooftop panels ... yet invest in fossil-fuel companies.'**
> Nathan Lim, Morgan Stanley

The arrival of ETFs is telling. Ethical investing traditionally suits active fund managers who assess the ethical credentials of companies, in addition to returns.

Ethical ETFs remove an impediment to investing ethically: higher fees. ETFs, generally, are expanding rapidly in Australia as more investors favour lower-cost "passive" products that aim to mirror the return of an underlying index or strategy.

"We expect strong growth in ethical ETFs," says BetaShares managing director, Alex Vynokur. "The launch of ETHI on the ASX, which adopts a rigorous ethical investment approach, delivers proof that ethical investing does not need to involve high fees. It can be done as effectively through ETFs, with transparency and at less cost."

Listed investment companies (LICs), a form of listed managed fund on the ASX, is another new option for ethical investors. The Morphic Ethical Equities Fund raised almost $50 million in an initial public offering (IPO) and listed on the ASX in early May.

Morphic is the second ethical LIC on the ASX, joining Hunter Hall Global Value LIC. Hunter Hall International in March announced a merger with Pengana Capital, in a deal orchestrated by Washington H Soul Pattinson, an investor in coal through its 59 per cent stake in New Hope Group.

Morphic Asset Management managing director Jack Lowenstein, a leading ethical investor who helped build Hunter Hall's peak $3 billion asset base, saw an opportunity to launch a new LIC. "The LIC structure appeals to people who want exposure in ethical funds directly and may not have a lot to invest, so are not viable clients for financial planners," he says. "We believe ethical LICs can[appeal] to a wider audience, including younger investors."

Morphic's mandate allows the short-selling of companies with poor ESG performance – a controversial move that enables the LIC to profit from investment activity in companies that are seen to act unethically should their share price fall.

"This feature undoubtedly cost us some investors," says Lowenstein. "But we believe the market will inevitably come to us on this issue. Effectively, we can use short-selling of companies with poor ESG practices to help fund investments in companies with good ESG. That will support our goal of higher returns and lower volatility in the LIC, over time."

Ethical ETFs over fixed interest and other asset classes is another emerging development. It's understood Australian ETF issuers are considering launching ethical ETFs over local and international fixed-interest indices.

Ethical investing has mostly focused on equities. Now more investors want to know fixed and floating-rate securities are issued by companies with sound ESG practices, from non-harmful sectors. Ethical funds over property securities are another option as investors seek buildings with higher environmental ratings.

RIAA's O'Connor says: "A wider spectrum of products is coming to market. It will range from 'light green' to 'deep green' products that allow people to invest according to their level of conviction and extend across asset classes. There will also be a shift in industries fund managers invest in, as they respond to investor demand to avoid industries they are not comfortable profiting from."

Factors driving growth

Nathan Lim, executive director of Morgan Stanley Wealth Management and an ethical investing expert, says generational change is driving growth. "Younger investors, in particular, are engaged in the broader narrative of how day-to-day activities, including investing, affect the planet. It makes no sense to have solar rooftop panels to help the environment, yet invest in fossil-fuel companies through their super fund," he says.

"It's no different to someone favouring free-range eggs or fair-trade coffee at the supermarket. Those values are being reflected in financial markets by a more informed, engaged investor base that no longer tolerates funding unethical companies."

Lowy Institute polling has shown consistent growth since 2012 in Australians who believe climate change is a serious, pressing problem. Just over half of Lowy's survey respondents hold this view, from a low of 36 per cent in 2012 – a trend that bodes well for growth in ethical investing.

Returns are the second factor driving the ethical investing boom. Ethical funds achieve higher returns – a message that is getting to investors.

Core responsible investment Australian share fundsoutperformed the S&P/ASX 300 index and average large-cap Australian equity funds over one, three, five and 10 years to the end of 2015, RIAA data shows. Sustained outperformance is rare in active funds management, where the majority of funds underperform their benchmark index over long periods.

Some active ethical funds have top returns. The Generation Wholesale Global Shares Fund delivered a 20 per cent annualised return over five years to March, 2017, Morningstar data shows.

Australian Ethical Investment, manager of several ethical funds, has a five-year annualised total return of 39 per cent, making it one of the market's top small-cap stocks.

Ethical funds globally are outperforming. A Morgan Stanley Institute for Sustainable Investing study of more than 10,000 mutual funds found that sustainable equity funds met or exceeded median returns of traditional equity funds during 64 per cent of time periods examined.

It said: "Investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments. This is on an absolute and risk-adjusted basis across asset classes and over time."

A body of academic research confirms higher returns from sustainable investing. In 2016, Harvard University researchers Sakis Kotsantonis, Christopher Penney and George Serafeim wrote: "Companies committed to ESG are finding competitive advantages in product, labour and capital markets, and portfolios that have integrated 'material' ESG metrics have provided average returns to their investors that are superior to those of conventional portfolios, while exhibiting lower risk."

The upshot is ethical investing is emerging as an unlikely source of alpha (a return higher than the market return) as the weight of money gradually flows towards companies and industries with stronger ESG credentials and away from the laggards.

Portfolio risk reduction is the third factor boosting ethical investing. Rampant growth in shareholder activism is targeting companies that act unethically. Those with poor ESG performance are prey for activists to force change, often driving share prices lower.

Every Fortune 500 company in the US now has at least three activist firms, mostly

HOW TO CUT THROUGH THE JARGON

■ **Use the spectrum approach** Terms such as ethical investing, environmental, social and governance (ESG) criteria, socially responsible investing and sustainability investing often mean different things to different people. The easiest approach is to view responsible investing as a spectrum from "deep green" to "light green" products that let people invest according to their level of conviction.

■ **For the more committed** The deep-green end includes ethical funds that avoid sectors considered harmful — for example, tobacco, controversial weapons (landmines), pornography and companies that earn a significant amount of revenue from fossil-fuel industries. Ethical funds usually have relatively higher fees because of an extra screen to weed out negative companies/sectors and include positive ones.
Ethical funds fall within core responsible investment approaches, a category measured by the Responsible Investment Association Australasia (RIAA).
Ethical funds, still a small part of the funds management industry, are growing quickly.

■ **First steps** The other end of the spectrum includes a growing number of funds that integrate ESG considerations into their investment strategy.
Their broad responsible investment approaches often focus on corporate engagement, active ownership and stewardship. A large super fund might use its influence to engage with a board to ensure the company improves its environmental performance, for example.
Some funds in this category avoid entire sectors (tobacco, for example). But most are sector-agnostic, instead focusing on the ESG performance of individual companies and incorporating ESG principles throughout their investment process.
Assets invested in broad responsible investment approaches are about 10 times the size of those invested in core responsible investments, RIAA data shows.

■ **Takeout for investors** Stick to ethical funds if you have strong convictions about avoiding companies/sectors that do harm and want to invest in those that do good.
Those not interested in ethical investing should still ensure their fund has integrated ESG principles; avoiding ESG laggards is becoming a bigger risk-management issue. Take extra care with products that have limited sector tilts away from harmful industries.

Quick bites Giving to charity fell 1 per cent over the year to February 2017, reports the NAB Charitable Giving Index. Subdued wages, high household debt and softer labour markets meant consumers spent more on essential goods and services and cut back on "non-essentials", including charitable donations.

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US hedge funds, looking for chinks in ESG or earnings performance that can be exploited.

"We view ESG investing as best-in-breed investing," says Morgan Stanley's Nathan Lim. "Investors recognise there are more risks to a company than only earnings risk, and that companies and industries that have good ESG practices tend to exhibit lower volatility over time. By incorporating ESG analysis on top of financial analysis, investors are taking extra steps to reduce risk and protect their portfolio."

Lim sees responsible investing as "new-economy" investing. "You're putting your money in growth industries, such as renewables, and avoiding industries with challenged prospects, such as fossil fuels, tobacco, weapons and other controversial sectors," he says. "If you can achieve higher returns at lower risk, while investing in growth industries of tomorrow, you'll favour responsible investing regardless of what type of investor you are."

Ensuring portfolios are on the right side of the ESG divide has never been more important. Westpac Banking Corporation's decision in April to rule out financing Adani Group's coal mine development in Queensland's Galilee Basin is symptomatic of the pressure on financiers and large investors to review their climate change policies.

The Australian Prudential Regulation Authority in February warned financial institutions that climate change must be viewed as a risk-management issue.

From a board perspective, risks associated with climate change have evolved from "ethical environmental" to material financial issues, meaning company directors who fail to grapple with them are potentially legally exposed, according to some legal opinion.

It is unclear how far, or how fast, public pressure on corporate ESG standards will spread to other sectors.

Tobacco, weapons, pornography, fossil fuels, nuclear energy and high-polluting sectors are obvious areas for ethical funds to avoid. But market pressure on gambling, alcohol, junk-food and sugar stocks could rise if shareholders believe they cannot influence how these sectors respond to social problems, such as addiction and obesity.

Companies with repeated human rights and supply-chain violations could also be screened out of ethical funds, as could countries that enforce mandatory detention of asylum seekers (in terms of geographic funds allocations in global funds).

Whatever happens, investors must ensure their portfolio is stacked with companies and industries with sound ESG practices, to get ahead of this trend.

The fourth factor driving ethical investing is the removal of industry bottlenecks. As super funds show greater interest in ESG performance, more fund managers are incorporating ESG data into their investment analysis. This is forcing large broking firms to produce detailed company ESG analysis and underpinning a new industry of external ESG data providers and analysts.

At the same time, ASX-listed companies are publishing more ESG data, through their sustainability reports, for investors. Fund managers, for example, can assess the occupational health and safety performance of a mining company to analyse its risk-management processes, approach to staff and culture. A declining safety record and rising employee turnover might signal ESG risks and poor management.

These trends, under way for a decade, have quickened in the past few years as companies, fund managers, intermediaries and investors pay extra attention to ESG data.

The intersection of these forces should mean more money flowing into ethical funds, more managers entering the sector and a wider range of product that provides a spectrum for investors to choose the level of ethical investing that matches their conviction. Greater scale in ethical investing should, in theory, lower fees.

This trend could also lead to funds that incorporate ESG principles excluding sectors considered harmful (such as tobacco) – and start to look a bit more like ethical funds.

The risk is the boom attracts too many managers who latch on to demand for ethical funds by launching "light green" products that do meet ethical investing standards. The emergence of long/short ethical funds (buying companies with good ESG practices and short-selling those with poor ESG) is another complication. So is the rise of ethical global ETFs that are stacked with US technology stocks that rate well on ESG criteria.

As with any financial product, it pays to understand the detail before investing. Knowing what the ethical fund owns, its investment mandate, personnel and record, is critical. Investors with deep convictions might find they invest in new-style ethical funds that do little more than replicate the main sharemarket indices – for unnecessary high fees. They may also find that not all ethical funds are ethical.

How they rate

Top-performing managed funds in socially responsible investments*

Managed fund	Returns (%) 1-year	5-year
Generation Wholesale Global Share	20.7	20.6
CFS FC Inv-Generation Global Share	20.1	20.2
Perpetual Wholesale Ethical SRI	13.3	15.9
Candriam Sustainable Global Equity	14.3	15.9
Australian Ethical Australian Shrs Whols	17.3	15.8
Australian Ethical Divers Shrs Whols	11.1	14.8
Perpetual WFIA-Perpetual Ethical SRI	12.0	14.7
AMP Capital Res Inv Leaders Intl Shr	13.4	14.2
Australian Ethical International Eq Tr	11.1	14.1
Australian Ethical Australian Shrs	15.5	14.1
AMP Capital Res Inv Leaders Intl Shr A	13.2	14.0
Australian Ethical Advocacy B Whols	11.0	14.0
OnePath OA FR IP-AMP Cap Res Intl Share	13.0	13.7
Australian Ethical Divers Shrs	9.7	13.4
AMP FLI S2-Res Inv Leaders Intl Shr	12.3	13.1
Stewart Investors W Glb Emerg Mkts Sus	13.7	13.0
Australian Ethical Advocacy	9.6	12.8
Hunter Hall Value Growth Trust	1.3	12.8
ANZ OA IP-AMP Cap Res Ldr Intl Shares EF	12.0	12.7
OnePath OA IP-AMP Cap Res Ldr Intl Sh EF	12.0	12.7
AMP FLI-Res Inv Leaders Intl Share	11.9	12.7
Maple-Brown Abbott Responsible Invmt	23.9	12.0
ANZ OA IP-AMP Cap Res Ldr Intl Shares NE	11.0	11.7
OnePath OA IP-AMP Cap Res Ldr Intl Sh NE	11.0	11.7
Hunter Hall Global Equities Trust	18.6	11.4
Alphinity WS Socially Responsible Share	16.0	11.4
BT Wholesale Australian Sustainable Shr	19.8	11.3
Yarra Australian Real Assets Secs Fund	7.9	11.2
UCA Growth Portfolio	15.2	10.8
BT PPSI-Westpac Ins Aus Sust Shr	14.2	10.8
BT Wholesale Ethical Share	17.5	10.8
Mercer Socially Resp Australian	12.2	10.6
Alphinity Socially Responsible Share	14.9	10.3
AMP Capital Res Inv Leaders Aus Shr	13.5	10.2
OnePath WS-Sustainable Inv Aus Shares	14.0	10.2
OnePath OA FR IP-OP Sust Inv Aus Shares	13.8	10.1
AMP Capital Res Inv Leaders Aus Shr A	13.2	10.0
BT Sustainable Balanced	11.7	9.9
OnePath OA FR IP-AMP Cap Res Aus Share	12.9	9.8
AMP FLI S2-Res Inv Leaders Growth	10.1	9.7

*Returns to March 31, 2017 SOURCE: MORNINGSTAR

'Ethical LICs can [appeal] to a wider audience, including younger investors.'
Morphic's Jack Lowenstein

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From 'Trump trade' to the 'impeach trade'

The cut-through

Patrick Commins

For now, what's bad for Trump is seen as bad for markets. But, as the chatter around impeachment grows, investors may decide they are better off without him.

This week's revelation of memos that seem to offer prima facie evidence of the Trump obstructing justice jolted markets. Added to recent reports of the US prez revealing secrets to the Russian foreign minister and ambassador, the interpretation was the chance of an impeachment had jumped from improbable to possible.

"The thought of President Trump being impeached has traders (and us) spooked," CBA bond strategists Adam Donaldson and Philip Brown wrote on Thursday, the day after the S&P 500 index had suffered its worst night of trading in eight months.

"One point is stunningly self-evident," CLSA strategist Christopher Wood says. "The latest developments have not encouraged hopes of a speedy implementation of tax reform."

A special prosecutor – with a reputation for independence – was appointed to look into the Trump-Russia links and to determine if anything illegal had gone on. That investigation could potentially result in hard evidence of the "treason" or "high crimes and misdemeanours" required to trigger an impeachment process.

It's an outcome that "cannot be ruled out completely", Citi chief global political analyst Tina Fordham says. Can't be ruled out, but still a remote scenario.

Fordham points out that "no US president has been impeached by his own party, and given the highly charged environment, we think that evidence of a breach deemed sufficient to trigger impeachment proceedings would have to be robust".

So the consensus is that heightened US political risks threaten the delivery of market-friendly policies. And the more the controversy around Trump builds, the worse it is for the sharemarket. This is the "delayed-policy-agenda" trade. For example, analysts, including Citi's Fordham, are upping their warnings that tax reform has the potential to be a 2018 story.

I mentioned the fact that Wall St mid-week had its worst session since September. That's less dramatic than it sounds: the S&P 500 lost 1.8 per cent. It was only earlier in the week that the index crossed 2400 points for the first time. By contrast, the US dollar index has unwound all its post-election gains, while Treasury yields have pulled well back from their March highs and have given back half of their gains since November.

So you can imagine that, if the bond and currency market is any guide, there is still some room for the Trump trade to be priced out of US stocks, even if the economy continues to build strength as expected.

But the the word "impeachment" is likely to keep coming up, and that also will take its toll, CBA's Donaldson and Brown reckon.

"Our previous stance was that the underlying economics would eventually drive the US yields higher and the Australian curve steeper," they write, referring to the idea that longer-term rates would rise in line with the global trend, while shorter-term ones would remain anchored to the RBA's determination to keep rates steady.

"However, now there is a realistic, though small, chance of impeaching a president in the next few months, we think discretion is the better part of valour," they say. "Politics will trump economics for the time being."

My favourite line over the past couple of days is the idea that even if Trump is impeached and/or resigns, well, wouldn't we really all prefer vice-president Mike Pence anyway? As a GaveKal analyst says, in that instance "markets may quickly focus on 'Trump without the bad stuff'".

For now what's bad for Trump looks bad for markets.

Let's call it the everything-will-be-peachy-if-Trump-gets-impeached trade. Or, more economically, the Impeach Trade. When heightened chances of impeachment start to correlate with rising sharemarkets, then you know the script has well and truly flipped, Trump is seen as a liability rather than a potential source of support for the market, and the Impeach Trade is on.

That may sound ridiculous, but looking back at the most common historical reference of recent days – Richard Nixon and the Watergate scandal in the 1970s that led to his resignation on August 9, 1974 – there is some evidence to support it. Indeed, investors back then also had cottoned on to the idea that the dead duck president was weighing on the sharemarket.

At an institutional investor conference in March 1974, *The New York Times* interviewed a dozen attendees on what would happen to the market if Nixon resigned. Eight said it would "have an immediate effect of sending prices higher", the Times reported. Two were undecided.

They got the timing wrong, but the overall direction right. By August 9 Nixon did indeed resign. The market continued to fall for a little after the resignation, but reached a clear turning point soon after, as the charts show. Bond yields trod a similar path.

For now what's bad for Trump looks bad for markets. That's normal and to be expected. But when that relationship is reversed, then markets really will be sending a signal: investors see a path to an early end to his presidency, and they like it.

A playbook

US 10-year bond yield (%)

S&P 500 Index (points)

SOURCE: CBA