AWFM Fact File

"Ethical Investing" v2

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Do I want my Investments/Pensions managed Ethically?

For a number of years we have run both Unrestricted portfolios alongside Ethical portfolios. Environmental issues have increasingly moved to centre stage, particularly as our news updates regularly feature articles on issues such as climate change and workers' rights. This has resulted in an increasing interest in investors having an impact with their investments, and the financial industry has seen significant inflows into ethically managed investment funds. Many of our clients are concerned about both environmental issues as well as issues associated with health and global human rights. As such they may wish to consider the possibility of investing on an ethical basis.

There are many interchangeable terms you may have heard of in relation to ethical investing, such as Environmental, Social and Governance (ESG), Socially Responsible Investing (SRI) or sustainable investing. There are some important issues to be aware of when considering whether to adopt an ethical mandate to your investment. We have produced this Fact-File to try to cover the main aspects for any client considering investing ethically through our model portfolio funds.

<u>Holding and Avoiding</u>

Nearly all ethical investment funds first employ what is known as 'negative screening', which aims to filter *out* companies whose activities are considered harmful to society and the environment, for example those involved with tobacco, gambling and armaments. Some ethical investment funds then also use a 'positive screen' which looks to identify companies that are having a *positive* impact on society and/or the environment, for example those having an influence on cutting carbon emissions.

There are other various ethical investment approaches such as thematic investing (seeking to capitalize on key trends in regard to the environment and society, such as the move to renewable energy sources), however the screening process tends to be the most widely used.

Ethical investment fund managers may have slightly different interpretations of the word 'ethical', which may also be different from your own views. Certain ethical funds may have a blanket policy to avoid energy companies due to their impact on the environment and climate change, however others may be comfortable owning these companies if they are making meaningful progress towards a credible net zero commitment. The common denominator for ethical investment funds is avoiding those companies which are deemed to have the greatest negative impact on society and the environment, with some funds having stricter restrictions than others.

A bespoke portfolio run by a Discretionary Fund Manager (DFM) can be tailored to an individual's particular views, but this does come with an additional layer of costs and may not be a viable investment option in all cases. For most investors who wish to engage broadly with an ethical overlay to their investments, the fund approach and our model portfolios is likely to be a suitable investment strategy.

As you might imagine, the restrictions put in place by ethical fund managers does limit the number of sectors that ethical funds can invest in, which could lead to potential periods of underperformance, for example if oil and mining companies perform relatively strongly over a given period. Conversely of course it could benefit an ethical portfolio if the avoided sectors underperform. Many ethical fund managers argue the sectors they invest in are the 'sectors of the future' and are likely to benefit from long-term structural trends such as the increased reliance on technology and innovation in healthcare.

Fund Choice Restrictions
If you run an Unrestricted portfolio, you have a choice of perhaps up to 5,000 different collective investment funds. If you adopt an ethical overlay, you will restrict that fund selection to about 500 funds. In theory, this could potentially harm performance relative to an Unrestricted portfolio as there are less funds to choose from when constructing an Ethical portfolio. Therefore, if you wish to adopt an ethical investment mandate, you do need to be willing to see short-term, and possibly longer-term, periods of underperformance relative to Unrestricted portfolios. With that being said, the surge in popularity in ethical investing has helped to boost the value of ethical investment funds in recent times, and the number of ethical investment funds available has grown significantly in recent years.

Costs
Typically investing ethically involves an additional layer of research (positive and/or negative screening), hence an ethical portfolio usually comes with a higher ongoing annual cost due to these additional fund management charges. This will have an impact on the net (after fees and charges) return that you receive as an investor, although the ultimate net return will depend largely on the performance of the underlying investments.

Who defines what is Ethical?
Taking an Ethical approach when using collective funds does not allow an individual investor to be specific about the issues that are of concern to them specifically. With a fund/collectives based approach, you have to accept a broad/standard approach to generally accepted Ethical issues. If you want to take a more hands-on approach to this, you may need to define your own parameters and use the more expensive DFM approach. The AWFM Ethical funds engage with both positive and negative approaches to produce a broad Ethical portfolio.

Summary
We recognise that is up to clients to decide how they would like their investments managed. We will seek to ask clients at any early stage of the investment process whether they would like us to manage their investments based on an Ethical portfolio. This will usually be part of the risk profiling process. If desired, we can provide specific details of the investment processes and restrictions employed by the fund managers within our Ethical portfolios.

If you have any questions or need an independent review of your financial planning or investment arrangements, please contact us to discuss your situation further. AW Financial Management LLP is an Independent Financial Adviser regulated by the Financial Conduct Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.