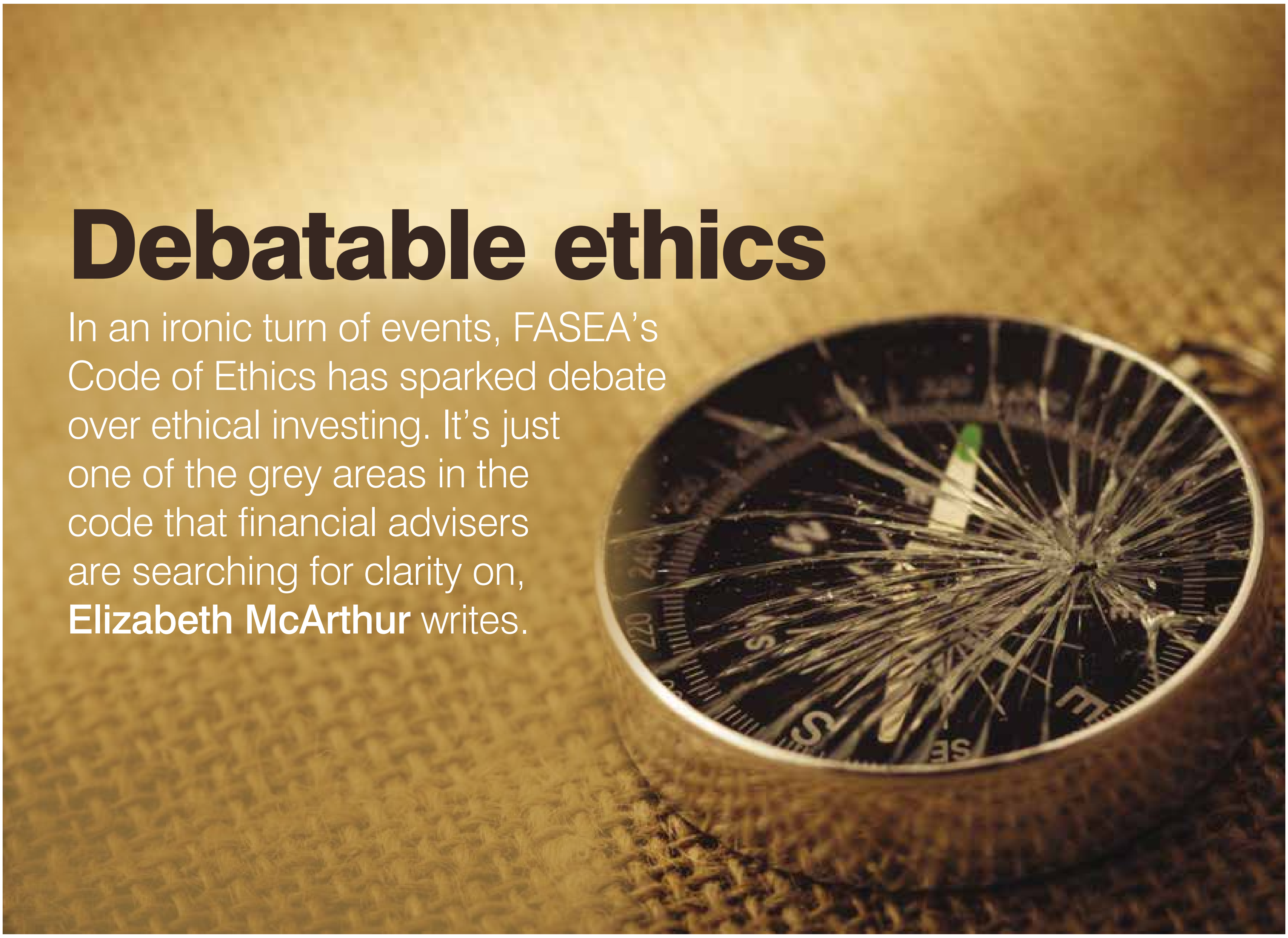

Debatable ethics

In an ironic turn of events, FASEA's Code of Ethics has sparked debate over ethical investing. It's just one of the grey areas in the code that financial advisers are searching for clarity on, **Elizabeth McArthur** writes.

A debate is raging about what the Financial Adviser Standards and Ethics Authority's Code of Ethics means for ESG investing and advising clients on ethical investment options, with FASEA's chief executive forced to clarify the issue.

An example provided along with Standard 6 of the Code of Ethics appears to be the source of the confusion. The standard states that financial advisers must take into account the broad effects arising from the client acting on their advice and actively consider a client's broader, long-term interests and likely circumstances.

In the accompanying Code of Ethics Guidance, released FASEA in October 2019, this example is given in relation to Standard 6: "Where your clients indicate they only wish to invest in ethical or responsible investments, you will need to consider whether limiting your product recommendations in this manner is appropriate."

Dave Rae, a financial adviser and owner of DPR Wealth, explained that his reading of the guidance indicates that advisers should be asking clients whether they would prefer to invest in an ethical or responsible manner.

For Rae, who is a member of the Ethical Adviser's Co-op and the Technical Working Group for the Australian Sustainable Finance Initiative, that would mean business as usual – however for other advisers it could present a significant hurdle to jump.

"The way the explanatory statement is worded to me quite clearly says that every adviser will have to consider ethical and responsible investments," Rae said.

"And the only way you can consider that is by asking the client whether they have particular ethical considerations or preferences."

For Rae, the issue of whether the FASEA code means advisers have to ask whether their client has ethical investment preferences is one of semantics.

Stephen Glenfield, FASEA chief executive, offered this clarification to *Financial Standard*: "In short, Standard 6 does not require the adviser to ask about ethical investments."

"Rather, where a client indicates they only wish to invest in ethical or green investments, Standard 6 requires the adviser to consider whether this is in the client's best interest."

Nonetheless, Rae is not alone in his interpretation of FASEA's comments; others have also taken the explanatory statement around Standard 6 to mean ethical investing may require more attention from advisers.

Karen McLeod, financial adviser at Ethical Investment Advisers, explained her interpretation: "I believe the code encourages advisers to have deeper and broader conversations with their clients."

McLeod pointed out a survey conducted by the Responsible Investment Association of Australia found that nine in 10 Australians expect their money to be invested responsibly.

If that's the case, then conversations about ESG investing concerns are likely to come up for many advisers.

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> *In short, Standard 6 does not require the adviser to ask about ethical investments.*
> **Stephen Glenfield**

"Ignoring ESG factors puts your clients financially at risk and is potentially in breach of the FASEA code," McLeod added.

FPA head of policy and standards Ben Marshan said: "They've used an example where a client has a preference for ethical investing, the planner would be obligated to consider them. They're not really clear on what they're saying."

He added that there are some views on ESG investing that FASEA may or may not be taking into account.

"There are some views out there that ethical investments might not always be high quality products, might not always perform well or provide appropriate diversification," Marshan said.

"That view had some validity five or 10 years ago but today ethical investments are reasonable for planners to consider. However, their views might not be up to date."

Rainmaker analysis of ESG investment options in superannuation has revealed that both ESG balanced and growth options outperform their non-ESG equivalent indexes.

For the period ending May 2019, ESG balanced investment options outperformed the balanced index across one-year, three-year and seven-year time periods.

The ESG benchmark gained 8.5% per annum over three years vs 7.7% for the balanced index.

Ethical Advisers Funds Management recently launched new separately managed accounts (SMAs) which screen out investments in oil, tobacco, weapons, heavy polluters, gambling and coal.

Portfolio manager and head of research Luke Price explained the SMAs are designed to meet the potential increase in demand for ethical investments following the introduction of the FASEA Code of Ethics – with which all advisers must be compliant from 1 January 2020.

"It is basically the law from 2020 that all financial planners need to incorporate this type of advice into their recommendations," Price said.

"We believe these types of ethical investments will be in high demand going forward, particularly due to the new FASEA Code of Ethics for financial advisers."

Ilan Israelstam, co-founder of BetaShares Capital and head of strategy and marketing, has seen strong continuing growth for BetaShares' responsible investment ETFs.

"For example, BetaShares' two socially responsible funds, ETHI and FAIR, the largest two RI ETFs on the market have funds under management of $800 million, up from $400 million at the beginning of the year," Israelstam said.

He sees opportunity in FASEA's mention of ethical and responsible investing, and noted that much of BetaShares' growth in this area has come from financial advisers.

In 2018, the BetaShares/Investment Trends ETF Report found that 35% of advisers provide advice on ethical/sustainable investments.

That number was only 19% four years ago. While that represents significant growth, it also remains that the majority of advisers do not provide specialised investment advice based on the ethical considerations of their clients.

"Obviously Standard 6 is very broad. I think in the end it's just making sure advisers are taking into account a broad set of factors when giving advice," Israelstam said.

"I think the fact that FASEA mentions ethical and responsible investing is significant. It means that is something that needs to be addressed.

"Although it doesn't say that the adviser has to bring up ethical and responsible investing, it does say that where a client brings it up the adviser must respond appropriately."

Whether that can be taken to mean that an adviser should ask a client if they have any ethical investing preferences, or anything they do not wish to invest in, Israelstam acknowledged FASEA has left the issue murky.

"I don't think there's an answer to that question, but I think FASEA's mention of ethical and responsible investing is an indication of the focus on the area," he said.

"FASEA could have chosen to include any other example but instead it chose to include ethical and responsible investing and that, I think, is the notable part – it is an acknowledgement that it's an area likely to be dealt with and that clients are likely to bring up."

Israelstam sees the guidance as an indication that advisers should be prepared with options if even one client were to ask, and as demographics change and there is an increasing awareness of ESG concerns, advisers are more and more likely to have a client bring up this issue.

Israelstam predicts that ratings and labels on ethical funds will become more important as more advisers attempt to work out which ethical funds are true to label. Those advisers will have to rely on research in order to not fall victim to greenwashing.

McLeod thinks that as advisers have deeper conversations with clients in response to the FASEA code that will have a carry-on effect for product providers.

She says more ESG-related questions from clients may well result in advisers being forced to interrogate the underlying companies in the investment solutions they are recommending.

And if that's the case, they may run into some difficulties.

"Australia is lagging on transparency of holdings and rates a D- by Morningstar when it comes to transparency," McLeod said.

She hopes that if the FASEA code prompts more ESG conversations among retail clients, fund managers will have to provider better holdings disclosures.

Rae agrees, saying he has seen product providers produce educational tools on ethical funds that aren't just designed for advisers – but for them to pass on to their clients.

"Some of the reporting I've seen is based on non-financial measures like measuring the carbon emissions of this portfolio versus the index," Rae said.

However, he added: "There's definitely already greenwashing going on. The lack of consistency on fund labelling means without doing work on it you cannot simply rely on an approved product list, you have to do your own research."

Rae pointed out that he has come across funds labelled as ethical with absolutely no difference in top 10 holdings against the index.

"Product providers have seen an opportunity in the growth around ESG investing to take advantage," Rae said.

"You have to actually investigate whether the funds are doing what they say they are doing and hold them to account over time."

He said he empathises with advisers who are unsure where to start when it comes to educating themselves about ethical investment options that they can then recommend to clients.

"Once you understand the client's preferences you still can't fit them into a box easily. Every client is different," Rae said.

"When you start discussing negative screens you can be talking about 10 or 15 issues, and then the same on the positive side. That's not easy to fit into a portfolio across different clients."

A document released by the FPA in April, when only the code and explanatory statement were available, also delved into the issue of ethical investing to help financial advisers understand Standard 6.

It included an entire sub-heading on ethical and responsible investments and suggested to advisers that they "review your advice process to ensure you consider limiting your recommendations for your client to 'ethical' or 'responsible' investments", adding that the consideration should be based on broader long-term interests and future circumstances of the client.

Marshan said the confusion has largely arisen by how delayed the FASEA guidance has been, and the authority's less than clear communication style.

"FASEA is basically saying where the client says they want ethical investments the planner has to take that into account," Marshan said.

"But equally, where the client says they don't want international shares the planner has to take that into account."

He said that while FASEA's real point may not be in relation to ethical investing specifically, but rather to investment preferences more broadly – that doesn't really clear up whether the questions advisers ask clients will have to change in vew of the code's guidance.

"The point FASEA seems to be trying to push is that planners should get a better sense of their clients' investment preferences, and perhaps ask those questions rather than just go ahead with their default models," Marshan said.

"So yes, I think those conversations will have to happen under the code."

He explained that advisers have expressed confusion on this point to the FPA.

Rae said he too has had advisers come to him with questions about this element of the code. In his case, they are looking for advice on integrating ethical and responsible investing into their practice.

"I've had advisers ask me what funds I use and what questionnaire I use," Rae said.

However, he countered that the questions are not only FASEA-related but are also due to a general increase in the number of clients interested in ethically-minded investment options.

To aid planners, the FPA is currently working on a new document to explain the code to members in light of FASEA's guidance.

"FASEA's communication style is very unclear. They use a lot of contradicting statements in both the explanatory statement and the guidance," Marshan said.

"Planners are reading that and saying, 'Does this mean I always have to consider ethical investments?' We've had this conversation with them."

Despite Glenfield's attempted clarification, for Marshan, one thing is clear, time is still an issue.

"This leaves no time for planners to change their business models and actually be compliant," he said.

"There's not enough time to understand what FASEA is saying, because it's still not clear, then make changes to all your advice processes and procedures."

The FPA is calling on FASEA to extend the time advisers have to be compliant with the code by two years.

Marshan pointed out that no matter how the point of ethical and responsible investing works in with the FASEA code, there are potential changes to approved product lists to be made and that has to go through governance, something that takes time.

"FASEA's guidance is way too late," Marshan said.

"FASEA could support our call to give advisers an extension to be compliant with the code - particularly while there is actually no body monitoring compliance with the code."

He added: "I'm not sure how you can consider whether recommendations can be limited to ethical and responsible investments without asking your client whether they have some preferences in that area."

For Rae, the issue of semantics is: "How can you say you've considered it if you've never had that conversation, if you've never asked the client whether there are things they do not want to put their money into."

Rae said it's important for advisers who are interested in learning more about integrating ESG investing into their practices to not lose sight of the bigger picture.

"What we're starting to see is a shift that is having an impact on so many aspects of the investing landscape and society as a whole," Rae said.

"For me, personally, as an investor I want to invest in a way that looks after myself and my family but if I can do that in a way that also benefits the community, people and the planet – why wouldn't I?" **FS**

> *There's not enough time to understand what FASEA is saying because it's still not clear.*
> **Ben Marshan**