

Driving impact through responsible investing

Opportunities for business and business schools

20th ABIS Annual Colloquium
23 November 2021 | Online



20th Annual Colloquium hosted virtually by ABIS – The Academy of Business in Society¹, a global network of over 100 companies and academic institutions whose expertise, commitment and resources are leveraged to invest in a more sustainable future for business in society.

Towards a definition of Ethical Investment

Quintin G Rayer

P1 Investment Management Ltd and Centre for Financial and Corporate Integrity, Coventry University

Panagiotis Andrikopoulos

Centre for Financial and Corporate Integrity, Coventry University

Keywords: Aristotle, ESG, ethical, greenwash, investment, Markowitz, moral, optimisation, responsible, sustainable, utility.

Abstract

An individual may hold strong moral or ethical values which guide how they live their lives. Naturally, they desire to see their values reflected in their investments, which may include pensions as well as directly owned portfolios. Professional advice or commercial investment products may channel them to invest ‘responsibly’ or ‘sustainably’. If the resulting approaches are not ethical, then the underlying investor has not been invested according to their wishes. Many responsible and sustainable investment approaches focus on risk management (BSI 2020, Sullivan 2011). They seek to protect portfolios from loss of value caused by firms’ harmful or unsustainable activities, but not to prevent or reduce those harms.

¹ ABIS is based at Avenue Louise 231, 1050 Ixelles, Brussels, Belgium.

Such risk management approaches may protect wealth, but an ethical investor would wish to prevent or reduce harms, or support solutions.

For example, one may wish to address the root causes of climate change but be invested in a manner that instead protects one's wealth from the financial consequences of global warming, rather than seeking to prevent (or reduce) it. An investor intending to use their investments to prevent or reduce harms may feel aggrieved, or "greenwashed", by products that only protect portfolio value from the consequences of those harms. Such products only protect the investor without addressing the underlying moral concerns.

The purpose of this study is to offer definitional clarity on ethical investment to guide professional investors, advisers, and individuals on the specific micro-characteristics of a "true" ethical investment, to help ensure they invest as intended. We then explore differences between 'responsible' and 'sustainable' investment, as typically practised, asking whether they are appropriate approaches providing ethical investment solutions?

Introduction

Ethical investment broadly encompasses commercial practice, informed by ethical or moral considerations, faith-based teachings, physical and social sciences, governance, and other inputs (Cooper and Schlegelmilch, 1993; Krosinsky and Robins, 2008; Krosinsky *et al.*, 2012; Michelson *et al.*, 2004). Motivations may include religious teaching (Jackson, 1872; United States Conference of Catholic Bishops, 1997), timeless moral values, or stakeholder capitalism (Andrews, 1972; Cavanagh and McGovern, 1988). Ultimately, investment is no different from other activities in having a moral aspect (Irvine, 1987). Ethical investment approaches have included excluding firms involved in activities deemed harmful or inclusion if deemed benign (Cooper and Schlegelmilch, 1993; Lean *et al.*, 2015; Luther *et al.*, 1992; Mackenzie, 1998; Posner and Langbein, 1980). Other approaches include using shareholder voting to influence management or investment in the least "bad" firms in a harmful sector (Lewis and Mackenzie, 2000). Engagement with corporate management permits investors to use their 'voice' rather than exiting by selling shareholdings (Hirschman, 1970; Michelson *et al.*, 2004). Recent practice has promoted a more integrated approach, by including non-financial, 'ESG' (environmental, social and governance) criteria in investment decision-making (Derwall *et al.*, 2011; Kreander *et al.*, 2005; Krosinsky and Robins, 2008; Krosinsky *et al.*, 2012; Louche and Lydenberg, 2011; von Wallis and Klein, 2015).

Defining ethical investment

We motivate our definition of ethical investment by appeal to Aristotle (350 BCE). A key emphasis is on altruistic intent rather than personal benefit. Ethical investment involves more than meeting minimum legal requirements. By appealing to Aristotelian roots, we treat ethical investing as an over-arching term, aiming to keep the range of possible investment approaches as comprehensive as possible.

Following Mackenzie and Lewis (1999), we argue that investors may make trade-offs between financial returns and moral values and find utility in certain altruistic behaviours (Cullis *et al.*, 1992). Hence, while a conventional investor seeks utility function maximisation

based on a priori wealth ($\$$) and legal (L) considerations² (which we denote as $U(\$, L)$), following Aristotle (350 BCE), an ethical investor additionally requires *a priori* altruistic intent (E), or $U(\$, L, E)$. By this we mean that an ethical investor would seek to construct their portfolio so that it addresses the moral issues identified as having merit in their own right, rather than because the approach would yield financial advantage.

Utility function approach

Expressing ethical investment in terms of utility offers a potential link with Markowitz's (1952) risk-return optimisation, as $U(r\$, \sigma\$, L, E)$, but requires further justification. Prior literature shows that investors have individual utility functions, perhaps balancing wealth with reputational benefits (Kuran, 1990). Ethical investors may desire to feel good or promote social change (Michelson *et al.*, 2004). "Warm glow theory" suggests that individuals may derive utility from the physiological and psychological benefits generated by their actions (Ryan and Deci, 2000), including the release of 'feel-good' neurotransmitters (van der Linden, 2015). Ethical investors' utility may further be enhanced by fulfilling needs identified by self-determination theory (Ryan and Deci, 2000). One or more of these factors could contribute to the utility function of an ethical investor, benefitting from a virtue payoff, D (Feddersen and Sandroni, 2009). Even between competing ethical aspects, there is evidence that investors will trade-off to maximise their utility function (Kohler, 2011), further suggesting that ethical considerations can be considered within a utility framework. As an ethical investor seeks to maximise utility across multiple aspects, including financial, legal and diverse moral concerns, this points to a multi-dimensional optimisation approach.

Financial returns can be considered in terms of income, capital, and risk, while multiple dimensions can cover a range of legal and ethical requirements. In principle, optimisation can be within an extended Markowitz (1952) framework. Considerations could include climate and the need to constrain damaging carbon dioxide emissions (Allen, 2016). Optimising an ethical utility function can address exclusions, positive selection approaches, underweighting exposures to harmful activities, and overweighting solutions. Expressing ethical investment in utility function terms also helps us conceptualise the debate whether ethical investment should imply underperformance.

We further investigate the differences between 'responsible' and 'sustainable' investment, as typically practised, using our definition of ethical investment. We explore the questions, "is sustainable investment ethical?" and what about responsible investment? Our conclusions are relevant to those wanting to invest ethically, including those seeking to address global warming as climate-friendly investors.

References

Allen, M. R. (2016). Drivers of peak warming in a consumption-maximizing world. *Nature Climate Change*, 6(7), 684-686. doi: 10.1038/NCLIMATE2977.

² By legal considerations, we primarily mean compliance with financial markets regulations and national and international laws.

- Andrews, K. (1972). Public Responsibility in the Private Corporation. *Journal of Industrial Economics*, 135-145.
- Aristotle. (350 BCE). *Nicomachean Ethics: Book II*. Retrieved from <http://classics.mit.edu/Aristotle/nicomachaen.2.ii.html>
- BSI (2020). PAS 7341:2020 Responsible and sustainable investment management – Specification. London: British Standards Institute.
- Cavanagh, G. F., and McGovern, A. F. (1988). *Ethical Dilemmas in the Modern Corporation*. Englewood Cliffs, N.J.: Pearson .
- Cooper, M., and Schlegelmilch, B. B. (1993). FOCUS : Key Issues in Ethical Investment. *Business Ethics: A European Review*(2), 213-217. doi:10.1111/j.1467-8608.1993.tb00047.x
- Cullis, J. G., Lewis, A., and Winnett, A. (1992). Paying To Be Good? U.K. Ethical Investments. *KYKLOS*, 45(1), 3-24.
- Derwall, J., Koedijk, K., & Ter Horst, J. (2011). A tale of values-driven and profit-seeking social investors. *Journal of Banking & Finance*, 35(8), 2137-2147.
- Fedderson, T., and Sandroni, A. (2009). *The Foundations of Warm-Glow Theory*. Working paper, Kellogg School of Management, Northwestern University. Retrieved from <https://www.ssc.wisc.edu/~mrostek/warm-glowd%2010-08-09.pdf>
- Hirschman, A. O. (1970). *Exit, voice and loyalty*. Cambridge, Massachusetts: Harvard University Press.
- Irvine, W. B. (1987). The ethics of investing. *Journal of Business Ethics*, 6(3), 233-242.. doi:10.1007/BF00382870
- Jackson, T. (1872). John Wesley, sermon 50: the use of money. (Global Ministries, The United Methodist Church) Retrieved August 8, 2017, from <http://www.umcmission.org/Find-Resources/John-Wesley-Sermons/Sermon-50-The-Use-of-Money>
- Kohler, S. (2011). Altruism and fairness in experimental decisions. *Journal of Economic Behavior & Organization*, 80, 101-109. doi:10.1016/j.jebo.2011.02.014
- Kreander, N., Gray, R. H., Power, D. M., and Sinclair, C. D. (2005). Evaluating the performance of ethical and non-ethical funds: a matched pair analysis. *Journal of Business Finance & Accounting*, 32(7-8), 1465-1493.
- Krosinsky, C., and Robins, N. (2008). *Sustainable investing, the art of long-term performance*. London: Earthscan from Routledge.
- Krosinsky, C., Robins, N., and Viederman, S. (2012). *Evolutions in sustainable investing: strategies, funds and thought leadership*. John Wiley & Sons.
- Kuran, T. (1990). Private and Public Preferences. *Economics and Philosophy*, 6, 1-26.
- Lean, H. H., Ang, W. R., and Smyth, R. (2015). Performance and performance persistence of socially responsible investment funds in Europe and North America. *The North American Journal of Economics and Finance*, 34, 254-266.

- Lewis, A., and Mackenzie, C. (2000). Support for Investor Activism among U.K. Ethical Investors. *Journal of Business Ethics*, 24(3), 215-222. Retrieved from <https://www.jstor.org/stable/25074280>
- Louche, C., and Lydenberg, S. (2011). *Dilemmas in Responsible Investment*. Abingdon, Oxon OX14 4RN, United Kingdom: Routledge.
- Luther, R. G., Matatko, J., and Corner, D. C. (1992). The investment performance of UK "ethical" unit trusts. *Accounting, Auditing and Accountability Journal*, 5(4), 57-70.
- Mackenzie, C. (1998). The Choice of Criteria in Ethical Investment. *Business Ethics*, 7(2), 81-86.
- Mackenzie, C., and Lewis, A. (1999). Morals and markets: the case of ethical investing. *Business Ethics Quarterly*, 9(3), 439-452.
- Markowitz, H. (1952). Portfolio selection. *The Journal of Finance*, 7(1), 77-91.
- Michelson, G., Wailes, N., van der Laan, S., and Frost, G. (2004). Ethical Investment Processes and Outcomes. *Journal of Business Ethics*, 52(1), 1-10. Retrieved from <https://www.jstor.org/stable/25075228>
- Posner, R., and Langbein, J. (1980). Social investing and the law of trusts. *Michigan Law Review*, 79, 72-112.
- Ryan, R. M., and Deci, E. L. (2000). Self-determination theory and the facilitation of intrinsic motivation, social development, and well-being. *American Psychologist*, 55(1), 68-78.
- Sullivan, R. (2011). *Insight Investment. Reflections and Lessons Learned from Integrating Sustainability*. In C. Krosinsky, N. Robins, & S. Viederman, *Evolutions in Sustainable Investing: Strategies, Funds and Thought Leadership* (pp. 261-275). Wiley Finance.
- United States Conference of Catholic Bishops. (1997). *Economic Justice for All: Pastoral Letter on Catholic Social Teaching and the U.S. Economy*. Washington, D.C.: United States Conference of Catholic Bishops.
- van der Linden, S. (2015). Intrinsic motivation and pro-environmental behaviour. *Nature Climate Change*, 5, 612-613.
- von Wallis, M., and Klein, C. (2015). Ethical requirement and financial interest: a literature review on socially responsible investing. *Business Research*, 8, 61-98. doi:10.1007/s40685-014-0015-7

This abstract may be cited as: Q G Rayer and P Andrikopoulos (2021). Towards a definition of Ethical Investment. Presented at the 20th ABIS (Academy of Business in Society) Annual Colloquium on 'Driving impact through responsible investing', 23 November 2021, online (abstract).