

# Towards a definition of Ethical Investment

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### 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. 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 nonfinancial, '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 ( $L$ ) considerations [2] (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).

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

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(continued from page 9) 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.

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