

The Rothschild Report

Ethical and socially responsible investing... the next wave?

Summary

Ethical investment – sometimes referred to as green, socially responsible (SR) or conscious investment – refers to a style of investing arising from a desire to ensure that an individual's investments are in line with their "ethics". For many people this means investing in investments that protect the natural environment or contribute to a just and sustainable human society; or at least avoiding investments that jeopardise these objectives. Ethical investment can be defined as the integration of personal values with investment decisions. It is an approach to investing that considers both profit potential and the investment's impact on society and the environment.

Whilst an accepted part of investment in the United States and Europe, Australian investors only now seem ready to embrace the concept of ethical investment in a traditional investment framework.

In addition to the growing local research on ethical investment, Rothschild has undertaken the first comprehensive survey of retail and masterfund advisers, institutional consultants, and researchers to determine their interest in ethical investing and that of their clients.

This "Rothschild Report" White Paper – based on the survey and other research – will support the following assertions:

- The Australian market for ethical or SR investments, in both retail and institutional areas, is poised to grow rapidly;
- The financial advisory "gatekeepers" – both retail (and masterfund) and institutional – are open to recommending such funds to their clients, provided a robust and transparent product is available;
- Australian investors are becoming increasingly aware of the option of choosing Ethical and SR investments and are willing to transfer existing investments into Ethical and SR investments; and
- Ethical investing can be profitable.



April 2001

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Ethical and socially responsible investing... the next wave?

Background

Ethical investing, defined in the summary as the integration of personal values with investment decisions, has its origins in church funds some 50 years ago. From the turbulent so-called "anti-establishment" period of the '60s and early '70s grew a force of socially concerned investors who were very discerning about what companies they invested in.

What started off as more of a symbolic and often emotional response to investment became an established form of investing as US mutual funds recognised a customer-driven demand in the market for robust ethical or socially responsible funds.

From its grass roots beginnings, North America and the UK have seen assets dedicated to ethical and SR investment grow by 50% pa over the last 10 years. Research quotes that one in every eight dollars invested in managed funds in the US is screened through an ethical or social perspective.

It is worth looking at the Canadian situation as it has a similar managed funds market to Australia. According to the Allen Consulting Group, four screened mutual funds with a little over AUD\$102 million in net assets were available in 1989. By 1998 this had grown to 14 screened mutual funds comprising AUD\$3.8 billion in net assets. This was an increase of 37 times compared to unscreened funds growing only 14.5 times over the same period.

This suggests considerable scope for growth in Australia even with a fraction of this level of interest.

There is currently more than \$400 million invested in "ethical" products in Australia. Growth has been slow but interest has increased significantly in recent times along

with considerable media coverage. A Resnik-KPMG survey indicated that if given the opportunity to choose the investments of their super fund, 69% of Australians would consider investing in a SR fund. We are starting to see the emergence of a response to meet the growing demand, including:

- Fund managers offering ethical investments
- Financial planners seeking high quality ethical investments to recommend to investors
- Academic research
- Researchers analysing and reporting on available investments.

There are two main approaches to ethical investment:

1. Avoiding "unethical" investments (Negative Screening);
2. Seeking out environmentally and/or socially responsible investments, such as green and sustainable technologies (Positive Screening).

Common screens used in an "ethical" portfolio include:

- Environmental
- Human rights
- Community citizenship
- Workplace practices
- Animal welfare
- Corporate governance
- Gambling
- Alcohol
- Tobacco
- Weapons
- Uranium



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The time is right...

Australia has been slower in embracing the concept of ethical investment compared to the US and the UK. The Resnik-KPMG research indicated that the present local market was relatively small, with less than 4% of adult Australians with assets (apart from their homes) who already have super or non-super investments in an ethically-screened managed fund. The reluctance to invest in ethical or SR investments was due to a number of reasons, including the dominance of the mining and energy sector in the domestic sharemarket until recent years, and the belief amongst many investors that returns in such investments will be lower. A consistent comment has been that there is a lack of high quality products in this area in Australia.

However, in just over a year the awareness and interest in ethical and SR investment in Australia has accelerated. This includes activities such as:

- Major superannuation bodies, such as HESTA, UniSuper, and VicSuper, offering ethical/SR screened investment options;
- Australia's largest masterfund operator, Asgard, adding funds to its investment menu;
- ASFA opening up the debate to its members;
- The establishment of Australia's first environmental index, the Eco-Index;
- Increasing research demonstrating the positive outcomes of ethical investment; and
- The plan of a number of major fund managers – including Rothschild – to release ethical or SR managed investments on the local market.

The Resnik-KPMG research indicates that over three-quarters of Australian superannuation members would like to know what their super is invested in. An even higher majority said they would be concerned

if their super was invested in companies which had ethical issues (such as multinational companies which used child labour). Significantly, the research also showed that about half of the investors surveyed were willing to allocate 22% of their investment into a SR fund and virtually all said they would be happy to allocate 12% of their portfolio.

As stated previously, a major stumbling block for investors was the belief that screened funds delivered poor returns. This was the initial problem encountered in the United States and is seen as being a key issue in Australia. However, investor awareness (and investor activism) of the nature of companies they invest in has contributed to a realisation by investors that their altruism can be profitable. For instance, investors see good environmental management as a key to good overall management of a company.

In fact, research from the United States in 1998 showed that over one, three, five and 10 years, the performance of ethically-screened funds was up to 30% better than non-screened funds.

Even after the burst of the technology bubble last year, 12 of the 17 socially and environmentally-screened mutual funds with US\$100 million or more in assets earned high ratings from either or both of two of the industry's respected investment tracking firms: Morningstar and Lipper. In addition, of the 65 SR mutual funds tracked by Morningstar 11% (7) received the firm's coveted five star rating and 26% (17) gained a four-star rating.

Only Australian research house, Three Sixty Degrees, has formally begun to assess local ethical or SR funds, although most of the research houses have indicated they plan to in the near future. Leading institutional research house InTech recently reported that SR investment is a viable option for a trustee to add to a super fund if offered as a stand-alone investment choice and done well.



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Rothschild's Ethical/Socially Responsible Investment Survey

A key to market acceptance in Australia is the so-called "gatekeepers": retail and masterfund advisers, researchers and institutional consultants. Rothschild undertook a survey of some 2000 financial planners and 100 institutional key decision-makers during January 2001. The survey signals a definite positive shift in interest by both the retail and institutional markets with the "gatekeepers" very clear on where they see the demand for such funds and how they want them implemented.

The majority of "gatekeepers", in both retail or institutional, are either already using the limited number of ethical funds available in Australia or had considered using them, according to Rothschild's survey.

When asked of their involvement with SR/Ethical investing for their clients, retail and masterfund advisers responded:

- 17% said they were currently using ethical investments
- 49% said they had considered using the funds, and
- 34% have not considered using them.

The institutional market responded:

- 14% said they were currently using ethical funds
- 50% said they had considered using the funds, and
- 36% have not considered using them.

Many retail respondents said their consideration of such funds was client-driven, while some institutional respondents said whether they recommend such funds or not would be dependent on the performance of the fund compared to the standard Australian equity funds on the market.

Retail advisers saw a retail and wholesale trust option for masterfunds as the preferred product, while asset consultants and institutional researchers saw members choice as the key to offering ethical investment options.

The institutional market, according to the survey, sees Australian shares as the preferred sector for ethical SR managed fund investing, while the retail market, prefers both domestic and international share offerings.

In the retail section of the survey:

- 8% chose Australian shares only
- 3% chose international shares only
- 89% chose both an Australian and/or an international shares option.

When asked which sector they would implement first in ethical or SR investment:

- 57% of the institutional respondents chose Australian shares
- 14% chose international shares.

Both the retail and institutional "gatekeepers" were clear on the make up of the funds. They wanted the funds screened and they were clear on areas they felt were important to screen. On the former, they were asked which type of screening process they felt was the most appropriate approach. The choices were:

- Positive screening – seeking out environmentally and socially responsible investments, such as green and sustainable technologies
- Negative screening – avoiding "unethical" investments
- Combination of positive and negative screens or
- No preference on type of screening.

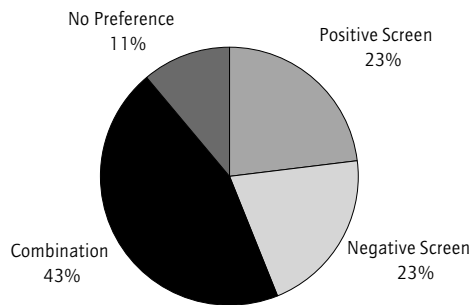


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Both the retail and institutional markets prefer a combination of both positive and negative screening for such funds. Forty-three per cent of respondents in both areas of the market preferred this combination.

When asked which particular areas they felt important to screen, both segments of the industry ranked the areas similarly. (Interestingly, Australian investors in the Resnik-KPMG survey ranked the same areas of concern).



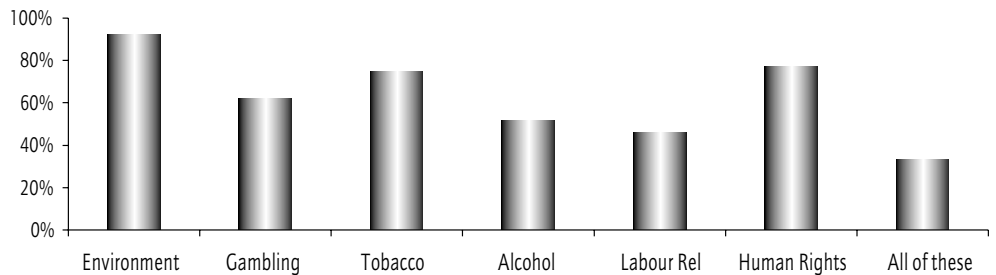
In retail the areas ranked in order of importance were (see retail survey graph below):

- Environment
- Human Rights
- Tobacco
- Gambling
- Alcohol
- Labour Relations

In institutional:

- Environment
- Human Rights
- Weapons
- Gambling
- Uranium
- Corporate Governance
- Animal Welfare
- Community Citizenship
- Tobacco
- Work Practices
- Alcohol

Percentage of retail respondents feel area is important to screen



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Conclusion

There is little doubt there is demand for ethical or socially responsible investment funds in Australia. We are unlikely to see the same extensive embracement of the concept as we have seen in North America, but as Rothschild's research indicates, both the retail and institutional sectors of the financial services market are well versed in the concept.

The retail market in this area is still primarily client-driven, and while some of the major superannuation funds are showing strong interest the market seems to be waiting for a catalyst for Australian investors to be more comfortable with the concept "ethically investing is profitable".

That catalyst is likely to come from key, brand name fund managers demonstrating that such funds are not "fringe dwellers" in the market place, but robust investment products that can match the performance and wealth creation ability of the traditional products. As Rashmi Mehrota, an associate director with the well respected research house van Eyk Research said in a newspaper interview: "Some more high-profile and credible managers need to step forward and offer ethical products so investors feel more comfortable with the investment ability of the fund as well as the investment selection process."

With the present level of interest, ethical investing is undoubtedly going to become an accepted part of the Australian investment landscape in the very near future.



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