

Leave room on the shelf for ethical funds

74% of Canadians expect advisors to recommend SRIs

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If advisors take AIM Trimark's suggestion to tighten their shelf to just five mutual fund families and 15 funds seriously, that would make it tougher on smaller, niche fund companies.

One such niche is "ethical" or "socially responsible" investing (SRI), although the new buzzword is "sustainability." This is defined as "development that meets the needs of the present without compromising the ability of future generations to meet their needs."

That definition, drawn from a report called Our Common Future, is the foundation for the sustainable investing program used at The Ethical Funds Company.

It began as the Ethical Growth Fund in 1986, created by the Vancouver City Savings Credit Union. The full family of funds was founded in 1992 by a co-operative movement of seven Canadian credit unions.

The funds, which all use external advisors, now have \$2.2-billion under management.

That gives the company 46% of the Canadian SRI market if you include the \$2-billion Investors Summa Fund, a one-off SRI fund in a fund family that otherwise runs "unconstrained" funds.

Robert Walker, vice-president of sustainability for Ethical Funds, clearly doesn't view Summa as occupying the same high ground. "They don't do any shareholder action we're aware of. Though it may be behind the scenes, it's not readily apparent to us. For us, it's a core business."




Walker was previously executive director of the Social Investment Organization. At Ethical Funds, he spearheads proxy voting guidelines. This year alone, the funds have "engaged" such firms as Alcan, Bombardier, CIBC, Encana, Petro Canada, Power Corp., Teck Cominco and Telus "to make these



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Robert Walker spearheads Ethical Funds efforts to make "good companies become even better corporate citizens," through proxy voting.

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good companies even better corporate citizens."

During the 2006 annual general meeting season, it voted 353 proxies and voted on almost 4,000 agenda items. It takes credit for encouraging Suncor Energy Inc. to reduce greenhouse gases, and for Tesco PLC to launch the "Fairtrade" brand of food products.

Individual investors wishing to encourage sustainable investing would buy the funds through advisors. Some 2,500 advisors sell Ethical Funds through the credit unions, and 5,900 more independent advisors sell them. The company is making a determined effort to "get on the shelf" of the independents, and began to use wholesalers two years ago. Naturally, it pays the same trailer fees regular funds pay.

Traditionally, SRI was defined by what it avoided investing in. Typically, such funds use "screens" to eliminate investments in tobacco, guns or nuclear weapons, and in some cases alcohol or gaming stocks.

However, after a major rethink -- the firm had a two-day retreat in British Columbia last fall -- Ethical Funds wishes to be defined by what it invests in, not in what it avoids. It looks for companies with "progressive policies in place regarding employee and community relations," human rights and environmentally responsible practices. Its core values are respect for the environment, stakeholders and human rights.

Its marketing materials describe seven myths about SRI. Financial advisors should note the second myth that "SRI doesn't appeal to my clients and prospects." To the contrary, 84% of Canadian investors say the financial community should be more aware of social and environmental issues, and 74% of them expect advisors to incorporate this trend into their investment recommendations.

Other myths: That SRI is just a fad, that the funds underperform, that due diligence creates higher Management Expense Ratios. No, no and no, according to Ethical Funds. Assets in U.S. SRI funds have risen fifteenfold during the past decade, 75% of Ethical Funds have MERs at or below the category median and the Ethical Special Equity Fund and Canadian Dividend Fund are award-winning products.

So what do the fund analysts who influence advisor recommendations say about SRI?

Two such funds are on the recommended list of Dan Hallett, a Windsor, Ont.-based fund analyst.

One is Ethical Special Equity, a small-cap Canadian equity fund that is essentially the SRI version of Clarington Small Cap. "It has the same mandate and the portfolios are virtually identical," Hallett says.

The other SRI fund on his list is Meritas International Equity Fund, sub-advised by Thornburg Investment Management of Santa Fe, N.M. Meritas is run by a Mennonite community in Cambridge, Ont. (see www.meritas.ca)

Dave Paterson, president of Toronto-based Paterson & Associates, says there is "or at least should be room for ethical-type funds on an advisor's shelf."

There are always going to be some investors who are keen to use such funds, Paterson says, though he personally prefers "unconstrained" funds. (That sounds so much more palatable than "unethical" funds, doesn't it?).

"Managers have a tough enough job trying to achieve decent returns -- running traditional mandates and adding an extra screen to that only adds another hurdle for them to deal with."

Paterson finds the eight Ethical Funds he follows to be "a mixed bag." Like Hallett, he recommends the Ethical Special Equity Fund but also likes Ethical Canadian Dividend Fund. "Both funds have posted above-average returns with levels of volatility that are less than the applicable benchmarks." A new manager was appointed to the latter in June, 2006, so Paterson is taking a wait-and-see stance.

Based on his screens, Paterson says "the two Ethical funds and two Acuity funds are the only SRI type funds that look to provide decent risk adjusted returns. The rest of them appear to be underperforming, some dramatically."

Ethical Funds is also an early adopter of "lifestyle funds" that gradually reduce equity exposure and raise fixed income as a particular trigger point arrives: typically, retirement or when a child needs the funds to attend post-secondary education.

Another interesting fund is the Ethical Canadian Index Fund. This has a MER of 1%, which isn't bad considering it has to do the same as most actively managed funds and pay advisors trailer fees. It has below-average exposure to energy stocks and income trusts than the pure S&P/TSX.

Of the 278 companies on the Toronto Stock Exchange that the firm screens, 45 of them (16%) were excluded. Walker concedes the loss of some energy stocks did cause the fund to lag the index by 1%.

These days, advisors need a way to differentiate themselves from their competitors. Some specialize in serving only athletes or people in a certain ethnic group.

It seems evident that advisors choosing to cater to the SRI niche would ultimately thrive. They would certainly feel better about what they do and no doubt would end up connecting with a fine bunch of well-connected clients.

Seems like a win-win situation to me.

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