

April 2009

# Comments on the Charity Commission guidance on ethical investment

## Introduction

This document came about after a review of the formal Charity Commission Guidance on ethical investment for our clients. While my initial reaction was that the guidance was fair and reasonably supportive of ethical investment, discussions with some charities revealed that it could be construed far more cautiously than my interpretation. Re-reading the guidance more carefully (and cynically) revealed that there was considerable scope for improvement in its treatment of ethical investment, and lead to the development of the comments below and the creation of this document.

Essentially, I feel that while the fundamentals behind the guidance are in broad agreement with my understanding of charity law and investment principles, the way the guidance is written is likely to generate unnecessary caution among charities. I primarily focus on specific technical points and terminology. My comments fall into two categories:

1. Those areas where the wording of CC14 is unclear, unfair, ambiguous or creates an inadvertent presumption against ethical investment.
2. Those areas where investment practice has moved on since the guidance was written. In particular, the guidance implicitly seems to equate ethical investment with a negatively screened approach and while this is still popular, much ethical investment is now far more sophisticated and constructive. In addition the treatment of social investment ignores recent developments.

Seven areas are discussed, as follows:

1. Social investment
2. 'Best' returns
3. Permitted exclusions
4. Positive ethical investment
5. Risk
6. Policy development
7. Engagement and corporate governance

## 1. Social investment

In CC14, and elsewhere, the Commission makes a strong distinction between “social” investments and ethical investments. However, working as an investment professional, this is a distinction which is not always obvious.

Firstly, there are examples of investments which have a strong “social” (or mission related) purpose but at the same time are financially mainstream investments, such as:

- bonds used to finance social housing, which are highly-rated and investment grade;
- companies working in areas such as environmental technology or in social areas such as debt counselling and restructuring; and
- property funds focused on mixed use regeneration in partnership with local authorities and others.

Secondly, and perhaps more significantly, there are other investments which are ‘return orientated’ but may not be fully mainstream – often unlisted investments of one form or another. In recent years there has been significant growth in such investments – for example in 2006 we invested in three unlisted fixed interest bonds with a strong mission focus: one by a social bank (paying 1.4% over government bonds), another by a microfinance organisation (paying 1% over gilts) and a third from a wind energy company (paying 2.5% over gilts). All offer better returns than bank deposits, and, at first glance, appeared to offer reasonable return for the risks involved. However, they are illiquid and not mainstream, in the sense that they have not been adopted by mainstream investors to any great degree. We have also seen a number of equity and quasi-equity issues which are even harder to assess.

Such investments, which offer a decent return but also appear to fulfil a social purpose, are an area of considerable interest for many charities, and several are interested in making investments in this area. I note these sorts of investments have been categorised as “investment plus” in a recent report ‘Social Investment and Foundations’, supported by the Esmée Fairbairn Foundation, the Ashden Trust and CAF. They are what many other organisations may consider ‘mission-related investments’. Our research has identified a continuum of investments from mainstream to purely social, with many of the most interesting investments at the intersection of two – see the annexe for the classification system used by Rathbone Greenbank Investments.

However, the guidance ignores the reality of this overlap and assumes investments are easily classified as either mainstream or social, and from this classification very different accounting treatment follows. This fails to reflect a practical reality, and creates real dilemmas for charities and their advisers. For example, should charities disaggregate out from their portfolio any investments that are not mainstream in a strict sense? But then how is ‘mainstream’ defined and just how unconventional does an investment have to be to be seen as different?

I would encourage the Commission to recognise this overlap, and provide more practical guidance as to how charities should treat both in terms of accounting and investment strategy. For example it would be useful to see it stated that charities should be able to account for ‘investment plus’ as conventional investments, unless they involved clearly reduced returns.

Guidance might also be appropriate at a portfolio level. While the odd ‘investment plus’ asset can easily be justified in a mainstream portfolio on the grounds of diversification, many charities might wish to allocate rather more to ‘investment plus’ assets than might be typically suggested by narrow financial considerations, on the basis that they make sense in terms of the mission of the charity. It would be useful to have clear guidance that as long as such investments were clearly supportive of the objectives and that the financial impacts have been considered that such investment would be acceptable. Clearly, it might be prudent to also require greater disclosure of such investments.

## 2. 'Best' returns

While I have no fundamental issue with the general thrust of paragraph 84, it makes reference to the concept of “best returns”. Significantly this is used nowhere else in CC14. So it is only if trustees wish to consider ethical investment do they have to address the concept of “best returns” – a concept that is far from straightforward and arguably a very demanding test. To start with, I note that the concept of ‘best returns’ is conceptually unclear as we do not know what returns will be, and so cannot determine ‘best returns’ with any degree of certainty.

Furthermore, taken literally, if trustees want to consider ethical investment, they might feel they have to consider the myriad of investment options available to them and only if ethical investment option is the ‘best’ can they consider it. Not surprisingly this is a major deterrent to the uptake of ethical investment – whereas if investing conventionally there is no need to consider ‘best returns’ and such onerous considerations need not trouble trustees.

It would be more fair to state that trustees have to consider the various financial issues diligently and openly and only adopt a policy of ethical investment once they are satisfied that the prospective investment returns are likely to be broadly similar to (or better than) conventional alternatives.

Paragraph 90 is essentially a repeat of paragraph 84, but arguably the language is clearer and fairer: “a risk of significant financial detriment”; “likely to perform as well as”. It does not clearly fit beneath paragraph 85, and arguably should be merged with paragraph 84. Similarly paragraph 91 is very useful and clear.

## 3. Permitted exclusions

Paragraph 86, which considers cases where there are direct conflicts with the aims of the charity, is ambiguous. Firstly, it could be explicit in recognising that in such cases exclusions are permissible, which is implied but not obviously stated. Furthermore, it could usefully make clear that in such cases the financial impact need not be a consideration – often I have heard charities suggest that even in this case they need to consider the financial impact. Indeed, it might worth providing some balance by stating that trustees who carelessly allow investment in conflict with their mission could be equally in breach of their duties.

That said, some common sense will often be necessary, and it may be worth mentioning it – thus such exclusions should not be drawn unnecessarily wide. The example provided of an environmental charity is actually quite a good instance, as all companies pollute to some extent. However, trustees would be sensible to consider where such conflicts are significant and reach a balanced judgement. Indeed, at the margin (although not at the core) it may become appropriate to consider financial factors (in a way similar to paragraph 89).

## 4. Positive ethical investment

Much of the treatment of ethical investment implicitly seems to focus on negative screening, and with the resultant impact on investment choice. However, this is only a small part of the ethical investment universe and ignores other more constructive approaches – positively screening good companies, best of sector approaches, thematic approaches. The guidance could usefully provide some indication as to how these should be treated.

I note that, in practice, many thematic or positive approaches may implicitly be quite restrictive in practice, compared with limited negative screening. However, they often appear more acceptable, firstly because they invite consideration at the level of the whole fund or portfolio, and secondly, because they are often based on a broad economic premise which offers some investment rationale.

## 5. Risk

The guidance could cover risk and ethical investment in a more constructive way. In paragraph 89 for example the guidance requires caution if “there may be a risk of financial underperformance if those investments are excluded from its portfolio”. However, interpreted dogmatically this will always be the case – because there is a possibility the excluded investment might outperform – and as a consequence any restrictions become difficult to justify. However, the statement ignores the equal possibility that the excluded investments might underperform and so exclusion would lead to outperformance. More generally, I would argue that a broad approach to risk on the whole portfolio is what is required here, and any exclusions should be viewed in this light. Typically a few exclusions will not increase overall portfolio risk significantly, particularly in absolute terms, and it is this impact that trustees and their advisers should focus on.

So a better wording would read “trustees should consider the impacts on investment risk (particularly on the overall risk of poor absolute performance by the portfolio) of any exclusions. The trustees need to be reasonably certain that any increase in overall risk is outweighed by the disadvantages and risks to the charity of not adopting those exclusions.”

Paragraph 91 (bullets 3 and 5) are better but could be improved. Thus the risk of lower returns may be more than offset by the risk of higher returns even before the consideration of other non-financial aspects (which might be the case if trustees were to decide to pursue a higher risk/higher return strategy).

Generally the language about risk and return could be tightened up. Risk can only really be sensibly addressed at a portfolio level. Furthermore, it is important and useful to distinguish between relative risk (the risk of underperforming a particular benchmark) and absolute risk (the risk of returns being below expectations / significantly negative). The general consensus is that an ethical investment policy may increase relative risk, but is less likely to increase absolute risk significantly. Typically, trustees should be more concerned about absolute risk than relative risk, and thus an ethical investment policy may be acceptable in risk terms. Put another way, for many the real impact of an ethical investment policy may be an increase in relative risk (but not absolute risk or expected return) and this indeed may be a reasonable ‘price to pay’ for an ethical investment policy.

## 6. Policy development

In paragraph 148 on policy development, the language used appears to presuppose a particular approach to ethical investment which is not necessarily best practice and certainly ignores many recent developments. The use of the phrase “criteria with sufficient precision” implies the use of a long questionnaire of ethical criteria, and consequently a negatively screened approach. However, for many charities, such criteria may not be the best way to address ethical investment. They may have broad thematic missions which may not lend themselves to simple criteria – ‘sustainable development’, ‘human rights’ and even ‘public health’ are complex issues which are difficult to deal with through a tick box approach.

Much may depend on interpretation and balance, and in some cases the investment manager (or a third party adviser) may understand the issues in an investment context better than the trustees and thus may be better able to exercise judgement than the trustees, or certainly to contribute to a dialogue. In many cases, rather than dogmatic criteria, a process of debate and discussion may be more sensible. (For example I have had long discussions with many charities on the oil and gas sector – a significant investment area, and with many companies at the leading edge of environmental and social responsibility management and reporting, but still with huge negative impacts on the environment and human rights.)

Furthermore, such a call to develop criteria may create practical issues – it almost invites the trustees to consider a long list of criteria, and thus to risk imposing their personal issues and prejudices. Debates over criteria can be long and difficult. Many trustees might prefer to let an independent professional interpret their mission appropriately, or at least to evolve the specifics

of a detailed ethical investment approach over time within the context of a broad policy statement (e.g. ‘investments compatible with the mission of the charity’).

Overall, the guidance on policy development should reflect greater flexibility and not presuppose a particular approach to ethical investment. Perhaps something along the lines of:

“Trustees should clearly explain their required approach to ethical investment to their investment manager (through their investment policies, mission statements and other policy documents), and monitor the implementation of this approach, particularly if some discretion is given to the investment manager in the interpretation of key issues.”

It may also be useful for the guidance in this area to reflect practical considerations – for example if using collective funds, trustees may have to balance which funds best fit their objectives (as well as their financial objectives). If using investment managers, trustees should consider the expertise and research capability of the managers.

I note that reasonably detailed guidance in this area may become particularly useful in light of the disclosure of ethical investment policy now required in SORP 2005.

## 7. Engagement and corporate governance

Paragraphs 169-171 deal with engagement and governance in a generally positive and constructive way, and are to be welcomed. However, at the risk of being churlish, for many charities it may present an overly simple and positive view of engagement. In most cases, effective engagement is difficult – particularly so for small organisations – and exclusion may be a simpler and more efficient approach, particularly where issues are relatively clear cut. (Note that engagement is unlikely to be effective where the concern is over the fundamental business activity of a company – e.g. a tobacco company is not going to stop making and selling tobacco.) Token engagement should be treated with caution by trustees.

The issues with engagement are essentially practical and centre on the issues of resources and effectiveness. The different ways of implementing an engagement strategy illustrate the issues:

Firstly, some fund managers offer to engage actively on behalf of clients. This can be effective, as they have the resources and expertise to engage successfully. However, trustees need to ensure that the investment manager’s engagement priorities are closely aligned with the charity’s and that there are adequate resources. A key issue is that focusing on an engagement approach may limit the choice of investment managers, and so charities need to ensure that this is acceptable (and in particular any financial impact is worthwhile).

Secondly, charities could consider some form of ‘overlay’ service to ensure more active engagement with companies. This will probably involve some additional financial expenditure and it essentially becomes an assessment for trustees as to whether this is a cost effective way of furthering the charity’s mission.

Finally, charities may consider engaging directly. This is likely to be quite effective – companies respond well to hearing from their shareholders. However, it does involve time and commitment from trustees or charity staff and this has to be balanced with other uses of their time.

Overall, engagement can be a useful tool and is a positive way in which many charities can use their investments to further their mission. However, there are issues of resources and costs, which the guidance could recognise more explicitly.

## Conclusions

The detailed version of CC14 is a useful and positive document, considerably better than its predecessors, which recognises that ethical investment, done well, may be an appropriate and sensible tool for charities. However, it does take a generally cautious view and there is considerable scope for more constructive guidance as detailed above.

More broadly, there is a tendency for the guidance to treat ethical investment in a negative context –removing conflicts with a charity’s mission and risks to reputation. However, there is growing recognition that ethical investment can be seen much more constructively, as a positive tool for furthering a charity’s mission – whether through social investment, supporting best practice companies or through company engagement. In part this reflects the fact that in many cases the investment world and the work of the charity are becoming increasingly intertwined, and it is no longer appropriate to treat investment completely separately. Greater recognition of these changes would be invaluable in making CC14 a more powerful and useful document for charities seeking to understand how they can deliver their objectives.

**Mark Mansley**  
**Updated April 2009**

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### **Important note:**

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### **About the author**

Mark is responsible for institutional SRI advisory services at Rathbone Greenbank Investments. He started in investment management in 1983 with Capel-Cure Myers and later at Schroders. Since 1993 he has focused on ethical investment, helping investors understand social and environmental issues, such as climate change. He is the author of ‘Socially Responsible Investment - a guide for pension funds and institutional investors’.

## Annexe

# Classifying mission-related investment returns

## The Rathbone Greenbank Investments approach

	Type of mission-related investment	Annual return sacrifice (on £10,000)	Examples
A	<p><b>‘Normal’ returns</b></p> <ul style="list-style-type: none"> <li>Typically either listed (equities) or rated (bonds)</li> <li>Usually have conventional investors (but also strong ethical purpose or values)</li> </ul>	<p><b>0%</b></p> <p>-</p>	<p>Debt Free Direct plc</p> <p>Workspace plc</p> <p>HBOS Social Housing Bond</p> <p>Impax Environmental Markets</p>
B	<p><b>‘Near normal’ returns</b></p> <ul style="list-style-type: none"> <li>From some perspectives returns could be seen as ‘normal’ but from other perspectives not</li> <li>Often have reasonable income and capital protection, but may involve unknown entities; unusual structures; lack liquidity</li> <li>Conventional investors interested but only limited involvement</li> </ul>	<p><b>&lt;1%</b></p> <p><b>(£100)</b></p>	<p>Microfinance Bond</p> <p>Next Generation Bond</p> <p>Ethical Property Company</p> <p>Triodos Renewables Fund</p>
C	<p><b>‘Reduced’ returns</b></p> <ul style="list-style-type: none"> <li>Some positive returns likely, but clearly reduced compared with the market</li> <li>Ethical justification needed to invest</li> </ul>	<p><b>1-3%</b></p> <p><b>(£250)</b></p>	<p>Triodos bank accounts</p> <p>Cafédirect</p>
D	<p><b>‘Limited’ returns</b></p> <ul style="list-style-type: none"> <li>Investments offering little income return but with at least some reasonable prospect of return of capital</li> </ul>	<p><b>~5%</b></p> <p><b>(£500)</b></p>	<p>Charity Bank Preference shares</p>
E	<p><b>‘Negative’ returns</b></p> <ul style="list-style-type: none"> <li>High risk investments with a significant risk that capital will be lost, without any compensating potential for substantial gains</li> </ul>	<p><b>&gt;10%</b></p> <p><b>(£1,000)</b></p>	<p>Providing long-term private equity to non-viable entities</p> <p>Unsecured zero interest loans</p> <p>Refundable grants</p>

### Notes

It is generally harder to assess what is being given up with equity-orientated investments, where the capital is at risk anyway, compared to bond investments, where bond markets provide a benchmark, particularly where the equity investment is in a technology a long way from commercialisation.

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# Extracts from CC14

## Section F. Ethical and socially responsible investment

80. "Ethical investment" is a wide phrase which is used to cover many different approaches to investment strategy. An ethical investment policy may involve looking for companies which demonstrate best practice in areas like environmental protection, employment and human rights, or for companies whose businesses contribute directly to a cleaner environment or healthier society. Or it may involve negative screening, to avoid investments in a particular business or sector. Many ethical investors and ethical investment funds adopt a combination of positive and negative criteria.
81. "Socially responsible investment" (SRI) is often used as a synonym for ethical investment, although it can also be used to describe a particular ethical approach. Ethical investment and SRI both need to be distinguished from social investment – see [paragraph 13](#) above. Social investment **is not** investment in the ordinary financial sense at all. Ethical investment **is** investment in the financial sense, and the duties referred to in [section E](#) apply to it.
82. The governing document of a charity sometimes imposes ethical restrictions on the scope of the general power of investment. These restrictions cannot, consistently with the body being regarded as a charity, go beyond those which are compatible with the principles which are discussed in this section. Such restrictions must, of course, be observed by trustees.
83. More commonly, it will be the trustees themselves who decide to adopt an ethical investment policy. In doing so, they need to keep in mind the underlying principle that their power of investment has to be used to further the purposes of the trust, and that those purposes will normally be best served by seeking the maximum return consistent with commercial prudence. As the Judge put it in the case of **Harries (Bishop of Oxford) v Church Commissioners [1992] 1 WLR 1241** (commonly known as the Bishop of Oxford case), "most charities need money; and the more of it there is available, the more the trustees can seek to accomplish".
84. An ethical investment policy may be entirely consistent with this principle of seeking the best returns. For example, there is an increasingly held view that companies which act in a socially responsible way are more likely to flourish and to deliver the best long term balance between risk and return. Trustees are free to adopt any ethical investment policy which they reasonably believe will provide the best balance of risk and reward for their charity. As with any other investment strategy, they must be careful to discharge the duties referred to in [section E](#). In particular, they must consider the need for diversification and must take advice where appropriate.
85. The next question is how far trustees can allow their investment strategy to be governed by considerations **other than** the level of investment return. The Bishop of Oxford case recognised three situations where they can properly do so.
86. First, there are cases where investment in a particular type of business would conflict with the aims of the charity. A charity with objects for the protection of the environment and wildlife may decide not to invest in businesses which pollute what the charity is trying to protect. But the point here is a **practical** conflict with the charity's aims and activities; not just **moral** disapproval. Where the judgment is a moral one, the trustees' room for manoeuvre is more limited, as explained below.
89. Secondly, a charity can avoid investments which might hamper its work, either by making potential beneficiaries unwilling to be helped because of the source of the charity's money, or by alienating supporters. This requires a balancing exercise. On one side are the difficulties which the charity would encounter, or the likely cost of lost support, if it were to hold the investments. On the other side there may be a risk of financial underperformance if those investments are excluded from its portfolio. The greater the risk of underperformance, the more certain the trustees need to be of the countervailing disadvantages to the charity before they incur that risk.

- 90.** Thirdly, even if an investment does not come into either of the previous two categories, trustees can accommodate the views of those who consider it to be inappropriate on moral grounds, provided that they are satisfied that this would not involve "a risk of significant financial detriment". In many cases, trustees may be able to conclude, after taking advice where appropriate, that a particular ethical policy is likely to perform as well as an unrestricted policy. But trustees are not free to use their investment powers to make moral statements at the expense of their charity.
- 91.** The key here is for charities to make a judgment in the light of their own circumstances, rather than trying to conform to a supposedly homogeneous "public opinion". Here are some pointers for trustees:
- Consider the aims and objectives of the charity.
  - Keep in mind the fundamental principle of maximising return. If an ethical policy is adopted, it should be set out in writing and should be clear both on positive aims and any exclusions.
  - If companies or sectors are excluded, the reasons for exclusion should be clearly thought through. The more restrictive the policy (in terms of exclusions), the greater may be the risk to returns.
  - Trustees need to evaluate the effect which any proposed policy may have on potential investment returns, and this will usually require expert advice.
  - If a proposed policy increases the risk of lower returns, this must be balanced against the risk of alienating support and damage to reputation. This cannot be an exact calculation. It is just one of many areas where trustees have to identify and manage risk.
  - Trustees are unlikely to be criticised for adopting a particular policy if they have considered the correct issues, taken appropriate advice and reached a rational result.
- 92.** Since July 2000 some pension fund trustees have been required by law to state in their statement of investment principles "the extent (if any) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments", and "their policy (if any) in relation to the exercise of rights (including voting rights) attaching to investments".
- 93.** In its Report "Private Action: Public Benefit", the Cabinet Office's Strategy Unit has recommended that the trustees of larger charities should be required to make similar disclosures in their annual reports. They have also expressed the view that it would be good practice for all charities to make such disclosures even where not required to do so. Whilst there is, at present, no legal requirement on any charity trustees to do this, it would be good practice to include such information in the charity's annual report.

## Section J: Delegation of investment management

### Policy statements: The charity's stance on ethical investment

**148.** It is important that the charity's stance on ethical investment is explained to the investment manager in a way that enables the manager to give proper effect to it in the decisions which the manager makes. If the trustees do not define the criteria with sufficient precision, then there is the danger that the manager will either select investments which are incompatible with the charity's ethical stance, or will unnecessarily avoid particular types of investment.

### Shareholder activism

- 167.** Another important area for a review to cover may be the approach of the investment manager as regards the use of the rights and powers which are available by virtue of the investments which have been made on the charity's behalf.
- 168.** The government has suggested that a specific statutory duty may be imposed on the trustees of pension funds, and on their investment managers, to use such rights and powers as are available by virtue of the investments which they hold in the best interests of the beneficiaries. There is a suggestion that the duty may be applied to investment managers when acting for other institutional investors, including, possibly, charities. But this statutory duty is seen essentially as a clarification of a common law duty which already applies generally to trustees.
- 169.** Where a charity is concerned to pursue an ethical or socially responsible investment policy, its trustees may well expect the manager to engage with companies in which the charity's funds are invested so as to ensure that the charity's policy is not being compromised by the activities of the company. Disinvestment is, of course, one option for the charity which decides that the business of a particular company does not fit in with its particular policy. But disinvestment will not always be in the charity's best interests: the use of shareholder rights in particular ways can influence the way in which the company does business, and this may be enough to end the conflict with the charity's policy.
- 170.** But there may also be purely economic considerations for the use of shareholder rights to influence the way in which the business of investee companies is conducted. Of course, any shareholder activism duty has to be formulated in a way which recognises the practical and legal limitations on the ability of small shareholders to exert direct influence over the policies of companies in which they are invested. But the appropriate use of shareholder rights in response to evidence, say, of weak management, over-payment of executives, or unfair dividend policies, may well ultimately have an impact on the level of investment returns, whether or not the particular shareholders can technically affect the outcome of a vote. Again, this approach may be more beneficial to the charity than disinvestment.
- 171.** Trustees should consider asking their investment manager, in the process of reviewing its performance, about the steps which it takes to ensure that the business of investee companies.
- fits in with the charity's declared ethical or socially responsible investment policy; and
  - is conducted with a proper regard to the interests of the shareholders