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# ETHICAL INVESTMENT

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**QUILTER CHEVIOT**  
INVESTMENT MANAGEMENT

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**This guide outlines our approach to ethical investment.**

**Ethical investment is when we implement a client's specific ethical concerns within their investment portfolio.**

**We use an external screening system to implement ethical policies for our clients.**

**In this guide we cover:**

- Jargon
- What we do at Quilter Cheviot
- What is ethical investment?
- Understanding the context and implications
- Implications for your portfolio and performance
- The screening process



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## JARGON

The investment industry has developed a number of different phrases associated with this topic. For the purposes of this document we are using the following definitions:

### **Ethical/Faith based investment - negative screening**

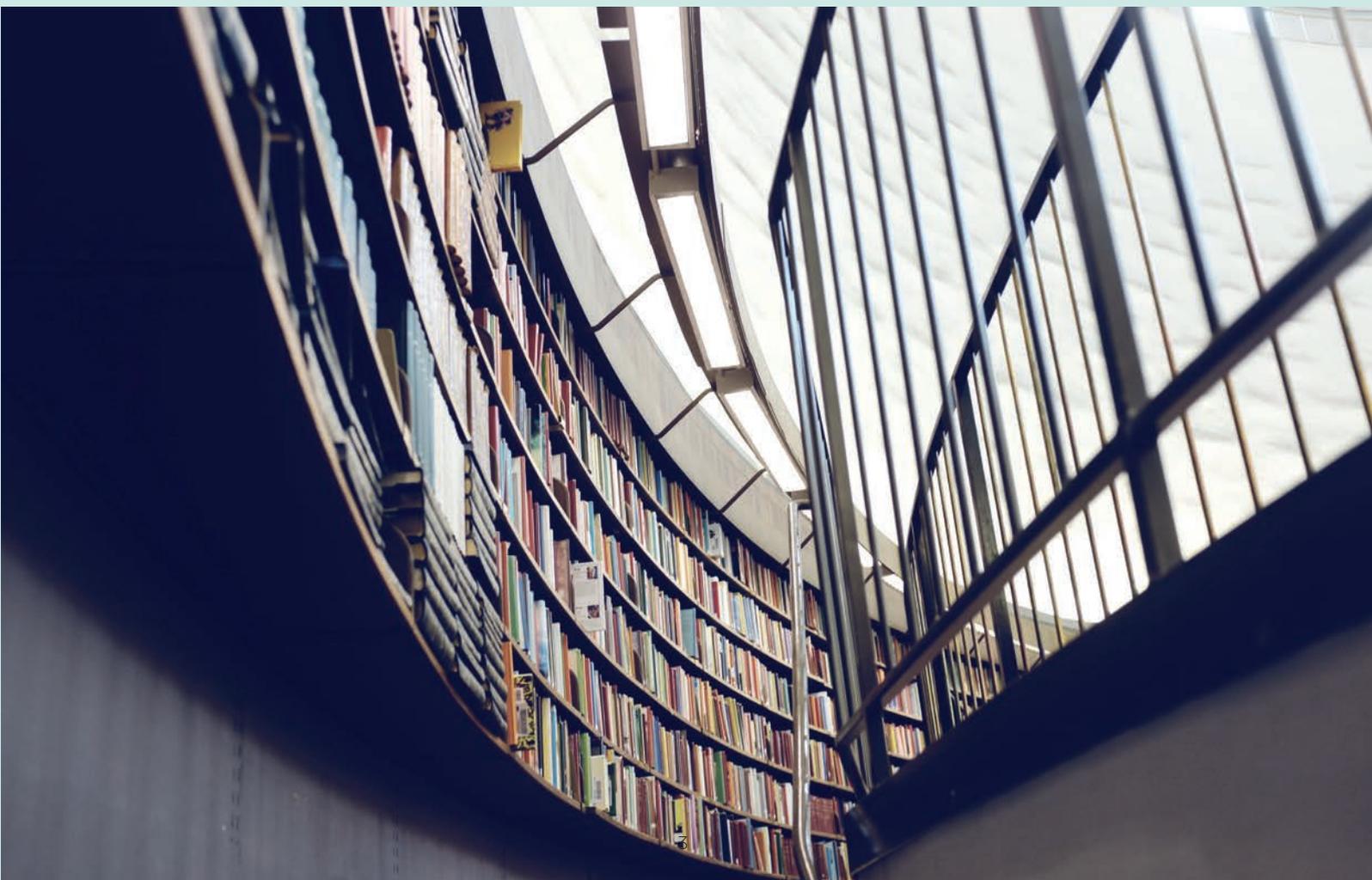
- Investment universe constrained by certain ethical criteria

### **Responsible investment - ESG (Environmental, social and governance) analysis**

- Calls for the integration of environmental, social and corporate governance (ESG) considerations into investment management processes and ownership practices
- Not about reducing investment universe
- Simply about pricing ESG risk and demonstrating responsible ownership practices

### **Sustainable investment - thematic investment**

- Seeks to invest in the companies providing the solutions to deliver a cleaner and more efficient economy. Delivering more with less: serving a rapidly growing population with fewer resources and under a carbon constrained environment



## WHAT WE DO AT QUILTER CHEVIOT

### *Ethical investment: based on client requirements*

Created on a client by client basis and informed by their specific ethical policies

### *Responsible investment: for all our discretionary clients*

We vote and engage with companies on environmental, social and governance matters

### *Sustainable investment: Climate Assets Fund and strategy*

Five key themes: low carbon energy, food, health, resources and water

Charities have legal guidelines they should consider when formulating an ethical policy and therefore we have produced a guide to help with this process.

[https://www.quiltercheviot.com/wp-content/uploads/2017/04/OS006316\\_QC\\_Knowledge\\_Guide\\_Ethical\\_Policy412pp.pdf](https://www.quiltercheviot.com/wp-content/uploads/2017/04/OS006316_QC_Knowledge_Guide_Ethical_Policy412pp.pdf)





## WHAT IS ETHICAL INVESTMENT?

### Ethics are personal

- **There is no such thing as an ethical portfolio that will suit every ethical investor**
- **Portfolios or unitised funds will be constructed to reflect a specific set of ethical concerns**

There are  
5 traditional  
sin sectors:

tobacco, arms, gambling, alcohol  
and pornography.



These are the five sectors which tend to receive the most attention when ethical policies are being discussed. However these areas may not align with every client's objects and concerns.

Ethics are very personal and therefore we do not have a one size fits all approach; instead we work with you to determine the right policy to meet your criteria. Our screening system covers the following areas:

- **Alcohol**
- **Animal testing and treatment of animals (food and non-food including fur)**
- **Armaments**
- **Consumer credit**
- **Environment**
- **Fossil fuels**
- **Gambling**
- **Genetics**
- **Human rights - direct and indirect (supply chain) impacts**
- **Nuclear power and weapons**
- **Product responsibility - infant nutrition, pharmaceuticals, privacy & surveillance**
- **Sanctity of life**
- **Pornography**
- **Tobacco**





## UNDERSTANDING THE CONTEXT AND IMPLICATIONS

Your investment manager will discuss your ethical concerns and help you formulate the ethical policy that meets your requirements. We have two ways in which we approach this:

- 1 **Common ethical concerns are covered in our ethical restrictions supplement**
- 2 **If you have more complex concerns then we will use a more detailed questionnaire in order to map the appropriate policy**

We mentioned the classic sin stocks of tobacco, alcohol, armaments, gambling and pornography previously. However even with these, there are different ways to screen these activities.

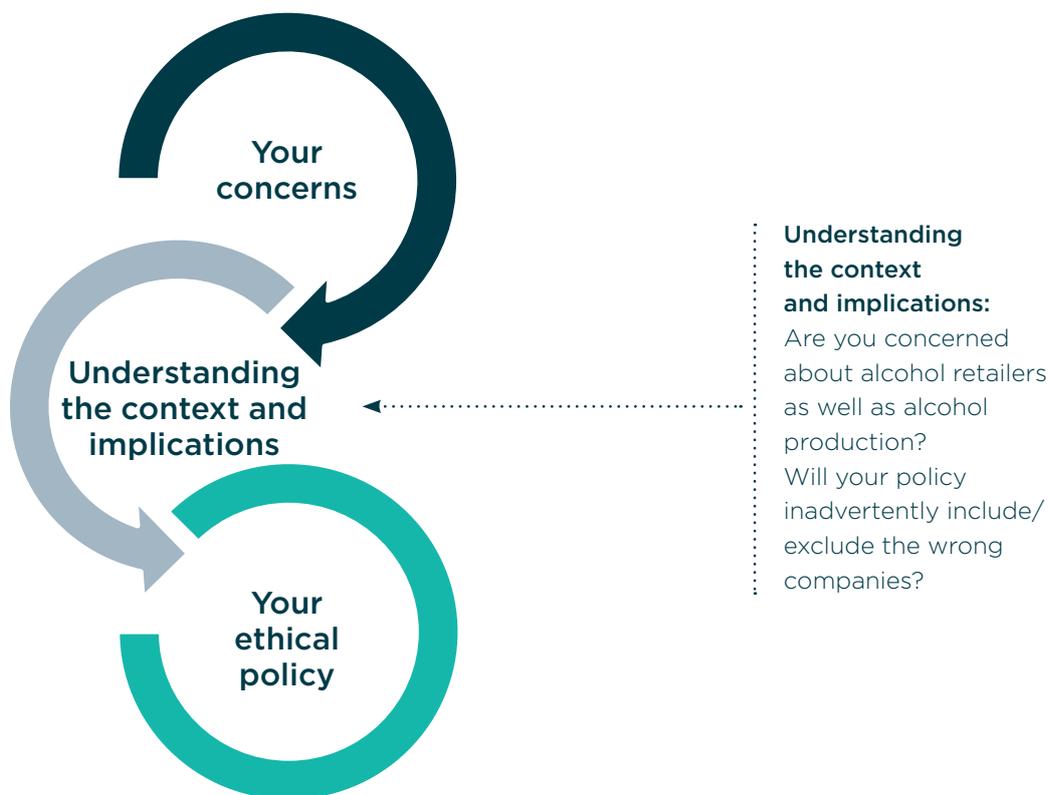
- **Production versus retail** – if you decide to exclude tobacco and alcohol from your portfolio, we would usually recommend that you exclude the producers rather than the retailers of these products. The rationale is that if we incorporated companies that sold these products we would capture a plethora of companies across a number of different sectors; for example: oil companies would be excluded as they operate petrol stations which sell tobacco and alcohol products, as well as of course, supermarkets. From the retailing aspect we would instead look to include companies, such as pubs, which derive a significant proportion of their revenue from the sale of alcohol - see materiality below.
- **Retail of guns** – calibrating the armaments' policy is important, for example some well-known retailers in the US, sell guns. The intention of the armaments' policy may well be aimed more at military use so it is important to calibrate the appropriate level of screening.
- **Pornography** – there are very few companies that are picked up in a screen of producers of pornography; however mobile providers may be captured in a distribution screen.

### Materiality

It is important to evaluate the materiality of the exposure a company might have to an excluded activity. As part of the screening process we are able to quantify this.

As shown in the above example of production versus retail, understanding the extent of the exposure a company might have to an activity is an important part of the process.





A client may wish to exclude exposure to fur; this is defined as excluding companies which are involved in:

- Breeding and rearing of animals for their fur or skin
- Trapping and other means of taking animals from the wild
- Retailing of fur or exotic skin products that have been farmed specially for that purpose (non-food)

This has the potentially unintended consequence of excluding companies such as Amazon and eBay. In the case of Amazon, it is captured within this exclusion as it facilitates the sale via its intermediary role between sellers and customers. The sale of fur from endangered or threatened species is not permitted.

It may be that you wish to exclude these secondary markets; however it may be that the focus was more on primary sellers of fur. Therefore being able to understand the reason why a company is excluded under your policy is a very useful tool.



### TIP – what are you excluding?

The more complex an ethical policy becomes, the more important it is to understand why certain companies are excluded so that the board remains informed of the implications of the policy.

In order to help our clients understand why certain companies are being excluded we are able to provide you with a report including the rationale for exclusions.





## IMPLICATIONS FOR YOUR PORTFOLIO AND PERFORMANCE

Portfolio construction will be impacted by a complex ethical policy or even one which focuses on only a few specific sectors or industries.

**FOR EXAMPLE: If the policy excludes more than 20% of the investment universe it is likely that the portfolio's performance will deviate (at times) significantly from the comparable (non-constrained) benchmark.**

### Benchmark

The FTSE4Good indices are sometimes recommended as useful comparators for ethical portfolios. However these rarely match a client's specific ethical concerns and therefore should be approached with some caution.

In order to be included in the FTSE4Good index, companies are assessed on environmental, social and governance (ESG) criteria.

The FTSE4Good indices exclude the following areas:

- Tobacco
- Weapons systems
- Components for controversial weapons
- Coal
- Companies that generate nuclear power and those that manufacture infant formula must meet a higher threshold on ESG scores in order to be included in the index.

Given the potential mismatch between a client's ethical policy and that of the FTSE4Good we use the FTSE Private Investors indices, the ARC (Asset Risk Consultants) peer group indices for private clients and charities, as well as composites of market indices as performance comparators.

However it should be noted that these are not adjusted for any ethical exclusions and therefore at certain points in time, depending on your ethical policy, there may be significant differential between the benchmark or peer group return, and the portfolio's return.

### Performance

The issue of whether the investment performance of ethical mandates is worse than 'unethical' portfolios is complex. It will depend on a number of different factors including:

- What is the ethical policy?
- How much of the investment universe does the policy rule out?
- Does the policy result in there being a concentration on specific sectors and zero weighting in others?
- What replaces the excluded companies? It is not just about what you don't invest in, but also what you do

In order to assess clearly the impact of an ethical policy on performance then we would recommend considering the following:

- Over a period of time i.e. three or five years – market cyclicity will mean that at different times the ethical policy may help or hinder performance depending on what the policy excludes
- The 'ethical' portfolio should be compared to a similar portfolio managed by the same investment manager which does not have an ethical policy. It is then much easier to determine whether it is the ethics or not impacting performance (negatively or positively).





## RISK

**Depending on the extent and remit of the ethical policy you may inadvertently change your risk profile. This will depend on a number of factors:**

- How much of the market are you excluding?
- How much of the investment manager's core investment universe is impacted?
- Is there a particular bias within the policy to specific sectors? For example excluding tobacco, alcohol and animal testing for cosmetic purposes leads to a significant proportion of the consumer sector being excluded
- Is the activity you wish to exclude a significant part of the index? For example the UK market has a significant weighing in oil & gas; most investors who have concerns about fossil fuels tend to exclude those which are engaged in specific activities such as tar sands or thermal coal rather than excluding the entire sector

We work with our clients in understanding the potential impact an ethical policy might have on risk adjusted returns.





## THE SCREENING PROCESS

**We use Ethical Screening, an external research firm which was established in 1998 to provide research and analysis identifying corporate activities which may concern an investor who wishes to set an ethical policy. Ethical Screening gathers the information from a range of sources to build a picture of the company and its activities, additionally it engages directly with companies.**

At the same time we utilise the knowledge of our investment managers and analysts to understand the ethical issues that specific companies may present for investors.

When we have defined your policy, we link this to our dealing system in order to ensure that the portfolio is managed in line with your ethical concerns.

We are able to screen direct holdings such as bonds and equities; we are able to screen a small number of funds as well i.e. those within the ethical or environmental space.

When we use funds we discuss with the client the most appropriate approach to take. In some cases it is felt that given the size of the holding this is not a material issue, in others we will agree to invest in funds where the significant holdings are acceptable under the ethical screen.



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## CONCLUSION

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Ethical decisions are client-led and we work with each client to implement their policy to ensure that it meets their specific concerns.



The value of investments, and the income from them, can go down as well as up and past performance is no guarantee of future returns. Investors may not receive back the amount originally invested. Investments and investment services referred to may not be suitable for all recipients.

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