• Issue 40 / May 2018 •

FE Trustnet

magazine

The **only way** is ethics

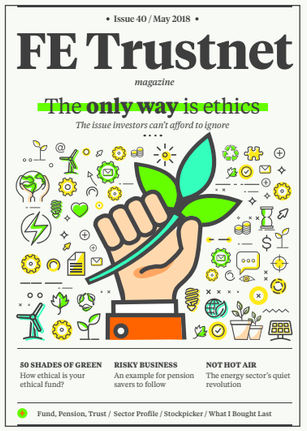
The issue investors can't afford to ignore

50 SHADES OF GREEN
How ethical is your ethical fund?

RISKY BUSINESS
An example for pension savers to follow

NOT HOT AIR
The energy sector's quiet revolution

Fund, Pension, Trust / Sector Profile / Stockpicker / What I Bought Last



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CREDITS

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FE BE BETTER INFORMED

Editor's letter

The notion that investing ethically comes at the expense of financial returns was almost taken for granted when I began my career in financial journalism almost eight years ago. One financial adviser even said that if someone wanted to make a positive impact on the world, they would be better off investing in a mainstream fund and giving away any excess returns to charity, rather than committing their money to an ethical vehicle which would be lucky to break even.

However, with a body of evidence suggesting the opposite to be true, a growing number of fund managers – many without any sort of ethical mandate – are incorporating a focus on ESG factors into their stock-screening process. In this month's cover story, I discover how this can make you money. Elsewhere on this subject, Pádraig Floyd finds out where fund managers are unearthing opportunities in cleantech, Holly Black reveals why your fund manager's idea of ethical investing may not match your own, and Adam Lewis investigates why the sector's market share hasn't budged in a decade.

Our regular columns see the return of reader favourite John Blowers as he explains why pension savers in the UK could learn a thing or two from their US counterparts. Finally, BMO's Kelly Prior reveals why she has bought Legg Mason Western Asset Structured Opportunities and Hermes' Martin Todd names three UK mid-cap stocks that are casting their eye towards the US.

Enjoy reading,

Anthony Luzio
Editor

Contents

Anthony Luzio finds out why a focus on ESG practices is no longer the preserve of ethical funds

The only way is ethics

By far the largest deterrent to investing in funds that prioritise a focus on ESG – environmental, social and governance – issues is the belief that the warm glow that comes with acting in a principled manner comes at the expense of higher returns. In March 2017, then chief executive of WPP Sir Martin Sorrell made headlines when he said: "Corporate structures that seem to offend customary good corporate governance may deliver better long-term results." And while his statement drew criticism from the press, there was a nagging feeling that he was just saying what many people felt was true but were too scared to say out loud.

Yet the numbers tell a different story. Data from FE Analytics shows the FTSE4Good UK, Europe and US indices have beaten their mainstream counterparts over the past decade, with Japan the only major developed market where the opposite is true.

Meanwhile a report from Bank of America Merrill Lynch, published in 2016, indicated that investors who held stocks with above-average ESG scores would have avoided 90 per cent of bankruptcies that took place in the US after 2008.

With figures like these, it is unsurprising then that a growing number of fund managers are beginning to incorporate ESG scores into their quant screens – and not just those with a socially responsible mandate.

> "It's not about finding the best companies, it's about avoiding the worst companies"

The Merchants Trust is unlikely to be many people's idea of an "ethical" fund, holding defence firm BAE Systems and oil majors BP and Shell in its top-10. However, it has a team that weighs up the ESG score on every potential holding, taking external measures as a starting point before verifying these internally.

"ESG factors are important along with a lot of other factors such as competitive position and structural growth within the industry," says manager Simon Gergel. "Why? Because they are risk factors that can affect businesses both in a positive and a negative way."

But how exactly does a focus on ESG factors make you money?

For Geir Lode and Louise Dudley, managers of Hermes Global Equity, a company's ESG scores are among the first metrics they look at when searching for potential investments.

"It's not about finding the best companies, it's about avoiding the worst companies," says Lode. That's really important to us."

"If you divide governance scores into deciles, the companies in the lowest

Just as important as avoiding companies with low governance scores is looking closely at those that are working hard to improve in this area

...

decile have underperformed over the past six or seven years. So if you want to invest in that type of company, you have to be pretty sure about the other types of financial characteristics."

Just as important as avoiding companies with low governance scores is looking closely at those that are working hard to improve in this area.

Lode says this is because investors tend to put a risk premium on a company with poor governance levels, for example.

"In financial theory, people talk about a high discount rate for higher risk, so we identify companies that are trying to change. You get rewarded when investors re-evaluate these companies with a lower discount risk."

Social work

While the benefits of focusing on good governance are not difficult to grasp – the quality of a company's management team, how it is remunerated and the degree

LIES AND STATISTICS

Gergel says investors should not consider ESG scores as the be-all and end-all and in some cases they can be misleading.

For example, the manager recently held a meeting with Shell about its involvement with onshore operations in Nigeria, for which it has been criticised due to widespread instances of oil leakage, theft and corruption.

However, Gergel points out that the local population is keen for Shell to stay put.

"Shell is probably the most reputable operator of onshore assets in Nigeria and people are worried that if the company pulls out, which would be the easy option, there would be more corruption and less of a focus on standards," the manager says.

"So whereas Shell's ESG score might go up if it pulls out, it would be likely to have a detrimental effect on the community."

We are seeing much more in the opportunities side, through consumers who want to be aligned with companies that are sustainable

to which their interests are aligned with shareholders are likely to be a concern of even the most cold-blooded fund manager in the post-financial crisis world – Dudley says environmental and social issues are just as important.

"From an environmental perspective, we look at the operations of a company such as the carbon footprint as that is most likely a direct business cost – whether it is consuming energy or their waste or water consumption. If they can use those resources more efficiently, that's obviously going to help."

"That's historically what we have seen. Now going forward, we are seeing much more in the opportunities side, through consumers who want to be aligned with companies that are sustainable."

James McAlevey, co-manager of the Aviva Multi Strategy Fixed Income fund, notes investors do not have to look too far to see where this trend is having a visible impact.

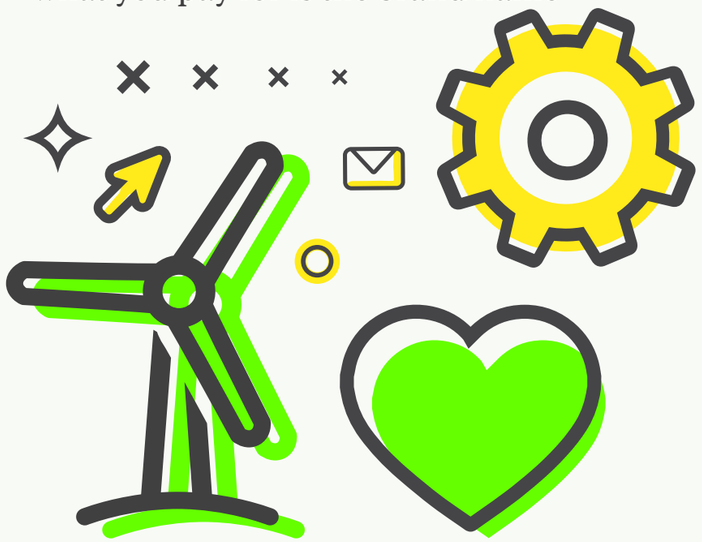
"Two palm oil producers recently came to market that didn't sign up to sustainable investment practices, so we didn't invest in them," he says.

"Most multi-nationals that use palm oil in their products have now signed up to minimum standards on sourcing this commodity and because these companies don't abide by them, they won't be able to sell to the biggest buyers in the market."

Lode says this also helps to explain the benefits of strong social practices, which are becoming even more important with the move towards a services-led economy.

"Everything is about the brand," he explains. "Say Apple sources some of the metal for its phones from a controversial source. With social media, now things like that get out quickly, so you need to be careful."

"If you look at some of the valuations of tech companies, a lot of what you pay for is the brand name – that needs to be protected as it is actually 99 per cent of the value."



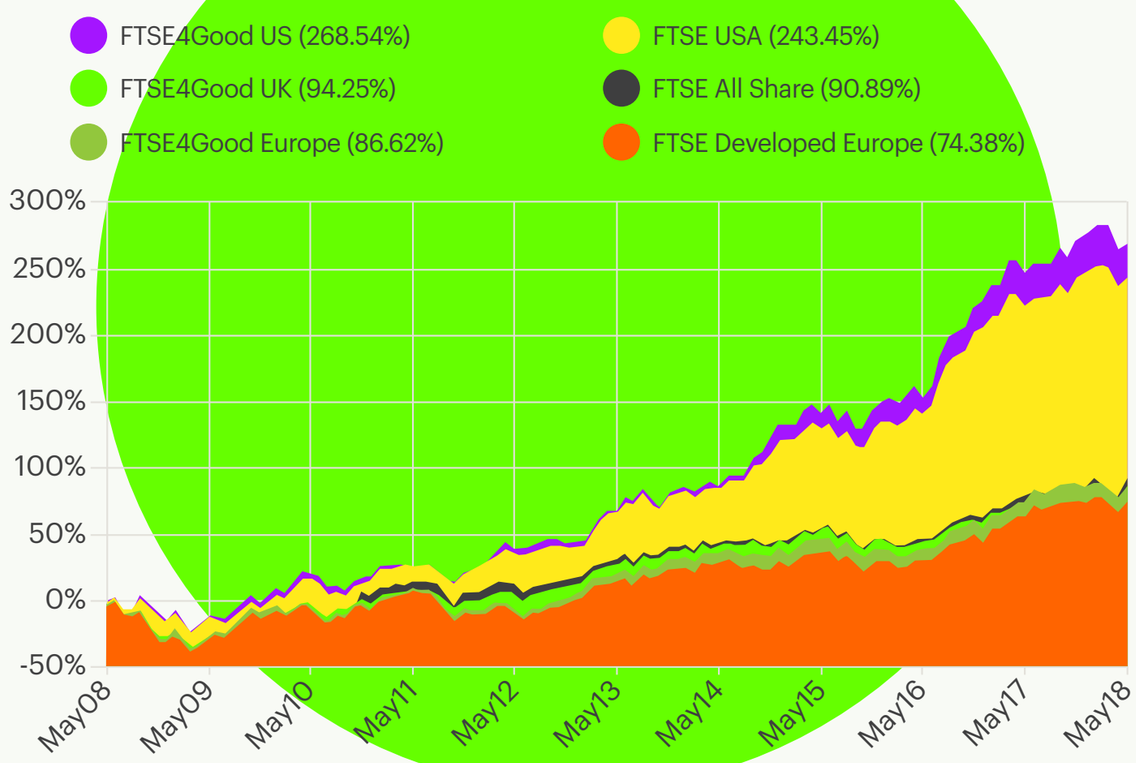
An uncomfortable truth

Amid all the talk of above-average ESG scores correlating with higher returns, there is an elephant in the room: tobacco. It would be safe to assume a product that kills its customers and those around them doesn't score particularly highly in any measure of social responsibility, yet it has been one of the best performing sectors of the past 20 years – data from FE Analytics shows the FTSE 350 Tobacco index has made more than 2,000 per cent over this time, more than 10 times the return of its mainstream counterpart.

However, Gergel points out tobacco is a unique product, with advertising restrictions making it impossible to break the dominant oligopolies.

"You have slight declines in volume every year but prices are up because you've got an addictive product," he explains. "That allows novel ways of cash generation, which are extraordinarily strong, plus you can consolidate within the industry."

PERFORMANCE OF INDICES OVER 10YRS



Source: FE Analytics

"All the car manufacturers are now transitioning to electric cars and in 15 or 20 years, people will say 'I can't believe the air I was breathing'"

There are signs tobacco's best days are behind it, with stringent taxation making it unaffordable and vaping – which has minimal barriers to entry – offering a cheaper, but less profitable, alternative; the FTSE 350 Tobacco index has lost a quarter of its value in the past year. However, the point is that if an industry with rock-bottom ESG scores has outperformed over the long term, what is to stop a repeat of this in the future? For Dudley, the world is now a different place.

"There is a general trend towards health and wellness, and products like tobacco don't fit into that," she says.

Lode points out this can be seen in other industries as well.

"All the car manufacturers are now transitioning to electric cars and in 15 or 20 years, people will say 'I can't believe the air I was breathing'."

"It is like smoking, people used to smoke on planes and in restaurants, but people hated it and now it is not acceptable. It will probably be the same with all the car fumes in London."

Self-fulfilling prophecy

McAlevey believes the trend towards socially responsible investing could become a self-fulfilling prophecy: "With investors demanding greater standards, more money will go into companies with higher ESG scores, pushing up share prices."

There are still sceptics who maintain the belief that a focus on anything ethical will be down to pressure from PR departments rather than any desire from the fund manager.

You may attach more meaning to the words of someone like Sorrell, who doesn't feel the need to toe a particular line. It is worth bearing in mind though that while he turned a small basket maker into one of the planet's biggest advertising firms, he was forced to step down from WPP this year when his behaviour fell short of the company's own ethical standards. This serves as a reminder of one of the most important rules of investing: things always change. •

High valuations mean Bankers Investment Trust's **Alex Crooke** is taking a selective approach when allocating to the US

American excess

We are taking a very selective approach to the US in order to capitalise on a number of macro-level drivers that we think make the US an interesting market

Last year saw global growth accelerate at its fastest pace since the financial crisis as this long-running bull market defied expectations and found another gear. It was a period of synchronised global growth reminiscent of yesteryear – a brief boon for global stock market investors. But with growth inevitably cooling in 2018, the challenge now is to assess where the momentum is strongest and which firms are going to thrive.

With a mandate to invest globally, The Bankers Investment Trust enjoys the privilege of buying stocks without limitations regarding market cap or geography. It is an enviable position, but it also requires a broad depth of expertise across regional markets. My job is to tie together the knowledge of seven stock pickers, each with deep regional expertise, and guide the overall weighting and direction of the portfolio. Right now, we think the US economy is on a strong footing to outperform other markets in the short- to medium-term, but we think valuations are expensive.

Given these expensive valuations, we are underweight US (27%) relative to our benchmark (51%) – the FTSE All-World Index. The Trust might be underweight US, but North America still makes up the largest geographical exposure in the portfolio, followed closely by the UK (25.4%). Therefore, we are taking a very selective approach to the US in order to capitalise on a number of macro-level drivers that we think make the US an interesting market.

Glossary

Bull market: A financial market in which the prices of securities are rising, especially over a long time. The opposite of a bear market.

Underweight: To hold a lower weighting of an individual security, asset class, sector, or geographical region than a portfolio's benchmark.

Secular trends: An economy or market trend associated with some characteristic or phenomenon that is not cyclical or seasonal but exists over a relatively long period.

Emerging market proxies: Securities that derive performance from emerging markets.

US tailwinds

Perhaps the most eye-catching event for global investors was the approval of President Donald Trump's tax reforms towards the end of 2017, which was the first major legislative triumph for the outspoken president. It was also the country's biggest tax system overhaul in 30 years. We expect his corporate tax reductions to spur on wage growth and fuel a pick-up in consumer spending during the next 12 months.

Talk of a trade war with China might spook some investors, but I'm on the fence. I don't think a trade war between the world's two largest economies benefits either country and looks more like a push to force the Chinese to open their economy. Whether or not a 'trade war' does develop, there are some things that we are confident will keep the US on track, such as the strong domestic economy and a clear pickup in capital expenditure. This growth may be dampened by further US interest rate rises but I expect the Fed to stay behind the curve by limiting the number of interest rate rises this year.

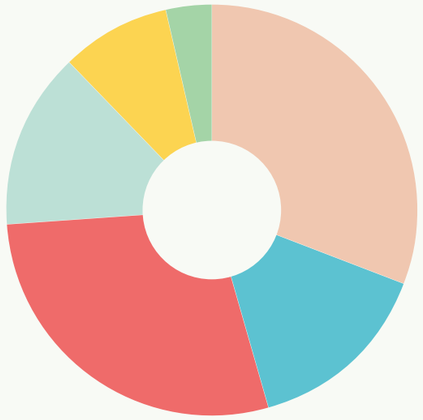
Another positive for the US is the recent revival of the dollar. Since the lows of 2012, the trade-weighted dollar (against a basket of currencies) has appreciated by almost 40%, albeit in 2017 it weakened against most currencies. There are longer-term concerns about the country's national deficit rising, but it's not something to worry too much about now and as growth picks up around the world the deficit could naturally decline.

There are some things that we are confident will keep the US on track, such as the strong domestic economy and a clear pickup in capital expenditure

THE BANKERS INVESTMENT TRUST PLC

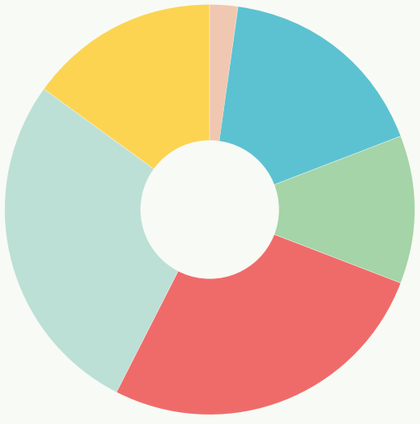
Positioning as at 31 October 2017

By revenue generated



- Asia Pacific ex Japan **3.5%**
- Japan **8.7%**
- North America **28.1%**
- Emerging Markets **30.9%**
- United Kingdom **13.9%**
- Europe **14.9%**

By listing location



- Asia Pacific ex Japan **16.9%**
- Japan **11.6%**
- North America **27.7%**
- Emerging Markets **2.4%**
- United Kingdom **26.6%**
- Europe **14.8%**

Reweighted to exclude cash. Totals may not equal 100 due to rounding

A hold forever approach

Broadly speaking, the valuation of the US stock market appears elevated on most measures relative to its history. Our North American team remain very conscious of this and continue to abide by a strict valuation discipline. Although they operate with a "hold forever" mind-set, meaning each company is bought with a view to owning into perpetuity, each holding must demonstrate sufficient upside over the next five years to earn a place in the North American portfolio. The aim is to create a portfolio of undervalued companies which enjoy a sustainable competitive advantage and operate in structurally growing end markets.

The majority of the portfolio is tied to the following five long-term secular trends, which the team believe to be underappreciated by the wider market; the transformational effect of the internet, healthcare innovation, paperless payments, energy efficiency and emerging market growth.

Take healthcare innovation, which is important given America's ageing demographic – the country's population aged 65-and-over reached 50 million for the first time in 2016 and is expected to continue growing as the 'baby boomers' reach retirement. Considering this, we look for companies that aim to provide solutions to the challenges brought on by an ageing population. For example, California-based contact lens manufacturer The Cooper Companies is a stock we like because one of its revenue drivers stems from the growth in multifocal lenses, which are widely amenable to an ageing population.

Given the relative expensiveness of US equities, we have sold more than we have bought in recent months. The additions we have made to the portfolio come from a diverse

I like to invest in companies listed in developed markets because they typically have higher quality accounting, audits, governance and lower leverage on the balance sheet

• • •

range of sectors but importantly all share a common feature: a sustainable competitive advantage, which allows for reinvestment at a high rate of return. Some of our recent additions include luxury cosmetics manufacturer Estee Lauder, computer gaming company Electronic Arts, freight hauling railroad Union Pacific and software giant Microsoft, which is a rarity in the tech sector for its 2% dividend.

Emerging market proxies

Our North American exposure is well diversified across sectors with technology (c. 24%) and financials (c. 21%) afforded the largest allocations. That said, the financials exposure is potentially misleading as most of us think of banks and insurers when we say financials, but much of our exposure to the financial sector consists of electronic payment institutions like MasterCard and American Express, and conglomerates like Warren Buffett's Berkshire Hathaway, for example. These companies are positively involved in the long-term socioeconomic trends, particularly the transition to paperless payments.

The trends we refer to are not specific to the US or North America, but the region is typically at the forefront of innovation – perhaps only rivalled now by Asia's growing technology sector. One of the key trends that guide our stock selection is emerging market growth. This is most easily demonstrated in the chart on page 12, which shows that although North American stocks account for the largest geographical weighting (27.7%), the companies in the portfolio generate most of their revenues from emerging markets (30.9%).

The Bankers portfolio will continue to look globally for quality companies with strong drivers in place for future earnings growth

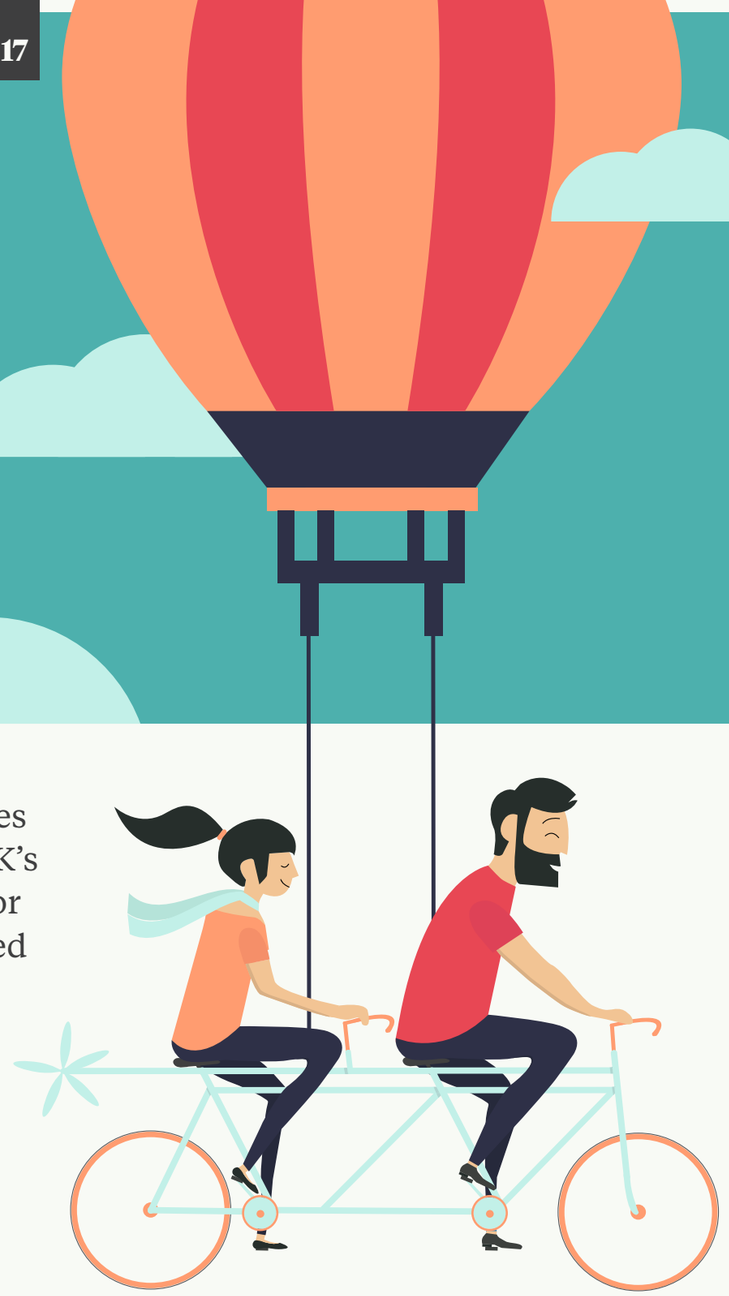
We could invest directly in to emerging markets – and we do, albeit with only 2.4% of the portfolio – but I like to invest in companies listed in developed markets because they typically have higher quality accounting, audits, governance and lower leverage on the balance sheet. We look for firms in developed markets that have strong business operations in emerging markets, where consumer spending is expanding at a rate only possible with a growing middle class.

The Bankers portfolio will continue to look globally for quality companies with strong drivers in place for future earnings growth but will continue to maintain a strict discipline in terms of the share prices we are willing to pay. •

Recent advances mean renewable energy is beginning to challenge fossil fuels in terms of price as well as environmental impact. **Pádraig Floyd** examines the funds riding the cleantech wave

Not hot air

Renewable energy accounted for a quarter of the electricity produced by the UK last year, enough to meet its entire requirement from 1958



The Paris Climate Accord, agreed at the end of 2015, demonstrated an unprecedented level of intent on the part of (most) G20 nations to grapple with environmental issues.

Climate change and social projects such as sex and gender equality have raised the profile of sustainable investing and demand has grown considerably.

In fact, for renewables, it has never been higher, though the UK figures disguise this. Data from Bloomberg New Energy Finance (BNEF) shows that UK investment in wind, solar and other renewables has fallen by 56 per cent over the past two years to £7.5bn, while worldwide spending increased by 3 per cent to £242bn, just short of its peak.

A growing global and increasingly urbanised population is driving demand, but cleantech and renewable energy is attracting a great deal of attention as it becomes an important component in the UK's energy production. It accounted for a quarter of the electricity produced by the nation last year, enough to meet its entire requirement from 1958, largely from offshore wind turbines.

Earth, wind and fire

Yet there is more to cleantech and renewable energy than wind and solar farms and this is reflected in the holdings of all but the most specialist renewable funds.

Jon Forster, senior portfolio manager at Impax Environmental Markets, has less than 10 per cent of his portfolio in renewables with half of that in utilities which build and run the infrastructure. He is cautious on wind, at less than 1 per cent of assets, due to concerns about pricing and margins as Europe introduces auctions for generation capacity.

While there are also concerns about the falling cost of tools such as solar panels and wind turbines, other industry commentators remain upbeat, pointing out the withdrawal of subsides shows the sector is beginning to stand on its own two feet.

"We are getting to the point where renewables will beat production from traditional sources, not through subsidy, but by fundamentally better technology," says Charlie Thomas, manager of the Jupiter Ecology fund.

Making the most of it

Nevertheless, all investment managers agree that finding good projects is hard in the renewable energy sector if the focus is simply on electricity production.

"Energy efficiency is the biggest part of the strategy," says Forster, "which includes smart metering, individual energy efficiency, factory automation – in fact anything that requires efficiency, from buildings needing insulation and lighting to components for electric vehicles."

• • •

You can almost guarantee that what is the right technology today will become obsolete in the future

• • •

Thomas has a considerable allocation to technology as it controls everything – from the level of superconductors (silicon chips) used in increasing numbers of household items as the internet of things expands, to power delivery in electric vehicles, or much bigger systems, such as smart grids.

"These smart grids will manage the peak power on the grid and could for instance switch off a supermarket's fridges for half an hour at peak times," he adds.

Janus Henderson's head of SRI Hamish Chamberlayne is also enthusiastic about software's status as an "enabler" and as a result it is one of his largest allocations.

"When you generate digital information, you need to do something with it in order to harness efficiencies," he says. "That means you need memory, storage and software to make use of it. Our biggest allocation is to Microsoft, because it helps customers achieve sustainability."

The next big thing

Chamberlayne says the "next big thing" in this sector will be energy storage, for when the sun doesn't shine or the wind doesn't blow. Battery technology is improving and although currently expensive, is likely to become cheaper in the future and offer secondary and tertiary lives as storage.

FUND CHOICES

Simon Holman, a partner in the investment team at Castlefield and manager of one of its sustainable funds, is agnostic about the type of fund used to access investments in this area.

"We take each one on its own merits. Investment trusts have worked quite well on the infrastructure side and there are thematic funds which work just as well."

He has used a water ETF in the past, but says it is "a blunt tool" for this type of investment as indices only capture markets rather than the best ideas.

Impax's Forster says investors should not look to ETFs or a passive approach in general for investing in this area.

"The market is susceptible to bubbles and you can get a lot of volatility, which makes a good case for active management."

There is also a lot more to cleantech than just energy, covering other utilities such as water, pollution, public transportation, waste and resource recovery, and sustainable food, agriculture and forestry.

Changes in behaviour will also remove some of the drawbacks with batteries. In the case of electric vehicles, drivers will become accustomed to charging vehicles overnight and spend less time waiting for a charge than they do making trips to the petrol station.

However, Thomas says that you can almost guarantee that what is the right technology today will become obsolete in the future. Just as CDs are going the way of the dinosaurs, so today's solar, wind and other technologies will follow.

The bottom line

While the sector is maturing and becoming more standardised, concentration in a fund poses the same risks that it always does and the consensus is active management is paramount.

"Look for broad market exposure, reasonable valuations, good governance and companies that represent critical components in the supply chain," says Forster.

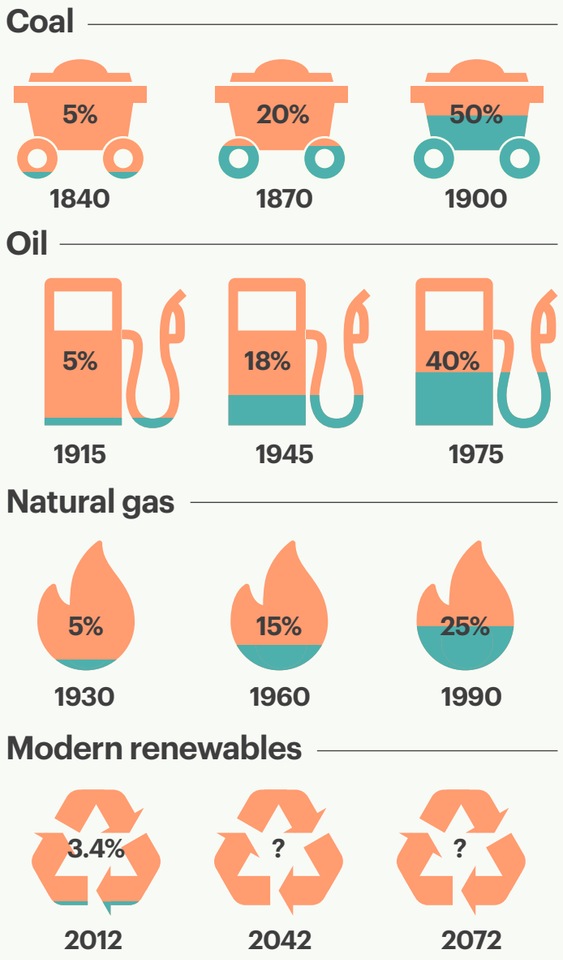
Finally, as always, the success of your investment will come down to how well a company is run and that depends squarely on the quality of the management.

"You can have the greatest green ideas, but you have to bridge from there to a great investment and that needs the right management," says Thomas. •

The "next big thing" will be energy storage, for when the sun doesn't shine or the wind doesn't blow

SHARE OF GLOBAL ENERGY MIX

History shows that the world's adoption of new energy sources unfolds over several decades



Source: mega.online

James Anderson,
joint manager, Scottish Mortgage Investment Trust

The US, the UK and company creation

I'm sitting in the sunshine with a fashionable coffee at the Cool Cafe in Menlo Park Business Park. There are Teslas in the car park and I'm waiting for my Lyft after meeting the extremely impressive new (female) CEO of Grail. Grail may be able to make most cancers curable. So I'm living the clichés but what's the substance? Why doesn't this happen in Britain? Is it chance or more serious?

The best conceptualisation that I've heard of why new companies flourish comes not from the left coast of America but from the right side of China. Robin Li of Baidu opines that three characteristics are required: lots of nerds, serious venture capitalists and markets of scale. Everyone now has nerds and most venture capitalists at least pretend to be global. This leaves us with markets at scale.

For sure China and America offer this but nowhere else does; it's conceivable India will but it's already been colonised by Sino-America before this can be clarified. So perhaps we just need to accept this and move on. QED so to say.

But although this is appealing I don't think it's fundamentally sufficient. Out of modesty I think Robin Li neglects the most critical factor of all: founder and firm motivation. After all as our government endlessly tells us global Britain isn't excluded from international markets and most certainly not from those of American hegemony. Indeed at times we're welcomed as being neutral outsiders with the right language. ARM has benefited hugely from not being a US company. Spotify is beating Apple, Amazon and the music labels without being troubled by its very Swedish values.

So my prevailing belief is that new British companies fail to compete at scale because they deserve to fail not because they are doomed to do so. To put it more bluntly: they are unsuccessful because they (and we) are unambitious - indeed unfit for purpose.

Such a strong view needs considerable justification. That's why I started with Grail. At one remove this could - should - have been a British success story based not in Menlo Park but in Cambridge. As Kevin Davies relates in 'The Thousand Dollar Genome' next generation genomic sequencing was literally invented in a pub in Cambridge. The resultant company was called Solexa. It was eventually bought by Illumina for $600m as a scientific success but total commercial failure. Illumina in turn spun off Grail with the ambition of finding a universal test for cancer via liquid biopsy and generating a substantial value creation for shareholders. Illumina itself is now valued at $37bn.

But there's another avenue to explore before I visit Illumina tomorrow. Roche tried to buy Illumina for $6bn in 2012-13. Illumina has determined leaders but no controlling founders or families. Yet the bid failed. Why? Because three institutional shareholders refused to sell. We were one of the three. Roll this forward to 2016. SoftBank tried to buy ARM - almost certainly Britain's sole serious shot at building a global technology platform. SoftBank succeeded. We were the largest shareholder but we were alone as opposing active managers (L&G index funds were willing to fight too). But there wasn't a quorum. There was a recommendation from Board and management to sell. Mr. Son rejoiced and went on to say that ARM would be as valuable as Alphabet.

The examples roll onwards on both sides of the Ocean. We don't need to speculate as we know what happens. SkyScanner was - is - a great business but, CEO apart, the owners wanted to sell. The only decision was to become Chinese rather than American.

But we also need to refine the US perception. This isn't about America: it's about the profound contrast between the US of Wall St., Washington and Trump and the US of the West and of immigrants. The former is at least as short-term greedy and long-term stupid as are the British mentalities. The latter pairing is totally different. Jeff Bezos driving to Seattle, Mark Zuckerberg deserting Harvard, Steve Jobs returning to Apple are all just as momentous but intrinsically Western epics as cowboy legends. They are also predominately immigrant stories far from the establishment. Why is South African Elon Musk in California? He's clear it's because people like him can dream there, although the general American dream is long over statistically speaking. Britain doesn't understand that outliers matter. Yet another tragedy of Brexit is that London in the age of Trump could have become the natural home of the determined potential genius. That's no longer possible.

So I think there isn't even much need to speculate as to our failings versus the Western fringe of America. We fail at every level - from management softness, to investment feebleness to societal love of the safe return over the spectacular possibilities. I see nothing on the horizon to change this terrible record. It's very sad. •

Ambiguity over what counts as "ethical" means you will need to check whether your fund manager's definition of the word matches your own, writes **Holly Black**

50 shades of green

When ethical funds were first launched in the UK in the 1980s, they typically used negative screening, excluding companies based on various criteria. Businesses involved in tobacco, alcohol, gambling, pornography and arms were usually out of bounds and other areas such as fossil fuels or animal testing were often ruled out too. A fund would be labelled as either light or dark green depending on how strict it was.

Today, investors are often more interested in finding companies that are doing good in the world. Environmental, social and governance (ESG) factors have become more important as well as so-called impact investing, which takes into account a firm's positive or negative effect on the world.

However, this changing landscape means the strategies of ethical funds can vary drastically and investors need to closely monitor each fund's holdings to ensure its definition of ethical is aligned with their own.

Lurking

Independent website Good With Money publishes a bi-annual review of funds rated according to the positive impact they have as well as their financial performance. It says the number of funds with a mandate to do good and avoid harm has increased 10 per cent to 216 over the past six months.

Rebecca O'Connor, co-founder of Good With Money, says: "Within this stable of funds is a wide range of activities, so it is important for investors to check a fund's holdings. It is not unusual, for example, to find oil & gas

"Given we can't operate a global economy without oil & gas, would it be right to exclude those companies on the basis they pollute, or should we engage with the ones trying to do better?"

companies lurking in funds labelled as sustainable."

The strategy of the Standard Life UK Ethical fund has also evolved since it was launched almost 20 years ago, shifting more towards positive screening. Its criteria are determined by an annual survey of its investors who, in recent years, have become more outspoken against fossil fuels and climate change.

Turning point

If the culture of a company starts to change so that it no longer meets the criteria, it is given an opportunity to turn things around and, if it doesn't, is sold – one recent example is retailer Sports Direct. Manager Lesley Duncan says: "We know from our survey that investors want us to sell holdings if the company is not changing."

BEING REALISTIC

The 7IM Sustainable Balance fund excludes the traditional "sin" investment areas such as arms and tobacco, then considers ESG and impact factors to whittle down its investment universe. However, manager Camilla Ritchie says it is important to be pragmatic: "Given that we can't operate a global economy without oil & gas, would it be right to exclude all those companies on the basis that they pollute, or should we be engaging with the ones trying to do things better?"

The fund, which has returned 32.1 per cent over the past five years, doesn't expressly exclude industries such as animal testing or gold either, although they would be unlikely to make it through its screen.

"Ethical investing is moveable and I think we can be absolutely sure this is not the end of the journey," Ritchie adds.

"In the future we will probably have different exclusions based on what is important to people. This fund might not be for investors who want 100 per cent clarity."

No matter how innovative a company is, for some people the ethical criteria are more important

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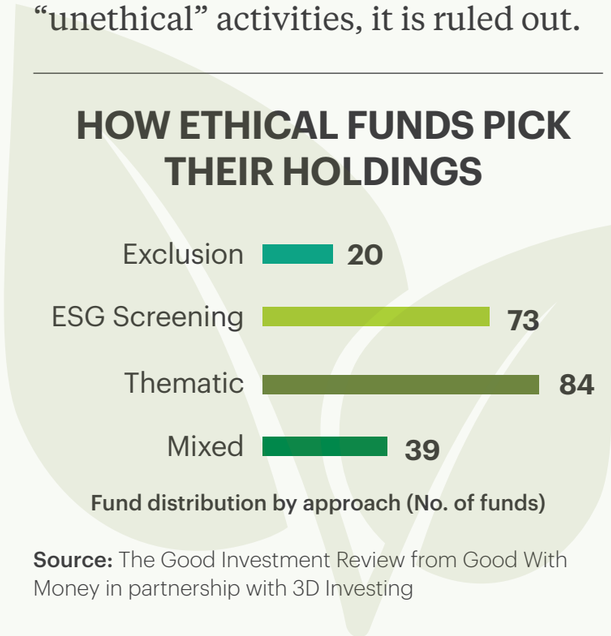
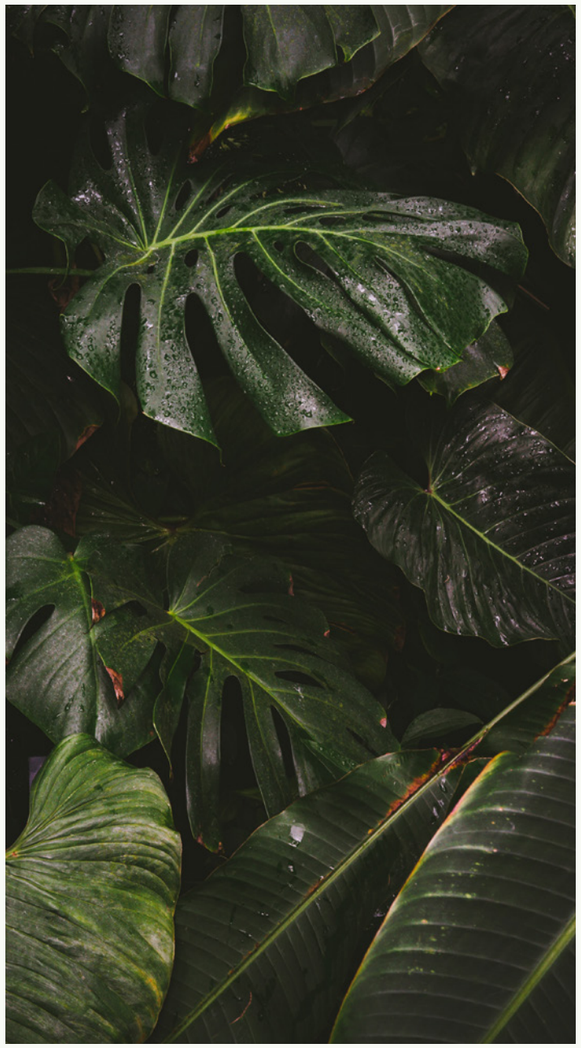
Top performing holdings within the fund, which has returned 68.3 per cent over the past five years, include online retailer Boohoo and cyber security firm Sophos.

Claudia Quiroz, manager of the Old Mutual Ethical fund, says the key to ethical investing is getting the right balance. A business must be a well-managed market leader in its field with a strong balance sheet to make it a viable investment, but it must also be doing good – the fund's strict screening means that if a firm gets even a fraction of its revenue from "unethical" activities, it is ruled out.



Source: The Good Investment Review from Good With Money in partnership with 3D Investing

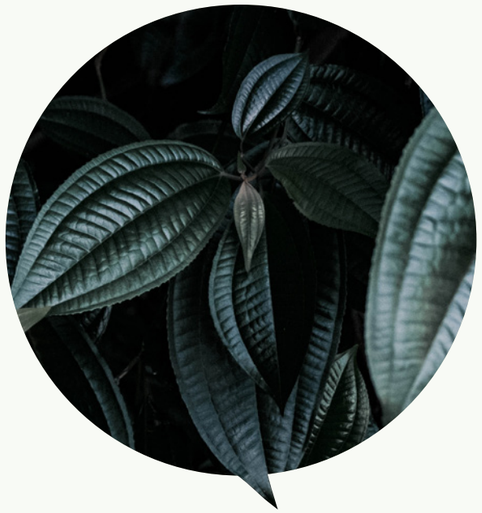


"No matter how innovative a company is, for some people the ethical criteria are more important," says Quiroz.

There are always opportunities

"But if you're a good investor you can always find opportunities – there are thousands of companies out there making a positive contribution."

You don't have to compromise your financial returns to invest and you don't have to compromise your ethics either



Energy efficiency is one of her favourite themes, as the trend towards reducing carbon and moving from combustion engines to electric vehicles gathers pace. Favourite holdings in the fund, which has returned 64.3 per cent over the past five years, include building insulation firm Kingspan and US LED lighting company Acuity Brands.

Duncan adds: "Historically there has been the perception that you have to sacrifice performance to invest, but that seems to be changing and hopefully that means we can open up responsible investing to a wider audience."

Certainly, more investors seem to be paying attention: the latest figures from the Investment Association show that more than £1bn was poured into ethical funds over the past year, with assets now totalling £15.4bn.

The discerning investor

With more options than ever before, investors can be more discerning: you don't have to compromise your financial returns to invest and you don't have to compromise your ethics either.

"When choosing a fund, investors should look beyond the manager and performance charts," says O'Connor. "Examine the top-10 holdings and visit the company websites to get a feel for what they do and keep going until you find a fund that fits with your world view. If you can't stand smoking, do you really want to invest in a fund with lots of tobacco holdings?" •

Crunching the biggest trends down into figures

Charging Forward

28%

of **global electricity** generated in **2021** will be **renewable energy**

1880s

renewable energy first developed in the form of **windmills, dams** and **solar cells**

1 in 3

automobiles at the start of the **20th Century** were **electric**

68%

Average fall in cost of **utility-scale solar systems** from **2009-2015**

Amazon are already trialling a **Prime Air drone delivery service**

2-3 million

electric cars to be produced by **Volkswagen** per year by **2025**

$1,000

average electric vehicle battery price per kWh in **2010**

$273 in 2017

2.28 secs

fastest ever 0-60mph set by a production vehicle, the electric **Tesla Roadster S P100D**

Source: Rathbones

It is hoped Daniel Hanbury's third stint on this fund can return it to the top of the performance charts

R&M UK Equity Smaller Companies

While the departure of a star manager can be a harbinger of underperformance, the return of a familiar face can do much to steady the ship.

With this in mind the significant outflows from R&M UK Equity Smaller Companies since the departure of Philip Rodrigs seem a little over the top with new/old manager Daniel Hanbury taking the helm.

FE Alpha Manager Hanbury launched the fund alongside Richard Staveley in 2006 before stepping down in 2010. He returned for a short stint following Staveley's departure for Majedie Asset Management but was in charge for little more than a year before being replaced by Philip Rodrigs.

When Rodrigs was dismissed from the firm earlier this year, Hanbury took his place in the manager's seat for the third time.

Despite all this upheaval, the fund's performance throughout this period has been spectacular. It is the sixth best performer in the IA UK Smaller Companies sector over the last decade, returning 340.87 per cent compared with 198.12 per cent from the average fund.

While Hanbury is not responsible for all of this outperformance, he has managed the fund for more than half of this time. R&M UK Equity Smaller Companies lost 3.24 per cent during his first stint and made 45.58 per cent in his second, putting the fund significantly ahead of both its sector and Numis Smaller Companies + AIM ex IT index over both periods.

As well as outflows, the fund has struggled with poor stock selections more recently, including Bargain Booze owner Conviviality which recently went bust.

However, Hanbury tends to be more cautious than Rodrigs and undertook a thorough review of the fund's focus and holdings upon his return.

Although this may limit potential upside, it should help to avoid disaster stocks like Conviviality.

Adrian Lowcock, investment director at Architas, said that Hanbury focuses on three key areas: potential, value and timing.

"The fund therefore is likely to be less focused on one particular style," he added.

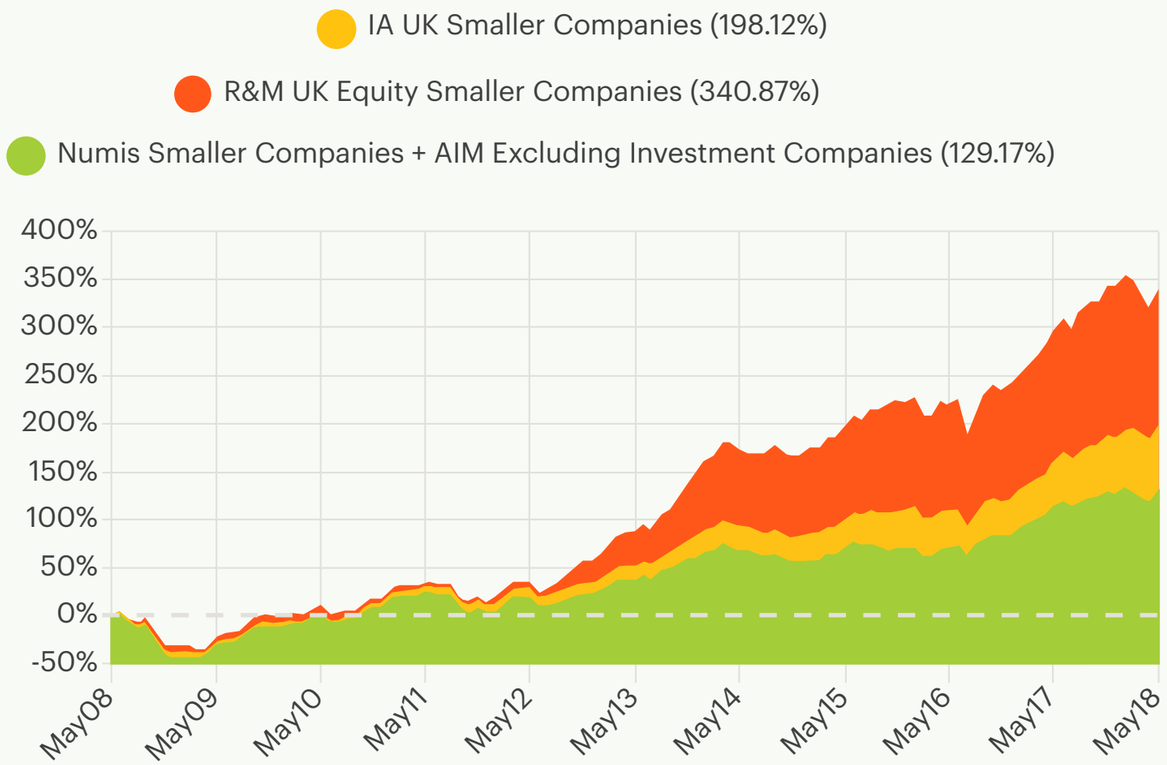
There are already signs of progress, with the fund's strong showing in the past month taking it from the bottom to the third quartile over one year. •

FACT BOX

MANAGER: **Daniel Hanbury** / LAUNCHED: **30/11/2006** / FUND SIZE: **£650.2m** / OCF: **0.85%**

FE CROWN RATING

PERFORMANCE OF FUND VS SECTOR AND INDEX OVER 10YRS



Source: FE Analytics

This recent entrant to the FE Invest Approved List could offer a solution to the problem of lengthening time horizons in retirement

Montanaro UK Income

Longer lifespans mean retirees should be looking for an element of capital growth as well as income from their portfolios to help them keep pace with inflation over what could be a period of 30 years or more.

Montanaro UK Income is a fund that excels at both. Although its yield of 3.58 per cent places it in the top quartile of its peer group, it is its capital growth that steals the show, with returns of 202.68 per cent over the past decade more than double those of the IA UK Equity Income sector.

This strong performance is the result of a focus on small and mid caps. However, the high returns generated from investing in this area of the market tend to come at the expense of stability and the fund's volatility score of 16.6 per cent is higher than its average peer's.

Montanaro UK Income has a structured investment approach: a six-strong committee selects 50 stocks from a shortlist of 200 that are subjected to a screening across 14 metrics and deep financial analysis. The portfolio will then be split into one-third dividend-producing companies and two-thirds earnings growth companies.

Robert Wilson, fund analyst at FE, said: "The level of detail and analysis conducted by the team and the discipline of the investment process gives comfort that this is a repeatable process that will continue to add value to any income investors looking for some diversification from the larger cap income managers."

The fund is also suitable for the conscientious investor and will consider environmental, social and corporate governance (ESG) issues before investing in a company.

Manager Charles Montanaro recently described the current market environment as "increasingly fickle" and said concerns over a US-China trade war have been overblown.

"Proposed tariffs on Chinese goods amount to just 0.1 per cent of Chinese GDP. Tariffs on US goods are even less significant for US and global growth."

"We are not, however, attempting to dismiss the risks from a protectionist trade war," he added. "You only have to look at the 1930s to see how bad things can get. [But] it is worth remembering that sometimes, it is no bad thing to be a small company with domestic exposure and a strong balance sheet."

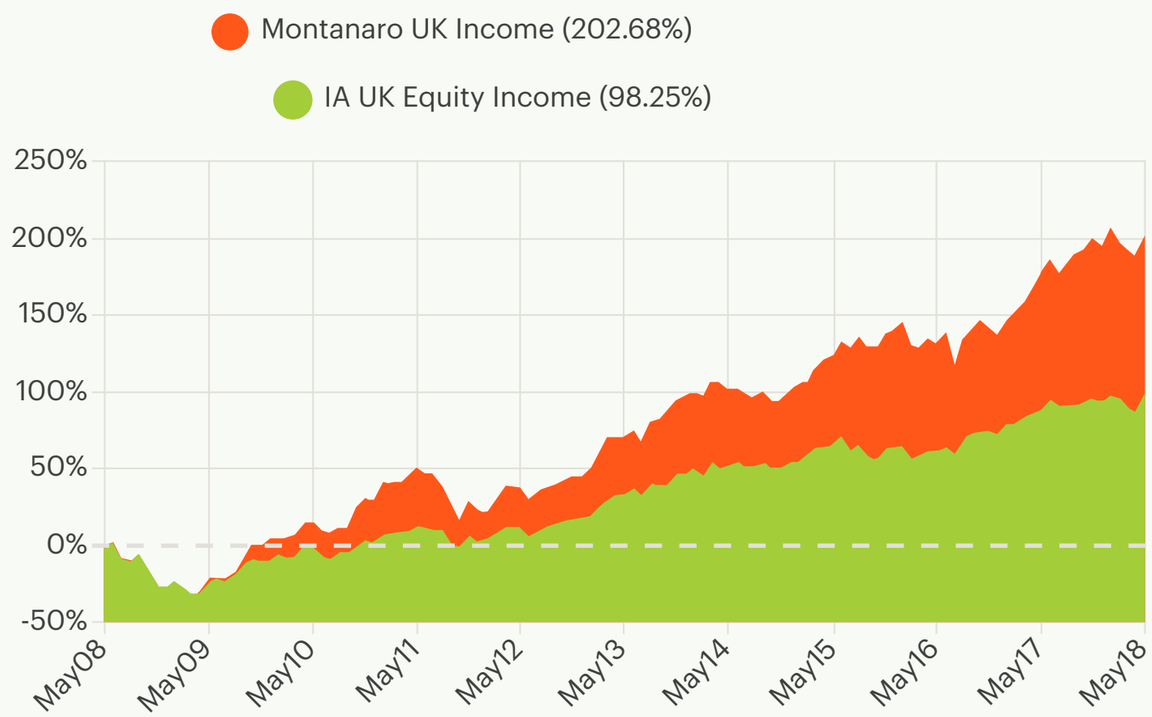
Montanaro UK Income was recently added to the FE Invest Approved List. ●

FACT BOX

MANAGER: **Charles Montanaro** / LAUNCHED: **29/12/2006** / FUND SIZE: **£275m** / OCF: **0.35%**

FE CROWN RATING

PERFORMANCE OF FUND VS SECTOR OVER 10YRS



Source: FE Analytics

This Aberdeen-managed trust is bucking the trend towards passive investing in the US market

North American Income Trust

It is notoriously difficult for fund managers to beat the S&P 500. As a result, even the biggest active proponents often end up admitting defeat, deciding instead to opt for a passive strategy when allocating to the US equity market.

However, the North American Income Trust has gone the other way, switching from an index tracking strategy to an active one in 2012.

Managers Fran Radano and Ralph Bassett, appointed in mid-2015, aim to provide investors with above average dividend income and long-term capital growth through a portfolio of S&P 500 equities. And they appear to have had some success.

The trust has made 61.61 per cent over the past three years, compared with 48.01 per cent from the S&P 500 and 37.34 per cent from its sector.

Its portfolio is made up of around 40 stocks and nine fixed income investments, as well as a small number of open option positions. A yield of 3.08 per cent is less than that offered by some of its sector peers such as BlackRock North American Income, however unlike other unconstrained trusts it only invests in S&P 500 stocks.

The trust's largest sector exposure is to financial stocks, which represent 26.4 per cent of assets under management, followed by oil & gas (12 per cent), consumer staples (11.7 per cent) and technology (11.3 per cent).

Despite the uptick in volatility during 2018, Radano and Bassett said they are significantly more upbeat on the US macroeconomic picture than they were at the start of 2017. For example, the managers pointed out tax cuts in the US have begun to work their way through corporate decision-making to the benefit of increased investment, especially in more capital-intensive sectors.

However, they remain wary of the impact of rising inflation on input costs and corporate operating margins.

"It is important to note that higher-yielding company shares have lagged those of the broader market for roughly the past year, providing an increase in attractively valued investment opportunities," they said.

"So, while we anticipate continued volatility as the market grapples with the prospect of rising interest rates and higher inflation, we believe the environment could offer some very good income investment opportunities in coming quarters."

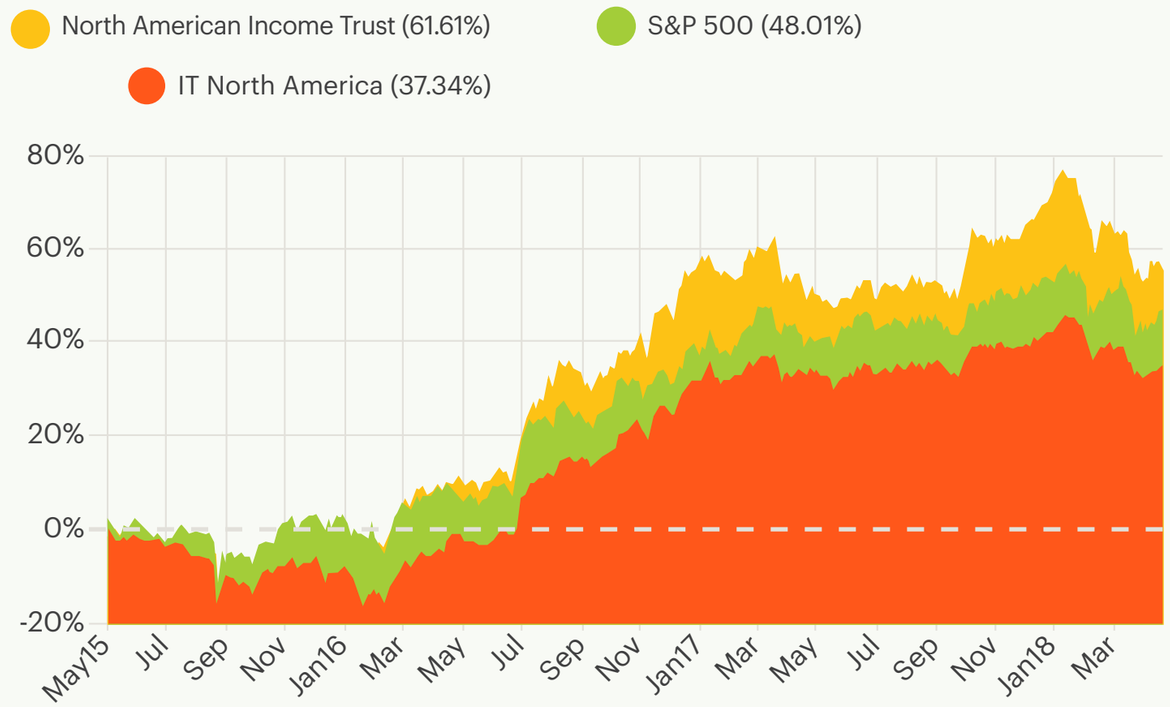
The trust pays a quarterly dividend. It is 5 per cent geared and is currently on a discount of 6.29 per cent. ●

FACT BOX

MANAGERS: **Ralph Bassett & Fran Radano** / LAUNCHED: **1902** / PREMIUM/DISCOUNT: **-6.29%** / OCF: **0.98%**

FE CROWN RATING

PERFORMANCE OF TRUST VS SECTOR AND INDEX OVER 3YRS



Source: FE Analytics

Sustainable investing is growing in popularity, but many misconceptions remain

Investing sustainably: five myths debunked

Myth 1 Sustainable investing is just avoiding "sin stocks"

The phrase "sin stocks" emerged to describe firms linked to industries perceived by some to be unethical, such as tobacco, alcohol or gambling.

Such funds will exclude these stocks, or screen them out. But each investor has views on what is and isn't ethical, as the results of the Schroders Global Investor Study demonstrated.

Rather than merely screening out certain stocks, sustainable investing is about closely evaluating a range of environmental, social and governance issues, known as ESG. This could be analysing a company's track record on pollution from its factories, or how socially responsible it is in the communities where it operates.

On corporate governance issues, it is a matter of judging how well the interests of shareholders, customers and staff are managed.

Put simply, well managed companies that care about the sustainability of the world in which they operate should have a better long-term future.

Sustainable investment is really about integrating ESG considerations into the investment decision-making process, with a view to enhancing returns.

Myth 2 Returns will be hit if you invest sustainably

Isn't there a cost to investing sustainably? There is mounting evidence to the contrary.

Studies by Friede, Busch & Bassen (2015) and Morgan Stanley to name but two found that companies focused on ESG had, on average, enhanced financial performance.

A study by Empirical Research, which has been evaluating and monitoring 60 ESG factors since November 2014 for US stocks, found that those companies with better ESG scores outperformed those with lower.

By examining ESG issues, investors gain a better understanding of not just what companies do but how they do it.

ESG analysis puts companies into a wider global context and helps to identify which ones have the most resilient models.

Investors can choose investments based on moral beliefs and personal values, but that would be ethical investing rather than sustainable investing.

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Myth 3 It's all about green investment

It would be easy to assume that the "E" of ESG dominates the other two. Most of the thematic investment funds in the space focus on environmental issues, from water shortage to new environmental technologies.

And environmental issues, especially in the wake of the COP 21 Climate Change talks in Paris last year, are high up on investors' minds. However, social and governance issues are of increasing importance.

Rising inequality and strapped governments have led to the introduction of living wages in a number of regions, putting pressure on costs.

Changing consumer tastes and new regulation have seen the introduction of sugar taxes and ongoing declines in sugary drink consumption. CEO pay and boards are rarely out of the headlines.

Successful ESG investment processes take a holistic look at the changing world companies have to navigate, and assess the performance of their investment across a number of factors.

They engage where performance is lacking, pushing companies to improve their performance in ESG factors across the board, accepting the need for continual improvement in these areas.

Myth 4 It only works in the most developed markets

The bulk of ESG data that we have is disclosed by large companies operating in developed markets. This does not mean that ESG considerations are not pressing for those in emerging markets.

A 2013 report by UBS, analysing the World Economic Forum (WEF) Corporate Governance Index and emerging market equities valuations, concluded that companies that score well on governance are valued more highly and have lower volatility.

Evaluating how companies manage stakeholders, and environmental and social change, is relevant whatever the market. With emerging markets, it may just take more digging.

Myth 5 It only works for stocks

We tend to think mostly about equities, but it doesn't end there. With bonds, for instance, ESG analysis helps identify risks to a borrower's ability and willingness to repay debts.

Put simply, a well managed company should be less likely to stumble into value-destroying disasters and be better positioned to repay investors who lend them money.

CONCLUSION

Investments do not operate in a vacuum; global industries face social, economic, environmental and industrial changes on a larger scale and faster pace than ever before.

The gap between the values of companies on the right or wrong sides of those trends may grow ever-wider as a result. By investing in sustainable businesses, investors may increase their chances of success.

Schroders: A leader in sustainability

We are rated A+ for our approach by the United Nation's PRI organisation and the No.1 asset manager by ShareAction. We don't tick boxes, but add value through real insight and actively engaging to improve companies' behaviours and governance.

Integrating sustainability

We integrate our sustainability research into the way we invest across asset classes and geographies. We don't stop at equities, but use our insights to inform decisions in other areas including fixed income and real estate. It's integral to everything we do.

To find out more, visit **schroders.com** and view our Strategic Capabilities including Sustainability

Despite surging interest in ethical and socially responsible investing, the sector's market share hasn't budged in a decade. **Adam Lewis** asks...

Where's the money gone?

There is no ethical or ESG sector to compare like-for-like funds and, as a result, many portfolios that are different in nature often get lumped together

The concept of ethical investing is not a recent phenomenon. Its origins can be traced back to the 1800s when religious groups such as Quakers and Methodists established socially responsible investing (SRI) guidelines for their followers.

However, it was not until 1984 that UK funds officially began investing "ethically". Since then, the industry has accumulated some £15.2bn of funds under management, according to the Investment Association.

Evolution, not revolution

In recent years, changes in terminology and practice have resulted in the evolution of SRI (socially responsible investing) into ESG (environmental, social and governance) investing, while there is growing interest in impact investing, which prioritises positive social and environmental impacts alongside financial return.

The problem is that despite several surveys suggesting more investors, especially millennials, want to put their money to work in more ethical and sustainable companies, at 1.3 per cent the market share of funds focused on this area hasn't shifted in the past decade. So what is holding them back and are things starting to change?

Jason Hollands, managing director at Tilney Investment Management, says that on first impression it may seem surprising that the amount of money invested in ethical funds has remained so modest. He notes there has been growing interest in areas such as ethical consumerism and sustainable tourism over the period in question, as well as a renewed focus on improving standards of governance.

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Untapped potential

"My sense is that there is latent demand which is untapped, partly because many fund investors are not inclined to look under the bonnet, so it may not occur to them that such approaches are available unless this is flagged to them," he says. "Some advisers may overlook these funds because of the added complexities involved in evaluating them."

A problem for many advisers could be the fact that there is no ethical or ESG sector to compare like-for-like funds and, as a result, many portfolios that are different in nature often get lumped together. To try and address this, FE has itself generated a list of funds in the IA universe that have a sustainable investment focus.

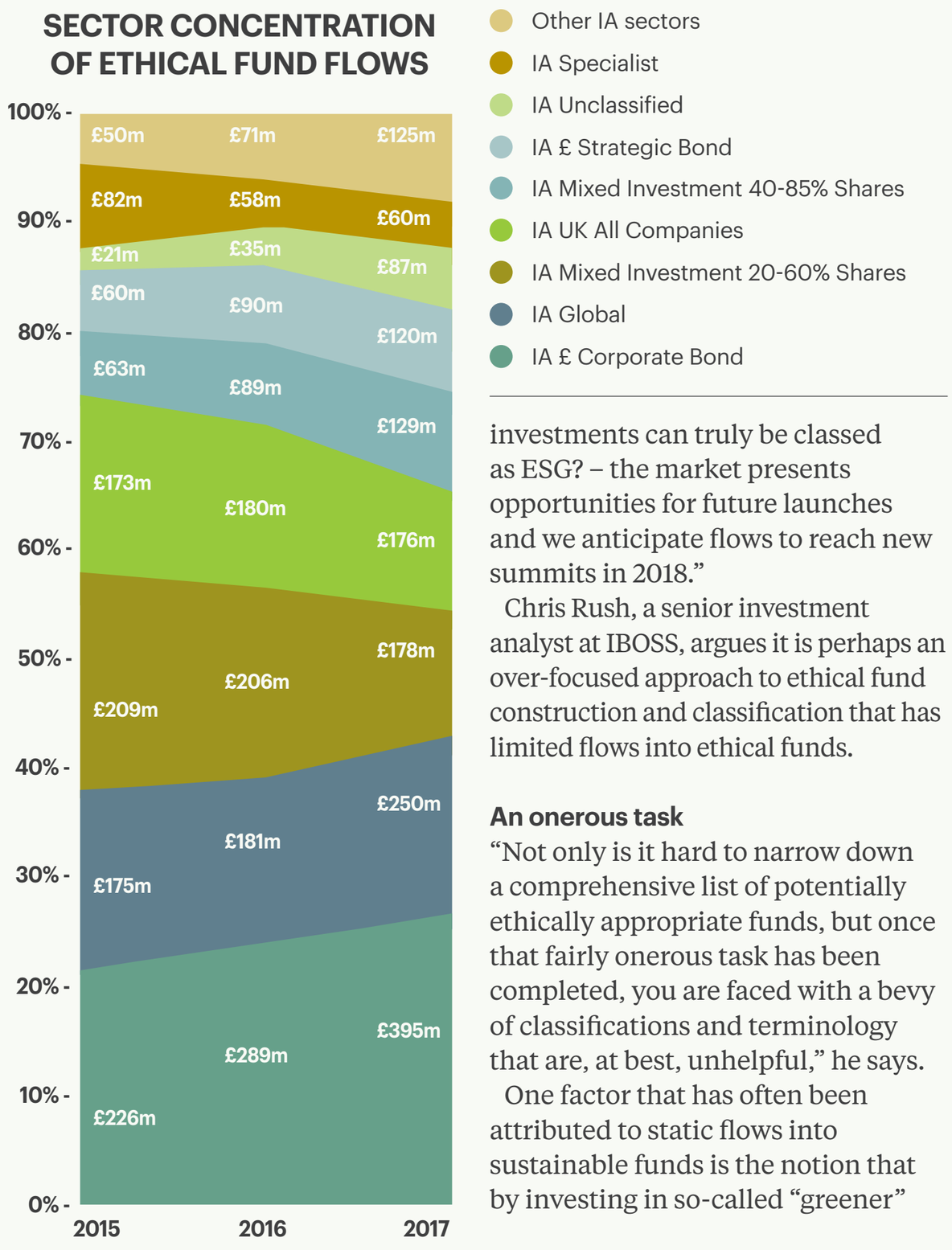
It asked asset managers what they offer in this space, which resulted in a list of 80 names, including a mix of funds focused on UK and international equities, fixed interest and specific themes. According to data gathered by Strategic Insight, more than a quarter of ethical fund flows

The evidence that ESG indices tend to outperform standard indices is becoming more compelling within both developing and developed markets

during 2017 took place in the IA Sterling Corporate Bond sector, where most of these products reside.

While market share may not be increasing, Ran Vispap-Rich, a senior analyst at Strategic Insight, notes ethical investment via platforms hit £1.5bn in 2017, which is 27 per cent more than 2016 and 44 per cent more than 2015.

"This was partly due to numerous launches of ESG funds in 2017," he says. "Despite, or perhaps thanks to ESG's ongoing search for identity – namely, which investments can truly be classed as ESG? – the market presents opportunities for future launches and we anticipate flows to reach new summits in 2018."



Source: Strategic Insight

Chris Rush, a senior investment analyst at IBOSS, argues it is perhaps an over-focused approach to ethical fund construction and classification that has limited flows into ethical funds.

An onerous task

"Not only is it hard to narrow down a comprehensive list of potentially ethically appropriate funds, but once that fairly onerous task has been completed, you are faced with a bevy of classifications and terminology that are, at best, unhelpful," he says.

One factor that has often been attributed to static flows into sustainable funds is the notion that by investing in so-called "greener"

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companies, you are limiting your returns. For Rush, however, this argument does not stack up.

"The evidence that ESG indices tend to outperform standard indices is becoming more compelling within both developing and developed markets," he says. "The upshot to this trend hasn't been an increase in flows into ethical products, but rather an increase in the purchase of ethical stocks by unconstrained managers."

Rush says the result is that the average investor owns more ethical stocks than ever before, without being acutely aware of it.

"While this is positive for the everyday investor, it is perhaps a concern for ethical fund managers as the edge they once had is being impeded upon by the average manager," he argues.

For Hollands, the notion that investing ethically will result in lower returns fails to recognise that those investors who care passionately about a particular issue are unlikely to be pushed into areas of the market they may morally object to on the basis of financial arguments.

Going their own way

"The reality is that ethical funds, particularly those with strict criteria, are likely to experience periods when returns may diverge significantly from broader market indices that they

simply cannot replicate," he says. "That can mean periods of potentially worse returns and much better returns.

"Of course, in recent years a combination of weakness in commodity prices and strong returns from mid-cap shares versus larger ones have played out very well for UK ethical funds in particular, many of which have convincingly outperformed over the last five years. This has been a great period for ethical investors who have been able to profit and stand by their principles, but I would still caution those who are actually ambivalent about taking an ethical approach from investing in funds with a highly constrained investment universe."

While IBOSS runs an ethical product as part of its model portfolio range, Rush says the criteria used to select ethical funds has almost as much to

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do with the underlying performance and risk characteristics as their ethical credentials.

"In terms of identifying whether a fund is sufficiently ethical, and therefore up for inclusion in the portfolio, it is largely down to the classification given by its particular fund house," he says. "Put simply, if a fund house deems one of its funds to be ethical then, additional research aside, we will take them at their word.

"Anecdotally, we have found ourselves selecting ethical funds not only for our ethical portfolio but for our core model portfolios too. The Rathbone Ethical Bond and SVM All Europe SRI funds in particular have performed very well against both their ethical and wider market peers."

While ethical investing has evolved considerably in the past decade,

At present the sector still struggles to form a unified identity and is instead a mix of different philosophies and approaches

Adrian Lowcock, investment director at Architas, says challenges still remain. At present he says the sector still struggles to form a unified identity and is instead a mix of different philosophies and approaches.

Do it yourself

"Although the sector has seen a growth in the number of funds, it remains hard for investors to build a globally diversified portfolio of ethical investments which offers exposure to all major markets and asset classes," he says.

"Finding ethical funds is usually a case of manual filtering: you have to look by name and read up on each fund, working out where it invests and how. But by looking at the name, others will fall through the filter."

For Hollands, the real triumph of "responsible investment" could be it is eventually integrated into mainstream investing, although he adds there will always be a niche market for those who don't want their wealth put to work in companies engaged in certain activities. •

PERFORMANCE OF FUNDS VS SECTORS

Name	1yr (%)	3yr (%)	5yr (%)	10yr (%)
Premier Ethical	7.98	30.53	83	154.8
IA UK All Companies	7.4	23.03	51.13	97.9
Rathbone Ethical Bond	4.45	16.22	31.91	95.19
IA Sterling Corporate Bond	1.22	11.12	19.88	68.79
SVM All Europe SRI	7.66	34.96	66.61	163.05
IA Europe Including UK	6.32	27.09	56.42	87.67

Source: FE Analytics

The UK equity option: Premier Ethical

With a return of 83 per cent, Chris Wright's £177m Premier Ethical fund has not only beaten every one of its ethical peers in the IA UK All Companies sector over the past five years, but also the 51.13 per cent made by the average fund. The fund is bound by the ethical criteria set down by Premier's independent ethical committee, which determines areas it should target and avoid. For example, it cannot invest in companies with significant interests in tobacco, pornography or weapons of mass destruction, instead targeting those that are improving their ethical behaviour or promoting ethical causes.

The bond option: Rathbone Ethical Bond

With inflows totalling £395m in 2017, the IA Corporate Bond sector is a favourite when it comes to ethical investing and with assets of £1.1bn, Bryn Jones' Rathbone Ethical Bond fund is one of the most popular in the peer group. Given it has outperformed over one, three, five and 10 years, it is not difficult to see why. "Bryn Jones strongly believes that he can improve society through selective debt financing and, over its history, the fund has invested in many educational and social housing programmes," says FE Invest. The ethical screen is the last step of the process, and FE invest says this has had a positive impact on performance.

The impact option: Hermes Impact Opportunities

Impact investing has been labelled "the next step in the evolution of responsible investing", following on from SRI and ESG funds. It tends to be more forward looking, aiming to deliver a measurable and positive effect on the environment or society. The Hermes Impact Opportunities fund, launched in December last year, holds 25 to 50 companies that generate sustainable and beneficial impacts, leading to rising prosperity across society and financial rewards. Manager Tim Crockford also runs Hermes Europe Ex UK Equity, which has outperformed since launch.

AltRetire's **John Blowers** says pension savers in the UK could learn a lot from the way their counterparts in the US look at risk

Risky business

In the good ol' United States of America, there is a culture of investing. Where people use their 401(k) or Roth IRA to save for retirement, they play the stock markets and are generally more comfortable with taking risk.

In the UK, it's a different cultural story. We have grown up with savings accounts, building societies and even cash under the mattress. Us Brits just don't like risk and never really have done, which is fine if your savings accounts are generating interest of 6 per cent or more, but those days are now long gone.

However, we have – as a nation – shown signs that we are adapting. In September 2017 (almost 10 years since interest rates fell to historic lows), stocks & shares ISAs overtook cash ISAs in the sales charts.

This has taken longer than it should have. Investing in any cash-based product is likely to result in a fall in real value as inflation has been higher than interest rates for some time and the gap is widening.

Psychologically vulnerable

So why are we culturally scared of investing in the stock market and what can be done to allay those fears?

Let's start with some facts. The FTSE 100 index – a decent measure of stock market performance – has risen by 4.45 per cent over the last year to 1 May 2018. It's been a challenging year and investors were right to be worried when the index fell almost 11 per cent between January and March this year.

We have grown up with savings accounts, building societies and even cash under the mattress

And herein lies the first big issue we as a nation have as investors rather than savers. We are psychologically vulnerable to uncertainty. We don't seem to mind if our cash is gently eroded by the forces of inflation, because it is stealthy and the amount of money you have looks safe – at least on face value.

But a stock market correction creates real havoc, causing our portfolio values to dip alarmingly. It feels like you have lost money and you wonder if your investments will ever climb back to their value of just a few days ago. Who knows? This might be the moment when stock markets lose value permanently.

This uncertainty plays on our minds and leads us to seek methods of reducing risk. By doing that, however, we are also – by default – seeking methods of reducing our potential returns.

There is now a thriving industry in behavioural economics. Investment

People tend to get drawn in by success – meaning they often begin investing at the worst possible moments

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firms want to know why investors – and private investors in particular – get spooked and behave irrationally.

Public house accountants

The most common problem investors encounter is buying high and selling low. When the markets are doing well, talk in the pub turns to portfolios and people tend to get drawn in by success – meaning they often begin investing at the worst possible moments. The dotcom bubble was a classic example and there have been other instances in history (the Great Depression in the 1930s and Bitcoin earlier this year) where rookie investors have flocked to markets in an attempt to get rich quick.

Then, when prices crash, they often panic and cut their losses, nursing a bruised bank balance or worse.

The media plays an important role in exacerbating our psychological fears, always keen to report on billions wiped off the stock market or pension funds decimated.

DOWNSIDES TO LIFESTYLING

1. **Reducing** risk in your 50s (as you approach retirement) can have a major impact on the growth potential of your portfolio, particularly as the value should be significant at this moment

2. **You** no longer have a fixed date to cash in your investments, so your entire future lifestyle is not at the mercy of stock markets on your chosen retirement date

3. **People** are living for significantly longer. This means your investment time horizon will be greater but you will also need more money to fund a lengthier retirement

4. **Most** people do not benefit from generous final salary pensions anymore and company/personal pensions tend to be smaller (and need to last longer)

This fear is never more acute when you know you need to access your money in the near term and it has given rise to an investment strategy called lifestyling.

Most people will plan to access their investments at some point, typically at retirement. In the old days, many people would cash in their investments and buy an annuity, so defending the value of their assets against market falls was paramount.

Lifestyling

To this day, lifestyling is still common practice among advisers and even in pension and auto-enrolment funds. Lifestyling involves three investment stages: taking greater risk when you start your investment journey, less risk as you start to approach your target, to lessen the impact of market falls, then removing almost all risk when you get there, instead focusing on income-generating assets.

Sounds sensible? Well, this type of investment planning is now viewed as a little dated and restrictive. So, this is the dilemma. Many people saving for retirement need more money to last for longer, but everlasting (defined benefit) pensions are now largely a thing of the past.

Yet, a large part of the industry continues to push the line that you should take less risk in your investments from as early as your 50s to ensure you don't suffer from a fall in the markets.

I am arguing that if your pension fund is less than £500,000, you may struggle to live a decent lifestyle through lifestyling. Adjusting risk is about the only "lever" an investor

When prices crash, investors often panic and cut their losses, nursing a bruised bank balance or worse

• • •

£86.10

Real value of **£100** left in savings account over 10yrs (assuming interest paid at Bank of England Base Rate)

has if it looks like they are not going to have enough cash to meet their target. You can invest more each month, but removing the ability to generate growth in your portfolio can make a significant difference to the amount you will have to live on in retirement.

Obviously, if you already have a portfolio large enough to pay for your desired lifestyle in retirement, then you may still want to consider managing down the risk in your investments.

Choosing the right investments

You can find quality funds through websites such as FE Trustnet, which has the FE Crown Rating system. This looks at empirical factors that have shaped past performance and looks for sustainable and repeatable traits and track records.

I would be happy if I could generate 10 per cent per annum growth on my investments as that would shoot the lights out against other benchmarks.

Finding the real stars to invest in is much harder. I worked out the number of funds that made at least 30 per cent over the last year and then the percentages of funds that achieved it.

You would need to be pretty smart or lucky to pick these funds, although the average FE Crown rating for the top-10 unit trust/OEIC performers over the past year is 3.9.

The average FE Risk Score for the top performers is 136.4, so definitely on the higher end of the spectrum.

More realistically, I looked at the funds that had managed to achieve growth of 10 per cent or more over the last year.

The numbers are more encouraging here, but you still need to focus on picking the promising ones, by researching carefully.

So, is risk our friend?

I would argue that taking more investment risk is the central weapon in making your money go further. If you can't put more money into your portfolio, then you have two choices.

Take less risk, knowing you'll have a lower but more certain amount of money to last for what is likely to be a longer period after you stop working, or take more risk and continue to sweat your investments harder towards and through retirement.

You may need to flex your withdrawals more in retirement to reflect markets (meaning you shouldn't encash investments when markets are down), but you will expose yourself to more upside by staying in a higher risk portfolio.

Taking more generic risk is easier to do than consistently picking top-performing funds. But don't take crazy risks either: stay within the confines of tried and tested fund managers with a track record.

It's a personal choice, as you need to feel comfortable with what could be a roller-coaster ride and you need to know what you're doing by taking an interest in your investments and when to draw them down. •

FUNDS RETURNING +30% OVER 1YR

Investment type	Number of funds achieving +30% over 1yr	Total number of funds in market	% of market producing +30% growth
Unit trusts & OEICs	11	3,365	0.32
Investment trusts	18	267	6.75
Pension funds	7	7,709	0.09
ETFs	88	3,323	2.65

Source: FE Trustnet

Hermes European Alpha's **Martin Todd** names three UK mid-cap stocks that are casting their eye "across the pond"

Pond dipping

UK stocks remain unfashionable with investors, with a recent Bank of America Merrill Lynch fund manager survey ranking UK equities as the least favoured asset class out of 23. Given that valuations are in-line with or cheaper than US or European stocks, the fear factor looks to be driven by continued UK economic and political uncertainty. For domestic-facing businesses this has some logic, but less so for the plethora of companies growing profitably overseas.

Profitable growth on the other side of the Atlantic isn't easy. Some of the UK's most admired companies have floundered Stateside and Tesco's Fresh & Easy debacle will remain a cautionary tale for UK executives for many years to come. However, given the scale of the market, opportunities abound for those who can "step up to the plate". ●

Tesco's Fresh & Easy debacle will remain a cautionary tale for UK executives for many years to come

SSP GROUP

SSP, led by former WH Smith chief executive Kate Swann, has thrived since its 2014 IPO. The firm operates food and beverage outlets in travel hubs, primarily airports and railway stations, and after building strong market positions in the UK and Europe, it has turned its focus to the lucrative US market. SSP's offering is driving up spend per head at 5 per cent per annum, on top of 2 to 3 per cent passenger growth. While it is just one-seventh the size of the leading player and present in only 11 of the top-30 airports, its US business is ready to take off.

DS SMITH

A company long valued by investors for its robust fundamentals, DS Smith is undervalued with respect to opportunities in the US. Through a well-honed acquisition model, the company has become a European packaging leader, and the $1bn acquisition of US firm Interstate Resources is the ideal platform from which to generate new growth. On limited capital investment, the company can serve its fast-moving consumer goods customers across North America, allowing it to win a share of a complacent and oligopolistic market.

ASOS

An online fast fashion retailer, ASOS remains in the early stages of its international expansion. A key area of growth is the US market where the company will soon open a warehouse, allowing it to fulfil orders in-country and at a vastly lower cost than current deliveries which are air-freighted from the UK. The US apparel & footwear market is worth $220bn annually, of which ASOS currently captures just 0.2 per cent. Its US warehouse will significantly improve its delivery proposition, a key factor in winning new customers, thus driving market share.

BMO's **Kelly Prior** is using this fund to diversify her sources of fixed income without taking on more risk

Legg Mason Western Asset Structured Opportunities

This asset class is shrinking, but is less attractive than it once was given that the brave have now been joined by the masses

Structured credit is an area that strikes fear into the hearts of many investors. The development of over-leveraged products with negligible pools of assets caused the issues of 2007 and returning to this area is not a decision that was taken lightly.

Legg Mason Western Asset Structured Opportunities is run by an experienced team of specialists who cover a wide spectrum of investments in the asset-backed space. Whether residential-, commercial mortgage- or consumer-asset backed securities, the basic premise is to focus on quality borrowers with a low loan-to-value to achieve the best return for the lowest risk. This team of 14, led by Anup Agarwal, works from the bottom up, creating a portfolio of assets that are predominantly floating rate (the duration should always be less than one year) to limit exposure to illiquidity and minimise prepayment risk. Interest rate and credit hedges can also be used to minimise downside risk.

Nimble

The team is nimble in the areas that it invests in and works with the deal co-ordinator ahead of issue to create attractive opportunities. The fund will have a minimum of 65 per cent in non-agency mortgage backed securities (MBSs) and asset backed securities (ABSs), with allocations permitted to agency MBSs and ABSs, corporate and government debt. Its aim is to find the best opportunities across the whole structured opportunity asset class.

At the moment, 70 per cent of the fund is floating rate in structure with a minimum loan-to-value of 75 per cent on mortgage pool exposure. Another 15 per cent of the fund is in "reperforming" assets that have been restructured, where the managers have the ability to write their own covenants. The fund focuses on individual opportunities in the ABS space – it recently refinanced the debt of Avis where it achieved the same yield as the high-yield paper that the company owns, but with security over the asset pool. One of the key benefits to this space is that it is not owned by retail investors through ETFs, but active managers with more of a long-term perspective.

Much-misunderstood

One of the strongest areas for the team in recent years has been the much-misunderstood residential mortgage-backed securities (RMBSs). These were residential mortgages issued in the US before the onset of the global financial crisis, where the mortgages continued to be paid despite the fall in house prices. This asset class is shrinking, but is less attractive than it once was given that the brave have now been joined by the masses. The team can now move on and look for similar situations in a broader opportunity set. •

Kelly Prior is an investment manager in BMO Global Asset Management's multi-manager team

FE Trustnet

magazine

June preview

Yielding a better future

The next issue of Trustnet Magazine will concentrate on income generation. We will focus on the trusts that pay out the most to investors over the long term and find out how much of a hit it is worth taking upfront in terms of yield to ensure your dividend compounds ahead of inflation.

One area that offers an attractive income is AIC Sector Specialist Debt, where the average yield is 6.2 per cent. But is this a sector that is suitable for retail investors?