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Ethical and Socially Responsible Investment: From oxymoron to tautology?[1]

Charles Sampford and Virginia Berry

For many years, corporations and the investment community were routinely urged to concern themselves with one thing – shareholder value. Corporate governance experts promoted the idea that management and boards should pursue a single goal, whether conceived as 'profit', 'bottom line', 'shareholder value' or 'long–term shareholder value'.2 The singularity of this goal was so prevalent that board members of large corporations – mostly decent individuals committed to a range of values – believed that it was unethical to consider issues other than shareholder value in their deliberations. Board members who did champion the importance of the social dimension in corporate governance usually did so from the standpoint of indirect profit maximisation.

When universal superannuation was introduced in Australia some years ago, there was a widespread assumption that the only goal that future retirees were concerned about was the total value of their payout. The idea that employees might make collective decisions about how their superannuation should be invested, based on other values, was considered ridiculous. Instead, it was thought that all superannuation should be handled by professional wealth managers whose sole goal is maximising the dollar value of superannuation funds. This approach, however, is based on a misleadingly simplistic image of human values and motivation – a corporatised version of neo–liberal economic theory in which economic man seeks to maximise profit for himself.

The increasing demand for alternative investment funds such as ethical or socially responsible investments (and their success)[3] makes explicit individual investors' concerns with other values – something not captured by traditional rational choice economics. Ethical entrepreneurs and ethical funds should, therefore, see it as their role to help integrate individual investors' values with their investment decisions.

Resisting the Shareholder value approach

The 'shareholder value' approach appears simple and it is sold on this basis. However, there are two reasons why we should resist this approach.

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1 This is the latest version of a paper first delivered by Professor Charles Sampford to a socially responsible investment conference in 1991. Sampford, C. and Berry, V. "Shareholder *Values*, not Shareholder Value: The Role of 'Ethical Funds' and 'Ethical Entrepreneurs' in Connecting Shareholders' Values with their Investments," *Griffith Law Review*, vol. 13, no. 1 (2004), pp. 115–123. Subsequent versions have been presented at various conferences. These ideas are the basis of a book to be completed in mid 2007.

2 See, for example, Elton, E. & Gruber, M. *Modern Portfolio Theory and Investment Analysis*, 5th edn, New York: John Wiley & Sons, 1995.

3 See, for example, Sparkes, R. *Socially Responsible Investment: A Global Revolution,* West Sussex: John Wiley & Sons, Ltd., 2002; and "Socially Responsible Investment in Australia," The Allen Consulting Group, 2000 available at www.allenconsult.com.au/publications (accessed 20 May 2004).

Pragmatic reasons

The shareholder value approach appears simple, and therein lies much of its charm. But there are two main reasons why such simplification ought to be resisted. The first is that we cannot be certain what will maximise long–term shareholder value. The second concerns issues of individual agency.

Firstly, it is difficult to know exactly how to go about maximising long–term shareholder value. Although the end may be conceptualised as singular, the means of achieving it are sometimes manifold and complex. They may involve recruiting and keeping staff, delivering good products or services at a competitive price, developing good relations with customers, suppliers and communities, and complying with regulatory requirements. They may also involve identifying risks and developing strategies to minimise them. Real managers' jobs are about developing plans to simultaneously achieve a variety of valued goals. These plural goals might be merely instrumental to achieving the supposedly single value, but this does not mean that the manager does not have to manage for them. Quite the contrary – they are what make management *hard*. It might be said that the single value arbitrates between these different instrumental values. However, we are not talking about either/or situations. A company cannot decide to sacrifice its employees for its customers, or its customers for the community of which it is a part and which regulates it. If a manager attempts to sacrifice any of them, the business will eventually fail. It is a portfolio, but one where none of the constituents can be sold off.

We might try to justify considering other relevant values by arguing that these (and ethical values in general) are in the long-term self-interest of shareholders. While this is generally true, we should be wary of this suggestion for various reasons. We have already suggested that it is difficult to reliably maximise profit over the longer term. You might think it easier to follow ethical principles which you justify on the basis of them being generally advantageous. However, if others think that you are only adhering to these principles because you believe that it is generally in your long-term self-interest to do so, they will always be wondering if their current dealings with you might be an exception. Such an exception would be justified where acting against ethical or other declared values would be more profitable than sticking to them. They will have to take one of two kinds of precaution – either take more care contracting to ensure that you do not have the opportunity to cheat them or, more simply, just deal with someone else. This is why some have argued that the 'fanatical ethical behaviour' of stating values and living up to them might actually be more profitable, pre-commitment engendering trust. Such instrumentalism is not unknown to economic theory. Those who advocate markets often argue that the profit motive is a better way of achieving social goals than seeking to achieve them directly. However, conversely, sometimes the best way to achieve profits is to promote generally accepted goals, in particular by behaving ethically and seeking to promote values other than one's own narrow self-interest. The instrumental relation can be reversed.

The second reason for resisting the shareholder value approach concerns issues of agency – it can be a fragile rather than a stable motive. An individual who would act unethically to maximise corporate profits (and therefore shareholder value), might be more likely to (unethically) seek to maximise his own fortunes *regardless* of shareholder value. (Who hires a hitman will not sleep well. This is basically the problem with seeking an amoral person to further your own interests at the expense of others). Why should he cheat only your customers and suppliers? Why would he not go for the trifecta of cheating the shareholders as well? Indeed, we saw this in Australia in the 1980s, where the amoral business practices of various entrepreneurs were cheered on by shareholders who did not realise that they would be the next victims. We have seen similar phenomena in recent corporate scandals. If corporations are to behave as if they owe no duties other than to their shareholders, we will need to develop and enforce strict codes of behaviour to regulate their activities, since they cannot trust or be trusted. The alternative, of course, is to recognise that there are other values for public corporations than the narrowly prudential, and that real managers manage for them. They believe that recognising them will advance the corporation on the various measures on which it is asked to perform. However, that need not be there only motivation. They need not see their managerial role as so one-dimensional.

Where managers continue to insist that there is only one value worth pursuing, we should be wary of them. If the value they trumpet is financial reward, then we should be especially careful. If we hear an individual say that everyone is selfish or that everyone acts to maximise their own wealth, we should treat it as an accurate statement of their personal set of values (even if it suggests that they are ignorant of the ways of the real world and real people). We should also suspect that such a statement is an admission of the speaker's sociopathy. For that is precisely what economic man is; a sociopath whose only norms concern self–gratification and who holds no other norms except for instrumental reasons.

The literature on sociopathic behaviour is generally confined to criminology and psychology, where questions are concerned primarily with its origins and responses (and for psychologists' treatment). But the question of what ought to be done if this particular behaviour becomes universal – or merely universal among all economic and political actors – is not examined. Luckily, the criminologists and psychologists are correct. Sociopathy is not universal or even particularly common. Real shareholders and real executives do have a broader set of values (despite the economic ideology occasionally demanding that they either do not or should not enjoy such normative reasonableness).

Real shareholders and real shareholder values

Long–term shareholder value is not the only deceptively simple answer that has been given to the question of what should motivate corporate behaviour. Originally the goal was seen as profit, then as 'shareholder value'. Each of these was replaced because of perverse incentives created by the earlier, simpler answer. When the sole goal was corporate profits, it became recognised that these did not automatically translate to a benefit for the shareholder. Shareholder value was then trumpeted, taking into account the value of shares and the value of dividends paid. However, the manipulations of shares and their occasional rapid declines led to a recognition that shareholders were really interested in what shares were ultimately worth to them, rather than what the market could be persuaded to pay for them from day to day.

As unrealistic as the notion of a single master value is, its influence on corporate ideology and behaviour stubbornly remains. It is a corporatised version of neo–liberal economic theory in which economic man seeks to maximise benefit for himself (Hill, 1997). The idea is as deceptive as it is puerile. The facts refute it. Virtually no shareholders are so narrow as to value only the long–term price of the shares in which they invest; other values are relevant to any reasonable calculation about which shares they should invest in.

So what *do* shareholders value? Even if they were cardboard cut–out parodies of economic man, they would nevertheless value more than just the monetary price for which their shares can be sold today or at some point in the future. Shareholders are not merely investors. They are workers, members of communities, breathers of air, drinkers of water and parents of similarly varied people. It may well be that an investment that is slightly less profitable might increase the number of jobs significantly. Someone who is a member of that community might benefit because this increases taxes, decreases welfare payments, and thereby increases the possibility that they will have adequate health care in their old age. More directly, one of those jobs might be theirs or their child's. Accordingly, the justification of companies managing exclusively for shareholder value (because that is all that shareholders value) collapses.

It might be argued that 'shareholder value' simply *means* the marketable value of the shares. But this denotation is perverse. Why should shareholders only be interested in that? Indeed, the marketable value of shares is, for them, itself merely an *instrumental* value towards the achievement of their *real* goals. No one should tell them that they must raise to the apex of their moral lexicon what can only be a means to their own real ends – least of all a manager who is supposed to be serving them.

This shift to a wider and more pluralistic conception of value is natural for the ethically minded.[4] When you invest, you are still a moral agent responsible for your choices. If you invest in a company destroying a rainforest or the lives of its workers, or exporting weapons to dictators, your actions are contributing to those effects. To say 'I am an investor, I must maximise the value of my shares whatever the consequences of that action' is no defence. An investor needs to understand that investing in a corporation that

[4] For a comprehensive discussion of this idea see Kutz, C. *Complicity: Ethics and Law for a Collective Age*, Cambridge: Cambridge University Press, 2000.

compromise her values means ultimately that she is not being true to herself. Indeed, she is betraying herself. If she does not ask broader value questions, she is not a *smart* investor, but merely an investor ignorant of what she is about and why.

Being ethical can involve asking hard questions about our values, giving honest and public answers and trying to live by them. This can be a difficult process, but what is the alternative? If you do not ask yourself questions about your values, you condemn yourself to ignorance about them and become susceptible to unwittingly acting contrary to them. If you do not give *honest* answers, you are only cheating yourself. If you do not give *public* answers, you are merely being two faced, projecting yourself as someone less worthy than you are. If you do not live up to your own values, you make yourself a wicked person by your own lights.

Being ethical need not involve denying yourself. Rather, it is about discovering your better self and living up to being that kind of person. This is not to say that there aren't hard choices involved, as we may find ourselves holding conflicting values. However, if we do not seek to live up to our own values, we are a failure on our own terms. This may appear to make life more complicated – and life is already complicated – but it is only through questioning our own values and exemplifying them that we can chart our *own* course through that complicated world (as opposed to a path chosen by others). Even if this is difficult in some areas of our institutional existence, it should be easier when we are making investments.

If an investor decides to take into account values other than maximising the price of his shares, he is showing how one-dimensional economic man can become a human being by reintegrating his economic and other personalities. The more religiously minded might say that ethical investment allows economic man to regain his soul.

Of course, this is not to say that the long–term price of shares is irrelevant. The ethical investor is not donating to charity, but investing in enterprises which have realistic prospects of turning a reasonable profit while furthering, or protecting, values that she holds dear. Indeed, the ethical investor may consider the investment more 'profitable' because she is, in a sense, 'right' about its values – because others will come to see its importance or because alternatives will fail as environmentally or ethically unsustainable (if you put all your money into landmines, you will look at a bit silly the day they are outlawed). This is where ethical entrepreneurs – those who create sustainable corporations, formulate plans to make money by furthering other values, sell them to investors and then carry those plans through to vindicating success – have a critical role. This is also where ethical fund managers have a role in identifying the corporations that further values other than merely shareholder value, and facilitating more socially responsible investment.

It is very important to note the plural here – values. One of the unstated but commonly held assumptions about ethical funds or social responsibility funds is that there is only one set of values that socially responsible investors might adhere to. In fact there are a great variety of such values – environmental, labour relations, energy usage and association with undesirable elements like dictators, pornography, drinking and smoking. Investors will no more have unanimity on the values that would influence their ethical investment than they would their donations to charity.

Some may have very strong ethical views. Some of those who found 'ethical funds' or those who judge companies for the purpose of social responsibility indices may well have strong views and judge companies, funds and investments generally on that basis. However, other may legitimately disagree.

For us, being an ethical fund or an ethical corporation is a matter of process not of substance. It is not ethical because it adheres to a single externally determined set of values. It is ethical because it states what its values are – and seeks meaningful evidence to determine, with a reasonable degree of reliability, that the companies they invest in further those values. Ethical companies and ethical funds should enjoy a symbiotic relationship and attract the participation of ethical managers and the investment of ethical investors. Investors, managers, companies and funds will be ethical because their values are public and the last three are accountable for the furthering of those values. However, different individuals, corporations and funds may have different views on whether it is a good or a bad thing to produce alcohol or wine or the way in which drugs are marketed. If the companies are upfront about their values, it will be easier for managers to choose which companies to work for and funds and investors which companies to invest in. As soon as values other than share price are deemed relevant, an efficient market should respond to this fact.

Alternative approaches to values *other than* long-term shareholder value

The singularity of the shareholder value approach is, as we have already outlined, based on a misleadingly simplistic image of human values and motivation in which economic man seeks to maximise profit for himself. Most investors, company managers, company directors and fund managers would agree that there are other values, but disagree on what those values are and how they should be applied. There are six basic approaches:

1. Shakespeare had Hamlet say to Horatio, 'There are more things in heaven and earth … than are dreamt of in your philosophy'. Some investors, managers and directors might say "I'm with Horatio" – there *is* nothing more important than money, and individuals and societies are measured by the dollars they control.
2. Other values should be dealt with via legislation – environmental, employment and occupational laws, consumer protection, taxation etc., but shareholders, unit holders and managers should *only* concern themselves with long-term shareholder value.
3. Nothing destroys long-term shareholder value more quickly the corporate irresponsibility and any prudent director will see that long-term shareholder value can only be enhanced if is to respect and advance the interests of other 'stakeholders'.
4. Shareholders and unit holders may and should take into account other values they hold in deciding what to invest in, how to vote their shares, and whether or not they are convinced that this will increase long-term shareholder value.
5. Corporations should take into account values other than those they share.
6. Stakeholders who are not shareholders should take part in the governance of the corporation.

The third and fourth approaches are, in theory, fundamentally different. The third approach is a utilitarian argument about means – it suggests that other values and interests must be recognised in order to achieve long-term shareholder value. The fourth approach is a 'deontological' argument about ultimate values/ends/principles which should be valued even if they do not enhance long-term shareholder value. In practice the two will often generate similar outcomes. Many highly committed and ethical directors and managers believe that the long term value of the shares of the company will depend on retaining the good will of relevant stakeholders such as governments and communities, and in avoiding practices that will be harmful to the environment, social stability and so on. They are not cardboard cut-out economic man. They feel uncomfortable basing company policy on any other basis. Accordingly, they replace a principled argument about the values of the corporation and its owners with an empirical claim that can never be disproved and which the board is entitled to take into account. It replaces a 'deontological' argument based on ends/principles and fundamental values with a utilitarian argument about means. We find the utilitarian arguments highly persuasive and believe that they should be highlighted by directors, managers, shareholders, unit holders and stakeholders. However, for reasons outlined above, it is not only right in principle to argue that shareholders and unit holders have values other than long-term shareholder return, it is actually more profitable. Those who do the right thing (precisely because it is right rather than because it is profitable) will be more trustworthy and the transaction costs of doing business with them will be less. Such an approach is more effective in generating the 'goodwill' that is necessary for business to operate.

Our suggested approach to reform

The following section describes a suggested approach that takes into consideration the competing and often conflicting interests that regulators, legislators and corporate entities bring to the debate. Its starting point is that shareholders and unit holders have values beyond the narrow economic issue of the long term return on their shares and superannuation accounts and that capitalism is enriched rather than impoverished if mechanisms exist to allow investment decisions to link those values to investment decisions.

The setting of uniform minimum legal standards will not in themselves prove sufficient. A regulatory framework based on sanctions, by virtue of its reactive nature is weak in terms of imposing penalties after an event that contravenes a provision has occurred. Calls for changes to corporate culture as the most effective mechanism to alter corporate behaviour without outside regulation regularly refer to chief executive and board leadership, corporate frameworks to permit employees to act ethically and the reduction of the fear employees have of speaking up. Using such terms places the onus of recognising wider duties to stakeholders on the board to 'create' values and conditions conducive to this recognition. Proponents of such a method of encouraging CSR may be concerned that regulation hampers the ability of companies to set themselves apart and differentiate their product from others competing in the same market.

The central dynamic of CSR is that responsible directors, managers, shareholders and unit holders do recognize the importance of values other than the long term value of the shares and units involved – whether for utilitarian or deontological reasons. This should be encouraged and facilitated, impediments and roadblocks should be removed, and difficulties put in the way of those who would seek to profit by pretending to further environmental and other values.

This model incorporates the following:

1. Building a code of corporate ethics which reflects the purposes for which joint stock companies are created and sustained.
2. Amendment to legislation to make it absolutely clear that directors may to take into account values and interests other than long term shareholder return.
3. Provide mechanisms by which corporations may make claims to about such values to attract investment – either in prospectuses seeking funds or by endorsement of existing shareholders. The Corporations Act can be amended to give an indicative list of the matters on which such claims may be made.
4. Require that any such claims must be reported on in the annual report.
5. Provide mechanisms for the independent assessment of such claims – including internal and external auditing, monitoring and rating (though with ratings based on specific claims rather than a set of values set by the raters). Corporations holding themselves out as conducting their activities in a certain manner need to have supporting documentation that may be subjected to thorough scrutiny. The claims of social responsibility should be as testable and contestable as those of financial responsibility. If this means that the claims to environmental or other virtue have to be moderated to reflect the realities of how businesses currently operate then so be it.
6. Encourage the development of investment products that allow shareholders to weight investments according to their values (including concentrating on those that promote certain values or exclude those which further others)
7. Encourage investment advisors to ask if investors want to consider other values in choosing their investments.

1. Corporate Ethics

Corporations laws that authorize and encourage joint stock companies and superannuation trusts are put in place for a wider community purpose. These should be explicitly reflected in Corporations Laws and in the ethics of corporations. We would like to revive and idea previously suggested by Bob Baxt and Charles Sampford early in the 1990s for a new 'chapter one' of the corporations act which sets out a set of principles for guiding the legal regulation and ethical standard setting of corporations. This would provide a very clear statement of the purposes of the legislation that would guide its interpretation and future amendment. While it would have had to passed through parliament, it would be drafted by government and business with inputs from stakeholders.

Corporations would then have a common starting point in framing their own codes of ethics and the internal integrity systems through which they seek to realize the values set out in the ethics codes.

Corporations which are following such a code will find compliance much easier because they are operating under the same principles that guide the law and its interpretation.

2. Amending legislation to explicitly authorize and legitimate CSR

We do not believe that current legislation should be interpreted to mean that corporations and super funds cannot take into account values of importance to their shareholders and unit holders other than those which can be immediately and clearly justified as enhancing the monetary value of their investment. However, that interpretation is often offered as an excuse for ignoring issues of CSR by corporations. In the case of trustees, there is a legitimate concern.

The amendments should make it clear that taking into account other values which the Board believes are more likely than not to increase the long term shareholder/unit holder value is not only legal but specifically permitted and falls within the responsibilities of directors. However, a Board should minute their reasons to show that they have thought through the issue and had good reason for taking the view they did.

The amendments should also permit the Board to take into account other values held by shareholders and unit holders – such as environmental sustainability (generally or specifically – e.g. water use or carbon emissions), involvement in specific morally contested industries (gambling, sex industry, alcohol, nuclear industry, arms), non-exploitative labour relations, use of local product/services, non-investment in dictatorships etc. This list is merely illustrative of the kinds of issues that shareholders and unit holders might take value positions on (and in some cases, like nuclear energy, some will choose to invest in areas that others shun). However, corporations making such claims would have to be able to justify those claims. We seek to promote the integrity of claims not their substance.

3. Making claims

The emphasis of the reform process should be on permitting CSR, endorsing and encouraging it by listing the areas under which to make claims regarding CSR actions. Corporations then may make claims under such headings.

4. Annual reporting

Corporations do not have to make claims that they are furthering other values at the same time as long term shareholder returns. However, if they do so to differentiate themselves from others and to attract capital (or avoid shareholder motions for reform) they should report on the achievement of those claims and the means by which they can substantiate their claims

5. Assessment of claims

The means by which corporations internally justify their claims will vary. There are various mechanisms for internal audits for financial reporting despite well over a century of practice. The variety of other matters reported on will lead to even more variation. While such internally generated processes should be at the core of assessment (as they are in financial audits), there should be an independent assessment process to address the issue of 'pretended goodness'. Also, a requirement for the justification of a corporation's actions means increased and improved access to information and knowledge about the activities of the corporate sector. The mechanism that permits companies to make claims about their conduct means information is more likely to be informative rather than misleading. The process increases the contestability of claims made by companies.

The onus is on business to support any claims made about their conduct. If an interested party is not satisfied that the claims expressed by a corporation are accurate that interested party may make a submission to the appropriate assessment body, detailing specific issues and questions. The assessment body will then request further particulars from the corporation to substantiate the claims. This body could then report that the claim was valid, in need or modification, or unsubstantiated. Where the assessment body considered that the claim had been misleading or deceptive, it could refer the matter to the ACCC. However, the goal would be to improve the accuracy of the claims made.

There is a role for ratings agencies. However, it is important that there is not a single ratings agency and that corporations are rated on the values that they claim to further rather than the value preferences of the agency.

6. Development of flexible investment products

If an investor wishes to invest in shares and superannuation funds that seek to make money by furthering certain kinds of values it is not easy. In theory such an investor may invest in corporations which pursue those values or by voting shares to make existing companies alter their values it is not easy. They could join ethical funds. However, it is difficult for individuals to make much difference and ethical funds tend to package values based on their origins, the values of the Board or the predilections or those who rate ethical funds. The more that corporations/trustees are explicit about the values they seek to further in trying to enhance the interests and values of their shareholders/unit holders, the easier it is to tailor products to investors who wish to take into account such values and the particular mix of values that individual investors may hold.

7. Investment advice

If some investors want to achieve more with their investment than a monetary return, then investment advisors may have a very important role to play in assisting them to find the right funds and shares. They should be encouraged to do so.

Conclusion

Incorporating a values based model into the regulation of corporate behaviour need not be viewed as the antithesis of maximising shareholder interests and ensuring the longevity of the success of a company. By permitting corporations to make claims about their operations and the values that underpin the decisions they make, corporations are able to justify their actions while providing information to both shareholders and stakeholders to make informed decisions about how to react to such actions. Reporting on corporate activities allows investors and potential investors to formulate decisions based on the ‘values’ information the corporate entity has claimed. In this way, would-be investors are given the opportunity to ask values questions of themselves when making decisions. Values questioning means asking questions about your values, giving honest and public answers and living by those answers. This way the wide ranging interest of corporate entities and stakeholders is not limited to a fiction of there being one commonly held set of values.

Provision for corporations to consider interests other than shareholder interests and make statements about activities in relation to those interests may also include the making of claims about risk factors to ensure a balanced perspective. In terms of this approach, CSR is also about managing risk in relation to other relevant factors *in addition* to shareholder interests. Having said that, the focus on risk is not merely about avoiding negatives. The aim is to further positive activities in relation to CSR so that questions of risk become about risk outside of the corporation to encourage socially responsible awareness of risks to external stakeholders.

This proposal focuses on the need for business to reduce the impact of risk while allowing for business activities to be improved to enhance business success. It achieves this by encouraging market based competition and permitting office holders of corporations to make decisions about what is in the long term best interests of the company and its owners, and being able to make such claims and support them if required. This process brings to the forefront of corporate governance corporate reputation and the potential negative impacts if misleading claims are made to the public.

The ultimate goal is to make space for the 'ethical entrepreneur', individuals and corporations that have an idea about making money that also furthers values that are held by at least some investors. In that way, investors can link their values to their investments. If the values are or become more widespread, the firm may end up spectacularly successful. Corporations that meet widespread interests, needs and values may end up being worth more than those corporations that meet manufactured short-term wants. But in any case, where the corporation furthers values of importance to the investor, the investor will know that they have made a difference that might outlast the monetary returns on their shares and their superannuation.