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**sub-prime fallout reaches the ethical fund market**

*The credit squeeze in the financial markets that led the Bank of England to intervene on behalf of the UK mortgage lender Northern Rock is having a knock-on effect in the ethical funds market, says Mike Scott*

The financial sector has been in turmoil in recent weeks, as fears over sub-prime mortgages in the US led banks to stop lending to each other because they could not be sure of the risks involved. The short-term credit markets shut up shop and UK bank Northern Rock was left high and dry as its business model of borrowing in the financial markets to cover its mortgages was exposed.

The upheaval might be expected to hit the SRI sector hard as it is traditionally overweight in financial stocks, which provide strong earnings while meeting most exclusion criteria. In May, such stocks made up 32.2 per cent of the FTSE4Good index, for example.

As an individual stock, Northern Rock has very strong credentials on many social investment criteria, including treatment of employees, equal opportunities, diversity and job creation, according to Stephen Hine of Ethical Investment Research Services. It has also been well-regarded because of its charitable foundation ([see page five](#)).

'Northern Rock is one of the only banks to hold an annual corporate governance forum,' says a spokesperson from CCLA, which invests for a number of charities and the Church of England. Nonetheless, the fund had been selling down its holdings for some time prior to the crisis. 'That was a business strategy issue rather than an SRI one,' the spokesperson added. Jupiter Asset Management, another large SRI investor, also said it did not hold Northern Rock when the crisis broke.

Greg Larkin, a New York-based banking analyst at advisory firm Innovest Strategic Advisors, warned last year that the sub-prime sector was going to cause problems. 'We noticed that sub-prime lending in the US market had increased from \$58billion (€42bn, £29bn) in 2001, or six per cent of the market, to 40 per cent of the market, at \$625bn, in 2006 while real wages remained stagnant,' Larkin said.

Because many lenders securitized the loans, they did not have to worry about repayments. Larkin said many SRI funds that he talked to about the issue at the time were not interested. 'They said: "Let's not talk about that, let's talk about carbon." Stakeholders in sub-prime are not as loud as Rainforest Action.'

'Sub-prime lending in itself is not a bad thing,' says Hine. 'Done well, it boosts social inclusion, but if you are lending four to five times income, then you have to question this.' There are two sides to the issue, according to Penny Shepherd, chief executive of the UK Social Investment Forum. Banks should avoid encouraging excessive indebtedness but they should also provide access to appropriate finance.

'There has long been a focus in the SRI community on responsible lending,' she adds. 'Irresponsible sub-prime lending affects absolute returns.'

'It is interesting that the banking sector as a whole has not sought an increase in the amount of investor protection,' Shepherd continues. 'Had that protection been increased in line with house prices, we might have seen medium-sized savers being more confident in leaving their money in the bank.' The Northern Rock crisis also shows the importance of reputation, she adds. 'The original issues were about the company's business model and lack of diversification, but it was the reputational impact that did the damage'. Concern over reputation is one factor that leads SRI investors to engage with companies.

However, fears that SRI funds may suffer excessively from the turmoil may be overblown. Rory Sullivan, head of investor responsibility at Insight Investment, points out that funds differ in their investment approach. For example, of the funds that Insight is responsible for, the Halifax Ethical Fund excludes banks but allows other financial services companies, while Insight's Evergreen and European Ethical funds can invest in banks. 'Investing in financials is not a clear-cut issue like arms or tobacco,' he adds. 'The policies of different funds are quite inconsistent.'

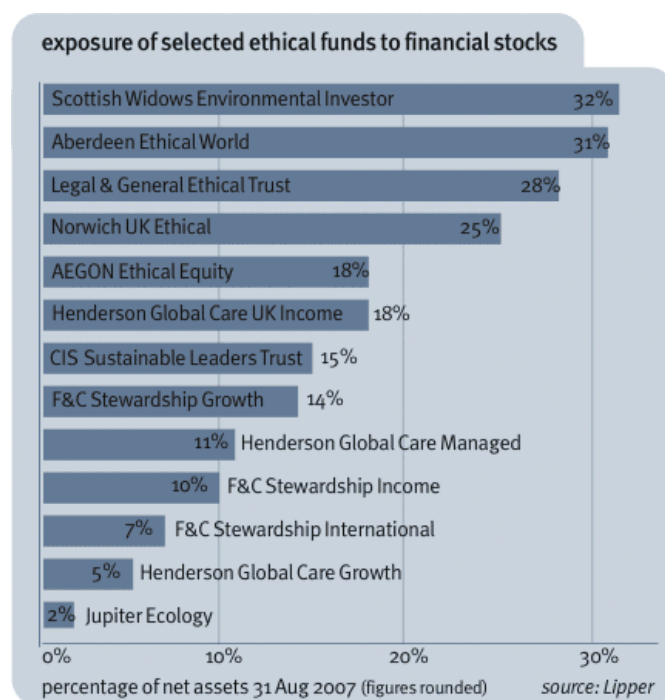
Some SRI funds also have little or no interest in financial stocks. The Jupiter Ecology Fund has only 1.8 per cent of its holdings in the sector because its focus is on clean technology companies. 'The SRI sector has grown massively - there are now too many funds to make generalizations,' adds Hine.

In terms of how the crisis will affect the sector in future, it is equally hard to make across-the-board assumptions. 'Because ethical screens vary so much, you cannot extrapolate to the sector as a whole,' says Sullivan (see graph below).

Hine suggests that the crisis may lead investors to seek out banks such as HSBC and ABN Amro with sound policies on sub-prime lending and other sustainability issues. Innovest's Larkin says that in the US, certain sub-prime loans may be made illegal, which would be a shame. 'Sub-prime lending is a critical ingredient for economic improvement because it helps people own their homes – good things tend to happen where that is going on.'

In one sense, this short term upheaval should not matter. Shares go up and down and SRI funds take a long-term view. Northern Rock illustrates the dangers of investors and businesses focusing on short-term gains. Shepherd says:

'If a fund has identified a particular factor such as a reliance on the credit markets as a risk and the rest of the market has not, it can look like that fund is underperforming. It is all part of the challenge of how to measure long-term performance.'



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