THE CHURCH OF ENGLAND
Ethical Investment Advisory Group

Church of England Ethical Investment Advisory Group

Pooled funds policy

September 2014

Introduction

1. The Church of England national investing bodies ('NIBs'), like most significant institutional investors, invest the majority of their assets directly (e.g. in equities, property and bonds). Direct investment allows the NIBs to implement their ethical investment policies: ethical exclusions; the integration of environmental, social and governance factors into investment management; proxy voting at company general meetings; and engagement with company management on ethical issues.

What are pooled funds?

2. Pooled funds are largely used by small institutional investors and retail investors. They are funds in which a number of different institutions and/or individuals invest. The underlying investments are not owned directly by the fund's investors. Unless the investor is the sole investor in the vehicle, or the investment is through a limited partnership where variations to an overarching legal agreement can be effected via side letters, there will not be scope for any one investor's ethical investment requirements to be accommodated.

3. One of the NIBs, the CBF Church of England funds, is a provider of pooled funds for smaller Church of England investing bodies such as parishes, dioceses, schools and church charitable trusts. The CBF Church of England pooled funds are fully compliant with the ethical investment policies recommended by the EIAG.

Why do the national investing bodies use pooled funds?

4. Notwithstanding the loss of control that comes with pooled funds, it can make sense for larger institutions to make some use of pooled funds and indirect investment vehicles, for the following reasons:

    - to access certain asset classes (e.g. venture capital, private equity), specialist areas of investment (e.g. frontier markets) or thematic investments (e.g. environmental technologies) that could not otherwise be accessed cost-effectively or at all;
    - to access illiquid asset classes (e.g. private equity) through liquid investments (i.e. investments that can readily be sold) in order to manage the portfolio's overall liquidity;
    - to access investments with large 'lot sizes' (e.g. property, infrastructure) and benefit from exposure to a more diversified range of underlying assets than would be possible through direct investment;

- to access investment strategies (e.g. long-short equity) or investment managers (e.g. hedge funds) that could not otherwise be accessed; or
- to access cost-effective vehicles for tracking or shorting equity indices (e.g. derivatives) for hedging purposes.

5. Examples of pooled funds (sometimes also known as commingled funds) and indirect investment vehicles include:

- investment trusts
- investment companies
- real estate investment trusts (REITs)
- property funds
- open-ended investment companies (OEICs)
- exchange traded funds (ETFs)
- private equity funds
- venture capital funds
- infrastructure funds
- hedge funds
- funds of funds.

Indirect exposure to restricted areas of investment via pooled funds and/or indirect investments

6. There are a number of ways in which investment in pooled funds and indirect investment vehicles can result in indirect exposure to restricted investments (that is, investments that the NIBs would avoid in direct investments which they fully control). Possible exposures to restricted investments include:

- exposure to the shares or bonds of companies that breach the NIBs' ethical investment policies;
- exposure to the ownership, or part ownership, of restricted companies by private equity and venture capital funds;
- exposure to rental income or other revenue streams from companies or activities that breach the NIBs' ethical investment policies;
- exposure to the short selling of the securities of companies that breach the NIBs' ethical investment policies;
- exposure to the sovereign debt of regimes on the EIAG's list of countries of greatest human rights concern;
- exposure through derivatives (e.g. index futures) to changes in the value of securities that are inconsistent with the NIBs' ethical investment policies.

Derivatives

7. The EIAG's yardstick for the exclusion of a security from investment is whether it is inappropriate for the Church to devote capital to, and derive profits from, that security. Although derivatives may not involve the actual purchase of underlying securities, they do involve benefiting indirectly from changes in the value of the

underlying securities. It is the EIAG's view that there can be exposure to restricted investments through investment in derivatives.

8. The EIAG is conscious that derivatives may be used in different ways by the NIBs. They may be used as part of an investment strategy - for example in a hedge fund that uses derivatives to go 'long' or 'short' a particular index of securities. Derivatives may also be used directly by the NIBs, however, for short-term hedging purposes. For example, an investing body may wish to reduce short-term exposure to falling share prices without selling physical securities. Or it may wish to allow funds that are due to be allocated to a fund manager for investment in a specific asset class to benefit from any rises in the value of that asset class in the period before the funds are allocated to a fund manager.

9. The EIAG recommends that exposure to restricted investments through derivatives should be subject to this policy on pooled funds when derivatives are being used as part of a long-term investment strategy but not for short-term hedging purposes.

<u>Theological reflections</u>

Biblical guidance

10. Since pooled funds are rather a recent financial tool, it is not surprising that there is little biblical or theological reflection immediately apparent. However, the main issue seems to centre around a major biblical theme – that of purity. Should God's people keep themselves pure and distinct from those around them for fear of contamination or being involved in Gentile or pagan practices?

11. These concerns form much of the thinking behind the Mosaic law, especially the dietary laws and those related to Sabbath and festivals (see e.g. Acts 10.28). In a similar way, anxiety about pagan practices in places like Corinth caused some early Christians to avoid eating meat for fear it had been sacrificed to idols, or to avoid civic associations (see Rom. 14.1-6; 1 Cor. 8.1-13; 2 Cor. 6.14-17).

12. On the other hand, Jesus himself appears to have been little concerned for purity regulations (Mark 7.1-23). His group of followers were a very mixed bunch, including terrorists/freedom fighters alongside tax-collectors collaborating with the Romans, or high-society women with former workers in the sex industry, not to mention Peter who denied him and Judas who betrayed him (Luke 6.12-16; 8 .1-3).

13. Jesus' parables of judgement also suggest that God allows both evil and good, righteous and unrighteous to exist together as seen in the parable of the Wheat and Weeds. This parable and its subsequent private explanation to the disciples (Matt. 13.24-30, 36-43) is unique to Matthew's gospel and provides a good example in which good and bad are allowed to live alongside each other until the judgement. Admittedly, the 'good seed' was sown by the master and the weeds by his 'enemy'—but to uproot the latter too soon might harm the former. And, of course, it is always possible that some things which look like weeds at first might turn out to be wheat after all. Nonetheless, there is a clear warning of judgement to come, when all will be harvested and the wicked weeds destroyed, so the existence of both

together should not breed complacency. The explanation is quite clear: 'the field is the world' (13.38). Similarly, the parable of the Sheep and Goats portrays good and bad being alongside each other (understood as those who feed the hungry and thirsty, clothe the naked, and visit the sick and those in prison) until they are separated at the final judgement (Matthew 25.35-40).

The approach of the Christian Church and the Church of England today

14. Subsequent church history and theology have often debated this question. The Reformed and puritan theological traditions, often exemplified within the free churches, tend to have a stronger focus on the difference between the 'elect' and the rest of the world with 'purer' boundaries and admission criteria. And whilst Anglicanism includes elements of that 'purity' tradition, in tension with other ecclesiologial emphases, as the Established Church it has had more fuzzy boundaries and greater openness, including taking the funerals of all parish residents without judging their final destiny.

15. Therefore we might conclude that a strict application of our ethical policies along the lines of purity legislation or concerns would be too harsh or unAnglican, while allowing for cooperation with others on projects waiting to see what produces good fruit or bad fits in more with Jesus' teaching and pastoral approach. However, there would need to be limits, or the whole point of ethical investment would be lost – and, as the Wonga affair showed, it is much more difficult for wider society to understand this idea, so pooled funds also carry the risk of reputational damage.

16. This is not just an attempt to find a pragmatic position – indeed, it reflects a basic theological truth about the human predicament. We live in the theological interim – the period between Pentecost and the parousia. Since Pentecost, the Holy Spirit is active in the world, leading us into all truth yet, until the parousia when God draws all things into himself, sin persists and, whilst the Kingdom of God is inaugurated in Christ it is not yet completed. In this interim age, the life of the Christian is touched by both grace and sin, and Christian ethics must walk a fine line between a naïve trust in an innate human goodness, which will always be frustrated by sin, and a crude 'realism' which leaves no room for altruism, virtue and the work of the Spirit. We cannot always know where the line between good and evil lies and may often have to risk sin if we are ever to rise above it.

17. In applying this theological approach to practical policies, there are no cast iron mechanisms for ensuring ethical outcomes. The challenge is to find the boundaries which rule out known and easily predictable unethical practices, to weigh any remaining risks with care and to accept that no action can guarantee purity.

A theological reflection on the need for solidarity

18. One of the distinctive aspects of investing in pooled funds is the fact that solidarity with other co-investors will be much stronger than when investing in completely unitised and tradable assets.

19. Solidarity has been a significant theme within post-war Roman Catholic social thought. The 1967 encyclical 'On the development of peoples' stressed the need for solidarity between the economically strong and the economically weak as a requirement for development that is in tune with God's purposes for the common good. The 1987 encyclical 'On social concerns' added reflections connected to a theological understanding of solidarity, based on God's solidarity with the human race in Jesus Christ, the solidarity between human beings within the church (the body of Christ), and the solidarity between human beings within the new creation foreshadowed by the resurrection of Jesus Christ.

20. Such solidarity is not quite the same thing as 'compassion', which is a 'suffering with'. Solidarity is more activist in scope, harnessing the vocation of work and purposeful development.

Romans 15.2-3

Each of us must please our neighbour for the good purpose of building up our neighbour. For Christ did not please himself; but, as it is written, 'The insults of those who insult you have fallen on me.'

21. These words, part of the core conclusion of this letter, remind us that the solidarity with the human race that Christ has demonstrated should directly influence the way in which we must build up our neighbour (not just our fellow Christians). While this 'building up' and solidarity is often expressed in terms of friendship and charity, it seems possible to understand a proper collaboration through co-investing as an act of solidarity, so long as all concerned are able to share in the true flourishing which results.

22. If so, use of appropriate pooled funds should be understood as playing a part in honouring the 'building up' of neighbour that Christians are called to pursue.

<u>Controls on the use of pooled funds</u>

23. Because the ethical investment policies of the EIAG and NIBs cannot be applied fully, or at all, in investments in pooled funds and indirect vehicles, it is essential that parameters are set for the use of pooled funds and indirect vehicles (including derivatives used for long-term investment purposes).

24. The EIAG recommends the following parameters:

a) The NIBs should invest directly (i.e. via fully segregated mandates) wherever reasonably practicable so that agreed ethical investment policies can be applied in full.

b) No investments should be made in pooled funds/indirect vehicles that focus on investment in activities that the NIBs do not invest in directly on ethical grounds.

c) In all cases, the NIBs should explore whether it is reasonably practicable (e.g. via a side letter to an overarching legal agreement) to ensure that their investment in a pooled fund/indirect vehicle complies fully, or failing that in part[1], with their ethical investment policies.

d) When investing in pooled funds/indirect vehicles, the NIBs should ensure that it will be possible to monitor exposure to restricted investments in the fund/vehicle.

e) The NIBs should ensure that all opportunities are taken, where they exist, to design-in the possibility of a cost-effective and quick exit from the investment in case an exit on ethical grounds at a future date should be required.

f) In all cases, before the NIBs make an investment in a pooled fund/indirect vehicle that does not comply fully with their ethical investment policies, they should review the underlying exposure to restricted areas of investment, and the potential for future exposure. They should consider the appropriateness of the proposed investment in the light of the nature and materiality of the underlying actual or potential exposure(s), the possibility of ongoing monitoring, the ease of exit should this be required on ethical grounds at a future date and the track record and commitment to responsible investment of the manager concerned. If the investment proposal requires the agreement of trustees then these factors should be reported to and considered by trustees.

g) In all cases, to the extent relevant to the asset, the NIBs should brief the managers of pooled funds on their policies on the integration of environmental, social and governance factors into investment management, proxy voting at company general meetings and engagement with company management, and explore the possibility for adherence to these policies. If the investment proposal requires the agreement of trustees then these factors should be reported to and considered by trustees.

Monitoring of pooled funds

25. Once an investment has been made, the underlying exposures in pooled funds/indirect vehicles will change. The EIAG recommends that funds and vehicles should be monitored by the NIBs no less frequently than quarterly.

26. The NIB should consider (involving trustees if appropriate) the continued appropriateness of the investment(s) involving exposure to restricted investments in the light of the exposures identified. Continued investment in an individual fund or vehicle may be inappropriate not only if the total exposure to restricted areas of investment in the fund/vehicle has increased but also if one or more of the exposures is particularly damaging to the credibility, effectiveness and unity of the Church's witness.

27. Pooled fund and indirect vehicle investments may, however, differ from, say, an investment in a single company share, which is unlikely to be material in the

[1] For example, it may not be possible to establish a special share class implementing all of the NIBs' ethical investment restrictions, but it may be possible to establish a special share class that implements the zero tolerance policy for companies producing indiscriminate weapons like cluster munitions.

portfolio as a whole and can be readily disposed of. An investment in a pooled fund/indirect vehicle may be tens of millions of pounds in value, and a material part of the portfolio. It may be the only allocation to that asset class, area of investment or strategy, or a substantial proportion of the allocation. Furthermore, the investment may be subject to a lock-up or it may only be possible to dispose of the investment at a substantial discount to the value of the underlying assets.

28. Where an investment is deemed inappropriate, but divestment is impossible to effect immediately or would be inconsistent with sound financial management, a trustee body should agree the appropriate way forward. There is no blanket requirement for forced disposals and there may be occasions where the exposure to an undesirable underlying investment may take a long time to be eliminated.

29. There may be limited instances where it is not possible to monitor quarterly the exposure of a pooled fund or indirect vehicle to restricted investments. Underlying exposures may be too hard for the fund manager to identify (for example a property fund of funds that invests in a fund that owns properties that each have multiple and changing tenants). Where quarterly monitoring of all underlying investment exposures would be disproportionate to the ethical risks, the NIB may agree an appropriate alternative monitoring methodology.

Maximum permitted exposure to restricted areas of investment via pooled funds

30. As noted in the theological reflections, over-use of pooled funds would undermine ethical investment by the NIBs. It is the EIAG's view that there should be a hard limit on the aggregate gross exposure to restricted areas of investment in the NIBs' portfolios resulting from the use of pooled funds and indirect vehicles, and that this limit should be 1% of the portfolio. Therefore the EIAG recommends that the NIBs should ensure that no more than 1% of their portfolio is invested, indirectly, in assets that are or would be inadmissible for direct investment for ethical reasons and that preferably exposure should be some way below this hard limit.

31. If a breach of this limit is recorded, a trustee body of the NIB should be informed immediately and the trustee body should seek to make pooled fund/indirect vehicle disposals to bring exposure back within the limit, while being mindful of their fiduciary duty to ensure the sound financial management of the NIB's investment portfolio.

32. Exposure to restricted investments arising from direct property investment (e.g. exposure to a payday lending shop as a result of an investment in a shopping centre) should be counted towards the 1% limit[2].

[2] See Property Policy for the ethical investment policy applied to property investments. https://www.churchofengland.org/media/1898077/property%20investments%20policy%202010.pdf

<u>Smaller church investing bodies</u>

33. The investment funds of many smaller church investing bodies (e.g. the Archbishops' Council, dioceses and parishes) are too small to allow for direct investment, and the entire portfolio of the investing body may be in pooled funds.

34. While EIAG advice is crafted for the NIBs who sponsor the EIAG, it is also intended as helpful guidance for all church investing bodies. The EIAG recognises that smaller investing bodies may find this pooled funds policy more challenging than the NIBs. The CBF Church of England funds exist to provide all church investing bodies with pooled vehicles that comply with the ethical investment policies recommended by the EIAG.

35. Smaller investing bodies are advised carefully to review, and to consider the suitability of, potential pooled funds investments against the investing body's ethical investment policies including on ethical exclusions, the integration of environmental, social and governance factors into investment management, and stewardship (especially proxy voting and corporate engagement).

36. Smaller investing bodies are advised to monitor their pooled fund investments at agreed intervals and to consider the continued appropriateness of pooled investments.

37. Finally, it would be advisable for smaller investing bodies, in the same way as the NIBs do, to agree a hard limit on exposure within their portfolio as a whole to investments restricted under EIAG policies.

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