UK Social Investment Forum
promoting sustainable and responsible finance

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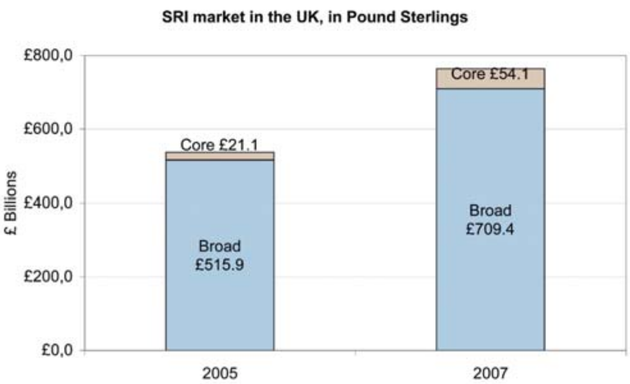
KEY FEATURES OF SRI

The City of London is widely recognised as one of the pre-eminent world centres for financial services, with an impressive track record in innovation. The UK's asset management industry plays an important role in this, with the Investment Management Association (IMA) reporting that at end December 2007 an estimated £3,400 billion (over €4269 billion) in assets was managed in the UK by their members.[1] This study found that the total of SRI AuM in the UK was £764 billion (€959 billion) with £54.1 billion (€68 billion) defined as Core SRI and £709.4 billion (€890.8 billion) as Broad SRI.

The UK has become a world centre for sustainable and responsible finance, with a growing reputation for developing and hosting catalytic initiatives. The Carbon Disclosure Project (CDP) and the Institutional Investors Group on Climate Change (IIGCC) are both based in London. They have been joined recently by the core secretariat of the UN Principles for Responsible Investment (UN PRI). London was a pioneer in carbon trading and is now a key centre for the carbon markets. The UK's expertise in responsible investment is spread across a range of institutions, including asset managers, investment consultants, investment banks and independent research houses.

Figure 1 shows the growth in the UK SRI Market from the end of December 2005 to the end of December 2007. Broad SRI has grown by 38% while Core SRI has grown by 154%.[2]

FIGURE 1



Source: Eurosif European SRI Survey, 2008

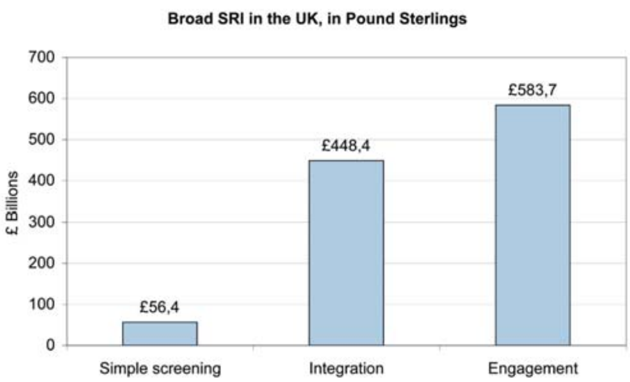
Main Practices

SRI strategies in the UK may be grouped as:

- **Integration** of environmental, social and governance (ESG) issues into investment decision making to deliver improved financial returns. This integration is performed for investors looking purely for improved risk management or greater alpha. When combined with other SRI strategies, it forms part of the offer to values-based investors. This study found that in the UK, £448.4 billion (€563 billion) in AuM were considered subject to Integration.
- **Engagement** with companies about their ESG performance - monitoring corporate behaviour and intervening where necessary. According to this study £583.7 billion (€732.9 billion) in AuM in the UK are managed under an Engagement policy.
- **Positive or negative screening** which takes account of the values of investing individuals or institutions.
- **Thematic investment propositions** based on ESG issues such as healthy lifestyles or the transition to a low carbon economy. In general, these thematic funds cover multiple ESG issues although a number of funds specific to climate change have been launched recently.

Investments are often subject to some mixture of these strategies. The funds subject to the various Broad SRI strategies are described in Figure 2 while the funds subject to Core SRI strategies are described in Figure 3.

FIGURE 2



Source: Eurosif European SRI Survey, 2008

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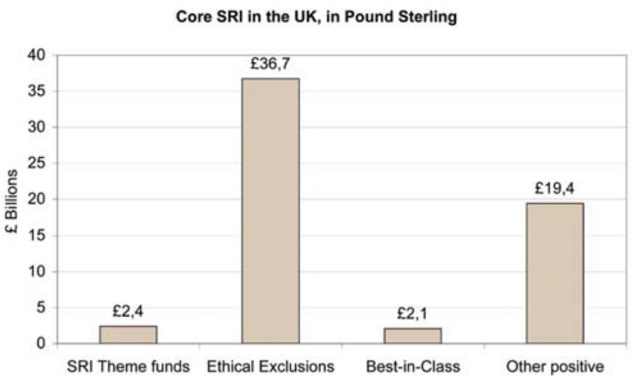
[1] http://www.investmentuk.org/press/2008/20080808.asp
[2] Data throughout the UK section of this study is reported in Pounds Sterling rather than Euros in order to exclude the effect of exchange rate fluctuations.

FIGURE 3



Source: Eurosif European SRI Survey, 2008

Who are the main investors?

High Net Worth Individual (HNWI) Investors: The last two years have seen the emergence of high net worth individuals and ultra high net worth individuals as a significant group within the SRI market. In general, their interest has focused particularly on thematic investment propositions. This development is covered in the Eurosif study "High Net Worth individuals & Sustainable Investment" (published September 2008).

Mass Market Individual Investors: The UK retail market for SRI funds is now in its 25th year, with the first retail ethical fund launched in 1984. According to the Ethical Investment Research Service (EIRIS), nearly £9 billion (€11.3 billion) was held in the UK's green and ethical retail funds (ie. funds available to the UK general public) at end 2007. These are held in almost three quarters of a million accounts invested across nearly 100 funds.[3] Effectively, all of this investment was in Core SRI although the totals do include a very small number of Broad SRI funds. In addition, some fund managers practice engagement on behalf of investments held in unscreened retail funds.

Church and Charity Investors: Church and charity investors remain the largest force in Core SRI within the UK. Nevertheless, they have not recently been a significant driver of growth or innovation. A new web site for charity investors www.charitysri.org launched in 2007 aims to support charity investors to deepen their approach to responsible investment.

Occupational Pension Funds: Major UK occupational pension funds form a significant force within Broad SRI. They hold over £1.580 billion (€1.983 billion) in assets with an average of 59.5% in equities, 27.7% in UK fixed interest and 12.8% in other.[4] In total, self-administered pension funds held about £970 billion in assets at end 2005.[5] Further pension assets are held in occupational insurance-administered pensions (£200 billion) and in personal and stakeholder pensions (£335 billion).[6] These two groups of assets are usually regarded as part of the retail market.

Insurance Companies, Banks and Asset Managers: To manage risk and protect and enhance financial returns, some financial services companies require their asset managers to address integration and/or engagement on ESG issues across all relevant asset holdings.[7] These financial services companies are drawn from the banking, general insurance and life insurance and purely asset management sectors.

What do SRI fund managers and service providers offer?

The SRI services provided by UK asset managers may be grouped as follows:

SRI Service	Comments
Pooled SRI funds for individual investors	Normally such funds are positively or negatively screened and/or deliver an ESG investment proposition. Engagement with companies may additionally take place.
Pooled SRI funds for charity investors, pension funds and other institutional investors.	For charity investors, these may be charity-specific funds approved by the Charity Commission (CIFs) or other pooled SRI funds. [8]
Segregated SRI mandates for institutional investors and high net worth individuals.	
Investment services not necessarily marketed as SRI but which incorporate the integration of ESG issues to some degree.	See the Market Evolution section below for a discussion on how the depth of integration is evolving over time with increasing sophistication in financially-oriented SRI research.
Engagement on ESG issues to protect or enhance financial return.	This engagement takes place for: • SRI funds as described above, • AuM not managed using overtly SRI criteria (including unscreened pooled funds not marketed as SRI and assets managed by investment subsidiaries for their parent bank or insurance company), • "Engagement overlays" where an "engagement only" mandate is awarded to a different provider from the asset management mandate.

[3] *http://www.eiris.org/files/press%20releases/ethicalinvestrecordhighfeb08.pdf*
[4] *Source: NAPF Annual Survey 2006.*
[5] *Source: Calculated using ONS Series RYIR and HM Treasury GDP deflators (quoted at www.napf.co.uk).*
[6] *Source: Pension Fund Indicators 2006, UBS Global Asset Management, June 2007 (quoted at www.napf.co.uk).*
[7] *This policy may be subject to restrictions on grounds such as geography and size.*
[8] *A report on pooled SRI funds for charity investors published in Autumn 2006 by the Eiris/UKSIF Charity Project is available at www.charitysri.org.*

In addition, an increasing range of associated services are available including:

Provider	Service
Investment Consultants	Assessment of ESG-related competencies of Asset Managers for use by Institutional Asset Owners. Investment Banks and
Independent Research Houses	Financially oriented SRI research for use by Asset Managers.
Independent Financial Advisers and their support providers	Assessment of ESG features of green and ethical investment funds – particularly to assess suitability for values based investors rather than to assess ESG-related competencies in effective integration or engagement using material ESG criteria.

MARKET EVOLUTION

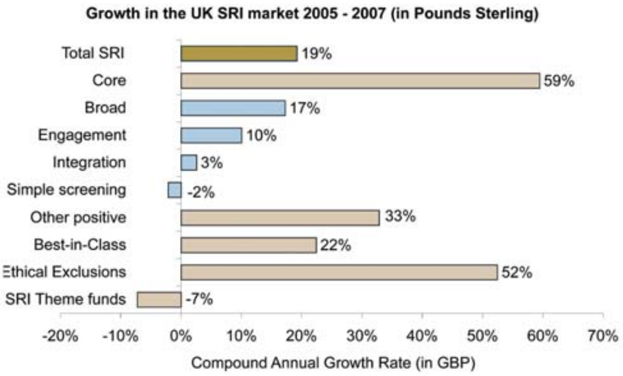
What is the growth rate of AuM?

Since the Eurosif SRI 2006 study, there was an increase of over 150% for Core SRI and an increase of almost 40% for Broad SRI, measured in Pounds Sterling as illustrated in Figure 4. It is most accurate to consider the UK growth rate in Pounds Sterling rather than in Euros so that the effect of exchange rate changes is excluded.

Within Core SRI, the strongest growth was in Ethical Exclusions (129% increase) and Best in Class (50% increase). Although qualitative feedback indicated a strong growth in SRI Thematic, the data indicates a fall. This was due to tightening of definitions, reclassification of their approach by some funds and the effect of funds choosing not to identify some thematic funds as SRI. This is described further below.

Within Broad SRI, the greatest growth was reported in Engagement (23% increase) followed by Integration (8% increase).

FIGURE 4



Source: Eurosif European SRI Survey, 2008

What lies behind this? Have new trends emerged?

Since 2005, sustainable and responsible investment (SRI) in the UK has moved "out of the silo" in a very real way. Non-SRI investors are gaining exposure to ESG themes because these are now widely recognised as significant investment themes. Climate change is probably the most visible of these themes – driving assessment of corporate exposure to climate change risks, new business models based on responding to climate change and significant investment in green technology themes such as renewables. However, the range of themes is growing and is encompassing social as well as environmental issues.

Underpinning this is a significant shift from a need to demonstrate that some ESG issues are material to financial return (which is now routinely accepted) to a deepening of research into identifying how these issues are material and how this impact will play out.

This approach to ESG themes is resulting in the "greening" of a wide range of investment, rather than being restricted to the development of specialist SRI funds. Indeed, as a proportion of the total, the development of specialist SRI funds forms a minor part. This deeper approach to ESG integration goes well beyond public equities - it is an increasing feature of real estate / property investment, private equity and infrastructure investment. Interestingly, it is utilising and benefiting from the expertise developed by the UK's SRI analysts and research houses, meaning that the skills and knowledge of these individuals and organisations are often being drawn on by a much wider group within investment institutions than as recently as 2005.

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This highly significant move is not easily captured in raw market sizing figures. Indeed this exciting and important development brings into question the whole concept of measuring the size of the "SRI market".

The data within this survey measures investments that meet the Eurosif SRI criteria and that the reporting asset manager chooses to define as SRI. As such, it does not include a range of investments that integrate ESG issues but that UK asset managers prefer not to describe as SRI. For example, it is increasingly routine within property investment to take account the impact of regulation and standards about ESG issues but property fund managers tend to not define their investments as SRI. Similarly, many of the new climate change funds might be eligible for inclusion in this survey but the fund manager has preferred not to include them within their responses.

Meanwhile, institutional asset owners are increasingly interested in exploring responsible investment but this interest is not yet being translated by most into systematic implementation. In general, the new level of integration is therefore being driven by the asset managers rather than the asset owners. However, asset managers report an increased demand by asset owners for active engagement. They also highlight increased demand for their services from asset owners outside the UK.

HNWI and mass market investors are mainly responsible for the growth in Core SRI. The evaluation of the UK's first National Ethical Investment Week, held in May 2008, suggests that the key driver is a new level of interest by mainstream investors and their advisers. These mainstream investors want to achieve a good financial return for their investments but also have a positive impact on society and the environment. They probably do not invest exclusively in SRI investments and are less engaged with or interested in the details of ethical issues than the more traditional values-based investor. Instead they want to do what they can while not being willing to accept a financial trade-off and looking to others to make detailed ethical decisions for them. In this respect, the growth of green and ethical investing mirrors the growth of other forms of ethical consumerism in the UK, notably the outstanding success of the "Fairtrade" label.[9] In addition, the increasing interest by non-specialist advisers forms part of a broader drive for increased professionalism and a client-centred approach within the UK financial adviser community. UK asset managers also report an increased demand for their Core SRI products from investors outside the UK.

Beyond the scope of this study, the development of responsible investing has been complemented by a rising interest in 'social investment' in community businesses, social enterprises and other investments that have a particularly strong focus on delivering high social impact. While the total amount of such investment remains small, it has been actively encouraged by the UK government and interesting developments have included the launch of specialist funds and continuing research on the viability of a 'social stock exchange'.

MARKET PREDICTIONS

Customer Demand

UKSIF predicts that the appetite for sustainable investing among high net worth and ultra high net worth individuals will continue to grow over the coming three years, driven by the financial opportunities and supported by the demographic change of significant wealth being transferred to or earned by a more concerned generation.

Similarly, we expect that mass market green and ethical investment will continue to grow strongly, supported by:

- The increasing need for individuals to make their own provision for retirement,
- Increasing recognition by advisers and consumers that green and ethical investment need not have a financial penalty,
- Having recognised that financial returns need not be sacrificed, a growing interest in including savings and investments within ethical consumer lifestyle choices.

Over this time period, UKSIF expects that the interest by institutional investors highlighted above will start to translate into systematic implementation by the leaders. We expect that this will then transfer to the main body of institutional investors by means of learning from respected peers and utilising the increasing SRI capacity available within the investment consultancies. It is likely to be driven both by peer encouragement and also by benchmarking initiatives such as UKSIF's Sustainable Pensions Project which highlights leadership and progress among the pension funds of the UK's Corporate Social Responsibility leaders in their approach to responsible investment. Lobbying by NGOs, Trade Unions and specialist bodies such as FairPensions should also act as a driver.

Implementation of the UK's new personal accounts pension scheme is still over three years away but debate on its approach to responsible investment may also be influential.

[9] See www.fairtradefoundation.org.uk

Supply of Responsible Investment Services

UKSIF anticipates that the increasing sophistication of ESG analysis will continue. In particular, we expect that investors will develop their understanding of regulatory drivers. This should result in increasing engagement with governments by leading investors to encourage the creation of long-term regulatory frameworks that align profitability with responsible corporate behaviour and investment in innovative solutions to ESG challenges. Investors will also deepen their understanding of the impact on corporate profitability and growth of new legislation worldwide such as the UK's new Climate Change Bill.

We predict that ESG integration will continue to deepen for a wide range of asset classes rather than mainly public equities. For some asset classes, this may be driven by public pressure in addition to regulatory drivers. For example, we expect that UK private equity will continue to deepen its response to the public concerns about its social responsibilities that has already resulted in the 2007 Walker Guidelines on Disclosure and Transparency in Private Equity.[10]

The coming three years should also be notable for an increased focus on "capital market campaigning" by NGOs and trade unions in the UK, seeking to influence investors and partner with them to engage with companies. This is already starting to be visible. A new level of sophistication is in evidence compared with the first wave of such campaigning in the early years of the decade, with NGOs becoming increasingly skilful in putting their case in ways that make investment-relevant arguments.

NGO pressure, consumer demand and City champions should also lead to an increasing focus on measuring and demonstrating the positive social and environmental impact of responsible investment distinct from and additional to its positive financial impact.

Impact of the Financial Services Operating Environment on Responsible Investment

UKSIF expects that investors will start to identify and influence government not only on the regulatory environment for companies but also to demand action to address the market failures within the financial services supply chain that encourage short-termism and an insufficient focus on external ESG impact.

The UK's Retail Distribution Review will encourage greater professionalism by independent financial advisers, continuing the trend described above. This should drive a new interest by advisers in understanding the social responsibility approaches of their clients. This may lead in turn to demands both for increasing transparency by funds and to external fund endorsement by "cause champions" such as the most respected NGOs.

For occupational pension funds, the most significant external development is likely to be the future development of the pensions "buyout" market – where the assets and liabilities of occupational pension funds are taken over by new specialist insurance companies. Will the buyout companies make the breakthrough to becoming significant asset owners? And, if so, will they embrace long term responsible investment? To date, they have been notably silent on the issue.

[10] *See www.bvca.co.uk*