Investment Process and Philosophy

WHITE PAPER

ethicalfutures
make your money change your world

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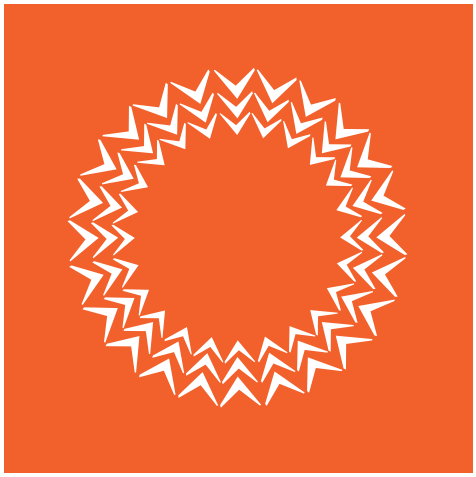
This is our Investment Philosophy which describes our approach to the provision of investment advice.

It outlines our beliefs about investment and explains our approach to managing your money. It is also about how you are involved with the decisions about investing; after all it is your money.



Our beliefs No. 1.

At Ethical Futures, we share the belief that your money can help to change your world. In our world of financial advice, our experience has convinced us that there's a better way of helping people plan for their futures, by connecting their money to their values by ethical investment. We formed Ethical Futures to do just that.

We therefore feel that our clients interest are best served by only advising on investments that have some form of ethical screening or sustainable investment policy or those unscreened funds that we can mutually agree will be fit for purpose and reflect our clients values. If you want to invest in unscreened mainstream funds we're sorry but we can't help you – but we can introduce you to someone who will!

Our beliefs No. 2.

Investors should understand the reasons for investing and how it is designed to meet their goals. The world of investing can be complex, but a lot of this complexity is down to 'jargon', tax rules and plan structures. We believe in keeping things simple. So while there is a lot of experience and research behind our investment philosophy and process, we are keen that every client understands our recommendations and how it fits with their own financial objectives.

Our conversation with you will look into a number of key areas when advising on your investments, including:

» your need for capital security
» your age
» your family commitments
» the need for income and / or growth
» whether there is a specific item that needs funding in the near future
» the investment time horizon
» your ethical concerns, values and aspirations
» your attitude to risk, risk tolerance and capacity for loss
» the impact of charges and penalty fees
» interest rate risk
» inflation risk

When delivering investment advice, we always start with a detailed understanding of your financial planning objectives. These inform decisions about the level of investment risk that needs to be taken.

Our beliefs No 3.

A conversation about risk and its many dimensions is the essential first step when investing. When it comes to investing, risk and reward are inextricably entwined. Don't let anyone tell you otherwise. All investments involve some degree of risk - it's important that you understand this before you invest.

The reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you are likely to make more money by carefully investing in asset categories with greater risk, like stocks or bonds, rather than restricting your investments to assets with less risk, like cash. On the other hand, investing solely in cash investments may be appropriate for short-term financial goals.

1. Investment risk.

These are the risks associated with different types of investment and can include:

a. Inflation risk – the risk that inflation might exceed your investment return and erode purchasing power over time.
b. Volatility – the ups and downs.
c. Liquidity risk – can you get your money back when you need it.
d. Company risk – the risk that one company goes bust.
e. Default risk – the risk that a bond doesn't pay you back.
f. Emerging market risk – the fact that some markets are less efficient and transparent.

2. The need for risk.

All these risks might start to put you off. But even investing in cash carries risk e.g. inflation risk – your spending power goes down; default risk – your deposits may not be 100% safe. For some investors, and certainly for short term savings, cash is still likely to be the best fit with your needs and objectives.

3. Your attitude to risk.

Risk attitude has more to do with the individual's psychology than with their financial circumstances. Some will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues.

4. Your ability to tolerate risk.

If things go wrong what would that mean to your finances? You may be a risky investor but can you afford to be? You may be a risk averse investor but are you saving enough? This is about understanding your ability to withstand the shocks that might come along and making sure your portfolio meets your capacity for risk.

Generally speaking, a person with a higher level of wealth and income (relative to any liabilities they have) and a longer investment term will be able to take more risk, giving them a higher risk capacity.

Your ability to tolerate risk is very different to you attitude to risk – understanding this is a key part of our investment process. A conversation with you will help inform decisions about the level of investment risk that needs to be taken and that you can afford to take, rather than simply the maximum amount of risk that you feel happy with.

Our beliefs No 4.

Investing for the long term is very different than saving for the short term. While there is an understandable desire to keep things safe when investing the impact of inflation and the value of investing for the long term in more risky assets are compelling. Real assets such as equities, property and commodities tend to make a better investment than the apparently safe option of cash deposits in the long run, but it isn't that simple.

In the last 20 years, Gilts have just underperformed Equities, but in 8 eight of the ten year periods of the last century (1900 – 1910, 1910 – 1920 etc.) Equities beat Gilts.

Real returns (after inflation) over the past 20 years (%pa).	
Asset class	Return
UK Equities	4.6
Gilts	5.1
Index-linked	4.4
Cash	1.1

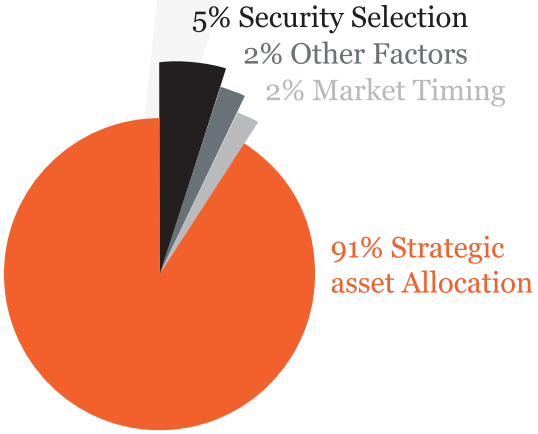
source: Barclays Capital 2014

Our view is that basing investment decisions on the longer term historic behaviour of asset classes enables investors to benefit from market growth. But that a regular review of your investments is also important.

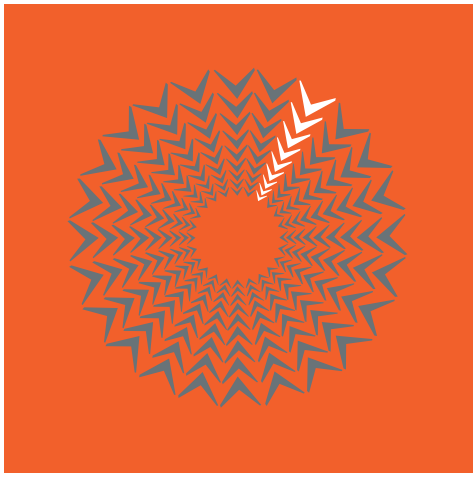
Our beliefs No 5.

The bulk of long-term returns come from asset allocation. Academics will continue to argue about the precise amount of value that comes from strategic asset allocation rather than stock selection, investment style or market timing, but it is widely accepted that asset allocation has the biggest influence over the variance in portfolio returns.

This means that investors and their advisers should be devoting the bulk of their time to constructing the most suitable asset allocation model, based on investment objectives and attitude towards investment risk of their clients. This is where we focus our attention when delivering investment advice.
It's like making a cake. The most important part is making sure you have the right combination of flour, eggs, butter etc. to achieve the desired result. Some might not think that it's worth worrying about where the ingredients come from, but in our case we also want to make sure that you are also selecting ethical and socially responsible 'ingredients'.



ref. Brinson, Hood, Beebower
Determinants of Portfolio Performance
1986



Our beliefs No 6.

Diversification using mainstream asset classes can reduce risk without destroying returns. Diversification is a strategy that can be neatly summed up by the timeless adage “Don’t put all your eggs in one basket.” The strategy involves spreading your money among various investments in the hope that if one investment loses money, the other investments will more than make up for those losses. A diversified portfolio should be diversified at two levels: between asset categories and within asset categories. So in addition to allocating your investments among stocks, bonds, cash equivalents, and possibly other asset categories, you’ll also need to spread out your investments within each asset category. The key is to identify investments in segments of each asset category that may perform differently under different market conditions.

Whilst there is a place for specialist sectors, non-profit, community and social impact investment in a client’s portfolio – our view is that financial aims are best met by use of a core of traditional investments with specialist satellite investments held only where risk and ethical concerns indicate they are appropriate.

The bulk of investors may find it easier to diversify within each asset category through the ownership of collective funds (unit trusts, investment trusts & OEICs) rather than through individual investments from each asset category. A collective fund is an investment vehicle that pools money from many investors and invests the money in stocks, bonds, and other financial instruments. Collective funds make it easy for investors to own a small portion of many investments. They also make it easier for clients to withdraw funds when needed, because they tend to be more ‘liquid’. However, for clients with substantial funds and the appropriate risk tolerance, a bespoke portfolio of individual holdings will give greater control over both investment objective and ethical concerns. Due to the cost of trading and management of this style of investing, it will generally only be viable for clients with investable wealth of £250,000 or more.

Our beliefs No 7.

Most clients appreciate simplicity. Where we have not recommended a discretionary solution, we will normally manage investments on a fund platform or wrap. The benefit if this is that you can consolidate all investments onto one simple reporting and administration system. You can also benefit from access to a wider selection of investment providers. The exception to this would be when we recommend direct investment in a multi asset fund or a simple product such as a stakeholder pension.

Our beliefs No 8.

Trying to time the market is a strategy doomed for failure. Investment markets often experience periods of volatility and can sometimes look expensive based on historic valuations. We believe that trying to time market entry decisions in the short term is a dangerous strategy as the biggest gains tend to happen quickly and are impossible to predict accurately. Market timing is also largely unnecessary when investing with a well- diversified portfolio across the different investment asset classes.

This does not mean you should take the “set it and forget it” approach, because over a 20- year time period your goals and objectives will certainly change, so you will need to make occasional modifications to your portfolio. But you should be making these moves based on changes to your risk tolerance or your progress toward your goal, not the gyrations of a particular stock.

You should have a guide or coach in this process. You need a trusted adviser to help keep you on track. That is a key part of our role.

Our beliefs No 9.

It is important to understand the effects of ethical screening on short term performance and the difference between sector led variances and prolonged under-performance. Strategic asset allocation (how you allocate between equities and bonds for the long term) is responsible for the bulk of long-term returns, but other factors can also play a role in short term performance. Typically for ethical funds, this will occur when ethical screening means that funds will be either under or outperforming the mainstream due to a particular screened sector (e.g. defensive stocks such as tobacco or alcohol) being in or out of favour by the mainstream market. We endeavour to take note of when this represents a short term blip and when its indicative of longer term fund management performance issues.

Our beliefs No 10.

The 'best' funds display consistent risk-adjusted returns combined with competitive charges. With strategic asset allocation forming such an important part of portfolio constructing, selecting suitable funds means looking for funds that will accurately reflect the relevant investment asset class.

We are looking for the best of breed funds within each asset class. How the funds perform is largely due to the asset class, which may be risky and deliver volatile returns (e.g. commodities). So we need to distinguish between what is in the manager's control and what is down to the asset class.

We use funds as building blocks in a portfolio and it is important that (subject to ethical considerations) they perform similarly to their asset class. In any given year there will always be funds that outperform their peers by taking large risks. However, we are searching for funds that perform consistently on a risk adjusted basis. We are very conscious of the costs and consider them carefully before recommending funds to our clients.

We can tailor our service in this area to your needs. Typically smaller portfolios will benefit from a smaller range of funds with a broad mix of assets to make the costs efficient. As portfolios grow in size there is greater opportunity to invest in a wider (and possibly less liquid) range of assets e.g. infrastructure, solar power.

Our beliefs No 11.

We don’t have all the best ideas; whilst we do undertake independent fund research for clients, we often feel that clients will be best served by delegating day-to-day management to a discretionary investment manager. Working together with a third party means that we can then concentrate on a stronger ethical oversight of investments as well as focussing on broader financial planning issues for clients. This gives clients the best of both worlds; utilising the greater funds research resources of discretionary managers to select suitable funds whilst allowing us to work with clients to understand their needs, values and attitudes to risk and inputting this into strategic asset allocation considerations.

Whatever is the best solution for your needs the basic philosophy of accurately assessing your risk profile, watching investment costs and diversifying will be at the core of our process.

Our beliefs No 12.

Costs are certain and returns are not – so they deserve attention. Costs are certain and fund performance is not. It therefore makes sense to reduce costs wherever it is safe to do so. One of the major issues in fund management is that not all the costs are transparent. There are three main costs with investing in funds:

01 // **the Annual Management Charge (AMC)** – is the fee that the manager charges;

02 // **the Total Expense Ratio (TER)** – this is the AMC plus legal, audit, depositary and other costs;

03 // **trading costs** – these are the costs of buying and selling the investments inside a fund. These include stamp duty, bid / offer spreads, stockbroker commissions etc.

Even though Total Expense Ratios are not the whole cost of running a fund, they are however a powerful predictor of fund performance.

Monitoring performance and costs of funds and discretionary services is a key part of our investment monitoring process.

Our beliefs No 13.

Ethical investment shouldn't mean accepting less. There is a perception that investing ethically means that you'll get a lower investment return. Whilst there are some strongly values led investments that do offer below market returns, we do not believe that this applies in general. As already established, asset allocation is the main driver of investment return and most asset classes are available to the ethical investor. Ethical funds do not normally carry higher initial and management charges than mainstream funds.

Different products carry different risks. With ethical investment, most products are unit linked and therefore will fluctuate as prices of the units go up and down according to market conditions. Over the longer term (10 – 15 years), ethical investments have tended to achieve returns on a par with mainstream investments. It's even arguable that increased focus on environmental, social and governance risks could lead to outperformance. However, due to the restricted stock selection or a focus on 'smaller companies', there may be occasions when the funds are out of 'sync' with the markets and experience either significant short term over or under performance against mainstream investment benchmarks.

Our beliefs No 14.

Only do the things that you can do well. We are a small business and our skill set is based in providing 'general practice' financial planning advice with a focus on ethically focussed deposit and collective investments. The investment market is constantly evolving and new ideas are coming to the market all the time. This is true of the alternative and 'ethical' market and in particular community and social enterprise investing. However, the bulk of these are essentially very small micro businesses bring an offering to the market for a limited time period. For traditional reasons of liquidity and market risk, we see these as 'high risk' investments and do not currently have the time and resources to carry out appropriate due diligence on these investment. For this reason, we will decline to provide advice (other than generic guidance) on these types of investment opportunities. We would rather pass up on an opportunity that we can't fully assess, rather than risk clients money with a well intentioned but poorly researched recommendation.

We have some simple rules that we apply to all portfolios unless the clients specifically request a different approach:

- Focus on a core, diversified portfolio of mainstream assets.
- Not all funds should be with one manager
- No hedge funds
- Only use funds run by FCA regulated or authorised managers
- No individual stocks (unless you have sufficient capital for a fully diversified portfolio)
- Where possible, incorporate different 'house styles'.
- No unauthorised funds

Risk Warnings.

All investments carry risk. These are a few of the important ones.

- The risk that the buying power of your capital decreases over time.
- The risk that the growth you experience is variable.
- The risk that you might get back less than you invested.
- The risk that you do not achieve one of your objectives.

Important Notice:

The value of investment units and the yield from them can fall as well as rise. Past performance is not necessarily a guide to future performance.

The content of the report is based on our current understanding of the law.

Ethical Futures llp are authorised and regulated by the Financial Conduct Authority.

Thank you

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