Introduction

It is common for professors to base inaugural lectures on work that they have already done, perhaps thereby giving a hint of why they have been appointed. One topic that has been an interest of mine over many years is ethical investment. The word ‘inaugural’ suggests a degree of looking forward. Therefore, in addition to outlining some of the work that has brought me to this point, I would like to indicate the broad direction in which I would like my own work, and I hope the work of others, to go in the future.

As I am focusing on ethical investment it would seem sensible to give an introductory indication of what is meant by that term. So the first question is:

What is ethical investment?

I will then consider three further questions:

- How do you do it?
- Does it hurt (financially)?
- Is it ethical?

What is ethical investment?

I take ethical investment to refer to a set of approaches which include social or ethical goals in addition to more conventional financial criteria in decisions over whether to hold a particular investment. What binds these approaches together is their contrast with what might be termed economic or mainstream investment, which is deemed to focus solely upon financial risk and return. In ethical investment we are interested in how a company makes its money, not just how much. The desirability of a company’s share cannot simply be summed up by its price-earnings ratio or beta-value.

I referred to a company’s share. Ethical investment can take a number of other forms, including depositing money with a social bank or lending money to a co-operative venture. These are sometimes known as ‘alternative’ investments, and some of them have a long tradition. However, I will focus here upon stock market-based equity investment. I should also point out that I am not just talking about individual private investors. For example, ethical investment can be carried out by religious organizations (Cowton 1990), universities or pension funds. And, if you want to invest ethically, you don’t have to do all the work yourself; you can use a suitably designed investment vehicle. Probably the best known example in the UK was the first, and is still the largest – Friends Provident’s Stewardship Trust.

I should acknowledge that the form of ethical investment on which I am focusing goes under a number of other names – including socially responsible, social and green investment (Cowton 1997). Some people try to distinguish green or environmental investment from other forms of
ethical investment. If the investment strategy is concerned solely with making money out of the increase in environmental concern and regulation, it is sensible not to term it ‘ethical’, not least because some of the companies chosen may be far from green themselves, e.g. some waste management companies. But if the intention is to invest in a way that endorses, and does not merely exploit, the rise in environmental concern, then it seems sensible to view green investment as part of ethical investment.

To some extent the use of different terms appears to be a matter of taste. For example, some people object to the use of the word ‘ethical’ because it seems to imply that other, mainstream approaches to investment are ‘unethical’. (Perhaps they are, but I do not want to address that issue just now.) Such people sometimes prefer the terms ‘social’ or ‘socially responsible’ investment, but fail to recognize that, following their own line of reasoning, such usage implies that mainstream investing is ‘anti-social’ or ‘irresponsible’, which is not necessarily much less offensive to its practitioners than ‘unethical’. However, I don’t mind too much exactly what it’s called or precisely how it’s defined. That there are different terms and definitions does not matter much if, in the final analysis, they show a reasonable degree of similarity in describing what is, after all, a varied and developing social phenomenon. What bothers me is not that someone manages to have the final word in summing up ethical investment in one sentence, but rather that we are speaking about more or less the same thing as we seek to understand and examine it more fully – which I will now do as I turn to the question of implementation.

How do you do it?

Perhaps the most common or basic approach involves the rejection of companies considered to be undesirable. Such an approach might be termed an avoidance strategy. It is an attempt to cleanse an investment portfolio of companies with undesirable features, and to keep it clean as companies merge, acquire other businesses or otherwise change their activities.

So what do ethical investors object to? Although it is difficult to talk about the ‘typical’ ethical investor, we can point to a number of common dislikes, many of which are reflected in the policies of ethical investment vehicles. I might divide them into two, depending on whether it is in the nature of the business itself – what product or service is supplied – or in how the business is conducted that the objection lies.

Many ethical investors, particularly those associated with churches, where many of the origins of ethical investment lie, avoid the so-called ‘sin stocks’ – alcohol, gambling and tobacco. In many cases their practice pre-dates the ‘modern’ era of ethical investment. We might add pornography too. Many church members would see problems in other areas too, of course. One which looms large is military contracting, which I shall discuss in a little more detail later. In some research I did some years ago on 125 pioneer users of EIRIS, the main information service for ethical investment in the UK, 111 wished to avoid investing in military contractors.

Some other grounds for exclusion reflect environmental concern. At one time nuclear power was the only environmental issue reflected in the policies of ethical investment vehicles, but since around 1990 a number of others have appeared, including mining and quarrying, plantations and pesticides. Other pet hates include animal-based products (that was a joke) and banking and finance. This latter category might seem ironic. Surely such people should not be interested in investing in the stock market at all. But one of the possible reasons for their position is a perfectly reasonable one; that banks, given their widespread operations, are likely to be helping the very companies that the investors are trying to avoid. In that sense it seems a simple matter of consistency not to buy bank shares.

The other sort of objection relates not to the what of company activities but to the how; under which latter heading I will include the where. Indeed, it is a where that can be said to have been the ‘top of the unpops’ in British ethical investment. Of the 125 pioneer ethical investors I referred to earlier, 120 wished to exclude shares on the basis of involvement in South Africa. It
would be fair to say that concern about apartheid was a massive stimulus to the development of the ethical investment movement in the UK. It united many groups and individuals of diverse persuasions and, as one director of a financial institution once remarked, it made things easy; 'you hate apartheid, so we avoid South Africa'. Other regimes have sometimes been mentioned, but it is South Africa which for long was centre stage.

I mentioned earlier that some ethical investors wish to avoid companies that deal in animal-based products. Similarly they might want to avoid companies dealing in products which have been tested on animals. Depending on the particular grounds for this objection, you might be willing to countenance investing in pharmaceutical companies but not companies which manufacture or sell animal-tested cosmetics. Other objections to how companies operate might be arranged by stakeholder group; treatment of employees (e.g. employment practices and health and safety record), customers (e.g. advertising practices (Cowton 1992) and power), the local community, and even the environment or future generations (e.g. pollution). A number of the issues can involve the breaching of laws or other regulations.

Although far from comprehensive, what I have presented so far is very much a shopping list of issues. But with a colleague in Oxford I did subject the dislikes of the 125 EIRIS pioneers to some statistical analysis. We did two things. First, we used principal components analysis to discern deeper seated attitudes (Anand and Cowton 1993). (They had indicated which of fourteen areas of possible concern they wanted to avoid.) What factors or attitudes, perhaps of a more stable nature, lay behind particular expressions of opinion? Somewhat tentatively, we inferred a number of things, including a left-of-centre, post-industrial factor. The second thing we did was to use cluster analysis to find how the individuals grouped to maximize intra-group similarity and inter-group dissimilarity. Table 1 shows what we came up with.

Group 1 and Group 2 consisted of 60 and 65 members respectively. Note that on each of the exclusion dimensions a larger proportion of Group 1 was bothered than Group 2. We had, within our pioneers, what we might term a 'sensitive' group and a more 'moderate' one.

Table 1: An Analysis of 125 'Pioneers'

<table>
<thead>
<tr>
<th></th>
<th>Group 1</th>
<th>Group 2</th>
<th>Group 2a</th>
<th>Group 2b</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>60</td>
<td>65</td>
<td>33</td>
<td>32</td>
</tr>
<tr>
<td>Advertising</td>
<td>67</td>
<td>15</td>
<td>0</td>
<td>31</td>
</tr>
<tr>
<td>Alcohol</td>
<td>47</td>
<td>32</td>
<td>3</td>
<td>63</td>
</tr>
<tr>
<td>Animals</td>
<td>72</td>
<td>22</td>
<td>39</td>
<td>3</td>
</tr>
<tr>
<td>Military</td>
<td>98</td>
<td>80</td>
<td>76</td>
<td>84</td>
</tr>
<tr>
<td>Gambling</td>
<td>62</td>
<td>34</td>
<td>12</td>
<td>56</td>
</tr>
<tr>
<td>Media</td>
<td>8</td>
<td>2</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Nuclear power</td>
<td>90</td>
<td>43</td>
<td>58</td>
<td>28</td>
</tr>
<tr>
<td>Overseas interests</td>
<td>48</td>
<td>5</td>
<td>9</td>
<td>0</td>
</tr>
<tr>
<td>Political donations</td>
<td>70</td>
<td>23</td>
<td>30</td>
<td>16</td>
</tr>
<tr>
<td>Company size</td>
<td>18</td>
<td>8</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>South Africa</td>
<td>100</td>
<td>92</td>
<td>85</td>
<td>100</td>
</tr>
<tr>
<td>Tobacco</td>
<td>90</td>
<td>51</td>
<td>9</td>
<td>94</td>
</tr>
<tr>
<td>Banks &amp; finance</td>
<td>82</td>
<td>32</td>
<td>48</td>
<td>16</td>
</tr>
</tbody>
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Given that the moderate group might be more like the outside world, we were interested to see that it broke down, on further statistical analysis, into two sub-groups which displayed interesting characteristics. As you would expect, both sub-groups have a large proportion of members who wished to avoid South African involvement and military contracting. But there are also some striking differences.

In the case of Group 2a, nuclear power comes out strongly. Financial institutions, animals and political donations also feature. In the case of Group 2b, tobacco, alcohol and gambling come out strongly, whereas they were of very little concern to members of Group 2a. The only other item to feature – just – is advertising (which referred to misleading advertisements). A plausible interpretation is that members of Group 2a have concerns which spring primarily from a left-of-centre political orientation, whereas Group 2b have traditional ‘religious’ concerns. Analysis such as this suggests the possibility of designing ethical investment products for particular market segments (Cowton 1994).

However, there is something about ethical investment, at least in its avoidance form, which makes segmentation less valuable than might be expected. Ethical investors don’t need to be of one mind for generic products to be a success – which has helped the concept become established. I will illustrate. Suppose Janet objects to gambling and tobacco, and John objects to tobacco and alcohol. An ethical fund which avoids alcohol, gambling and tobacco is going to satisfy both (unless John is desperate to invest in a casino, in which case he can go and buy an appropriate share anyway). Thus there is an incentive, when designing an ethical investment vehicle, to add avoidance dimensions so that you don’t put any investors off by adulterating the investment portfolio with a particular type of company to which they object.

However, ethical investment is not just about avoiding the ‘bad’. Increasingly, investors – and those offering them appropriate financial products – have been trying to complement avoidance with a positive bias towards ‘good’ companies. We might describe this as a supportive strategy. Again, positive features might relate to either the what or the how of a company’s business, perhaps viewed through a stakeholder lens.

Good business can be seen as building up or protecting the individual, society or the environment. Examples of good products and services include healthy food, housing, healthcare and pollution control equipment; while good conduct might include customer care, re-cycling policies, good employment policies and positive community relations. What the examples of re-cycling and employment practices help bring out is that some concerns, such as the environment and employee relations can be reflected in both avoidance and supportive strategies.

Avoidance and supportive strategies can be combined in two principal ways. One way is to divide the selection process into two stages, beginning with negative screening which leaves a set of ethically acceptable investments. Positive criteria are then used in conjunction with financial criteria in choosing the particular shares to hold. This is the approach that tends to be favoured by the ethical investment vehicles on offer in the UK, many of which began life pursuing pure avoidance strategies.

Such an approach, like a pure avoidance strategy, has the effect of imposing a blanket indictment on certain companies, even though their performance in some respects might be considered exemplary. An alternative is to permit a trade-off between good and bad features, perhaps calculating an overall score or rating for a company. A portfolio might then be considered ‘good’ but not ‘clean’, since investment in companies with negative attributes is permitted if they exhibit sufficient good points.

The concerns that I have cited are illustrative, rather than definitive, of the wide variety of concerns, both positive and negative, that can feature in ethical investment policies. Certainly the field is not static, as the decline of South Africa and the growth in the environment as investment issues serve to demonstrate. Moreover, while the examples have put some flesh on the bare definitional bones of ethical investment introduced earlier, they still do not fully explain how it works in practice. It is one thing to have a concern
about some aspect of business activity, but that concern could be turned into a wide variety of investment criteria. For example, although there was considerable consensus amongst ethical investors that some form of avoidance was appropriate while apartheid operated in South Africa, what about Namibia? Should all operations and links have been condemned, or only those in sectors of strategic significance? Or should the emphasis have been not upon *that* a firm operated in South Africa, but *how* it did so; as indicated by its pay and promotion policies for non-whites, for instance?

Such questions arise in all elements of ethical investment, even when it seems to be a simple matter of a company operating in a ‘bad’ business. For example, if you objected to alcohol, you might avoid investing in breweries or pub companies. But what about supermarkets, which sell massive amounts of alcohol? If you want to avoid military contracting, what might this mean? And do the ethical funds define it as you would like to? One might simply state that it avoids armaments, another might be more precise in citing armaments manufacture, while another might use a broader phrase such as ‘involved in the arms trade’. But you might not think this covers enough. What about companies that build military bases, or sell electronics which are vital to modern weapons systems, even if they have more general uses too? What about suppliers of specialist clothing or even food to the military? Some investors might find that the definition of military contracting used by ethical funds is not as wide, or as clear, as they would like (Cowton 1993).

There is a further word used in some of the fund brochures that is worthy of mention. It is not uncommon to see reference to ‘significant’ involvement. In other words, the portfolio might contain some of the undesired characteristic. A threshold rather than an absolute ban is being imposed. In practical terms it means that an otherwise good (financially or ethically) company can be invested in even if it has a small defence contract. It also provides a first line of defence in case a critic finds a small part of a company that is involved in military contracting. But whatever the practical benefits of thresholds, they do pose a problem in principle, because they explicitly condone the presence of supposedly unethical attributes in the investment portfolio. Nevertheless, the use of thresholds is common and might be easier to justify where the investment policy includes the possibility of a trade-off with positive features. Moreover, while the term ‘significant’ and the words discussed earlier lack precision, it is generally the case that there is more clarity regarding what funds avoid than what they support because avoidance is more easily described and monitored – which brings us to the question of information.

Information is vital for the successful implementation of ethical investment criteria, and getting it can be hard work. The potential sources of data are many and varied – corporate annual reports, press releases, newspaper articles, government statistics and regulatory reports, trade fair catalogues, and material produced by lobby groups. Much of the information is, depending on the concerns of the investor, hard to obtain, incomplete, difficult to interpret or unreliable. Monitoring full compliance of all shares held against all criteria might be particularly difficult during a period of merger and acquisition activity, and overseas companies tend to pose particular challenges.

What has had a major impact on ethical investment in the UK is the existence of a specialist information service serving both individual investors and ethical funds. The establishment of EIRIS in 1983, linked to the launch of Stewardship Trust in 1984, made ethical investment widely accessible. One of EIRIS’s long-established services is to offer a set of possible criteria, reflecting the information they hold on companies in their database. You indicate which criteria you wish to be applied, and they provide you with a set of acceptable companies. The information also helps people to get to grips with the issues, to turn perhaps rather inchoate general concerns about the impact of business on, say, the natural environment into concrete investment policies. EIRIS has thus helped make ethical investment feasible and affordable for the ordinary investor. But have investors who have gone in for it lost out financially?
Does it hurt financially?

This is one of the most commonly raised questions about ethical investment. Some proponents claim that it does not, and the slogans used to promote ethical funds suggest the absence of a conflict between financial and ethical objectives; for example, ‘profit doesn’t have to be a dirty word’, and ‘how to make money without selling your principles’. Some commentators even claim that ethical portfolios perform better. Certainly you can find individual ethical unit trusts which, over a particular period of time, have performed very well. But that could apply to any sort of investment portfolio. The good news for academics is that this is a question which needs some good, objective scholarly research. The even better news for academics is that it is not easy to answer. A number of different approaches have been used, which I might label conceptual, simulation and empirical.

On a conceptual level, it is generally more difficult to achieve a particular goal when other goals enter the equation. Other goals include constraints, which can be viewed as degenerate goals. An avoidance strategy imposes constraints so, put simply, ethical investors cannot do all that mainstream investors can do, but mainstream investors can always construct the same portfolio as ethical investors if it is financially attractive to do so. Thus it seems to be the case that ethical investment, on average, will involve financial sacrifice.

But this doesn’t tell us how big the sacrifice is. Based upon modern theories of portfolio management, a number of analyses have shown that the impact on risk and return is likely to be quite small. Unless the avoidance criteria are both wide-ranging in their scope and stringent in their definition, a reasonably well diversified portfolio can still be put together. This has been confirmed by simulation studies which have retrospectively constructed portfolios subject to ethical criteria and compared them with broadly similar non-ethical portfolios.

Simulation was particularly useful when there were few well established ethical funds, but you might be more interested in seeing how well actual ethical funds have performed. Furthermore, while conceptual and simulation studies have studied the impact of avoidance, empirical studies offer the prospect of picking up some effect of supportive strategies to the extent that they have been implemented.

There are still not many funds with a really substantial performance history behind them, but that is not the only difficulty in trying to assess impact empirically. One major challenge is to choose an appropriate ‘benchmark’ portfolio against which to judge performance. A general stock market index might seem to be a good yardstick, but ethical funds tend not to be invested in many of the larger companies because they are likely to contravene at least one negative criterion (Cowton 1991). Researchers have tried to control for this ‘size effect’, and so isolate any ‘ethics effect’, by using a smaller companies benchmark, although it is worth noting that from the point of view of the individual investor it depends on what their alternative investment strategy would have been. Would they have invested in smaller companies or all companies; or did the presence of an ethical investment option save them putting all their money in a mutual building society? Anyway, whatever the technicalities involved, the empirical evidence suggests a somewhat limited ethics effect – perhaps a small loss of return and/or an increase in risk. Furthermore, if ethical investment is the right thing to do, how much weight should be attached to the financial sacrifice?

Is it ethical?

So, is ethical investment ethical? If so, in what sense and with what caveats?

The prima facie case for applying ethical considerations to investment is that, like any area of human activity, it should not be immune from ethical scrutiny. Two strands of thinking are discernible. The first, which follows naturally from the prima facie case, seeks to ensure that consistent standards of behaviour are applied in all areas of life. For example, it might be considered inappropriate for someone who advocates teetotalism to hold shares in a distillery. To many observers, passively holding a stock and making a return from it indicates some support for a
particular activity. It looks hypocritical (see Crisp and Cowton 1994). This is emphasised in the publicity material of some ethical funds. ‘Invest for success with a clear conscience’ and ‘Investing with an easy mind’ are just two slogans that have been used. In this strand of argument, the integrity of the investor – or even ‘moral purity’ – is the priority. However, some commentators point out that moral purity is not possible; in our highly interdependent economic system no money can be considered totally clean. In any case, they argue that moral effectiveness, not moral purity, is the proper aim. For such people, what is important about actions is their consequences rather than their conformance to principle.

The consequentialist perspective is often reinforced by regarding shareholders as owners who not only possess rights but also have responsibilities. If a duty not to impose damage or harm on other people is regarded as a moral minimum, then it might be concluded that the avoidance of certain investments is appropriate, just as under an ‘integrity’ approach.

But what consequences, what impact, can simply buying, selling or ignoring certain shares have? Precious little, given the current scale of ethical investment, many people would say. But if it is linked to shareholder activism, perhaps much more can be accomplished. Indeed, many would argue that simply to aim for a clear conscience, quietly selling shares in companies which come to be viewed as unethical, is itself unethical, falling short of what is required. If you invest in a company and believe what it does is wrong, you should try to change it, perhaps asking questions at the AGM or engaging in constructive dialogue with management. On your own you might not be able to do much – unless you are a significant investor – but with other shareholders or other stakeholders such as consumers or employees, you might be able to accomplish something. Of course, you might not get anywhere, but if you do sell, perhaps you should at least let the company know why.

This kind of question is particularly important when an ethical policy is being introduced, since it is likely that a significant proportion of the portfolio will not meet the ethical criteria. But in due course, or if you are starting from scratch, such problems should come up rather less often. At that point, perhaps, more attention can be paid to the implementation of a supportive policy.

Of course, this discussion assumes that stock market investment can be ethical. Others, however, believe that any investment in a stock market is going to be unsuitable. They might prefer to focus on alternative investments.

On the other hand, many others view mainstream investment as ethically unproblematic, perhaps because of the overall benefits of the capitalist system. They might therefore object to the appropriation of the term ‘ethical’ by proponents of ethical investment. However, while they might be unconvinced by any of the arguments for ethical investment, they are likely to accept that investors have a general right to pursue it, holding or not holding shares as they wish, and participating in corporate affairs as active shareholders. They might also point out that ethical investment still represents only a small proportion of total stock market investment.

Nevertheless, although ethical investment is still economically marginal, it is surprising how far it has come. A few years ago people used to say that it could not be done because:

(a) it was too difficult to do – you couldn’t find clean companies, for example. But it has proved possible, with the right information, to develop practical criteria.

(b) even if you could do it, it would ruin your financial return. That has proved not to be the case.

Ethical investment might still have some way to develop – for example, in improving the quality of positive criteria or in ethical funds engaging more directly with companies – but with the experience that has been gained and the infrastructure that is now in place, that is an indication of potential rather than an indictment of failure.

Looking forward

The title of the lecture was Accounting and Financial Ethics, and this is the inaugural lecture.
of a professor of accounting. So what about accounting? At least two types of work are possible: attempts to develop new accountings which would be of help to ethical investors; and empirical research which seeks to understand how ethical investors currently deal with information, which is more akin to the work I have done to date.

You may be wondering where the sub-title, ‘From margin to mainstream?’ comes in. The topics I have described might be seen as interesting but marginal, since the areas of practice with which they are concerned are ‘marginal’ to the mainstream, at least for the foreseeable future. There is enough to keep me busy for years to come, but I hope that I – and others – will succeed in introducing a stronger ethical flavour to our understanding of the mainstream too. Where might that contribution be made?

An obvious starting point is creative accounting. The journalist Katherine Whitehorn once commented that, with creative accounting, who needs cheating? It’s a good quip, but if there is no single, correct profit figure to be calculated from a set of transactions data, can we talk about things like cheating, or truth and lies? Insights from moral philosophy might help here. We might start with the idea of what it means to be honest, for example. What is surprising is how little ethical analysis the notion of creative accounting, which is a major issue for business and the accounting profession, has prompted.

I usually argue that all accounting is fundamentally creative, particularly the accruals accounting that has developed in the private sector and is becoming pervasive in the public sector too. I shan’t explain how this is the case now, but suffice it to say that accounting creates particular ways of seeing or talking about the world. That picture or language has great strengths, but there are also problems. I am particularly interested in what happens when an organization moves from using accounting for the management of finance as a resource to management through finance, whereby the organization is depicted primarily, or even exclusively at a senior level, in financial terms. One project I am currently conducting with a colleague is looking at the role of financial information in GP fundholding practices. One thing we are interested in is whether the internal market in the NHS has had an impact on medical priorities. This is not just a question of more or less money affecting what can be done, but whether changed thinking has taken place. There are major ethical issues here.

Some people suggest that accountants have been promoting this ‘management through finance’. Possibly so. I would like to see work which takes a serious look at the contribution of professions such as accountancy to modern society. Professional bodies are largely absent from the business ethics literature, and the academic accounting literature takes a highly sceptical, not to say cynical, view. Perhaps that view is warranted in many respects, but I think that it neglects the potential of professions to work for good and fails to recognize the seriousness with which individual professionals approach their everyday work and face up to ethical challenges and dilemmas. If we can help them ask the right questions, perhaps develop their ability to relate the things they believe in or value outside work to what they do in their jobs, I think we will have performed a useful role. I would not claim to have much under way in this area, but I think it captures what should characterize our work as a modern university, forging a path between the generation of useful knowledge and critical reflection.

Note

1. This article is adapted from the text of an inaugural lecture delivered at the University of Huddersfield, 25 February 1998.

References


