Taking responsibility

Shanta Acharya takes a macro look at the role of socially responsible investment (SRI)

Global capital flows have a significant impact on sustainable development, the environment and ultimately the kind of society we create. It is critical we examine our priorities when investing and understand its long-term impact on all aspects of life on earth. If each one of us becomes more responsible, the incremental effects could literally change the world. It is true that corporations and pension funds wield enormous power, but these institutions are also collectively accountable to us, their shareholders. A tipping point can be reached if individuals share the socially responsible investment (SRI) agenda.

Definition and implementation

When we refer to SRI, several issues emerge with regard to definition and measurement. The problem of definition – what we believe to be ethical or socially responsible – is an issue because such decisions are subject to various biases including self-serving ones. When a small group of trustees of a charity or a group of like-minded individuals (such as Quakers) agree on what is ethical, or know what 'the right thing to do' is, they are also required to serve their constituency without compromising returns. For a larger group of investors, the concept itself is fraught with cognitive biases that can create ethical traps.

Various agreements and treaties, some internationally, have been established but levels of implementation vary. Developed countries have yet to invest adequately in the monitoring of SRI issues. In developing countries, mismanagement and corruption often result in the squandering away of meagre financial resources.

Poor people across the globe have not had a stake in wealth creation. On the contrary, environmental degradation, decline in public services and social welfare – in many cases the non-existence of public services and social welfare – along with the lack of opportunity in general to improve one's lot has dented confidence in the efficacy of global capital markets.

Recent history has taught us that market liberalisation can fail dramatically if responsible government, sound financial systems and the rule of law are lacking. As we examine our world in the 21st century, it is a sad indictment that a third of the population lives below the poverty line.

Measurement and value

Investors recognise the urgent need for a new ethical architecture to match the new global financial system, but do not have an effective mechanism for implementing such a system, let alone monitoring it. And this is the second and more pernicious hurdle – what cannot be measured cannot be managed. The reason an investment banker gets paid millions is simply because his or her ability to generate revenue for the firm appears to be measurable, though the blind spot of short-term assessment has resulted in massive errors of judgement; the sub-prime crisis is just one example.

The comparatively lucrative compensation structure in the financial industry both tempts professionals to act unethically and attracts persons with such tendencies to self-select themselves into the industry. While one cannot legislate against greed or stupidity, we can collectively influence policies that do not reward such behaviour. Teachers, doctors and nurses, among other professionals, have been working without any expectation of bonuses; but we have no problem paying a hedge fund manager 2 per cent to 3 per cent annual fees and 20 per cent to 30 per cent performance fees! Rewarding people for genuine wealth creation is meaningful; rewarding chief executives for failure or at best doing their job is, in my opinion, financial suicide.

We have not only been let down by economists, academics, investment experts et al who have spent time and money developing various trading strategies etc., but do not know how best to measure the contribution that teachers, nurses, policemen or firemen make to society. Nor do we know how to measure a 'good' company. Lack of relevant data remains a significant barrier to our ability to value things.

Gross domestic product (GDP), the most visible economic statistic, is the sum of an economy's money transactions. But it does not reflect broader economic health, welfare or environmental issues. While some countries are producing 'satellite accounts', measuring housework, social work and the environmental impact of activity, there is little evidence yet that such statistics have any impact on policy.

At the micro-level, the list of most balance sheet blind spots is impressive: they seldom include brand values nor account for intangible assets relating to research and development and related intellectual capital, and certainly never provide a capitalised value for human assets or for enterprise value. Annual reports fail to account for stakeholder relationships that underpin a company's long-term sustainability as an economic entity and thus fail to disclose the true sources of corporate value. Bridging the existing gap in the evaluation of social and environmental issues within financial analysis in the investment process is the challenge that analysts and investors face.

This is not to suggest that nothing

can be done; on the contrary, I would encourage 'responsible' investors to invest in what they believe; market efficiency depends on the rise of active, 'conviction' investors, like highly skilled hedge fund managers. And doing so would not only transform that ethical investment activity into a serious commitment, it will also involve better understanding of what one is 'engaged' in. As Warren Buffet pointed out, never invest in anything you do not understand.

Investors recognise there is a corporate governance dividend attached to firms; they usually command a higher market valuation, have cheaper access to capital and benefit from a strong shareholder base. Shareholder activism is becoming a popular means of influencing corporations in addressing their social and environmental policies. Since 2000, occupational pension schemes in the UK have been accountable for their ethical and voting policy as much as for their fund's financial performance. The legislation does not remove the requirement that trustees make decisions in the best interests of the plan beneficiaries. The law endorses the primacy of preserving financial interests of beneficiaries and the courts regard trustees of a charitable corporation as being subject to the principles of charity law concerning investment.

Ethical investment and SRI

Whether investors opt to screen out offending companies (as is the case, for example, with the Church Commissioners who avoid investing in companies whose income is derived from businesses associated with armaments trading, alcohol, tobacco or gambling) or engage actively with the management of companies they own shares in (as is the case with various funds managed by the Hermes group, for example), there is no reason not to engage actively in the investment process. While SRI or ethical investment is described as a particular ethical approach towards investments, both need to be distinguished from 'social investment', which is not investment in the ordinary financial sense of the term. Ethical investment is investment in the financial sense, and trustees are bound by law to act appropriately.

The governing document of a charity sometimes imposes ethical restrictions on the scope of that institution's general power of investment. Such restrictions must, of course, be observed by trustees. More commonly, it will be the trustees themselves who decide to adopt an ethical investment policy. In doing so, the Charity Commission stipulates: 'They [trustees] need to keep in mind the underlying principle that their power of investment has to be used to further the purposes of the trust, and that those purposes will normally be best served by seeking the maximum return consistent with commercial prudence. As the judge put it… "Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish".' An ethical investment policy is perceived to be entirely consistent with the investment aim of seeking the best returns.

There is an increasingly held view that companies which act in a socially responsible way are more likely to deliver the best long-term balance between risk and return. Trustees are free to adopt any ethical investment policy which they reasonably believe will provide the best balance of risk and reward for their charity. As with any other investment strategy, they must be careful to discharge their duties; in particular, they must consider the need for diversification and must take advice where appropriate.

Investors within the charity sector aim to invest their assets in a responsible manner reflecting their long-term investment objectives. Yet this insistence on 'being good' with securing good market returns may be unnecessarily confusing the issue. Just as hedge funds offer risk-adjusted returns, ethical investors should aim to capture the long-term intangible aspects of being responsible investors. The risk for a responsible investor is not having the courage of their ethical conviction in developing an appropriate investment strategy, and not being willing to accept a lower return if required as the true cost of conducting business ethically.

See also pages 8 to 9, *Caritas, Issue 3,* February 2008.

Dr Shanta Acharya is executive director of the Initiative on Foundation and Endowment Asset Management at London Business School. Previously, she worked as an investment professional in Morgan Stanley Asset Management, Swiss Bank Corporation Portfolio Management International, Baring Asset Management and Bank of Ireland Asset Management. She holds a DPhil from Oxford and was a Visiting Scholar at Harvard.

www.london.edu