Ethical Investors

Asset Classes
– What are they and which ones are ethical?

Introduction

Investing money can be a complicated and confusing business, especially if one isn't familiar with the jargon and terminology used by the investment industry. This document focuses on one of the most important areas of investment – Asset Allocation. Before we look at the detail, a good place to start is to look at what is meant by Asset Allocation.

In simple terms Asset Allocation involves dividing up your money into different areas, each of which will do different things and have a different type of risk. Even if you decide to put every single penny of your money in a single Building Society account, you have carried out an asset allocation exercise; you decided that the best thing for your money is to have everything in one place in a 'safe' savings account. For an explanation why we put the word safe in italics, please read our separate document which looks at Risk and Reward.

So, asset allocation is the act of selecting how you divide up your money, and the term Asset Class is just a fancy way of describing the different types of thing you can put your money in. Asset Class is not, however, a description of a product, it is a description of a 'type' of investment. For example, Cash is an Asset Class and a Building Society Savings Account is a type of Cash investment. Each individual Asset Class can be divided into perhaps hundreds of different options, but there is generally only a limited number of main Asset Classes. The rest of this document considers the main types of Asset Class and provides examples of the sort of things that can be included in each Asset Class.

1) Cash

This is the first Asset Class that each of us has to deal with. Once we receive our first £1, we begin the asset allocation exercise. If it is only £1 that we have, then the asset allocation exercise might be to allocate the £1 to a pocket or a purse! Once we start to accumulate a few more £s we might allocate these to a bank current account because the money will be spent quickly. If there is a surplus, perhaps we'll allocate some of the surplus to a savings account and as the surplus gets bigger we might split it between an easy access savings account and a fixed term higher rate savings account. Unknowingly, most people undertake an asset allocation exercise but deciding to keep all of their money in cash savings, but then try to manage the twin competing demands of easy access and higher return. You see, you've been Asset Allocating all the time and you didn't even know it! Examples of different types of Cash investments are:

Bank/Building Society accounts	Cash ISAs	National Savings, (incl Premium Bonds)	Credit Unions

The common factor amongst all types of investment considered to be a Cash asset is that the value of your capital does not go up and down due to fluctuations in an investment market and you receive a stated rate of interest on your money. Whether the rate of interest is enough to keep up with inflation is one of the risks of investing in cash. Yes, that's right, there is a risk to investing in Cash even though most people think it is the safest thing to do. It is only really safe if the rate of interest you are earning is greater than the prevailing rate of inflation – more in this in our Investment Risk document.

2) Fixed Interest

This is a term most commonly used within the investment industry rather than amongst the public. Although many of us regularly save money in a Building Society where the account offers a fixed rate of interest, this is not what is meant by Fixed Interest in investment circles. A Fixed Interest investment is any investment which offers a known (fixed) rate of return but where the capital value is subject to fluctuation in relating to movements in markets.

For example, you might buy a fixed rate investment for £1 offering fixed interest of 5%. In a building society account you would make your 5% interest and this would be added to your account. With a Fixed Rate asset, however, you would be earning your 5% but the capital value, your £1, might be moving up and down depending on market sentiment.

A year after you buy your fixed rate investment, you are still earning the fixed rate of 5% of the original £1, but because the market is having a good run your £1 is now worth £2. That's great because you've doubled your money, but remember that markets can also move down and your investment could be worth 50p.

Now, there are good and bad aspects to the capital value moving up and down if you are investing for income – the 5% you wanted when you invested £1. Before we go any further there is a very important principle to understand: you must remember that with a Fixed Rate investment the rate of interest quoted is based on the price of the asset when it was issued and this remains fixed.

So, if the asset was issued with a face value of £1 and a fixed rate of interest of 5%, the holder of the asset would receive 5p a year for every £1 holding. Understanding that the percentage interest is based on the original issue price and not the current market price is critical to not only whether you invest in a Fixed Interest investment, but also when you make the investment. Let's look at what happens to your income as your capital value moves up and down:

a) Your £1 increases to £2 – as mentioned above, this is good news because you've doubled your money. If you invested in this asset to get some capital growth and the interest was an added extra, then you've done very well. If, however, you invested for income, then although you would still be getting your 5p per annum on the face value of £1, your asset is now worth £2. So, the REAL rate of interest you are now earning has halved to 2.5% - you are earning 5p on something worth £2. If income is important to you it might be time to look around to see if you can buy a different asset which is paying a higher rate of interest than 2.5%. You can sell your asset for £2 and reinvest this elsewhere for a higher income.

b) Your £1 drops to 50p – in this scenario you have lost half of the money you invested (well, actually you only lose the money if you sell the asset now) but you are still receiving 5p per annum (5% of the original face value of £1). If you invested for capital growth, you haven't done very well. If, however, you are looking to invest for income then this asset might be a good thing because the 5p per annum income on a current 50p value is giving you an effective income of 10% - that's great! IF you bought the asset at £1 then selling now would realise a loss but if income is the most important thing you might have to look at other options. IF you are looking to invest for income and see this £1 @ 5% investment for sale at 50p, then you might want to buy it now to get a 10% return on your money. You do take the risk that the capital value might fall further, but getting a 10% income might be more important to you.

Examples of different types of Fixed Investments are:

- Government Gilts (held directly, or inside pension funds, Stocks and Shares ISAs and Unit Trusts etc)
- Corporate Bonds (held directly, or inside pension funds, Stocks and Shares ISAs and Unit Trusts etc)

3) Equities

Another term bandied around as if everyone knows what it means, but this is probably not the case. If one takes an 'equity stake' in something, it means taking partial ownership of something. In investment terms, an equity is a 'share' of ownership of a company. This is often why the term 'share' is used interchangeably with the term equity – they are essentially the same thing. When a company is set up for the first time, a set number of shares are issued in the business and these are divided amongst the founders. Any of these founders can sell their share to anyone else at any time. For small business this sale would have to be done privately and the value of each share will have to be agreed between the two parties. When companies get to a certain size (no fixed size) they might consider putting some or all of their shares onto the share market (also known as stock market). Once these shares are on the stock market, they can be bought and sold by anyone and the value of each share will be easy to see as there will be a daily quoted price. This price will be dictated by two main factors:

- Overall sentiment about how well the economy is doing, and
- How the wider market feels about how the individual company is doing.

The above factors can work together or can go in completely different directions. If the economy is booming then one would expect shares to be going up and if buyers of shares thought a particular company was going really well, the price of shares in the company would receive a double boost. Alternatively, if the economy is doing well but an individual company is struggling, the wider rise in shares won't have any impact on the individual company and its price might be falling as people sell out. The combinations of options are numerous, but we hope you get the point – buying shares means that the value of the asset you hold can go up and down at any time. You hope, of course, that over the long term you see a rise in the value of the shares you hold.

The vast majority of people won't hold shares in companies directly, but they will probably hold them via the following (even if they don't know it!):

Stocks and Shares ISAs	Unit Trusts and OEICs	Investment Trusts	Pension and Life Funds

As sub sets of the above products, equity funds can be:

UK Only	European	Global	Far East
North American	Emerging Markets	Latin American	.......and so on

By pooling your money with thousands of other people into a fund, you gain access to markets anywhere in the world and benefit from the investment expertise of professional investment managers. Whilst £1000 might be too small a sum to directly purchase shares in a single company, the same amount of money could be invested into a Stocks and Shares ISA, for example, with the money split between 10 funds investing across all of the areas listed above.

4) Property

Of course, for most people their own home is both somewhere to live and an investment. Those who buy a second home might do so purely as a holiday home or it might be held as an investment (buy to let). Either way, property investment (also known as bricks and mortar) is recognised as being a good long term investment and one that the people understand, in terms of what it is and the risks involved.

The above generally relates to investment in residential property, but what about investing in commercial property (office blocks, factories etc)? Few of us have the means to invest in commercial property directly, but there are many ways that individuals can benefit from holding commercial property over the longer term, such as:

Pension property funds	Property Unit trusts/OEICs	Stocks and Shares ISAs	Shares in property companies

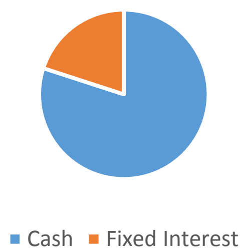
We are all ware that property prices can fluctuate, but unlike stocks and shares which are volatile on a minute-by-minute basis, the swings in property values generally happen slower and over longer periods of time. As such, any investment in property needs to be seen as a long term hold and one that is not very liquid, i.e. you can't just decide to sell today and expect someone to be ready to buy and complete the deal tomorrow. If you put a property on the market at a ridiculously low price then you probably will sell it quickly, but let's not see this as a serious option.

Property investment funds operate by collecting the money form thousands of investors and using this much larger pot of money to invest in property. Investors only have an investment in the overall fund, so can easily buy in and sell out at any time (in most cases) which is better than trying to buy a property with a group of friends and then trying to sell your bit of the property (a quarter of the second floor plus one of the ladies' loos!). The value of the property fund will reflect the overall movement in the property market and you'll benefit form a share in the rental income from the tenants of the factories/offices etc.

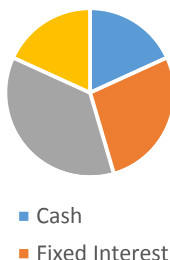
Examples of different asset allocations

The following examples show how the different asset classes might be mixed together based on different levels of investment risk. It is generally accepted that the lower the level of risk one is prepared to take, the lower the expected return will be. Any of the asset classes can be best or worst options on their own over short periods of time, but over the longer term those asset classes which involved a higher degree of risk would be expected to produce a better return.

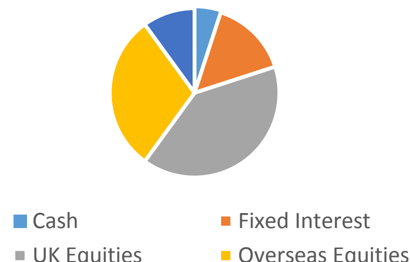
Lower Risk/Return



Medium Risk/Return



Higher Risk/Return



These examples are only for illustrative purposes and should not be seen as definitive examples of asset allocation/risk models)

Ethical Considerations – the different asset classes

Having outlined the four main asset classes above, we would now like to look at the ethical implications of investment your money in each. We do not intend to consider individual ethical criterion, we simply wish to highlight the ethical considerations you will have to make when looking at each of the different asset classes.

1) Cash: Once you deposit money with a bank or building society, your money goes into the system and that's the last you see of it until you want it back. Whilst it is in the system, however, you might be surprised at what your money is doing. Your bank might lend it on to someone buying a house, it might be used to fund someone's credit card or it might be leant to one of the bank's business customers. The latter should be of greatest ethical concern because your money could be leant to an arms company, an intensive farmer, tobacco company, a company using child labour – the list is as long as the list of unethical activities.
Unless you are using an ethical bank (such as Triodos), it would be better, ethically, to use a building society for your day to day banking needs.

The largest ones are able to provide all of the current account, credit card, cash machine services that any bank can provide. The ethical difference is that a building society isn't going to lend any of your money to directly finance the day to day activities of any company (good or bad).

2) Fixed Interest: Corporate Bonds and Gilts are loans to a company or Government respectively. If the Bond is bought when it is issued, then it really is a direct loan to the institution so you need to look at what the organisation does that you are lending your money to. What are you financing? If you buy a Fixed Interest investment that was issued in the past, you are not giving your money directly to the organisation, but the interest payments you receive will have been made from the activities of the business. So, if you have a corporate bond from an arms company, the interest payments you receive have come directly from the sale of weapons. Are you comfortable with that? There are ethical Corporate Bond fund available which will only hold the Bonds of companies that have passed through an ethical screen.

Gilts are interesting, because they are a loan to Government. Putting party politics aside, if you buy a newly issued Gilt you are lending money to the Government to finance education, health, roads, police, defence, overseas aid – a real mixed bag. Whether you object to funding any of these activities will dictate whether you are comfortable buying Government Gilts or National Savings.

3) Equities: As an owner of a business, you are linked to what the company does. It is taken for granted that you approve of all of the company's activities, you fully endorse those activities and wish to profit from them. This is easy for those who invest with no ethical values, but very problematic for those who have a social or environmental conscience. For example, how tenable is it for a Quaker to be a part owner of a weapons company, a vegetarian to own part of a factory farmer or slaughterhouse or an environmental campaigner to hold shares in a brown coal company? None of these investments make sense, but unless each individual chooses to screen every share they buy, or they make sure they only invest in ethical funds (ISAs, Unit Trusts, pension funds etc), they will be owners of companies whose activities they do not agree with.

The above situation is bad enough, but let's look at it from an active campaigner's point of view. This person spends their spare time campaigning against companies contributing to climate change. At the same time they don't invest ethically and therefore hold shares in some of these companies via their Stocks and Shares ISA and their private pension. As mentioned above, even though the shares are held via funds, they are still partial owners of these companies. Here comes the silly and unnecessary conflict; if their campaigning is successful and these companies close down and cease to make money, this person has directly reduced the value of their ISA and pension fund – they've made themselves worse off. How illogical is that?

4) Property: There are possibly as many different ethical ways to look at a property fund as there are investors. Every individual brings to the investment process their own views on what is ethical and what isn't and it is quite common for two seemingly similar clients to have completely opposing views on the 'ethicalness' of property funds. We have distilled these myriad of views into two main ethical areas, which are considered below:

Who are the tenants? – if a property fund owns and lets out the property it holds, what sort of business are their tenants involved in? None of the property unit trusts or investment trusts that we have looked at actually screen their tenants on ethical grounds. Now the chances of property funds having tenants who are trading as weapons manufacturers or abattoirs is very small, but nevertheless individuals need to consider whether they wish to apply a strict policy on property funds, or whether the more remote theoretical ethical problems should not be subject to their main ethical criteria.

Environmental considerations – all land development has an environmental impact. The new office blocks and out of town centres that are springing up are often owned and developed by property funds. Your personal attitudes to this sort of development will influence your attitude towards investing in property funds. Increasingly, property owners are leading the way in reducing the environmental impact of their properties, either at the building stage or as part of a refurbishment; efficient buildings are becoming an asset to tenants who wish to reduce their environmental impact and will, therefore, choose those sites to lease which offer a higher environmental rating.

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