WHAT THE REGULATION REQUIRES OF TRUSTEES

Under an amendment to the Pensions Act 1995, from 3 July 2000 trustees of occupational pension schemes will have to state their policy on ethical investment in their Statement of Investment Principles (SIP). To quote the regulation, matters on which trustees must state their policy in their SIP now include:

1. “the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;

2. their policy (if any) directing the exercise of rights (including voting rights) attaching to investments.”

Trustees are not obliged to take account of social, environmental or ethical considerations in their investment strategies, but they are obliged to state whether or not they do so. Stephen Timms, in his speech at a recent seminar organised by Forum for the Future, gave two main reasons why the government had introduced the regulation: “Pension scheme members want to know what is being done with the money invested on their behalf. I think they are entitled to know. . .the Government wants to encourage trustees to be fully aware of the entire range of factors which might affect the value of their investments and to invest only after taking into account all relevant considerations.” Local government pension schemes must include an equivalent disclosure requirement in their SIPs from 3 July 2000.

TRUSTEES AND ETHICAL INVESTMENT

Ethical investment is a subject that pension fund trustees cannot afford to ignore. Pension scheme members are increasingly showing an interest in it. A recent NOP poll, commissioned by EIRIS, showed that 77% of them wanted their schemes to operate an ethical investment policy. The government has also raised the profile of ethical investment, passing legislation requiring trustees of all occupational pension schemes to consider the issue. Trustees of these schemes must declare their policy on ethical investment in their SIP. The exact wording of the regulation is printed in box No. 1. It comes into force on 3 July 2000. EIRIS expects the new regulation will lead to increased interest in ethical investment services. We have produced this pamphlet to help trustees to respond to the opportunities and challenges of ethical investment.

THE REGULATION WILL BRING OPPORTUNITIES AND BENEFITS

The new regulation is a legal requirement, but it can be seen as bringing extra benefits to occupational pension schemes. People are more likely to join pension schemes, and have confidence in them, if they know how their pension works, and where the money is invested. Indeed, this was one of the government’s reasons for introducing the regulation.

Having an ethical investment policy can bring an extra benefit without any extra cost. It can be a benefit for many scheme beneficiaries who may have concerns that they wish to see reflected to some extent in the way their pensions are invested. There doesn’t have to be a price to pay for this; returns from investing ethically can be very similar to those from investments made without any ethical criteria applied.

Trustees have a duty to consider the interests of all the beneficiaries of the pension scheme and focus on the big picture and the long term. The regulation reinforces this: as Stephen Timms explains, it is intended to encourage trustees to take into account the whole range of factors which may affect the value of their investments.

Organisations which have good policies in particular areas, such as the environment, have an opportunity to extend them to cover their pension funds as well.

77% of present and future scheme members think that their pension scheme should operate an ethical policy whenever it can do so without reducing financial return.

Source: 1999 NOP/EIRIS survey
The paramount duty of a trustee is to act in the best interests of the beneficiaries. This is usually taken to mean their best financial interests. Clive Cutbill of lawyers Herbert Smith says trustees must also:

- put their own personal interests and views on one side
- exercise their powers prudently, taking such care as an “ordinary prudent man of business” would take when investing for the benefit of others for whom he felt morally bound to provide
- consider the diversification of investments

Today’s prudent person might well think ethical considerations are relevant to the financial returns of investments. For example, by failing to take its environmental responsibilities seriously, a company could be exposed to heavy fines for pollution incidents. Such incidents could also prejudice the company’s business. On the other hand, good environmental management systems may improve a company’s efficiency in the longer term. Charles Scanlan of the law firm Simmons and Simmons, argues that trustees should:

- ensure their fund managers address ethical considerations, if these are relevant to the financial merits of investment in a particular stock or sector
- exercise their rights and influence as shareholders to support socially responsible company policies where these are likely to enhance the value of their investment
- take into account the interests and wishes of the sponsoring employer when deciding on ethical investment policy

Trusting may adopt an ethical investment strategy that reflects the moral preferences of a substantial body of scheme members, so long as their fund managers have advised that financial performance and diversification will not be adversely affected. Questions often arise over screened approaches, where certain stocks are excluded from the investment portfolio. Screened approaches may be possible if:

- trustees have been advised that financial performance and diversification of the funds is not adversely affected. For example, in the case Harries (Bishop of Oxford) v. Church Commissioners, the Church Commissioners argued that excluding 12% of the market did not harm financial performance
- additional costs are balanced by other benefits. For example, trustees may have evidence that investing in certain stocks may deter potential members from joining the scheme. In this case the cost of screening out those stocks may be less than the benefit of attracting extra members
- exclusions are written into the Trust Deed

This article should not be read as a definitive statement of the law. Trustees should always seek legal advice before implementing an ethical investment policy.
There is now evidence to demonstrate that investing according to ethical and environmental criteria does not necessarily lead to poor financial performance.

Five ethical indexes created by EIRIS and covering the period between 1991 and 1998, produced financial returns roughly equivalent to the returns from the FTSE All-Share Index. Each of the five indexes was based on a different set of ethical criteria. These were intended to represent the investment preferences of different types of ethical investor.

In 1997 leading city analysts The WM Company compared the performance of 20 charity funds investing according to ethical criteria with 140 charity funds that did not invest using ethical criteria. It found little difference in the UK equity returns between the two groups of funds both on an annual basis and over a four year period, which ran from 1992-1995. The ethical restrictions placed on some of the charity funds related to alcohol, armaments and gambling, and all had tobacco exclusions. Some pension funds are now investing a proportion of their money according to environmental criteria. Nottinghamshire County Council decided to invest around one per cent of its £1 billion pension fund according to environmental criteria in autumn 1998. The decision followed publication of a major research study into the relationship between returns on investment and environmental issues. There is now some evidence to suggest that companies which take action to improve their environmental performance can perform better in terms of their stock market value compared with those that do not. A recent study, published in late spring 1999, suggested that sustainability strategies can boost the stock market value of companies by up to 15%. The two-year study was carried out by the Oslo-based Performance Group on behalf of seven international companies, including familiar names such as ICI, Volvo, Unilever and Deutsche Bank.

**SCREENING**

**FIRST**
offer an AVC in an ethical fund
screen the portfolio to assess how it is involved in issues of concern

**THEN**
offer an ethical fund as one option in a money purchase scheme. If the fund has a segregated smaller companies portfolio, replace this with an ethical fund
invest in an ethical index tracker; or set up a segregated portfolio to track an index, but with ethical criteria applied
develop own criteria for screening, and apply this to a part or all of the fund

**PREFERENCE**

**FIRST**
screen portfolio to show involvement in issues of concern, and compare with the market (e.g. FTSE All Share Index)
draw up a list of preferred stocks

**THEN**
develop an ethical policy for ranking companies, tracking the ethical performance over time, and against benchmarks (e.g FTSE All Share Index)

**ENGAGEMENT**

**FIRST**
subscribe to a voting service which offers voting guidelines on social and environmental issues. Send companies details of the proposed policy.
invest (part of) the fund with a manager who has an engagement strategy

**THEN**
develop an engagement strategy, identifying issues of concern and targeting laggard companies.
The aim of the policy will influence other decisions, for example about strategy and issues. Here are some possible aims:

**reflect members’ views**
Trustees may decide they need to consult members to help them identify issues of concern.

One example of a policy being devised to reflect the views of the members might be an animal welfare charity.

Trustees could consider offering as one option an ethical fund with strong animal welfare criteria. Or they could develop their own policy, again using animal welfare criteria, to apply to the whole or a part of the fund.

What members say may influence decisions about strategy as well as issues. For example, trustees may find members prefer to favour companies involved in positive initiatives rather than avoid activities that they consider unacceptable.

**reflect values or policies of employer**
In this case, it would be important to consult closely with the sponsoring employer to identify issues and strategies.

There are many examples of ethical investment policies aimed at bringing an organisation’s pension fund into line with its general policies or values. Health organisations, such as NHS Trusts for instance, may wish to avoid investing in tobacco. Another example is a company which has a strong record in fields such as equal opportunities or environmental practice.

The company may wish for the sake of consistency to bring its pension fund into line by favouring investment in other companies which have good records in these areas.

A recent NOP poll showed that 83% of pension scheme members agreed that a company wishing to be seen as “ethical” should make sure its pension scheme has an ethical investment policy.

**WHAT IS ETHICAL INVESTMENT?**
Ethical investment involves considering the ethical, social and environmental performance of companies selected for investment, as well as their financial performance. Socially responsible investment is another commonly used term for ethical investment.

**EIRIS**
- provides the research into corporate behaviour needed by ethical investors
- helps charities and other investors identify the approach appropriate to their requirements
- publishes guides to help investors and advisers identify and choose between funds with ethical criteria
- enables each investor to create a portfolio that reflects their own ethical concerns
- offers services for all types of client, from checking a portfolio to creating and implementing an ethical investment policy
- concentrates purely on ethical research and does not offer financial advice or investment management services
- set up in 1983 with the help of a group of churches and charities which all had investments, and strong convictions of what they thought was right and wrong. They needed a research organisation to help them put their principles into practice

**HOW TO REACH US**
EIRIS can provide advice for trustees on the different approaches to ethical investment, and on other aspects of setting up a policy. Please contact Daniel Johnson on 020 7840 5710.

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