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## Turbocharged: ethical investments beat the market

John Collett October 13, 2010

ETHICAL FUNDS - HOW THEY PERFORMED			
Name	Return 1yr %pa	Return 3yr %pa	Return 5yr %pa
Perpetual Wholesale Ethical SRI	12.74	-3.57	7.78
Perpetual WFIF Perpetual Ethical SRI	11.42	-4.63	6.57
Hunter Hall Australian Value	3.62	-3.41	6.35
Australian Ethical Smaller Companies	-4.45	-2.15	5.60
BT Wholesale - Ethical Share	-1.27	-7.69	5.10
Vanguard Sustainability Leaders Aus Shares	0.80	-6.21	4.39
AMP Capital Sustainable Share	-1.18	-9.25	3.85
Perennial Socially Responsive Shares	-0.79	-7.84	3.70
AMP Capital Sustainable Share A	-1.44	-9.53	3.56
BT Institutional - Aust Sustainability Share	0.23	-7.35	3.50
AMP FLI-AMP Sustainable Future Aus Share	-2.61	-10.53	2.40
Australian Ethical Larger Companies	-3.85	-8.64	-0.67
Alphinity Wholesale Socially Responsible Share	-0.97	-12.52	-0.85
Alphinity Socially Responsible Share	-1.78	-13.31	-1.76
S&P/ASX200 Accumulation Index	2.17	-6.95	4.24

Excludes funds under \$5 million Source: Morningstar. Performance data to 31-Aug-10

Ethical funds.

Can you invest successfully without harming the environment or others? Or better still, make the world a better place?

These are no longer fringe preoccupations. Climate change, pollution, destruction of the environment and unsustainable growth have moved centre stage.

Ordinary people have been prompted to question the wisdom of leaving future generations worse off and are investing more responsibly.

It may come as a surprise to investors that ethical funds have outperformed the sharemarket over the past five years, meaning people who go down this path don't need to forgo returns.

A co-founder of Australian Ethical Investment, James Thier, says more and more people are thinking about what their money is doing and whether it could be supporting personal values.

Australian Ethical seeks out investments that are positive for society and the environment and avoids investments involved in harmful activities while delivering good returns.

Clean technology, healthcare, efficient transport, recycling and waste management are some of the industries that can make a difference while rewarding their investors with good returns, Thier says.

## **GOOD RETURNS**

Grouped together, "ethical" funds are outperforming their mainstream counterparts. According to Morningstar, Australian share funds that invest ethically produced an average annual return of 4.65 per cent over the five years to July 31, 2010, compared with 4.21 per cent for mainstream share options.

Superannuation researcher SuperRatings says "sustainable" Australian share options offered by super funds have outperformed their mainstream Australian share options over the past five years.

Despite fund managers and super funds offering ethical and sustainable Australian shares for years that outperformed their mainstream counterparts, they attract relatively small amounts of money. Only a fraction of people's savings is invested ethically, mainly because financial planners aren't supportive of such funds.

## **STUMBLING BLOCKS**

People interested in such investments will be confronted by an array of labels that are more confusing than illuminating, with terms such as "green", "sustainable" and "responsible". What you think those terms mean and what the fund manager thinks they mean may differ.

For instance, one investor may believe that stem cell research is important because of the medical benefits it can provide while a religious investor may not support stem cell research at all.

Fund managers differ vastly in the way they apply these definitions.

Some of the largest that run "socially responsible" funds have BHP Billiton among their biggest shareholdings. It means their investors have more money in BHP than any other company.

Others, mostly smaller fund managers, avoid investing in companies with revenues from uranium, tobacco, old-growth forest logging or pharmaceutical companies that test products on animals. BHP Billiton is excluded from their portfolios because of its uranium mining, which although less than 5 per cent of its business, is significant because of the miner's size.

As well as avoiding investing in specific industries, these managers also seek investments in companies in the emerging industries of the low-carbon economy such as clean technology. This underlines the importance of going behind the fund labels to check that you are comfortable with their approach.

## **FINE PRINT**

A major barrier to a greater uptake of ethical investment is that many financial planning groups remain resistant to ethical investing. Steven Putt founded the specialist ethical planning firm Viridian Wealth Management four years ago after becoming frustrated by his former employer's lack of interest in offering clients ethical investments.

His old employer, a large planning firm, did not have a single question concerning ethical investment on questionnaires for new clients.

When Putt suggested it include questions on investing ethically, the managing director dismissed the idea as "hippie garbage, mung beans and that sort of thing".

As mentioned above, the array of terms such as "ethical", "responsible" and "sustainable" can be confusing. To some investors, "sustainable" could mean investments that are stable, secure and reliable in terms of risk and returns.

A former international head of Greenpeace, Paul Gilding, says standards cannot be applied universally "because for some people investing in coal and uranium is all right, while for others it's not and it's the personal judgments and opinions of people that will also change over time".

For those who are serious about investing ethically there are no shortcuts, Gilding says.

"There is no lazy way of doing serious investing in this area," he says. "Look at who manages the money and are they the real deal, in terms of what you care about. If you are a deep-green investor you will want to deal with people who live and breathe the values that you care about."

The head of communications at investment researcher Morningstar, Phillip Gray, says because our sharemarket is relatively small, fund managers struggle to build portfolios of companies that are very different to their mainstream share funds.

"This means an investor considering investing in an 'ethical' share fund should read the product disclosure statement very carefully," Gray says. Also, investors should not assume that ethical investing is some kind of magic bullet against market downturns. "These are still funds that invest in shares, with the market risks that that entails," he says.

## **BEST PERFORMERS**

Among the Australian share funds that invest sustainably, Perpetual's Wholesale Ethical SRI fund is the best performer. Morningstar says the fund produced an average annual return of 7.78 per cent over the five years to August 31, while the Australian sharemarket produced a total return of 4.24 per cent.

The manager of responsible investment at Perpetual, Paul Berrutti, says it has "one of the deepest and most stringent processes in the market, along with some of the deep-green managers that just do ethical funds".

The fund screens out companies exposed to gambling, tobacco, uranium and armaments. BHP Billiton is screened out because of uranium and other environmental concerns, Berrutti says. The companies that make it through the screening are then scored on environmental and social records.

Hunter Hall is the second-best performer over the five years, with its Australian Value Trust returning 6.35 per cent. The head of strategy and development at Hunter Hall, Michael Walsh, says the best way to make money is to take risks. "We ask people to make a long-term commitment and to recognise that the index is overly populated with large companies that do not offer substantial value," he says.

Hunter Hall tends to invest in smaller, undervalued companies and that removes the big miners, retailers and banks.

The manager will not invest in companies that are involved in the weapons industry or tobacco, gambling, cruelty to animals, destruction of the environment or uranium mining.

The deepest-green ethical manager of all, Australian Ethical Investment (which began in 1986), excludes companies involved with uranium mining, native forest logging, repressive regimes, pharmaceutical companies that test drugs on animals and most of the resources industry.

The co-founder, Thier, is critical of the "best of sector" (see breakout, left) approach, as it allows the fund manager to rule everything in.

He believes that the managers hold BHP Billiton because its shares are among the better performers and managers like to deliver returns not that much different from those offered by the sharemarket. Both Hunter Hall and Australian Ethical Investment give part of their pre-tax profits to charity.

## **BHP and uranium - a controversial issue for funds**

Of all the shares listed on the Australian sharemarket, none is more controversial for ethical investors than BHP Billiton. It is one of the world's biggest coalminers but is also regarded as one of the better miners in terms of its environmental record.

Less than 5 per cent of its revenue and profits is derived from its uranium mining interests. BHP owns Olympic Dam in South Australia, by far the largest uranium deposit in the world, and the miner has plans to expand its uranium mining.

Many of the big, socially responsible investment funds hold BHP Billiton.

AMP, for example, holds about 11 per cent of the assets in its AMP Capital Sustainable Share Fund in BHP - its biggest holding. The senior investment specialist at AMP Capital Investors, Angus Dennis, says BHP has better risk management of environmental and social issues than some of the smaller resources companies. He says uranium mining is an area of concern for the fund but BHP has a relatively small exposure to uranium.

The co-founder of Australian Ethical Investment, James Thier, says BHP is one of the biggest uranium miners in the world and the largest holder of uranium deposits in the world.

"It is also one of the most significant carbon emitters because of its sheer scale, notwithstanding it being one of the better mining companies," he says. "It just has a huge carbon footprint."

The subject of uranium mining evokes big differences of opinion, even among environmentalists.

One of the world's leading environmentalists, James Lovelock, argues that nuclear power is the only green solution.

Thier cites the problems of decommissioning nuclear power plants and disposal of waste and proliferation, as well as BHP's carbon footprint, as reasons for not holding the company.

"We much prefer to invest in newer technologies like wind and even gas, as a transitional fuel," he says.

## **Behind the definitions**

There are three broad approaches taken by ethical fund managers.

Deep-green managers tend to apply a negative screen that rejects companies involved in industries considered "dirty" and favours companies that make a positive difference, for example renewable energy.

The most widely used approach, though, is "best-of-sector" or "sustainable" investing. The manager selects companies with the best environmental and social records of all available companies. It is favoured by most super funds that offer "sustainable" investment options.

For example, the sustainable Australian shares options offered by most superannuation funds will usually hold shares in Rio Tinto and BHP Billiton.

However, a quarter of super funds do not make even these options available, says the researcher SuperRatings.

The third approach - which has attracted only a small amount of money - is taken by the few funds that invest with a theme.

These include climate change, water resources and clean energy.