The Ethical investors: Exploring dimensions of Investment Behaviour

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Abstract

The definition of ethical investing depends on personal beliefs. Ethical investing is highly subjective because each individual investor has different ideas about what constitutes ethical behavior by a company, and different priorities that they want to support with their investment. Broadly speaking, however, ethical investing is a way of earning returns in the financial markets by supporting companies that are creating positive change in the world, or, in some cases, that aren't creating positive change; but aren't making the world worse, either. Ethical investors want to reach their financial goals in ways that coincide with their values. Their investing decisions are usually part of an overall strategy for ethical living that includes making values-based decisions about work, housing, transportation and shopping, among other concerns.

Ethical investment is even called as Socially responsible investments (SRI), which are often also sustainable investments. Over the past decade, socially responsible investments have experienced an explosive growth around the world. Particular to the SRI funds is that both financial goals and social objectives are pursued.

This paper we focus on one fundamental question: Does ethical investment pay? In the paper, we define corporate social responsibility as a combination of good corporate governance, sound environmental standards, and care of stakeholder relations. As well as this paper will focus on the possible ways in which ethical investment criteria can impact the investor’s return.

Keywords: Socially responsible investments (SRI), corporate governance, investment Behavior.
Introduction

Over the past decade, socially responsible investments (SRI), often also called ethical investments or sustainable investments, have grown rapidly around the world and become a multi-trillion dollar market. SRI can be defined broadly as "an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis.

Government-controlled funds such as pension funds are often very large players in the investment field, and are being pressured by the citizenry and by activist groups to adopt investment policies which encourage ethical corporate behavior, respect the rights of workers, consider environmental concerns, and avoid violations of human rights. One outstanding endorsement of such policies is The Government Pension Fund of Norway, which is mandated to avoid "investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages."

Many pension funds are currently under pressure to disinvest from the arms company BAE Systems, partially due to a campaign run by the Campaign Against Arms Trade (CAAT). Liverpool City Council has passed a successful resolution to disinvest from the company, but a similar attempt by the Scottish Green Party in Edinburgh City Council was blocked by the Liberal Democrats.

Socially responsible mutual funds counted by the 2010 Trends Report increased in number to 250 in 2010, up from 173 in 2005 & 2007, 189 in 2003, and 167 in 2001. The overall number of mutual funds incorporating ESG has increased 45% since 2007. Additionally, 26 exchange-traded funds (ETFs) that incorporate ESG criteria were identified with $4 billion in assets at the end of 2009, a 76% increase from the eight ETFs with $2.25 billion in net assets identified at the
end of 2007. Unlike the Employee Retirement Income Security Act of 1974 (ERISA), which severely limits the extent to which socially responsible goals can be considered in managing corporate and Taft-Hartley pension assets (due to ERISA's overriding goal of protecting employees' pensions), registered investment companies can take these factors into account so long as the disclosure and other requirements of the Investment Company Act of 1940 are met. US SIF maintains charts describing the socially responsible mutual funds offered by its member firms.

**History of SRI (socially responsible investments)**

Ethical investing has ancient origins and is rooted in Jewish, Christian, and Islamic traditions. Judaism has a wealth of teachings on how to use money ethically, and in medieval Christian times, there were ethical restrictions on loans and investments which were based on the Old Testament. The Catholic Church imposed a universal prohibition on usury in 1139, which had not been relaxed until the 19th century. In England, a law called The Act against Usury which prohibited excessive interests on loans was in effect from 1571 to 1624. In the 17th century, the Quakers (‘Society of Friends’) refused to profit from the weapons and slaves trade when they settled in North America. The founder of Methodism, John Wesley (1703-1791), stated in his sermon ‘The Use of Money’ that people should not engage in sinful trade or profit from exploiting others. The Methodist Church in the UK avoided investing in ‘sinful’ companies, such as companies involved in alcohol, tobacco, weapons and gambling, when they began investing in the stock market in 1920s. Based on the teachings of the Koran and its interpretations, Islamic investors avoid investing in companies involved in pork production, pornography, gambling, and in interest-based financial institutions. Modern SRI is based on growing social awareness of investors. Since the 1960s, a series of social campaigns, e.g. the anti-war and the anti-racist movements, have made investors concerned about the social consequences of their investments. The first modern SRI mutual fund, the Pax World Fund, was founded in 1971 in the US. Created
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for investors opposed to the Vietnam War (and militarism in general), the fund avoided investments in weapons contractors. In the 1980s, the racist system of the apartheid in South Africa became a focal point of protests by social investors. SRI investors in the US pressurized companies doing business in South Africa to divert those operations to other countries, and urged mutual funds not to include South-African nor western firms with South-African subsidiaries into their portfolios. These campaigns were relatively successful, for instance, the state legislature of California passed a law amendment in 1986 requiring the state’s pension funds to divest over $6 billion from companies with activities in South Africa (Sparkes, 2002). On April 25th, 1986 the Chernobyl nuclear power plant in the former Soviet Union (now Ukraine) exploded during a test, spreading radioactive material across Europe and increasing the number of cancer deaths by over 2500. On March 23th, 1989 the worst environmental disaster in the US occurred when the oil supertanker Exxon Valdez ran aground near Alaska and spilled 11 million gallons of crude oil. The above and other environmental disasters in the late 1980s made investors aware of the negative environmental consequences of industrial development.

The Market of SRI

Over the past decade, socially responsible investments have experienced a phenomenal growth around the world which is evident from the total assets under management (AUM) of SRI screened portfolios and mutual funds in the US, Europe, Canada and Australia. Socially responsible investing is a booming market in both the US and Europe. In particular, it has become an important principle guiding the investment strategies of various funds and accounts. Assets in socially screened portfolios climbed to $3.07 trillion at the start of 2010, a 34% increase since 2005, according to the US SIF’s 2010 Report on Socially Responsible Investing Trends in the United States. From 2007 to 2010 alone, SRI assets increased more than 13%, while professionally managed assets overall increased less than 1%. As of 2010, nearly one of every eight dollars under professional management in the US is involved in socially
responsible investing—12.2% of the $25.2 trillion in total assets under management tracked by Thomson Reuters Nelson.

Research estimates by financial consultancy Celent predict that the SRI market in the US will reach $3 trillion by 2011. The European SRI market grew from €1 trillion in 2005 to €1.6 trillion in 2007.

In the US, the professionally managed assets of socially screened portfolios reached $2.3 trillion in 2003, growing by 1200% from $162 billion in 1995. Currently, SRI assets represent about 10% of total assets under management in the US (SIF, 2005). Although the European SRI market is still in an early stage of development, it is also growing rapidly. In 2003, the assets of SRI screened portfolios in Europe totaled around €230 billion, and they account for about 1% of total assets under professional management in Europe. The UK, the Netherlands and Belgium are the countries with the highest percentage of socially screened assets in Europe. In Australia, SRI assets have surged, rising 100% in a two-year period from 2001 to 2003. In the US, the assets under management of SRI funds reached $138 billion in 2003. From 1995 to 2003, the number of SRI mutual funds grew from 55 to 178 in the US (SIF, 2003), from 54 to 313 in Europe (SiRi, 2003), and from 10 to 63 in Australia (EIA, 2003).

**Regulatory Background**

The growth of the SRI industry can be partly attributed to the changes in regulation regarding the disclosure of social, environmental and ethical (SEE) information by pension funds and listed companies. In this section, we review the regulatory initiatives taken by national governments regarding SRI. Most of the SRI regulation is passed in Europe.

**United Kingdoms**

The UK was the first country that regulated the disclosure of SEE investment policies of pension funds and charities. This has contributed considerably to the growth of the SRI industry. In July
2000, the Amendment to the 1995 Pensions Act was approved, requiring trustees of occupational pension funds to disclose in the Statement of Investment Principles “the extent (if at all) to which social, environmental and ethical considerations are taken into account in the selection, retention and realization of investments”.

The Trustee Act 2000, which came into effect in February 2001, requires charity trustees to ensure that investments are suitable to a charity’s stated aims. According to the Charity Commission guidance, charities should include ‘any relevant ethical considerations as to the kind of investments that are appropriate for the trust to make’. In 2002, The Cabinet Office in the UK published the review of Charity Law in 2002, which proposed that all charities with an annual income of over £1 million reports on the extent to which SEE issues are taken into account in their investment policies. The Home Office accepted theses recommendations in 2003.

In addition, large organizations of institutional investors also have taken SRI initiatives. For instance, the Association of British Insurers(ABI), whose members invest in about $1 trillion assets, published a disclosure guideline in 2001 suggesting that listed companies report on material SEE risks relevant to their business activities.

**Continental Europe**

Over the past decade, some national governments in continental Europe passed a series of regulations regarding social and environmental investments and savings. Since 1991, the Renewable Energy Act in Germany gives a tax advantage for closed-end funds to invest in wind energy (Eurosif, 2003). In 1995, Dutch Tax Office introduces “Green Savings and Investment Plan”, which grants a tax deduction to investments in specific ‘green’ projects, such as wind and solar energy, and organic farming. Following the British Amendment to 1995 Pensions Act of 2000, four countries in continental Europe (namely Belgium, Germany, Italy and Sweden) have passed similar regulations requiring pension funds to disclose SEE related information. In 2001, Belgium passed the ‘Vandebroucke’ law, which requires pension funds to report the degree to which their investments take into account social, ethical and environmental aspects.
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2002, Germany adopted a regulation requiring that certified private pension schemes and occupational pension schemes “must inform the members in writing, whether and in what form ethical, social, or ecological aspects are taken into consideration when investing the paid-in contributions” (Eurosif, 2003). Sweden passed a regulation (effective since January 2002), requiring Swedish national pension funds to incorporate environmental and ethical aspects in their investment policies. In Italy, legislation was adopted in September 2004 requiring pension funds to disclose the effect of non-financial factors (including social, environmental and ethical factors) that influence their investment decisions. All these initiatives have clearly had a positive impact on the growth of the SRI fund industry in Europe. France is the first and so-far the only country making SEE reporting mandatory for all listed companies. In May 2001, the legislation “New Economic Regulations” came into force: listed companies are to publish social and environmental information on the companies in their annual report. Meanwhile, since February 2001, the managers of Employee Savings Plans are required to consider social, environmental or ethical issues when buying and selling shares.

Outside Europe

In the US, section 406 of the Sarbanes-Oxley Act (July 2002), requires companies to disclose a written code of ethics signed by their chief executive, chief financial officer and chief accountant. Australia is the only country outside Europe that has adopted a regulation regarding SRI. In 2001, the Australian government passed a bill requiring that all investment firms’ product disclosure statements include descriptions of “the extent to which labor standards or environmental, social or ethical considerations are taken into account.” Since 2001, all listed companies on the Australian Stock Exchange are obliged to make an annual social responsibility report.

Should Companies Be Socially Responsible
Finance textbooks tell us that companies should maximize the value of their shareholders ‘equity. In other words, companies’ only responsibility is a financial one. In recent years, corporate social responsibility (CSR) has become a focal point of policy makers (and the public), who demand that corporations assume responsibility towards society, the environment, or the stakeholders in general. SRI investors thus aim at promoting socially and environmentally sound corporate behavior. They avoid companies producing goods that may cause health hazards (like tobacco) or exploiting employees both in developed and developing countries (negative screening). They select companies with sound social and environmental records and with good corporate governance (positive screening). In general, SRI investors expect companies to focus on social welfare in addition to value maximization.

At the heart of the SRI movement is a fundamental question: is a firm’s aim to maximize shareholder value or social value (defined as the sum of the value generated for all stakeholders)? Classical economics (e.g. Adam Smith’s ‘invisible hand’ and the social welfare theorems) states that there is no conflict between the two goals: in competitive and complete markets, when all firms maximize their own profits (value), the resource allocation is Pareto-optimal and the social welfare is maximized.

In practice, the maximization of shareholder value often conflicts with the social welfare criterion represented by the interests of all stakeholders of a firm, including employees, customers, local communities, environment and so forth. By maximizing shareholder value, firms may not take care of the interests of other stakeholders. In Continental European corporate governance regimes, a stakeholder approach is more common than in the Anglo-Saxon countries.

**performance effects of ethical criteria**

There are a number of different ways in which ethics could influence performance. Firstly, it can impact at the company level and secondly at the ethical portfolio level.

**The effects of ethical behaviour on company share price:**
The World Business Council for Sustainable Development stated “we are convinced that investment managers stand a good chance of improving their portfolio performance and reducing their risks if they pay closer attention to the environmental performance of the companies in which they plan to invest”. It found that there were ‘downside’ factors which may serve to depress investment returns and ‘upside’ factors which could benefit companies. The downside factors outlined were: the cost and availability of capital; increased liability claims; expanded rules on disclosure; greater emphasis on environmental factors in credit-risk ratings; the availability and cost of insurance; the emergence of environmental taxes; and the increasing use of economic arguments by ecological pressure groups. The upside factors included: increased consumer demand due to increased ecological concern; increases in resource productivity; market share growth and new business development due to companies recognising the potential offered by the upside factors.
Portfolio effects

The ethical policy of the fund and the fund manager are the key influences on the portfolio performance. The ethical policy and the ethical approach will define the ethical universe from which the fund manager can invest. Of course, for a passively managed fund it is only the ethical criteria and the index construction rules that are the key influences, though very few passively managed ethical tracker funds currently exist.

The effects of ethical investment on a portfolio:

The models show that there are both positive and negative influences that can come into play. The combination of all these factors may have the overall effect of broadly similar financial
performance. It is not likely that ethical criteria will always lead to outperformance, nor will it always lead to under performance. Those who do believe in a consistently positive ethical investment effect on performance need to explain why a market focused on profit maximization would overlook a potentially successful strategy for so long.

**Conclusions:**

As the business diverges new challenges and threats emerges both internally and externally. The focus of the growth and development of the Company depends on how it looked in the eyes of customers, shareholders, society in general. Socially responsible investment is one emerging areas where the Companies are really tested. So, the survival and growth of Corporate rests on how close they are to the society in addressing the responsibility towards the society. Profit maximization of shareholder value often conflicts with the social welfare criterion represented by the interests of all stakeholders of a firm, including employees, customers, local communities, environment and so forth. By maximizing shareholder value, firms may not take care of the interests of other stakeholders. It is not likely that ethical criteria will always lead to outperformance, nor will it always lead to under performance. Those who do believe in a consistently positive ethical investment effect on performance need to explain why a market focused on profit maximisation would overlook a potentially successful strategy for so long.

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