

SOCIALLY RESPONSIBLE INVESTMENT

engaging behaviour

Fund manager Friends Ivory & Sime argues that institutional investors have a responsibility to encourage companies to improve their governance of ethical and environmental issues. Its new Responsible Engagement Overlay service enables investors to use their influence to encourage positive change

Three years ago, Friends Ivory & Sime began to detect a shift in attitudes to socially responsible investment (SRI) among its pension fund clients.

After years of indifference, many of the London-based fund management firm's clients were taking a greater interest in the social and environmental performance of the companies in which they invested, partly as a result of the UK government's decision to introduce a regulation requiring fund trustees to publish their policies in this area.

At the same time, most of these clients complained that traditional approaches to SRI, which identify 'unethical' companies and then exclude them from share portfolios, conflicted with the views of some pension fund members. They also worried that screening was incompatible with the fiduciary duties of trustees.

The Responsible Engagement Overlay programme has been developed by FIS specifically to address these concerns. A new model for social responsibility in investment, it allows institutional investors to hold shares in any company, but commits them to 'engage' with the companies to persuade them to behave in a more socially responsible manner.

USING INFLUENCE TO BRING ABOUT CHANGE

FIS believes Reo allows institutional investors to meet the growing demand for a more responsible approach to ethics in investment without increasing risk. Moreover, it fits with FIS's conviction that investors, as owners of public companies, should use their influence to bring about change, and not simply withdraw. 'We believe ethical investment should be as much about changing behaviour as about staying clear of unpalatable activities,' explains Craig Mackenzie, who heads the Reo team. 'We are shareholders and when we argue for change based on the business case for social responsibility we can be a powerful force.'

Once a pension fund has agreed to allow FIS to apply Reo to its investments, FIS's 11-strong SRI research team swings into action. The team is currently split into five groups specializing in climate change, forestry, human rights, labour standards, and property and construction. Each group identifies areas where companies need to improve their ethical performance, and then engages with senior executives at face-to-face meetings.

One of Reo's most successful engagement programmes in the past year has been on labour

the company

FIS, the asset management arm of the life assurance group Friends Provident, made pre-tax profits of £24.7million in 2000 on turnover of £71.3m. It employs 400 people and:

- has employed socially responsible investment techniques since 1984
- has £37billion under management and manages £18bn of this using its Reo service
- ran a year-long series of seminars on human rights during 2000/1 in conjunction with the International Business Leaders Forum
- manages the investments for the pension funds of Oxfam and Christian Aid using Reo
- is a member of the SRI Forum, which brings together investment institutions and businesses, and has produced guidelines on ethical investment.

the background Forty-eight per cent of UK pension funds want fund managers to consider the financial impact of ethical, social and environmental issues, according to research published by the UK Social Investment Forum in October 2000. Larger pension funds were more likely to take SRI considerations into account than smaller funds, the study found.

standards. In early 2000, FIS wrote to 11 British clothing companies asking them to explain what they were doing to tackle child labour in their supply chains. The responses analyzed, FIS then met with each company, often at chief executive level. 'We found some companies were managing these issues rather well, but that five hadn't even started,' says Mackenzie. 'We focused on those five and argued quite firmly that we thought this was a serious risk.'

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The results were encouraging. The Welsh clothing company Peacocks, for instance, quickly adopted a clear policy on labour standards and now requires suppliers to sign up to a code of practice. Others were not so easily convinced. One company steadfastly maintained its customers were not interested in labour standards. FIS's response was to organize a private seminar at which clothing industry executives spoke to company heads about the problems they might encounter if they did not tackle the labour

standards of their suppliers in developing countries. 'The risk manager at that company was convinced there and then,' says Mackenzie. 'They've since done everything we've asked them to do.' All 11 companies have now taken steps to address labour standards in their supply chain.

The Reo team also forms alliances with 'constructive stakeholders' such as Amnesty International and WWF on certain issues. All negotiations are based on two core Reo principles:

- engagement takes place only on issues where a broad consensus amongst clients is expected
- engagement focuses on issues where the argument for change is backed by a convincing business case.

SHARING A COMMON AGENDA

FIS developed its consensus approach after commissioning an NOP poll of 1000 pension scheme members that found some traditional ethical investment areas, such as alcohol, concerned only a small minority of respondents. Other issues, such as arms manufacture, produced strong feelings both for and against. Crucially, there were others – such as pollution reduction, alternative energy, human rights and equal opportunities – where around 90 per cent of those polled shared a common agenda. Reo focuses on these concerns.

'Pursuing a tobacco company to stop making cigarettes would not be supported by a large number of scheme members, and is not likely to be successful', says Mackenzie. 'But we might, for instance, look at getting a tobacco company to change its marketing strategy in the developing world. We have to be clear that engagement doesn't solve all moral problems.'

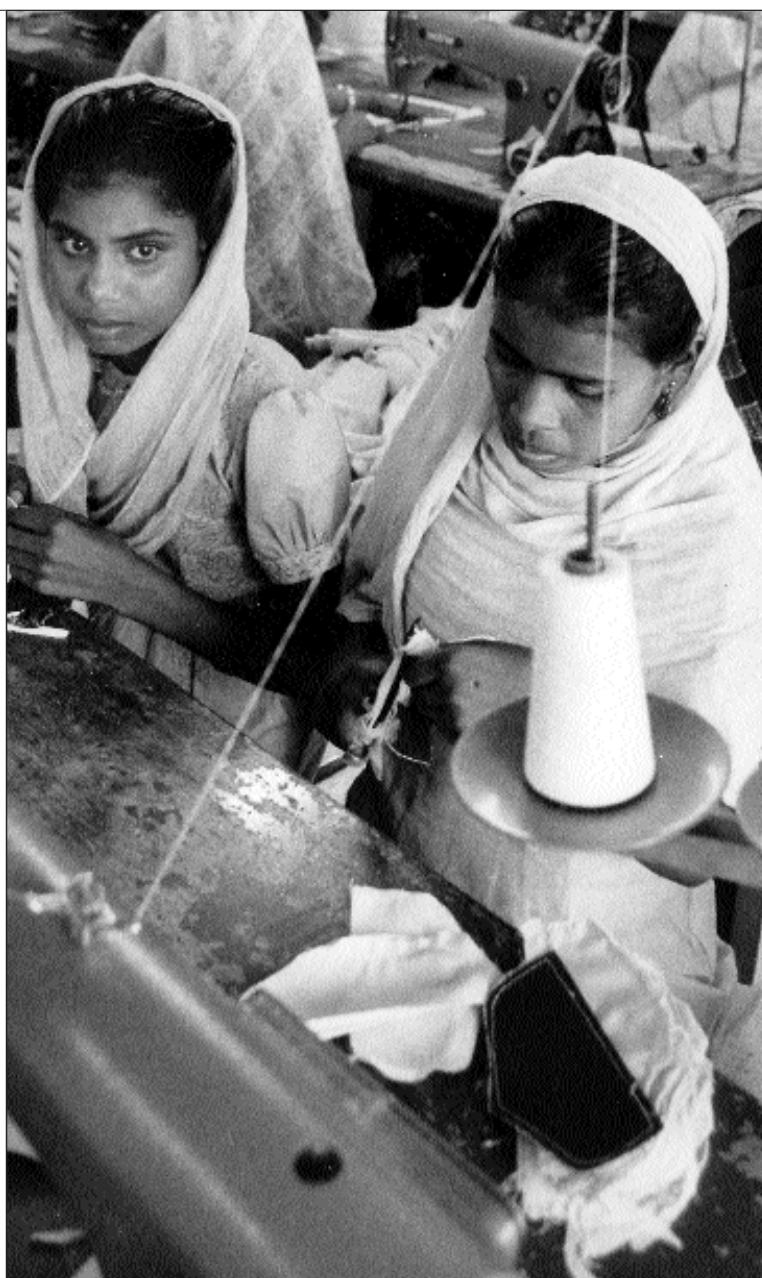
If boardroom engagement produces no results, then voting at annual general meetings is FIS's 'action of last resort'. For Reo clients, FIS will not pull out of an investment solely on ethical grounds, but will send to fund managers information on a company's policies on issues such as child labour. They may then, on purely financial grounds, reduce investment in 'laggard' companies to lessen risk.

Reo has helped FIS to win new business from institutional investors, including PPGM, the second largest pension fund in Holland. In addition, 318 of FIS's 320 existing institutional clients have adopted it.

FIS hopes that Reo, or variations of it, will become commonplace in the institutional investment community. 'We want to work with other mainstream investors to put CSR at the top of the board agenda, and to hold company directors to account for their ethical and environmental performance, just as we do on other corporate governance issues. This is a world away from traditional ethical investment.'

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■ Friends Ivory & Sime believes that engagement on issues such as child labour has a more lasting effect than screening



PANOS

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This case sets out the way a large investment house responds to its clients' requirements for investments in socially responsible companies. Instead of excluding companies because of a dubious reputation, product or practice, FIS 'engages' with them. Meetings with senior executives raise awareness of mainstream issues involving corporate social responsibility such as pollution, human rights and equal opportunities. Positive changes have resulted.

Features that impress about this model include:

- The likelihood that companies will listen and, where necessary, change their practices. This helps to improve governance of corporate social responsibility.
- Engaging on issues where consensus is possible, thus avoiding vociferous single issue disputes
- Working with others where possible to achieve a coherent approach by, for example, forming alliances with 'constructive stakeholders'
- Insisting on transparency with clients.

Constructive engagement is more productive than confrontation. This approach can generate a positive relationship between shareholders and the company.

SIMON WEBLEY, INSTITUTE OF BUSINESS ETHICS