Transforming Investment: Moving from Values-aware to Values Driven Investing

Becoming a Values-driven Investor

Ethical investment found its origins in avoiding unacceptable activities, but has since developed to incorporate a range of approaches under the social responsibility banner. These have tended to adopt what might be termed, a 'values-aware' approach to investing, which asks the question 'What are the social and environmental consequences of my investments'. However, the social impact of such an approach is open to question, and we propose a move to values-driven investing which asks a different question, namely, 'how can I deliver on my social and environmental goals through my investments?'

Socially responsible investment (SRI) has been one of the fastest growing parts of the investment world and it has certainly been one of the most talked about, but does it inspire and does it really make any difference? Within the investment community, many still regard SRI as a sop to a dedicated but misguided minority of investors,who would be better advised to maximise their returns and give the difference away. On the other side of the fence, environmental think tank, The Natural Capital Institute questioned the integrity of SRI funds, observing that the top 10 holdings of many SRI funds were indistinguishable from their conventional counterparts. So are ethical investors sadly misguided or are the gainsayers ill-informed cynics, and what does the future hold for SRI if traditional approaches are failing to make a difference?

In order to answer this question, let's go back to the origins of SRI. Ethical investment as it was then known was borne out of a desire to be disassociated with activities about which investors felt strongly – in this case Vietnam and agent orange, and the traditional ethical no-noes of alcohol, tobacco and gambling. Religious groups and anti-war campaigners were taking a moral stand by excluding companies on the basis of their involvement in such activities. This is still an approach that underlies many ethical funds today, but the limitations of such an approach are obvious. Firstly, it can be argued that such avoidance makes little difference – after all, for every seller of a share, there is a buyer, and the impact may be limited to satisfying an investor's moral responsibility. Secondly, this approach doesn't actually supply new capital to the market; nor does it directly change very much at all.
In recognition of this, institutional investors began to engage with the companies in which they were investing. Rather than selling shares, investors started to use their power as investors to influence corporations. In the US this took the form of shareholder resolutions, whilst in the UK, engagement has been less public, with institutions seeking to effect change through dialogue with company management. There is no doubt that this had a significant impact in raising ethical standards, with institutional investors sometimes helping companies to shape strategy and respond to ethical challenges. At its best, engagement has raised corporate accountability and has changed practice in quite a profound way, but it has also led to accusations of greenwash and obfuscation.

Likewise, a 'best of class' approach, whereby investments are assessed according to their relative environmental and social performance within their industry, is open to debate. Much corporate social responsibility (CSR) is limited to peripheral issues such as charitable activity and measuring standard outputs such as energy consumption, without addressing the key ethical issues posed by a company's activity. For instance, how valid is a CSR report for a tobacco company that fails to fully recognise the deadly impact on health that smoking poses? Or can you really have a socially responsible exporter of missiles? There is clearly scope for misunderstanding and confusion in the investor's eyes. Transparency is therefore key in delivering a credible investment solution based on engagement and 'best of class' assessment, and even then, it's hardly a revolutionary process. As The Natural Capital Institute observed, the top 10 holdings don't look that very different from unscreened portfolios.

Some of the Top 30 SRI Holdings in the US

All of the above approaches – exclusion, engagement, best of sector analysis – might be termed 'values-aware'. That is, they are informed by values, but don't necessarily represent a radical shift in the choice of investments or in changing financial flows. By way of contrast, investments that have the capacity to inspire are values-driven. In other words, extra-financial values have a major impact in terms of the type of investment made and are directly reflected in investment portfolios that look very different from more conventional funds.

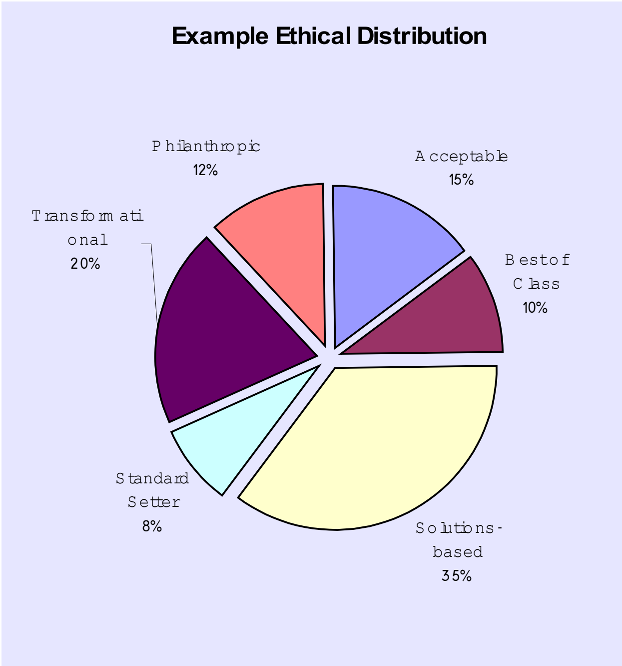
Values-aware or Values-driven?

Values-aware: What are the social and environmental consequences of my investments?

Values-driven: How can I deliver on social and environmental goals through my investments?

These are investments that connect with the heart as well as the head, where the motivation for investing has as much to do with achieving social or environmental change as it has to do with generating financial returns. Values-driven investments embody the concept of three dimensional investing, whereby returns are not thought of in pure financial profit, but also in terms of social and environmental impact. Thus asset allocation can be ascertained by looking at the social impact desired as well as the financial mix of the portfolio, and it can be measured in these terms too. This is a poorly developed area, but solutions are emerging. The Community Interest Company, Investing For Good, has created a tool for researching and reporting on social enterprise investments, whilst Ethical Money Limited has drawn up its own system for categorising ethical investments and this facilitates reporting on the ethical make-up of portfolios in much the same way as conventional portfolio analysis. This approach allows a holistic approach where social and environmental values directly inform asset allocation, in conjunction with conventional risk/reward analysis. This approach requires that questions move beyond the more usual, 'what would you like to avoid' and 'what would you like to support', since they often fail to be translated to the actual investments made. Instead of focussing on criteria, the emphasis is on content – i.e. How much of a portfolio is actually invested in activities that the investor might want to support?

The majority of funds in this area might be termed 'solutions-based'; i.e. they invest in companies that provide solutions to social and environmental challenges. The widespread recognition of the reality of climate change has led to a surge in investor interest in renewable energy and environmental technology, including mainstream investors. This has resulted in a corresponding increase in the number of funds focussing on these areas, and these funds enable investors to place money in investments that they consider to improve the world. The motivation for making these type of investments may derive from a heartfelt desire to use money for the benefit of the planet, but it may also have as much to do with recognising that major structural problems throw up equally major opportunities for companies with the foresight and expertise to capitalise on them.



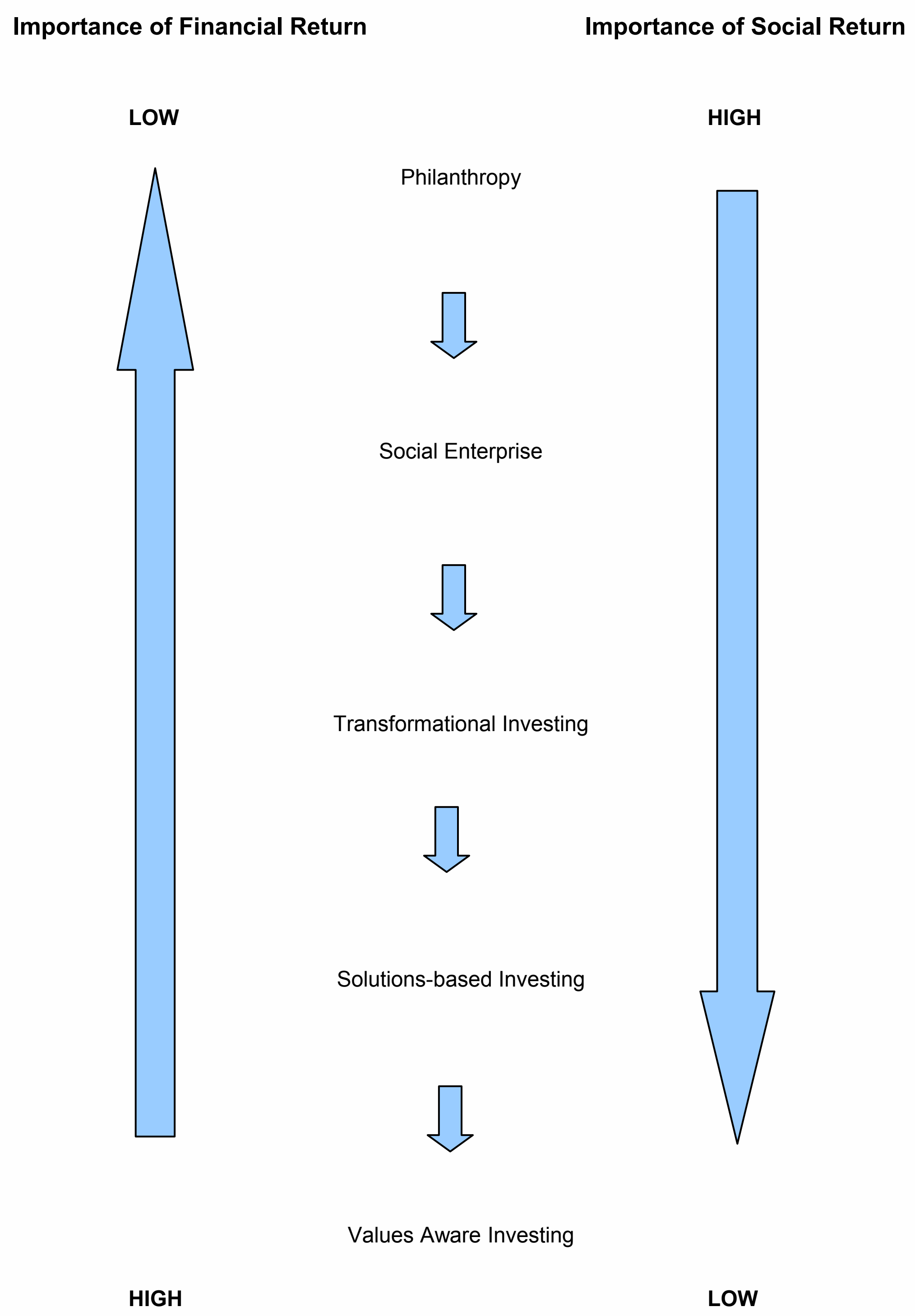
Most funds focus on environmental challenges such as climate change, pressure on resources, pollution, transport, food quality and pressure on water resources, but some look at wider issues like demographic change (and the consequent rise in demand for health services, etc.), safety and affordable housing. All of these problems- I prefer to call them challenges – generate demand for solutions, and many of these challenges are structural so they are not going to go away any time soon. The challenge of climate change is now well documented. Like several other challenges, it works on a slow burn, whereby problems may not become apparent for tens of years, but once they do, they may become unstoppable, or at least difficult and expensive to counter.

Furthermore, the challenge is not going away any time soon. Nor will all the other challenges disappear – as Asia, Eastern Europe and Latin America get richer, the pressure on resources will intensify. This will stimulate long-term demand for renewable energy, energy efficiency technology, energy storage systems and many other less obvious services such as storm surge control (in the light of increased storminess) and metering (as the increasing cost of energy demands more efficient use.) Pressure on other resources will also intensify due to limited and dwindling supplies, coupled with an exponential rise in demand as Asia's hunger for resources intensifies. This effect has driven up the prices of commodities to unheard of levels,but it also creates new markets – for recycling (where rising costs of virgin resources make recycling more cost-effective), for resource efficiency (doing more with less) and for resource substitution (replacing a non-renewable resource with a more sustainable one). There is a whole host of other opportunities that arise from Asian growth and demographic pressures . Clean air and water is one of the biggest, since Asian industrialisation has been highly polluting, whilst demand and the ability to pay for clean water outstrips supply. As the world gets richer, we need more efficient transport to relieve the congestion; better waste management to stop the mountains of rubbish growing yet higher; more doctors, more hospitals, more retirement homes and bigger pensions to support the elderly that live longer but require more care; and worries over the quality and healthiness of food will sustain the rise in popularity of organic production.

The burgeoning opportunities have led to a similar explosion in the number of companies providing solutions in these areas and this has naturally been reflected in an exponential increase in funds across the world investing in solutions-based companies. Typically, these are equity funds investing in major firms listed on one of the main stock-markets, but there are also venture capital, private equity and hedge funds investing in emergent companies. Clearly, these carry more risk and are less liquid, but since they supply new capital to the market (rather than representing a trading transaction as is generally the case for liquid markets) the social or environmental return is often much higher. Furthermore, some of these 'alternative' investments can actually reduce the overall risk of a portfolio as they are not correlated with the main equity and fixed interest markets. These include Quadris, a fund investing in sustainable teak forests in Brazil; the Truestone micro-credit fund investing in 40 banks making small loans for business advancement in some of the poorest countries in the world; and Africa Invest, a fund seeking to lift hundreds of thousands of people out of poverty by investing in agriculture in Malawi. In fact Africa Invest estimates that an investment of £1,000 will impact on 40 impoverished people in Malawi,illustrating that such investments can be transformational, in that they have the potential to bring about major social change where it is most needed. They can also be profitable: Africa Invest projects returns of 30-40% for investors,whilst Quadris has generated remarkably consistent returns on capital of around 10% per annum for the last five years.

Investing in your future – and theirs'

The Values-led Investment Continuum



However, not all values-driven investors seek competitive financial returns. At the other end of the spectrum, charitable gifts might be considered to represent an investment in social or environmental change, where financial considerations are wholly replaced by social or environmental return. Serious philanthropists don't give money - they invest it - for maximum social return. This demonstrates that there's no dichotomy between giving on the one hand and investing on the other: they are all part of a continuum with differing degrees of financial and social return.

So I hope that I've demonstrated that values-driven investing can make a real difference to communities across the world, and that SRI embraces a spectrum from philanthropy through to traditional exclusion. Be inspired, get involved, and make a difference!

Key Points

- 3D investing moves beyond the consideration of risk and return to social &/or environmental return
- Serious social investing demands social reporting
- Values-aware investing asks the question 'What are the social and environmental consequences of my investment'?
- Values-driven investing asks the question, 'How can I deliver on social and environmental goals through my investments'?
- Social investing embraces a wide spectrum from philanthropy to private equity.

About Ethical Money

Ethical Money is at the forefront of developing and promoting new and innovative investment funds which deliver '3D returns'. We work with major investment institutions and private clients, providing investment research, as well helping to develop and promote investments with a high social impact. Our ethical commitment is borne out by being one of the first companies to be awarded the prestigious Ethics Mark.

John Fleetwood founded Ethical Money and has been advising on ethical investments since 1991. He also jointly developed Ethical Analyst, the ethical analysis software for financial advisers, and founded the Ethical Investment Association, the industry body for ethical financial advisers. John is Ethical Funds Development Manager at King & Shaxson, a specialist manager of distinctive ethical funds and portfolios. He is also the author of 'The Money Test', the first UK book on Christian financial planning.

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