Harrison Beale & Owen

FINANCIAL SERVICES
CHARTERED FINANCIAL PLANNERS

Investing in ethical funds

Earning returns on ethical investments.

Go back a few decades and there were few options for investors who wanted to earn returns on socially-responsible investments. Even after the ethical investment market began to gain traction, these funds were not commonly thought of as being particularly profitable for investors.

These days, however, the phrase "high return ethical investments" isn't an oxymoron; it is perfectly possible for socially-conscious investors to make high returns by putting their money into ethical funds.

With a greater choice of funds on the market and a tiered system based on levels of positive social and environmental behaviour, ethical investors have never had more options.

This guide will weigh up the risks and provide you with all the information you need to know before making your first ethical investment.

The moral shift

Ethical funds are specialist unit trusts and open-ended investment companies that only purchase shares or bonds from companies designated as being socially, environmentally and morally responsible.

Ethical investments first began gaining a foothold in the market in the 1980s when a company with historic links to the Quakers established the first ethical investment fund.

In the years since, the market has expanded at a rapid rate. For example, in 1989 the total annual investment was £199 million but by 2010 this had risen to almost £11 billion.

Ethical funds select which companies to invest in through a screening process. This involves a fund manager conducting research into a company's operations based on a variety of positive and negative criteria.

Examples of positive criteria include:

- active attempts to limit pollution
- adopting environmental protection policies
- treating workers fairly and cooperating with trade unions.

Examples of negative criteria include:

- practices that damage the environment
- involvement in the arms trade
- exploitation of animals
- promotion of alcohol, tobacco, gambling and pornography
- relations with oppressive foreign governments.

Each fund will choose how stringent their screening checks will be and how ethical the company must be before it is included in the portfolio. The fund will then be categorised into the following types.

Types of ethical investment funds

Ethical investment funds are categorised into one of three types: light green, medium green and dark green.

These categories outline the levels of social responsibility of the companies invested in by the fund, with light green being the least restrictive and dark green being the most ethical.

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Investing in ethical funds

Light green

Light green funds have the least restrictions. Companies involved in the arms trade, alcohol, tobacco, gambling, pornography and nuclear energy may be excluded, but businesses that use pesticides, have poor labour policies and sell fur may be included.

The low restrictions allow light green funds to invest in blue chip companies, making them the most stable and the least risky ethical investment option.

Medium green

Medium green funds are more restrictive than light green funds. In addition to excluding the same companies as light green funds, medium green funds may refuse to invest in companies that have harmed the environment. Because of this, medium green funds tend to be mainly invested in smaller businesses.

Dark green

These funds are the most restrictive and will not invest in any company that fails to meet any of the negative screening criteria. Some funds in this category will only select companies that are actively trying to provide social and environmental benefits. Because of their total exclusion of large businesses and the consequent smaller universe of stocks from which to pick from, dark green funds are simultaneously the most ethical and potentially the most volatile.

Pros and cons

Building your investment strategy around ethical considerations has its pros and cons.

Pros

The feel-good factor: Many investors choose ethical funds over traditional investment vehicles because of the positive emotions it can generate. Putting your money into a company that shares your moral values or helps a business to deliver valuable social and environmental projects makes you feel like you're doing your bit.

Tax advantages: Many ethical funds are now eligible for investment into an ISA. You can place up to £20,000-worth of ethical investments into an ISA and pay no tax on your returns.

Driving change: The steady growth of ethical funds may lead more businesses to adopt socially-responsible practices to attract funding. By investing into an ethical fund you can play a part in persuading large businesses to adopt environmentally and socially sustainable models.

Potential for long-term growth: The past few years have seen a growing preference on the part of consumers for sustainable and ethical profits. Socially-responsible businesses are therefore likely to see a growth in profits should this trend continue.

Cons

Lower returns: Ethical funds will not typically generate the kind of returns earned from conventional investment funds. This is in large part due to ethical funds' refusal to purchase assets from companies that fail certain screening criteria.

Higher fees: Effective screening requires fund managers to conduct thorough research into each individual company. To compensate for this, ethical funds often charge higher fees than their non-ethical equivalents.

Time and research: You will need to spend more time researching the portfolios of ethical funds – particularly if there is a specific ethical issue you would like to promote or non-ethical practice you would like to avoid.

Fewer available funds: Even though there has been big expansion of the ethical fund sector, there are fewer funds to choose from.

Choosing an ethical fund

Reasons for investing ethically

Unless you're putting your money into dark green funds, you will need to consider which ethical issues you would most like to promote and which companies you would like to avoid.

For example, you may have a particular antipathy towards the exploitative use of animals but be more comfortable with investing in a company involved in the alcohol or tobacco industries. Considering which issues are most important to you will enable you to obtain a clearer understanding of which funds meet your preferences.

Management

When identifying possible ethical funds, you may want to take a look at the company that manages it. Many companies that operate ethical funds also manage conventional funds that might contravene your ethical standards. For some, this will not be a problem. However, it's best to make yourself aware of the company's broader investment practices before committing your money.

Financial performance

Because conventional investment funds tend to perform better, the primary motivation for choosing to invest in ethical funds tends to be their levels of social and environmental responsibility. This may be your main reason for choosing the ethical market, but it's important to not lose sight of your financial goals.

Any fund you choose needs to be performing well if you're hoping your investment will generate high returns. As previously eluded to, the most ethical funds tend to perform the worst in terms of providing returns. Therefore, you need to weigh up how much importance you attach to high returns versus ethical practices before you invest.

We can advise on ethical investments.