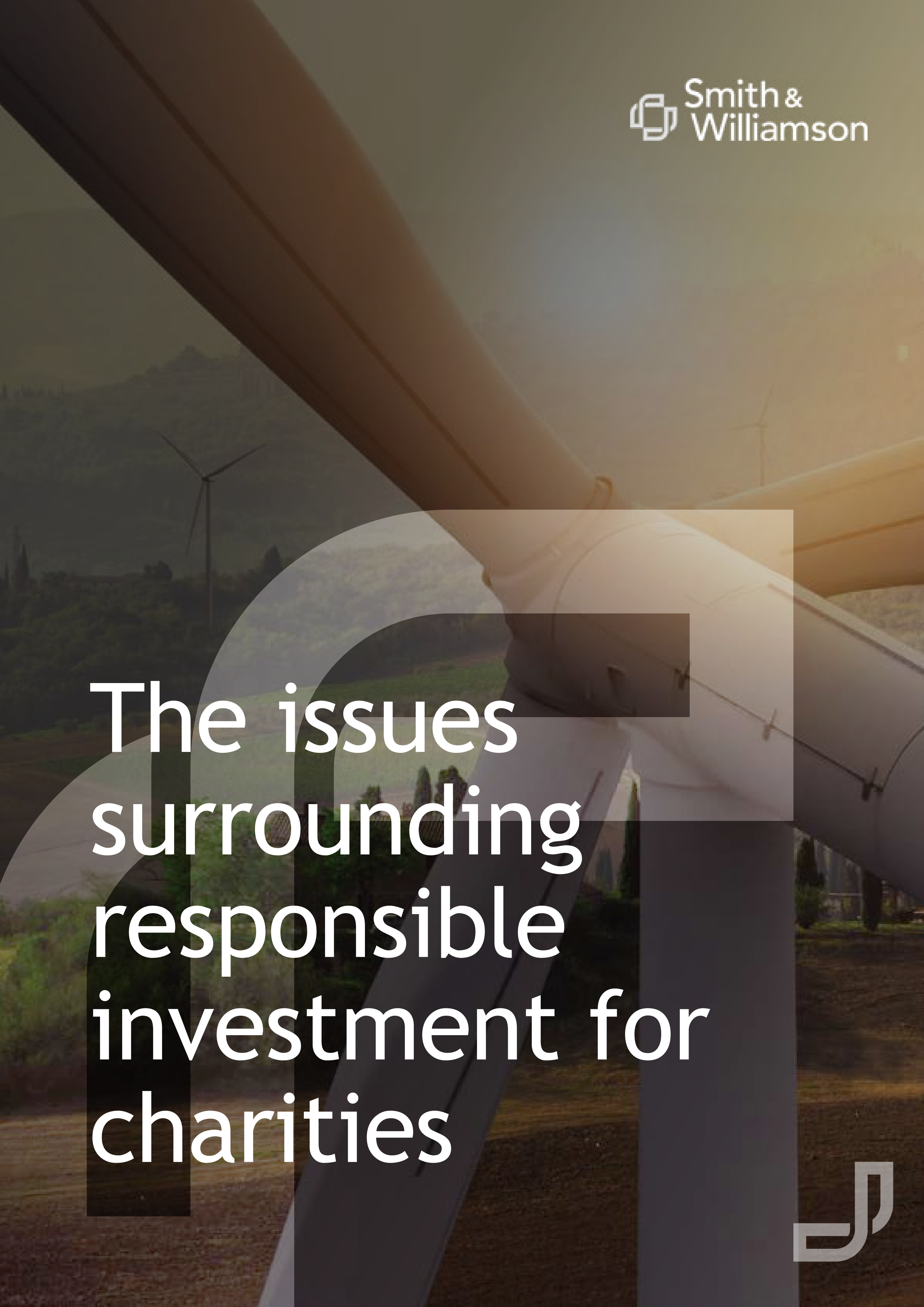


Smith & Williamson

# The issues surrounding responsible investment for charities

# Introduction

Many charities have led the way in ethical and responsible investing. They were pioneers of the negative exclusionary screens to avoid exposure to certain companies and sectors as well as the wider Environmental Social and Governance revolution we are seeing today.

The aim of this guide is to help trustees to make informed choices about how they want their portfolios managed.

**Defining responsible investing**

The first step is to ensure that the trustees and their advisers are singing from the same hymn sheet. Whilst responsible investing is a hot topic, discussion on this subject is often undermined due to different interpretations of what the term actually means. The term was first widely adopted by the United Nations supported Principles for Responsible Investment (UN PRI) and it is their definition which is typically used throughout the investment community. The two most important principles are:

- Incorporating Environmental, Social and Governance (ESG) issues into investment analysis and decision making
- Active stewardship: voting and engaging with companies to influence behaviour

The Charity Commission describes responsible investment as taking into account the charity's purposes and values, not just the financial considerations.

In today's world, adopting a responsible approach to investing is increasingly seen as the minimum standard expected of charities. Once formally adopted, this should be evidenced through regular reports which show the ESG credentials of your portfolio and the action your investment manager has taken on your behalf to influence corporate behaviour.

At Smith & Williamson, we do not believe that a responsible approach to investing detracts from achieving financial returns. On the contrary, there is good reason to believe that responsible and sound financial investment go hand in hand.

By adopting a responsible approach to investing, you are laying solid foundations upon which a more tailored ethical policy can then be developed, thereby ensuring that your investments echo your specific core values and purposes.

**Ethical investing**

Creating a detailed ethical policy can be daunting. The options available range from excluding specific activities and controversies, to impact investing by actively targeting specific environmental or social goals. Moreover, whilst the multitude of choices available may sound comprehensive, it is difficult for trustees to gauge the impact and how effective each option is in reality. It is even more challenging to weigh that up with any potential implication in terms of the risk profile of your investments.

It is therefore essential that we help guide you through the process of creating a tailored ethical policy, with the aim of ensuring optimal decisions and the right balance is struck between investing responsibly and ethically, whilst meeting your financial goals which underpin your primary purpose(s).

# Responsible investment for charities – summary of regulations

This section briefly considers the legal framework that charities operate within and the specific implications that this has on responsible investment.

In England, charities need to follow Charity Commission guidance (CC14) and charity law; Scotland and Northern Ireland have their own charity commission equivalents, OSCR and CCNI, respectively.

## Charity law

Relevant charity law includes the Trustee Act 2000, the Companies Act 2006, the Charities Act 2006, the Charities Act 2011 and the Charities (Protection & Social) Investment Act 2016 amongst others.

## Case law

The key piece of case law is from the 1992 Bishop of Oxford case. It reaffirmed the old principle that most charities need money and so the more of it that is available, the more the trustees can seek to accomplish. Accordingly, charities should aim to maximise the return commensurate with the appropriate level of risk for that particular charity. However, it also established that charities could exclude investments in sectors if:

- They would be contrary to the charity's purposes
- The charity might lose its supporters or beneficiaries
- It could be demonstrated that it put off donors
- There is no negative expected impact on the financial return or risk

The case also reiterated that trustees could not use the property of the charity for making personal moral statements.

## Charity Commission guidance

The Charity Commission investment guidance is provided under CC14, and they have a consultation process underway regarding amendments to this. Specifically, they wish to reduce potential barriers to responsible investing and argue that the legal guidance is unclear and case law potentially outdated. In addition to the consultation they have given permission for two charities to test this view in court.

A detailed critique of the proposed Charity Commission changes is beyond the scope of this document. However, we note that areas of ambiguity remain and hope the consultation, the High Court granted permission for two charity trustees to bring proceedings to seek declaratory relief and directions in respect of their powers to adopt a responsible investment policy.

## Unchanged areas of CC14 cover in summary:

- The distinction between financial investments to generate money from income, capital growth to spend on the charity’s purposes and the option to apply assets to further its aims directly in a way that may perhaps also generate a financial return
- The requirement to take advice from someone experienced in investment matters, and the power to delegate investment and safe custody to a third party with the requirement to review this at appropriate intervals
- The trustees need to set appropriate investment objectives, consider immediate and long-term risks, time horizons, the need to diversify/have balance, consider the suitability of investments, set the investment policy and regularly review
- Comply with the governing documents, avoid conflict of interests, ensure personal benefits are not received and keep records of decisions and how they were reached
- Apply any personal skills or experience as individual trustees
- Do not allow personal motives or prejudices to affect the decisions taken

## New draft guidance notes on responsible investment for non-permanently endowed charities:

- For investments in direct conflict with the charity’s purposes it is possible to adopt a responsible investment approach including negative screening, positive screening and stakeholder activism
- Even if there is no apparent direct conflict with the charity’s purposes, if the trustees can show that it is in the best interests of the charity, then it can adopt a responsible investment approach

## New draft guidance notes for permanently endowed charities:

- Different rules apply to permanent endowment and any similar charities which also have a duty to invest. This is because they can’t spend the money or manage it any other way
- The charity must aim for the best financial return within the level of risk appropriate for the charity
- However, a responsible investment approach can still be taken if:
    - o Specific stocks/sectors would be contrary to the charity’s purposes
    - o The charity might otherwise lose its supporters or beneficiaries
    - o Taking this approach would not bring significant financial downside
    - o The governing documents allow or require a responsible investment approach
    - o There are clear and compelling reasons, supported by evidence, about why the charity should follow a responsible investment approach

# Practical considerations

**Balance:** The Charity Commission holds trustees responsible for ensuring that the balance between risk and return is right for their charity. By having total exclusion (negative exclusions) on certain sectors such as pharmaceutical and/or oil, a significant percentage of the investable universe is removed and exposure to other areas therefore increases, potentially leaving unintentional biases. These need to be thoroughly understood.

**Black, white or grey:** Some issues are black or white and need zero tolerances, whilst others need a little flexibility. A zero tolerance for any revenues from tobacco would automatically exclude petrol stations, supermarkets and some hospitality venues that sell tobacco products. Although these sales represent a very small percentage of their total revenues, putting in a revenue hurdle to exceed before exclusion would allow greater flexibility and improved diversification.

There will be grey areas which need to be discussed by the trustees on a case by case basis, having been provided with the information available and given time to consider carefully. Trustees should establish a grace period for the investment manager to establish the facts and time to divest so as not to disadvantage the charity if, for example, a holding acquired another business that went against the policy.

**Unique needs:** Since no two charities are the same, we work with each charity to tailor investments to its particular ethos and needs. This allows a variety of approaches to ethical investment, rather than a one size fits all model.

**UN Sustainable Development Goals (SDGs):** Adopting a tailored approach to positive screening and impact will become increasingly important for charities. In this respect, we view the use of the UN's SDGs as playing an important role. The SDGs provide a common language which all stakeholders can understand and support, as well as offering a clear link between a company's activities and a charity's specific values. However, it is important to understand that use of SDGs in the investment world is still in its infancy and at this stage the reality is that they are not as impactful as you may think. As such, for now at least, we suggest any policy that incorporates SDGs is flexible and they do not form the basis for rule-based targets. As company disclosure improves and SDGs become more widely recognised and adopted amongst listed companies, their effectiveness will increase.

**Problems with data:** The quality of data collected on companies around the globe differs significantly between geographic regions, sectors, company size and how the information is treated by the data providers themselves. The European Commission is leading the world with new detailed disclosure requirements and their environmental taxonomy, but it is very early days. It is also worth noting that many of the screening criteria for the less quantitative issues, such as human rights and environmental controversies, are based on the breadth and depth of information the company provides. All screening data must only be used as a starting point for further investigation and discussion.

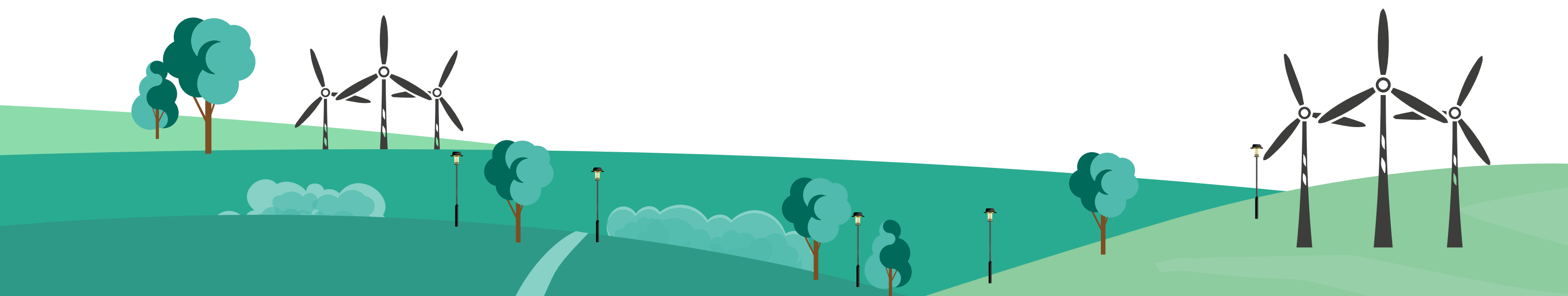
**Reputational risks:** What is more difficult are the issues that don't fall under these neat categories but may still leave the charity with some reputational risks. There needs to be an understanding that the investment manager has some empathy with the charity and that the old fashioned "smell test" is understood.

**Collective funds:** Investment managers often hold third party managed funds in specialist areas outside their core expertise or where the portfolio is not large enough for sufficient diversification. Most will not be following the same policy as the charity. As a minimum, the manager should be a signatory to the UN PRI and their responsible investment policies and activities should be regularly screened and monitored.

**Stewardship:** Effective stewardship is as important as ESG integration. The manager should engage with the companies invested in on your behalf, have a dedicated institutional charity team within their firm, provide regular ESG analysts training and have transparency and disclosure on voting and engagement activity.

**Reporting and review:** The responsible investment policy must be regularly reviewed and reported on. Breaches need to be disclosed promptly and dealt with in a pre-agreed manner.

**Documentation:** The decisions and how they are reached should be fully documented.



# What to expect from Smith & Williamson with regard to responsible investment

Smith & Williamson is a signatory to the UN PRI and the UK Stewardship code with an A and Level 1 assessment from the two organisations respectively. All portfolios at Smith & Williamson are invested along base level responsible investment principles required to achieve these assessments as a result.

**ESG factor integration:** We take into account ESG factors alongside traditional financial metrics.

**Tailoring the responsible investment policy to each charity's specific purposes and values:** All portfolios can incorporate negative exclusory screens and positive screening tilts.

**Voting:** We vote our clients' shares globally and write to the management of each company to explain our reasons when we vote against resolutions. Clients are free to direct their shares how they think fit and we can set notifications for the AGM's of particular companies.

**Engagement:** We have over 500 meetings with company management teams each year and directly engage with them on matters that concern our clients' interests. Voting and engagement activity is updated on our website every quarter and we produce a more complete annual stewardship report to ensure transparency.

**Collaborative engagement:** We are active members of the Investor Forum and Climate Action 100+, and Find it, Fix it, Prevent it and so combine with other shareholders to escalate material issues to the Boards of the companies we invest in.

**Understand the risk implications of your preferred approach:** A report on the number of stocks and the percentage of the investment universe excluded, the impact on sector weightings, a discussion on the likely impact on the portfolio in terms of financial risk and diversification, with a check to ensure that emphasis has not been placed on areas which are less relevant for the charity.

**Transparency:** Our overall voting track record, collaborative and direct engagements are updated each quarter and displayed on our website. There is an annual stewardship and responsible investment report which details this for the year as a whole, in addition to the Corporate Social Responsibility activities for the firm as a whole.

**Portfolio monitoring and responsible investment reporting:** Ad hoc reporting to coincide with review meetings to evidence good stewardship (individual portfolio voting and engagement on request), ESG, carbon and UN SDG alignment reports. Tracking progress over time is especially important.

**Help with implementation and monitoring policy:** Guidance and feedback on drafting reserves policies and responsible investment policies

**Reporting to other stakeholders:** Interest is growing in this area from all stakeholders, donors, staff and beneficiaries. Our responsible investment reporting can help improve communication in annual reports and websites.

**Information, training and practical assistance:** Monthly market updates and webinars, monthly charity insight articles, charity trustee training webinars, regional conferences.

# Conclusion

The challenge is finding the right balance between maximising the probability of achieving your target financial goal and ensuring your investments genuinely chime with your values and purpose(s), whilst navigating the challenges posed by disclosure shortcomings and subjectivity. Knowing when to set clear rules and targets and when a more qualitative and flexible approach is more appropriate is essential.

Our bespoke approach allows each charity to reflect their unique characteristics, consider the complexity of the topic and the range of different opinions, and travel at a speed at which the trustees and other stakeholders can be comfortable with.

# Appendix

### Definitions of common responsible investment terms

There are many new terms and people often use them differently, Smith and Williamson use the broader UN PRI definition which is the overarching description for all the commonly used terms in this space. The Charity Commission definition of responsible investment, which is shown below, is narrower.

**Charity Commission definition of responsible investment;** Where a charity decides that rather than just focusing on the financial return of its investments, the charity also takes into account its purposes and values. They note that responsible investment is sometimes referred to as ethical investment.

**UN PRI:** The United Nations supported Principles for Responsible Investment (UN PRI) is the key global driver behind the term responsible investment. All signatories commit to six principles which include incorporating ESG issues into investment analysis and decision making, being active owners, working collaboratively to enhance effectiveness and reporting related activity publicly.

- Environmental (E)
- climate change
- raw material and water scarcity
- pollution and waste
- deforestation
- Social (S)
- human rights
- labour policies and relations
- product liability and cyber security
- supply chains
- social impact reporting
- Governance (G)
- business ethics
- executive pay
- management diversity and structure
- transparency

**Sustainable investing:** Investing in a manner that considers environmental, social and governance criteria to generate long-term competitive financial returns and positive social impact.

**Ethical investing:** Aims to exclude profiting from activities that are considered harmful to society and the environment and to invest in companies and projects committed to operating in a sustainable fashion.

**Stewardship:** The responsible allocation, management and oversight of capital, through active ownership, to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

**UK 2020 Stewardship Code:** This updated code requires signatories to comply with 12 principles including to have policies and procedures to vote shareholdings, engage directly and collaboratively, manage conflicts of interests and monitor investee companies. They are designed to dovetail with the UN PRI.

**Negative exclusions:** Screening for companies that do not reach the criteria set by the responsible investment policy and to exclude them from the permittable investment universe.

**Positive Screening:** Selecting companies that set a positive example of environmentally friendly products and socially responsible business practices, positive and improving ESG factors. This includes positively rather than excludes.

**Impact investing:** Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.

**UN Sustainable Development Goals (SDGs):** The SDGs are the key focus of the UN's 2030 Agenda for Sustainable Development, which was adopted by members in 2015. There are 17 goals and 174 targets covering environmental, social and governance goals. These are often used to track impact over time for quoted portfolios.

## Contact

If you would like to find out more about our investment services for charities please look at our website
**https://smithandwilliamson.com/en/services/investment-management-charities/**
or contact:


**Sharon Hanshaw**
Associate Director, Business Development,
Smith & Williamson Investment Management LLP

**e:** Sharon.Hanshaw@smithandwilliamson.com

**Keith Burdon**
Head of Charities, Scotland & NI,
Tilney Investment Management Services Limited

**e:** Keith.Burdon@tilney.co.uk




Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

**smithandwilliamson.com**