

Australian Ethical Smaller Companies Trust

The Australian Ethical Smaller Companies Trust goes beyond the greenwash to help investors save more for their retirement without sacrificing their ethical and environmental concerns, writes MICHELLE BALTAZAR.

If you ask Andy Gracey, portfolio manager of the Australian Ethical Smaller Companies Trust, what his "best buys" were, one stock stands out: Pure Energy.

He bought shares in the Queensland-based coal seam gas junior when they floated at 20 cents per share, thinking at the time that the sum-of-the-parts valuation of the company could be higher than that.

He was right. By the time utility giant British Gas took over the company, Pure Energy's shares reached \$8.25 per share, more than 40 times what he paid for them.

This type of return won't happen everyday, Gracey said, but his portfolio is full of quality companies that did well for the fund.

Since its launch in 1994, Australian Ethical has delivered an annualised return, after fees, of 9.88 per cent more than 47 per cent higher than the returns of its benchmark, the ASX Small Industrials, which generated 6.71 per cent p.a. in the same period.

Even better, this return was gained from stocks that satisfy their tight environmental, social and governance (ESG)-based investment charter.

Born to be green

The Australian Ethical Smaller Companies Trust differs from competing ethical funds in that it screens for companies that have positive attributes under their ESG charter.

This is fundamentally different from most managers in the space who solely focus on screening companies out, or negative screens."

Not that a positive screen makes the fund's core principle of supporting environmental sustainability less rigorous.

For example, a part of Australian Ethical's charter is to avoid any investment considered to unnecessarily pollute land, air or water; or destroy or waste non-recurring resources.

These charter requirements contributed to the portfolio excluding mining stocks, even a top-performer like BHP.

Some other funds will say BHP publishes a sustainability report and ticks a lot of boxes so is responsible. This is perfectly valid," said Gracey, "but it is not where Australian Ethical draws the line."

Looking for greener pastures

One of the fund's levers is its ability to invest in three sub-categories of stocks: domestic small cap, domestic large cap and international equities. It can also hold up to 15 per cent of the fund in cash, if needed, or to drastically change allocations between the three sub-categories in volatile markets.

This flexibility meant despite the financial crisis, the fund returned an annualised 1.52 per cent versus its benchmark's loss of 12 per cent in the three years to March. Moreover, it beat the market at lower volatility rates against its peers, according to a Mercer survey.

Gracey said that over the long term, it's the fund's small-cap portfolio that added a lot of value while the recent three-year record is mainly due to their heavy weighting in the traditionally defensive sectors of utilities, telco and healthcare.

This year, he said the fund would remain cautious and stay overweight in quality companies with sustainable balance sheets and competitive market positioning. He will, however, take advantage of market opportunities as they occur,

as was the case on 7 May, when the Dow Jones fell 1,000 points overnight (then recovered quickly).

He said the fund put more cash into the market that day when quality stocks traded at lower prices.

That's a short-term manoeuvre counterbalanced with the fund's long-term play, including a small exposure into Australian Ethical's internally managed Global Smart Energy fund, where investors can access the global leaders in renewables and energy efficiency.

Can investors truly say that the grass is greener with Australian Ethical's Smaller Companies Trust? However, the advantage of an ethical fund is that it believes in being transparent and have listed the stocks they invest in on their website.

Listening to gut instincts

Gracey said one of the advantages of working at Australian Ethical is the support from two separate research teams: one for ESG company assessments and another for investment analysis.

He supplements this intellectual firepower with his gut instincts honed by years in the industry and the innate sense that investing is a people business.

"A lot of IP in funds management comes from the contacts, not just the cold hard spreadsheets. The numbers might look great and the chief executive might tell you the company's prospects are strong, but reality might be all too different," adding that the role of a chief executive is to be an ambassador of the business, not its worst critic.

Were there times in his career when his gut instincts turned out to be wrong?



"Yes," said Gracey. But that's where science comes into play. For example, he knows that liquidity is a big issue for investors, particularly because they invest in small caps.

"But we monitor it by looking through the entire portfolio and managing it to a days-to-liquidate metric," he said.

In short, the fund covers all bases and addresses client demand for an ethical fund without the investment tradeoffs.

"We argue that while the fund is active in fewer investment sectors, disparities between sector returns come out of the wash in the long term," he said.

The fund has also been running for 16 years which means investors know the fund is an expert in the space that it's in, such as renewable energy.

Ironically, while their best buy was Pure Energy at 20 cents, Gracey said it was also their worst sell, having sold some shares at only \$1. But five times return on your money is not such a bad thing. ●

Figure 1. Australian Ethical Smaller Companies Trust

Comparison with the Mercer Retail Equity Australia Small Cap Universe. Annualised risk and return for three years ended March 2010 (before tax and after fees)

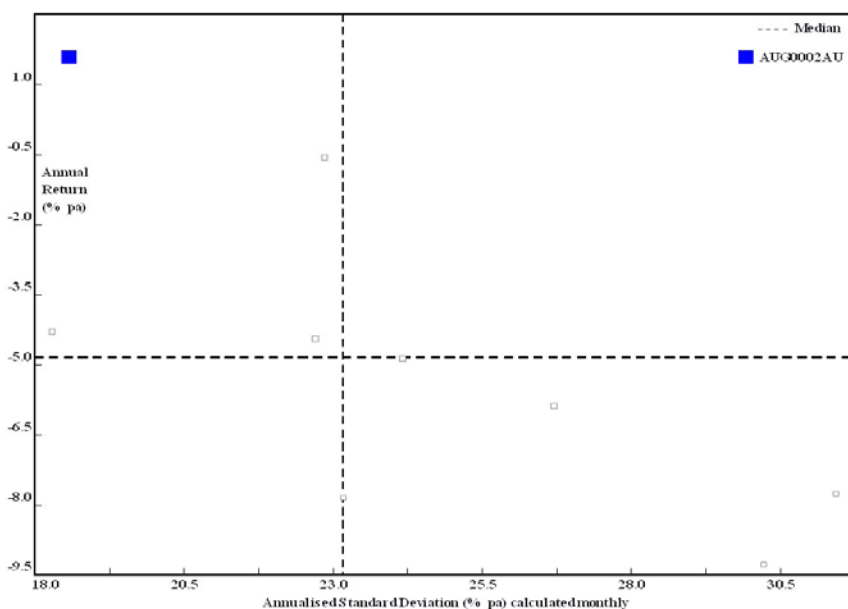
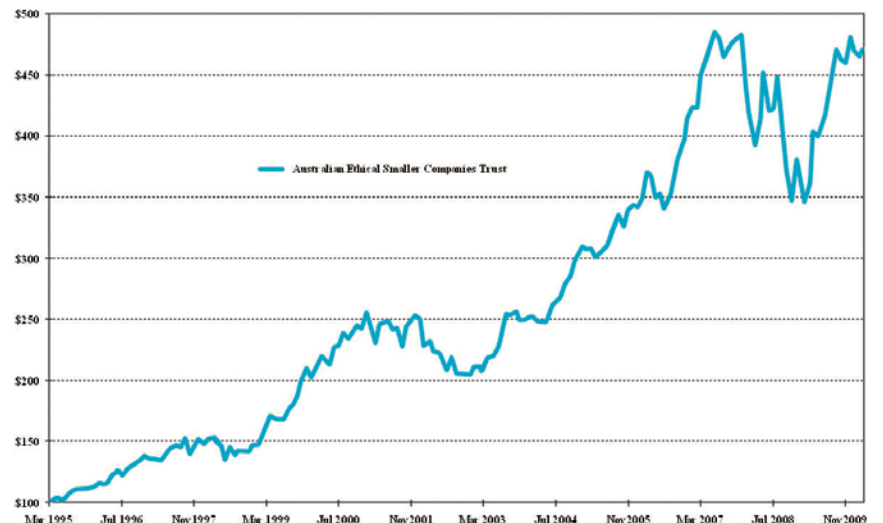


Figure 2. Australian Ethical Smaller Companies Trust

Value of \$100 invested in Retail Equity Australia Small Cap from April 1995 to March 2010 (before tax and after fees)



Data source: Lipper. A Thomson Reuters Company. Diagrams supplied by Australian Ethical.