**The Educational Institute of Scotland**

**Ethical Investment**

## 1. Introduction

1.1 Council at its meeting on 23 November 2012 approved an amendment to item (2)(a)(i) of the minute of the Executive Committee meeting held on 9 November 2012 by adding an item (d). The revised minute now reads as shown below:

(2)(a)(i) Investment Options

The Sub-Committee gave further consideration to an updated report by the Accountant outlining a range of options which could be taken by the Institute should it decide to discontinue with, or reduce, funds held under management of Newton as a consequence of concerns expressed over the long term investment performance of the company. Following discussion, the Sub Committee decided to:

(a) continue with the Institute's policy of having its investments actively managed, and accordingly not to pursue the option of utilisation of a "tracker" fund at this time;

(b) invite representatives of Baillie Gifford and Aberdeen Asset Management to make presentations to the Sub-Committee, and thereafter give consideration to their appointment as potential Fund Managers for a proportion of the Institute's investments;

(c) defer the investment of approximately £2,000,000, which has currently been placed on Bank Deposit, until the Sub-Committee has received presentations from Baillie Gifford and Aberdeen Asset Management;

(d) investigate and report on ethical investment opportunities before making any final decisions regarding future investments.

1.2 Finance Sub-Committee, which met on 22 November 2012 and therefore subsequent to the Executive Committee but prior to Council on 23 November 2012, decided following presentations from both Aberdeen Asset Management and Baillie Gifford: *"to appoint Baillie Gifford as Fund Managers and to provide an initial £3.1 million of Funds for investment, thereby enabling the EIS to be classified as an institutional client of the company and thus eligible for a reduced level of fees – both on initial investment at 1% as op*posed to 5%, *and in on-going management at 0.65% as opposed to 1.5%*."

1.3 As a consequence of the amendment to the Executive Committee minute investment of the £3.1 million with Baillie Gifford has not been progressed pending consideration of the issue by Council. Meanwhile the monies remain on Bank Deposit.

## 2. Existing and Proposed Investment Procedures

2.1 Prior to examining Ethical Investment issues it is appropriate to consider the Institute's investing practices as it is important that the implications of prospective changes in investment policies are recognised. In this regard members should note that in recent years a complete restructuring of our portfolio with Newton has taken place which has resulted in the cessation of the Institute's direct ownership of company shares and reinvestment in Managed Funds such as the Newton Bridge Fund and the Newton Balanced Bridge Fund. With Managed Funds the Institute purchases units in each Fund which rise or decrease in value according to the movements in value of the underlying investments. If Newton sell, or purchase, an individual company's shares in a particular Fund then there is no change to the number of units the Institute hold nor is there any change made to the Institute's financial records. Similarly the proposed investment with Baillie Gifford would be participation in a managed fund. The Diversified Growth Fund, as suggested by Baillie Gifford as being a suitable investment vehicle for the Institute, could feature at various times a wide range of investments beyond equities such as property, commodities, infrastructure, currency, government bonds etc.

2.2 The diversity of investment in managed funds is illustrated by the fact that the Newton Balanced Bridge Fund on 30 September 2012 had equity investments in 62 separate companies, a further 12 corporate bond investments, 4 UK Government bonds, USA treasury notes, gold, cash, participated in a UK smaller companies fund, and a Japanese equity fund.

2.3 If the Institute specified avoidance, of for example, alcohol in an ethical investment policy then there are currently producers, distributers, retailers and tourism/leisure businesses in the Newton portfolio. There are also governments who profit from taxes levied, and there are banks, utilities etc who provide services to alcohol producers as there are suppliers of raw materials to them.

2.4 It is considered that it would be extremely difficult, if not impossible, for the Institute to determine its own set of ethical investment criteria and remain as a participant in a conventional managed fund unless the criteria themselves were so diluted as to have little practical effect.

2.5 Furthermore the Institute could not - as a very minor participator in any Managed Fund – direct or even influence Newton, Baillie Gifford or other fund manager as to which companies should be considered or vetoed for investment purposes.

2.6 Conversely the Institute's investments managed by Charles Stanley are directly owned – thus for example at 31 August 2012 the Institute held 7,500 shares in Unilever in the General Fund at a cost of £131,374 and with a market value of £169,800. If subsequent to 31 August 2012 the shares were sold, either in totality or partially then this sale would be reflected in the portfolio and require to be individually recorded in our financial records.

2.7 The Institute could however, as a consequence of ethical considerations, instruct Charles Stanley not to hold shares in a particular company if it determined that company did not meet its ethical criteria.

2.8 As at 31 August 2012 the Institute held the following investments:

| | Market Value £k | Annual Income £k | 3 Year Return % | 2012 Yield % |
|---|---|---|---|---|
| Newton (Managed Funds) | 11,157 | 352 | 29.4 | 3.30 |
| Charles Stanley | 12,353 | 326 | 48.5 | 2.80 |
| Jupiter Ecol.(Managed Fund) | 276 | 1 | 18.3 | 0.03 |
| EIS Financial Services * | 65 | 76 | n/a | n/a |
| Unity Trust Bank * | 48 | 1 | n/a | n/a |
| Bank Deposits | 2,700 | 28 | n/a | n/a |

* Market Value not determined – shown at cost

2.9 Members should also note the growing importance of income from shares and dividends for the Institute – particularly in regard to the General Fund. Pressures on subscriptions from a three year pay freeze and a reduction in membership numbers have been accompanied by prolonged historically low levels of interest rates which have adversely impacted on income from Bank Deposits.

## 3. Ethical Investment and Socially Responsible Investment

3.1 For investors concerned about global warming and other environmental issues, there are a plethora of ethical investments that cover a multitude of different strategies. The terms 'ethical investment' and 'socially responsible investment (SRI)' are often used interchangeably to mean an approach to selecting investments whereby the usual investment criteria are overlaid with an additional set of ethical or socially responsible criteria.

3.2 The Ethical Investment Research Service (EIRIS) defines an ethical fund as 'any fund which decides that shares are acceptable, or not, according to positive or negative ethical criteria (including environmental criteria).'

3.3 Funds that use negative screening, known as dark green funds, exclude companies that are involved in activities that the fund manager regards as unethical. Each fund group has a slightly different definition of what is unethical, but this typically includes gambling, tobacco, alcohol and arms manufacture. It could also cover pollution of the environment, bank lending to corrupt regimes, and testing of products on animals.

3.4 Positive screening funds use positive criteria to select suitable companies. Funds that take this approach look for companies that are doing positive good, such as those engaged in recycling, alternative energy sources, or water purification. So an ethical fund of this type might buy shares in a maker of wind turbines or solar panels.

3.5 Engagement funds take a stake in companies and then use that stake as a lever to press for changes in the way that the company operates. This could mean persuading oil and mining companies to take greater care over the environmental impact of their operations or pressing companies to offer better treatment of their workers.

3.6 In addition, this process may involve making judgements regarding the extent to which such investments are perceived to be acceptable, and about the potential for improving through engagement the ethical performance of the party offering the investment. (Source – McParland and Partners Ltd).

Responsible Investment

3.7 Responsible investment covers a diverse range of investor activity. It can be a reflection of an organisation's values, a response to customer demand or a desire to manage investment risks related to environmental, social and governance factors.

3.8 Responsible investment includes, but is not limited to:

- investors managing ethical funds or tailoring investment - portfolios to meet the needs of particular clients;

- financial institutions who adopt a particular engagement or governance approach as part of their own corporate responsibility policy or with the aim of increasing shareholder value;

- those investors who want to make environmental, social and governance (ESG) considerations part of their investment valuation process.

3.9 Arguably the most important development in this area has been the United Nations backed "Principles for Responsible Investment". The Principles (PRI), which were launched in 2006, are seen as a set of best practices for institutional investors. The Principles do not advocate or require specific approaches to negative or positive screening based on ESG criteria – though some signatories may find this appropriate. The PRI's approach to responsible ownership focuses on engagement with companies to encourage improved disclosure and management of ESG issues that are important for long term value creation.

3.10 Institutional investors signing up to the Principles have a duty to act in the best long term interests of their clients. In this fiduciary role signatories believe that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios, and recognise that applying the Principles may better align investors with the broader objectives of society. Where consistent with fiduciary responsibilities signatories commit to:

(1) incorporating ESG issues into investment analysis and decision making processes;
(2) being active owners and incorporating ESG issues into ownership policies and practice;
(3) seeking appropriate disclosure on ESG issues by the entities in which they invest;
(4) promoting acceptance and implementation of the Principles within the investment industry;
(5) working together to enhance effectiveness in implementing the Principles;
(6) reporting on activities and progress towards implementing the Principles.

3.11 Additionally investment managers also commit themselves to completing the PRI Reporting Framework annually to highlight how they are implementing the Principles. The UN PRI website discloses that 710 investment managers and 272 asset owners (such as Pension Funds and Insurers) have now signed up with over $30 trillion of monies under management.

Why does responsible investment matter?

3.12 Investors are increasingly giving greater weight to a company's ESG performance when deciding whether to invest in that company.

3.13 According to a Goldman Sachs report: 'More capital is now focused on sustainable business models and the market is rewarding leaders and new entrants in a way that could scarcely have been predicted even 15 years ago.'

3.14 A survey on behalf of the United Nations Global Compact into the progress of its Principles for Responsible Investment (UN PRI) set of voluntary guidelines found that the world's major investors are now actively integrating ESG issues into their investment policies and engagement strategies.

3.15 According to the survey, 88% of investment manager signatories to the PRI are conducting at least some shareholder engagement on ESG issues.

3.16 The current financial situation is leading investors to seek out more sustainable models of doing business. This is likely to lead to the assessment of ESG issues becoming one of the core criteria used by investors to inform their investment decisions. Companies are increasingly engaging with these issues and reporting on that engagement.

3.17 There is evidence that responsible investors are less likely to sell their shares in a company once they have made the decision to invest. This is a benefit to companies as it reduces investor turnover. (Source EIRIS)

## 4. Environmental Social and Governance positions of Institute Fund Managers and Prospective Fund Managers

(a) Newton

Newton is a signatory to the United Nations Principles for Responsible Investment and its commitment to the matter is demonstrated by the material it produces on a quarterly basis illustrating examples of its ESG engagement, its voting profile, and the companies it has met to discuss either around financial performance (eg. executive remuneration, auditor independence) and/or responsible investment matters. The company's quarterly reports entitled "Responsible Investment - Corporate Governance & SRI" are available on Newton's website. The reports also list the companies Newton meet in the course of each quarter to discuss SRI issues (337 in Quarter 3 2012). Newton additionally publishes a separate commentary – also on a quarterly basis - considering various aspects of investment as they relate to SRI themes. The 2012 Quarter 3 report considered 4 issues including the EU Energy Directive, and improved governance of large scale land acquisition. Newton also co-operates with and is a full participant in the annual TUC Fund Manager Voting Survey.

Independently from Newton it may be of relevance that Fair Pensions – a registered charity which campaigns for responsible pensions investment, and is supported by a wide range of trade unions, in a major 2010 survey on UK asset managers' public disclosure practices on voting and engagement rated Newton as number 3 out of a total of 29 fund managers. The survey was conducted following publication of the Stewardship Code by the Financial Reporting Council in July 2010.

The principles of the Stewardship Code are that institutional investors should:

(1) publicly disclose their policy on how they will discharge their stewardship responsibilities;

(2) have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed;

(3) monitor their investee companies;

(4) establish clear guidelines on when and how they will escalate their stewardship activities;

(5) be willing to act collectively with other investors where appropriate;

(6) have a clear policy on voting and disclosure of voting activity;

(7) report periodically on their stewardship and voting activities.

Again the survey can be downloaded from The Fair Pensions website.

(b) Baillie Gifford

Baillie Gifford is also a signatory to the United Nations Principles for Responsible Investment and has a commitment to the Stewardship Code. It has issued an Environmental Social & Governance Policy (ESG), and has published a Governance Review for 2012. Like Newton it discloses on a quarterly basis details of companies it has met and its voting activities. All documentation referred to is available on the company's website.

In the Fair Pensions 2010 Survey Baillie Gifford were rated at number 2 out of a total of 29 fund managers. Baillie Gifford co-operates with and is a full participant in the annual TUC Fund Manager Voting Survey.

(c) Charles Stanley

It should be noted that the Institute's arrangement with Charles Stanley, where we are a retail client, is different from that now conducted with Newton, or indeed would be conducted with Baillie Gifford, where we are effectively institutional clients participating in managed funds.

Charles Stanley complies with the UK Stewardship Code but however view this as primarily involving their institutional clients.

Charles Stanley is not a signatory to the United Nations Principles for Responsible Investment (UNPRI) – however there are a number of valid reasons put forward by the company as to why this is the case, and it is only fair that the Committee is advised of them:

(1) The Principles are designed to influence global corporate culture by applying pressure to companies who fail to fit the UNPRI model. This is achieved through the voting of institutions holding stock as well as through non-investment or disinvestment. As stockbrokers, the stock we hold is beneficially owned by individual investors, companies, trustees etc. We have no vote at general meetings and therefore no influence over corporate governance. As custodians we are only nominees, whereas an OEIC (Open-Ended Investment Company) manager for instance, is the owner of the stock and is therefore entitled to vote the holding. The first sentence of UNPRI begins: "*As institutional investors we have a duty* …". In that sense we are not actually an 'institutional investor', while Newton, Jupiter etc are.

(2) The portfolios we manage are run on a bespoke basis. That means that if a client wishes to hold a certain stock then that is what we will do. Being a signatory to UNPRI would bring with it restrictions to the sort of personal investment decisions that every investor should be at liberty to make. Again, an institution making an investment, has absolute discretion to include or exclude any instrument from their portfolio. A stockbroker is merely an agent of an investor and the relationship might be discretionary, but it might be advisory or execution only at which point it would be impossible and undesirable to apply broad principles such as PRI.

(3) The general nature of UNPRI would make it impossible to try to operate one client's business, as a stockbroker, within its bounds and another client's business outside its orbit.

(4) Each client has a different tolerance to ethical/unethical behaviour, social responsibility or lack thereof, green or non-green practices and so forth. We believe it is within our capability to reflect clients' specific needs rather than to use a 'blanket' approach. This is obviously different from a fund management arrangement where the manager will lay down the parameters within which he will run his fund and the investor will either submit to those parameters or not.

The Institute receives a Discretionary Investment Management Service from Charles Stanley. Essentially this entails the day-to-day management of our investment portfolios by the Investment Manager, who monitors our holdings and makes investment decisions on our behalf. In matching the portfolios to the specific objectives (eg income, balanced or capital growth) and risk tolerances (eg medium high) the Investment Manager considers all asset classes. Investment objectives and requirements are discussed in advance, and guidelines formulated. Charles Stanley's investment decisions are then made within these guidelines, which are reviewed periodically. The Institute could, if it wished, instruct Charles Stanley not to invest in specific companies, although by doing so would make performance monitoring problematic.

The Institute also has the option of changing to an Advisory Investment Management Service. This would offer the same level of investment management and administration as the Discretionary Service with the exception being that the Institute would make the final decision on individual purchases and sales. Clearly, however, there is currently no in-house expertise available to advise Finance Sub-Committee on investment management.

(d) Jupiter Ecology Fund

Jupiter represents the Institute's first involvement in a specific ethical investment. This investment originated from a Council motion in November 1997 and £100,000 was placed with the Jupiter Ecology Fund in November 1998 after consideration by Committees and Council of the ethical investment options available at that time and the quantum to be placed. A further investment of £100,000 followed in April 2001. Since 2001 the Institute's income from the Fund has been reinvested as opposed to being paid out by way of dividend. The valuation at 31 August 2012 was £276,195. The overall return on the Fund since the original investments has been demonstrably below that achieved by Newton and Charles Stanley, as has been highlighted in reports previously submitted to Finance Sub-Committee.

Clearly, however, the Fund is strong on environmental issues and its managers see the increasing world population, the global using up of finite resources and their consequent scarcity, pollution, energy supply, and climate change as the problems requiring addressing stating:

*"Investment in businesses that provide solutions to these issues is essentially an investment in the long-term structural development of the global economy. This provides a deep investment universe underpinned by several key areas:*

> *Infrastructure: Companies which own or develop low environmental impact infrastructure in areas such as alternative energy, pollution abatement, waste management, utilities and transportation networks.*
>
> *Resource efficiency**:** Companies which provide technologies, products and services aimed at improving the efficiency and long-term environmental impact of natural resources and energy.*
>
> *Demographics: Companies which provide technology, products and services which enhance human well-being, consumer choice, communication and transportation whilst minimising environmental impacts.*

*We believe that this represents an exciting and diversified long-term opportunity to invest in some of the most forward thinking and innovative companies in the world.*

*Increasing numbers of companies are embedding corporate responsibility into their cultures.*

*As well as investing in companies that provide environmental benefits with their goods and services, we look for companies which show outstanding practices amongst their industry peers in terms of corporate responsibility. These companies have excellent policies, processes or performance and are effectively managing the environmental and social impacts of their activities in a responsible manner. Some companies may operate in sectors with potentially high environmental and social impacts such as resources, which includes mining and oil and gas businesses.*

*All companies considered for investment are fully researched,* *predominantly via face-to-face meetings, and all are constantly monitored".*

Jupiter also stipulates that each potential holding in the Fund is assessed by its Sustainable Investment and Governance Team to ensure it fits within the Fund's individual screening criteria. Additionally each holding must be re-approved every two years. Jupiter complies with the UK Stewardship Code.

The Ecology Fund is also negatively screened with companies involved in the following activities as *"may not be eligible for investment":*

the manufacture or sale of armaments, alcoholic drinks, tobacco or pornography;

the generation of nuclear power or construction of nuclear power plants. the operation of betting or gambling facilities.

Any company which derives over 10% of its turnover from any one of these activities will not be invested in. Additionally any company that conducts or commissions animal testing for cosmetic or toiletry purposes is avoided.

## 5. Potential considerations for the Institute

5.1 It is perhaps appropriate that in the first instance the Committee considers the ethical approaches adopted by its current investment managers.

5.2 It has been illustrated earlier in this report that the Institutional Fund Managers utilised and proposed by Finance Sub-Committee – Newton and Baillie Gifford – have demonstrable commitment to environmental social and governance issues.

5.3 The Jupiter Ecology Fund was originally selected on its ethical criteria and a practical way forward, if a decision was taken to amend investment policy, would be to increase the proportion of Institute resources held in designated ethical funds, such as Jupiter, up to a target %age of total investment.

5.4 The Institute could, if it decides to do so, also enter into discussions with Charles Stanley regarding the investments held by the company. Charles Stanley works with Ethical Screening, a well-known research provider, which enables its investment managers to provide a completely customised, responsible investment service to all clients. This allows Stanley's clients to invest their money according to their principles.

5.5 Screening, as referred to earlier, is a procedure for vetting companies as part of the ethical or socially responsible investment (SRI) process. This ethical screening process is in addition to the financial analysis that occurs as part of normal investment procedures. Screening excludes from investment those companies whose activities conflict with a chosen set of criteria; whilst at the same time approving for investment those companies whose activities do not conflict with ethical concerns, or have positive social or environmental benefits.

5.6 In addition to identifying core activities such as the sale of weapons or tobacco, which conflict with specific ethical concerns, the research and analysis behind the screening process focuses on what are often referred to as Corporate Social Responsibility (CSR) issues. CSR deals with how companies interact with key stakeholder groups such as their customers and employees and the communities in which they operate.

5.7 The research and analysis of Ethical Screening covers both positive and negative issues with screening criteria falling into loose categories covering social issues and human welfare; environmental issues; and animal welfare. Positive research covers business practices that have positive impacts such as investment in social housing; manufacturing energy saving technologies; and production of high-welfare meat and dairy products. Similarly, negative research identifies company activities with which people have ethical concerns, such as the abuse of human rights; sale of armaments to countries with oppressive regimes; irresponsible marketing of alcoholic drinks; and production of intensively farmed meat and dairy products.

5.8 Charles Stanley clients can opt to have their portfolio managed using its Ethical Screening Service and the company can customise their advice and the management of individual portfolios to suit the client's specific wishes.

5.9 Ethical Investment is, however, a complex matter and the issues involved may well span a wider area than that which is covered by Finance Sub-Committee's remit which, up to now, has been focused on investment performance. Were the Institute to determine that Finance Sub-Committee engage with Charles Stanley over the positive or negative screening of investments then firstly it would have to determine the criteria it sets for ethical investment and then presumably set tolerance levels. As a first step, however, Charles Stanley has expressed its willingness to meet the Sub-Committee and provide a presentation on its ethical screening and practices.

5.10 Were the Institute to determine ethical investment criteria a more "aggressive" approach would be to apply these criteria to its entire portfolio. This would entail investigation into our investments with Newton, Charles Stanley and Baillie Gifford. As stated previously it is possible to instruct Charles Stanley that specific investments fail to meet the Institute's ethical criteria and hence must be sold (or not purchased) but with Newton and Baillie Gifford it would be "all or nothing." Again it is worth emphasising that both Newton and Baillie Gifford appear to have a taken environmental, social and governance responsibilities extremely seriously, and that a more restrictive investment policy is highly likely to impact on income and performance.

## 6. Recommendations

(1) The Institute proceeds with the proposed investment of £3.1 million with Baillie Gifford as decided by Finance Sub Committee at its meeting on 22 November 2012. There are a number of reasons why this course of action is suggested.

Firstly the prospective returns over the long term - both in respect of capital growth and income - are higher in investments than with bank deposits. Secondly consideration of ethical investments by the Institute and investment in the Baillie Gifford Diversified Growth Fund are not mutually exclusive. Investments can be disinvested at any time with no "final" decision ever being taken. Thirdly Finance Sub-Committee has, with the exception of the Institute's involvement with Jupiter which stemmed from Council/AGM motions, used performance as the determinant in deciding whether to appoint, increase/reduce involvement with, or disengage from its Investment Managers. It then has two principal considerations to take into account - the differential between the purchase and sales prices which typically are circa 2%, and any Capital Gains Tax (CGT) implication. Although the purchase/sale differential is inevitable this will have already been factored into the decision to invest/disinvest whilst, at present, CGT is not an issue. Unless or until the Institute decides to change its investment policies it is believed Finance Sub-Committee should remain free to implement the decisions it takes. A full written report on the Institute's investment policy be made annually.

(2) The Institute continues to utilise the services of its existing principal Institutional Fund Manager - Newton - and, as stated above, confirms the appointment of Baillie Gifford as its second. Finance Sub-Committee, in addition to its responsibilities regarding assessment of the investment performance of the Institute's Fund Managers, should continue to monitor and review their ethical approach. A full written report of the Institute's Fund Managers performance in this respect be made annually.

(3) The Institute continues its involvement with Charles Stanley Ltd as a Fund Manager and invites the company to give a presentation on ethical investment screening to Finance Sub-Committee. A full written report of the presentation should be made to Council.

(4) The Institute, in determining the appointment of additional or replacement Institutional Fund Managers in the future, should only give consideration to those Fund Managers who have signed up to the United Nations Principles for Responsible Investment.

<u>Documentation</u>

Paper copies of the following documents can be provided on request to Council members:

United Nations Principles for Responsible Investment Annual Report 2012
Charles Stanley Ltd–Statement on Corporate Governance
Baillie Gifford-Environmental Social & Governance Policy 2012
Baillie Gifford–Where votes have been implemented globally–Quarter 3 2012
Baillie Gifford–Governance Review 2011/12
Newton-Responsible Investment, Corporate Governance & SRI-Quarter 3 2012
Newton-Environmental, Social and Governance Themes-Quarter 3 2012
TUC Fund Manager Voting Survey 2012