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Mainstream or Daydream?

The Future for Responsible Investing

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This essay updates a 2002 article entitled 'Envisioning Socially Responsible Investing: A Model for 2006', published in the *Journal of Corporate Citizenship*. Part One highlights developments in the corporate, institutional investor and financial communities, marking the progress of responsible investing and corporate social responsibility since that time. It notes increases by corporations in CSR reporting, both voluntary and mandatory, and in demand for that reporting; a trend by institutional investors toward transparency in proxy voting and the incorporation of social and environmental standards and best practices into investment policies; and the incorporation of social and environmental matters into stock analysis, academic business curricula, and financial professional training.

Part Two raises a number of questions about the possibility of fundamental change in these three worlds. It suggests that, despite various positive developments, fundamental change will take place only when corporations see their contributions to society extending beyond short-term profits to a longer-term view including a cooperative relationship with government; when institutional investors seek broad-based returns to society from all asset classes as part of their fiduciary duties; and when various professional communities recognise that the value of corporations to society can legitimately be measured in terms other than short-term price.

- **Responsible investment (RI)**
- **Pension funds**
- **Environmental, social and governance (ESG) factors**
- **Socially responsible investment (SRI)**
- **Corporate social responsibility (CSR)**
- **Proxy voting**
- **Shareholder activism**
- **Modern portfolio theory**

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In autumn 2002, an article called 'Envisioning Socially Responsible Investing: A Model for 2006', published in the *Journal of Corporate Citizenship*, assessed the state of socially responsible investing. At that time, the author made various predictions about developments that 'may well take place' in the worlds of socially responsible investing within five years (Lydenberg 2002).

That period having passed, some observations on how far in fact socially responsible investing (SRI) has progressed are in order, along with an examination of what developments might reasonably be expected to occur in the next five years. Much progress has been made since 2002, but it is fair to say at this time that responsible investing (RI) is far from mainstream.[1] What it means for RI to be mainstream, what true mainstreaming would look like and what it would take to achieve that goal are among the key questions that this article addresses.

At the heart of this essay lies the question of whether mainstreaming means that responsible investing will become a niche market within a fundamentally unchanged mainstream or, whether it means that the mainstream as a whole will adopt the basic tenets of responsible investing.

Part One of this essay highlights a number of important developments in the *corporate, institutional investor* and *financial communities*, marking the progress of corporate social responsibility (CSR) and RI over the past half dozen years. Part Two raises a number of questions about the possibility of fundamental change in these three worlds. We approach these questions as practitioners of responsible investment, with the various strengths and limitations that this practical experience brings. Academics and economists may well have much to add to our initial observations—in particular by answering in full the questions to which we have here only sketched out various parameters of possible responses. Our hope is that these preliminary observations about where we are in 2009, and where we are headed, can provide a degree of focus to the thinking and offer some direction to the collaborative work that is needed to bring about fundamental change in investment as usual.

Part One: state of responsible investing today

Although a complete account of the progress of responsible investing and corporate responsibility is beyond the scope of this essay, the following observations highlight just how far we have come. As remarkable as the progress has been, however, the changes that have occurred remain primarily superficial and the prospects of fundamental change are still before us.

The corporate community

The 2002 essay predicted, among other things, that most corporations would soon:

- 'State clearly and specifically their social and environmental values'
- 'Disclose comprehensive data on their actual social and environmental impacts'
- 'Adopt specific management practices to integrate these values into their operations'

1 The authors have chosen to use the term 'responsible investing' rather than 'socially responsible investing' in this updated article, as it is the term increasingly used in the investment community to identify these practices.

One surprising development in the corporate world is that executives and managers who profess commitment to CSR are no longer viewed as eccentric or misguided. Indeed, in certain regions, notably the United Kingdom and Europe, it is almost as unacceptable today not to embrace CSR as it was to talk about it publicly half a dozen years ago, a transition mirrored in the changed coverage by the influential business journal *The Economist* from 2005 to 2008.[2] By 2008, while only approximately 4,000 of the world's 75,000 multinational corporations had signed the United Nations Global Compact, 90% of company CEOs participating in the United Nations Global Compact reported doing more than they did five years previously to incorporate ESG (environmental, social and governance) factors into their management strategies (Bielak *et al.* 2007). At the same time, it is fair to say that the actual management of corporations—including the laser-like focus on short-term profits—has yet to change in fundamental ways.

Among the indications of progress in these three areas, the following are particularly noteworthy.

CSR reports and strategies

A tremendous growth has taken place in the number of companies issuing CSR reports and adopting strategies expressly addressing the ESG challenges (Davis and Stephenson 2006). In this sense, both the statements of companies' social and environmental values and their reporting of data in these areas has increasingly become the norm. For example, the Corporate Register found that for the period September 2006 to December 2007, 335 of the *Financial Times* Global 500 companies produced CSR reports. An overwhelming majority of European companies filed reports (152 out of 172), while only about half of the North American companies (118 out of 220) did so (The Corporate Register 2008). In addition, companies are increasingly integrating social and environmental reports with traditional financial statements. For one particularly well-integrated example, see the 2006 Annual Report of the French company Schneider Electric.[3]

Government reporting requirements

Governments and regulators increasingly expect, and are beginning to require, CSR reporting. The French government was the first to venture down this road in 2003, when it required publicly traded companies to include some 40 social and environmental indicators in their reports to shareholders. More recently, the Swedish government announced in late 2007 that all 55 publicly traded companies in which it holds ownership must begin reporting by 2010 on the extensive set of social and environmental indicators covered by the Global Reporting Initiatives guidelines.[4] In early 2008, the Chinese government announced that state-owned companies there would be expected to begin reporting on their CSR records (*Ethical Performance* 2008a). In addition, the Argentine capital Buenos Aires has passed legislation requiring large companies headquartered in that city to publish sustainability reports (*Ethical Performance* 2008b). Since 2006, all listed companies in Malaysia have been required to report on their corporate responsibility policies and programmes to the Malaysian Stock Exchange (Yusof 2006).[5]

2 Noteworthy is the change in editorial treatment of the concepts of sustainability and corporate social responsibility from 2005 to 2008. Compare the article entitled 'Corporate Social Responsibility: Just Good Business' (*The Economist* 2008) with 'The Good Company', on this same topic (*The Economist* 2005).

3 www.schneider-electric.com/sites/corporate/en/press/media-library/financial-statements-annual-reports.page, accessed April 2008.

4 www.sweden.gov.se/sb/d/8194/a/93506, accessed 22 March 2008.

5 See also *The Silver Book: Achieving Value through Social Responsibility,* a comprehensive social responsibility manual prepared by the Malaysian government for government-linked companies (PCG 2006).

In the UK, the 2006 Companies Act introduced a requirement for public companies to report on social and environmental matters. The Danish Parliament voted in mid-December 2008 to require from 2010 that the 1,100 largest enterprises describe their corporate CSR or socially responsible policies.[6] The United Nations Global Compact increased pressure on its signatories to report regularly on their CSR achievements, removing 394 of approximately 3,775 signatories for inadequate reporting (*Ethical Performance* 2008c).

Interests of investors and consumers

Systematic corporate disclosure on social and environmental issues is increasingly demanded by responsible investors and consumers. For example, in 2008, around 385 institutional investors representing some US$57 trillion had endorsed the Carbon Disclosure Project's call for systematic disclosure of carbon emissions by the 3,000 largest corporations worldwide.[7] Similarly, in September 2007, a coalition of 22 institutional investors representing US$1.5 trillion in assets, and led by Ceres and Environmental Defense, petitioned the US Securities and Exchange Commission to require full corporate climate risk disclosure.[8] One indication of consumer interest in the social and environmental records of companies is the growth of interest in purchasing organic food and clothing as well as fairtrade products. Ethical consuming has taken particularly strong root in the UK, reaching an annual total of some US$65 million in 2007 (Co-operative Bank 2007). In the US, the so-called LOHAS segment (lifestyles of health and sustainability), reached US$209 billion in 2007 (LOHAS 12 Forum 2008). Similarly, the interest in real estate with a 'green' and sustainability theme is increasing around the world. In the US, for example, the 14,000-member US Green Building Council had certified some 1,325 buildings under its LEED (Leadership in Energy and Environmental Design) green building guidelines as of 2008, and has an additional 10,309 buildings undergoing that certification process (US Green Building Council 2008). The 2008 conference attracted over 10,000 delegates.

While these examples illustrate how far CSR and sustainability issues have come since 2002, the trend does not yet demonstrate systematic and comprehensive integration of sustainability and CSR into the daily management decisions and actions of major corporations.

Institutional investors

The 2002 essay also predicted that major institutional investors would soon:

- 'Adopt comprehensive voting policies on social, environmental and corporate governance issues including guidelines for voting and the disclosure of actual votes'
- 'State publicly the extent to which they incorporate social and environmental issues in their investment practices'
- 'Undertake ongoing dialogue among themselves on social and environmental issues, as they already do on corporate governance'

6 www.samfundsansvar.dk/sw42800.asp, accessed 12 January 2009.
7 See website of the Carbon Disclosure Project at www.cdproject.net/aboutus.asp, accessed 6 January 2009.
8 See website of the Investor Network on Climate Risk at www.incr.com/NETCOMMUNITY/Page.aspx?pid=397&srcid=330, accessed 24 April 2008.

As with the case of mainstream corporate management, many promising developments have emerged since 2002, most notably in three general areas.

Voting transparency

The expectation that institutional investors should publicly report on their proxy voting is becoming a worldwide phenomenon. In a major development, since 2003, the US Securities and Exchange Commission has required that all mutual funds and money managers publicly report on their proxy voting guidelines and on their proxy voting. This transparency, and the increase in prominence of environmental, social and governance issues, is reflected in the changing behaviour of mutual fund voting on climate change issues (Baue and Cook 2008). In 2006, a Canadian regulation with similar requirements came into effect. In addition, public pension and investment funds have moved significantly on their transparency with respect to proxy voting. Dutch public pension fund PGGM, for example, reports on votes for its 4,000 company portfolios.[9] South Africa's Public Investment Corporation has announced that it will begin publishing its votes at corporate annual meetings (*Global Proxy Watch* 2008). Norway's Government Pension Fund–Global publishes its votes: in 2007, Norge Bank Investment Management (NBIM) voted at a total of 4,202 general meetings, or 89% of the meetings held by portfolio companies.[10]

Pension funds

Governments, especially in Europe, are requiring their national pension funds to adopt social and environmental guidelines for their investments. For example, in 2005 the Norway Pension Fund adopted a series of social, environmental and ethical guidelines that are being gradually implemented.[11] Similarly the Swedish government has directed its national pension funds to consider the implications of social and environmental factors in their investment processes, which resulted in four of the seven so-called 'AP funds' with US$150 billion in assets setting up a Joint Ethical Council in 2007 to monitor environmental and ethical compliance of funds holdings of foreign companies.[12] After the New Zealand government signed an international munitions treaty in Norway in 2008, the US$12 billion New Zealand Superannuation Fund sold US$37 million worth of shares in companies associated with the manufacture of cluster munitions and the manufacture or testing of nuclear explosive devices.[13] State pension funds including Sweden's AP buffer funds, the Norwegian Government Pension Fund and the US$32.7 billion Irish National Pension Reserve Fund (NPRF) divested such munitions firms in 2008 or plan to in 2009. The Danish government introduced new SRI policy initiatives in May 2008 (Kjaer 2008). In the United States, the State of California's Public Employees Retirement System in 2004 launched Green Wave initiative, which imposed environmental guidelines for US$200 million investments in real estate, venture capital and equities (Angelides 2004). In South Africa, the pension funds regulator, the Financial Services Board, in 2007 outlined the principles for good fund governance, with explicit coverage of the approach to responsible investment.[14]

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9 See PGGM website at www.pggm.nl/About_PGGM/Investments/Responsible_Investment/Voting/Voting.asp#1, accessed 1 May 2008.

10 www.norges-bank.no/templates/report_ _ _ _68488.aspx, accessed 12 January 2009.

11 Norge Bank Investment Management has its own Principles for Corporate Governance guidelines on corporate governance, based on OECD and UN Global Compact guidelines, and on the guidelines of the Norwegian government laid down by the Executive Board of Norges Bank (see Syse 2008). In 2007, NBIM published the *Investor Expectations on Children's Rights*.

12 www.ap1.se/en/Asset-management/Ethical-and-environmental-consideration-in-our-investments/Ethical-Council, accessed 12 January 2009.

13 www.responsible-investor.com/home/article/cluster4, accessed 30 December 2008.

14 The Registrar of Pension Funds of the Financial Services Board issued circular PF130 in June 2007; ftp://ftp.fsb.co.za/public/pension/circular/PF1302.pdf, accessed 12 January 2009.

Best practice for responsible investment

Institutional investors are increasingly sharing best practices and collaborating on the incorporation of social and environmental initiatives into their investment practices. Most recently the Principles for Responsible Investment (PRI)[15] aim to connect pension funds and money managers from around the world committed to six principles of responsible investment. The over 400 institutional investors representing around US$18 trillion in assets under management communicate among themselves on their environmental, social and governance policies, coordinate on engagement with companies, and examine best practices for responsible investment.[16]

Despite these encouraging developments, most institutional investors do not yet ordinarily incorporate social and environmental considerations into their decision-making. Nor has investment as usual changed. Investment decisions in the mainstream do not take possible risks or rewards of social and environmental factors into account, except where they incorporate short-term stock price implications.

Financial community

Finally, the 2002 essay also predicted that the mainstream financial, academic and RI communities would take the following steps:

- 'Mainstream financial firms will train their analysts to routinely incorporate CSR considerations into securities analysis'
- 'The academic community will offer courses and grant degrees in CSR and SRI'
- 'The SRI industry will develop quality standards, undertake theoretical research on topics of communal concern, and create a network of issue-specific, niche-market research firms'

A variety of initiatives—substantial in their scope—have emerged since that time within the financial community. Investment vehicles with specific social, environmental or governance (ESG) objectives are increasingly available. The most recent biannual survey of ESG investments in the US, the largest such market, identified US$2.7 trillion in assets under management as of December 2007 (Social Investment Forum 2008). The most recent similar European study in 2006, which covered nine countries, identified €1.6 trillion representing 10–15% of assets under management in those markets. Three noteworthy developments in this area are discussed below.

Enhanced Analytics Initiative

One strategic initiative in the mainstream financial community that broke new ground for RI was the Enhanced Analytics Initiative (EAI) launched in 2004 by asset owners with a long-term perspective. EAI successfully prodded mainstream investment banks to encourage their sell-side analysts to cover environmental, social and governance issues in their stock research. EAI consisted of some 30 institutional investors with approximately US$3 trillion under management committed to allocating 5% of their research budget to investment research, and banking firms whose analysts are judged to present the best coverage of environmental, social and corporate governance factors in their equity analysis (Enhanced Analytics Initiative 2008). In addition, mainstream

15 Launched in April 2006 at the New York Stock Exchange under the aegis of the United Nations Global Compact and UN Environment Programme Finance Initiative (see www.unpri.org, accessed 12 January 2009).

16 www.unpri.org, accessed 12 January 2009.

investment houses, such as Société Générale, F&C Asset Management, HBOS, JP Morgan Chase, UBS, Deutsche Bank and Goldman Sachs have in recent years established in-house research teams that conduct analyses for their investor clients on such issues as climate change, renewable energy, water, human rights, nutrition and diversity. In October 2008 the EAI folded into the PRI, while the fallout from the 2008 financial meltdown forced cost cuts at major investment banks including their specialist ESG teams.[17]

Growth in postgraduate courses and centres

Within the academic community, the number of courses offered in MBA programmes continues to grow, albeit slowly. Contributing to this progress has been the growth in the Net Impact network[18] of MBA candidates seeking new curricula that cover ESG themes. The 2007 annual Beyond Grey Pinstripes ranking listed some 60 graduate-level business courses that include CSR components. It ranked Stanford, University of Michigan and York University (Canada) as among those schools with the best offerings.[19] In the US, programmes include Duquesne University's MBA Sustainability programme, Marlboro College's MBA in Managing for Sustainability, and Bainbridge Graduate Institute's MBA in Sustainable Business. In the UK, Nottingham University awards a Corporate Social Responsibility MBA. In Switzerland, HEC Genève offered a masters-level CSR diploma for the first time in 2008, while St Gallen University houses oikos International, a foundation that sponsors up to five PhD fellowships for students pursuing topics of business sustainability, as well as an innovative case sustainability study development programme.

Some progress has also been made in the development of academic resource centres that support the development of RI and CSR. Among those in the United States are the Center for Corporate Citizenship and the Institute for Responsible Investment at Boston College, the University of North Carolina–Chapel Hill Kenan-Flagler Center for Sustainable Enterprise, the Center for the Study of Fiduciary Capitalism at St Mary's College in California, the Center for Responsible Business at the Haas School at the University of California in Berkeley, and the Corporate Social Responsibility Initiative at the Kennedy School of Government at Harvard University. Elsewhere, the European Academy for Business in Society (EABIS) is leading a laboratory on 'Corporate Responsibility and Market Valuation of Financial and Non-financial Performance'[20] while the University of South Africa's Corporate Citizenship Center established a Chair in Responsible Investment in 2007.

These developments are indications of progress, but are still far from representing systematic changes in the philosophy or approach to investing or best practices for investment analysis that currently dominate the financial and academic communities.

17 www.responsible-investor.com/home/article/deutsche, accessed 30 December 2008.

18 Net Impact is an organisation including some 10,000 MBAs and post-MBAs in chapters at major business school campuses in North America, Europe and the world (www.netimpact.org, accessed 8 January 2009).

19 Beyond Grey Pinstripes (www.beyondgreypinstripes.org/rankings/index.cfm, accessed 22 March 2008).

20 In cooperation with Cranfield School of Management, University of Lille, University of Bocconi, among others. Umeå University, Sweden, and Maastricht University, The Netherlands, are active in the European Centre for Corporate Engagement (www.corporate-engagement.com/index.php?pageID=1880&n=329#partner_128458, accessed 12 January 2009).

Part Two: key questions about fundamental change

One of the most frequently asked questions about both RI and CSR these days is one of impact. Have RI and CSR brought about fundamental transformations or are they in fact nothing but greenwash and a feel-good palliative that sound good but represent no real change? It is not surprising that this question is arising now. Both RI and CSR are so widely publicised, have received endorsements from such prominent and influential actors, and have aroused such widespread expectations of potential progress toward a better and more sustainable world that indications of real progress will inevitably be demanded.

One disturbing possibility for RI proponents—those of us seeking to influence investment practice to maximise positive externalities and minimise negative externalities—is that this discipline may become just an accepted niche market within the financial community without resulting in any fundamental change. Or similarly, CSR might prove to be no more than a management fad, widely discussed but only sporadically implemented. Both RI and CSR may be studied in academia, but only as curiosities bringing no fundamental change to today's underlying theories of finance and the corporation, and without true legitimisation or institutionalisation of their practices.

Thus, the single most important issue today is whether the 'rules of the game' are going to change. Put differently, the fundamental question is not whether the current financial markets can be used to fix social and environmental problems, although in certain circumstances they certainly can, but whether social and environmental concerns can drive fundamental changes into the current markets, which today create as many social and environmental challenges as they address.

We pose here a set of three specific questions for each of the three communities influential in the marketplace—corporations, institutional investors, and the worlds of finance and academia—that need to be addressed if we are to see such fundamental change (see Appendix). A complete response to each of these questions will require new thinking, vigorous debate and frank discussion. Our brief comments here are intended to point out briefly some of the directions today's thought leaders are currently taking in addressing these questions and to open up a broader forum for more structured and detailed discussions.

Corporations

To understand what it might mean for CSR to be more than a management fad, we pose three questions.

- Can the widely accepted definition of the role of the corporation as a short-term profit-maximising machine be changed, and, if so, how?
- Will corporations come to recognise that rule-setting by government can enhance their abilities to address social and environmental challenges, and, if so, why?
- Can corporations work cooperatively with government to define the relationship between these two powerful forces so that the pursuit of private goods does not undercut the creation of public goods?

Can the widely accepted definition of the role of the corporation as a short-term profit-maximising machine be changed, and, if so, how?

Today's corporate managers are being pulled in two opposite directions. Globalisation and the increasing propagation of the stockowner-centric Anglo-American model of the

corporation drive managers towards relentless profit maximisation. Simultaneously, CSR advocates—including many national governments, the United Nations, academics, and activist non-governmental and international organisations—promote a stakeholder model where managers treat employees, suppliers and local communities and their environment on an equal footing with stockowners. How should corporations best balance the tension between generating short-term profits for stockowners and investing long-term in the full range of their stakeholders?

Unless this question can be resolved in favour of those advocating a stakeholder model of the corporation, corporate management as it is now widely practised is not likely to change fundamentally.[21] This debate is particularly crucial in the United States, where stockowner supremacy has had broad acceptance. A number of efforts to promote a fundamental redefinition of this model are now under way there. For example, Corporation 20/20—a multi-stakeholder collaboration that has proposed six 'principles of corporate redesign'—would build into the definition of the relationship between corporations and society a broader social purpose than profit maximisation. Corporation 20/20 asserts that 'It is no longer enough to ask, "What is the business case for social responsibility?" Now the question must become, "What is the social purpose case for business?" ' (Kelly and White 2007). Similarly, B Corporation, a coalition of small, primarily privately held, for-profit corporations, seeks to brand its members as alternative to the mainstream, setting rigorous standards for their commitments to social and environmental initiatives.[22]

This fundamental shift must also take place on a theoretical level. A number of legal scholars, for example, are evolving new theories of corporate law. Professor Kent Greenfield, in his book *The Failure of Corporate Law*, argues that the laws governing corporations need to be more protective of corporations' various stakeholders and the general public (Greenfield 2006). Similarly, Professors Margaret Blair and Lynn Stout in their article 'Specific Investment and Corporate Law: Explaining Anomalies in Corporate Law', reprinted in collaboration with Corporation 20/20, argue that shareholder primacy is in decline and that an emerging new theory posits that the primary obligation of managers and directors is to recognise 'specific investments' in the company made by various stakeholders and to distribute returns appropriately from those investments to these stakeholders (Blair and Stout 2007).

On a practical level, this means that, as the authors of *Beyond Good Company: Next Generation Corporate Citizenship* argue, a 'transformative change' that moves managers away from the primary focus on stockowners is necessary if CSR is to become fully integrated into for-profit business. If the rules of the game are to change, however, this *redefinition* will need to encompass shifts that are legal, regulatory, theoretical and cultural (Googins *et al*. 2007).

Will corporations come to recognise that rule-setting by government can enhance their abilities to address social and environmental challenges, and, if so, why?

In 2003, Deborah Leipziger published *The Corporate Responsibility Code Book*, which analysed 32 well-established voluntary codes of conduct for corporations (Leipziger 2003). Since then, the rather astounding proliferation of standards, norms, codes and guidelines for best social, environmental and corporate governance practices has continued. Some of these codes of conduct are general in nature, such as those promulgated by the United Nations Global Compact, the Principles for Responsible Investment,

21 See Kelly and White 2007 on the Corporation 20/20 website (www.corporation2020.org, accessed 8 April 2008). In addition, the website contains a series of papers addressing various aspects of the question of fundamental corporate redesign.

22 www.bcorporation.net/home.php, accessed 8 April 2008.

the International Labour Organisation, Social Accountability International, the Caux Business Round Table, and others. The International Organisation for Standardisation (ISO) plans to issue its own set of global guidelines for CSR in 2010. Many other sets of standards and principles are industry- or issue-specific. In the past several years, for example, the coffee, tea, cocoa and palm oil industries, as well as the diamond and mineral extraction industries, have developed various codes of conduct specific to their industries.

As these voluntary codes proliferate, it is not surprising that the advantages in terms of legitimacy and simplicity of government's ability to regulate will become increasingly apparent to corporations themselves. In the United States, for example, in 2007 Google called for clearer government regulation of privacy issues on the Internet in the face of public pressure for it to address censorship issues in China; toy manufacturers began lobbying for increased funding for the Consumer Products Safety Commission in the face of increased safety concerns; and the agricultural industry, also facing safety issues in imported foods, called for an increased government monitoring role.

Moreover, the recent crises in the financial markets—which have led to billions of dollars in losses and were catalysed by the overly aggressive practices of unregulated mortgage brokers and the packaging and selling of unregulated asset-backed securities based on these loans by unregulated investment bankers—have reminded the financial services industry that government regulation and backing of the financial markets is essential for assuring their long-term stability.[23]

Both the proliferation of spontaneous voluntary business codes and the periodic resurgence of scandals stemming from the excesses of the unregulated 'invisible hand' of those in the business and financial worlds make it clear that government's role is essential. There may be battles between corporations, government and NGOs over the appropriate circumstances for regulation and the degree of that regulation, but the ground rules will have changed only when corporations are seen fighting for, not against, such oversight.

Can corporations work cooperatively with government to define the relationship between these two powerful forces so that the pursuit of private goods does not undercut the creation of public goods?

During the 1980s, the UK under Margaret Thatcher and US under Ronald Reagan pushed for privatisation and deregulation that in the 1990s led Russia and Eastern Europe to dismantle state ownership of major industries, China to embark on its no less monumental transition towards market-based economies, European governments to privatise multiple sectors of the economy, and US regulators to abandon price controls and monopoly regulation of numerous industries. Advocates of increased worldwide trade cheered these initiatives, while anti-globalisation protestors took to the streets and many pointed with dismay to a weakening of government oversight of a corporate world prone to abuse.

The debate over which goods and services government should provide versus which should be turned over to private enterprise is far from resolved. Which aspects of healthcare should be shouldered by government, the degree to which water utilities should be operated for profit, or who best can provide public transportation, postal services, toll roads and airport maintenance are all topics of ongoing debate. Corporations are not shy about asserting that they can handle such basic services as prisons (e.g. Correction Corporation of America), primary school education (e.g. Edison Alliance) and fighting wars better than governments (see *Corporate Warriors: The Rise of the Privatized Military Industry*, Singer 2003).

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23 Among many press articles on the need for re-regulation in the financial services industry, see Gavin 2008: C1.

In many senses, the history of the relationship between business and government in the 20th century has been one in which the pendulum has swung from few public goods provided by government to many and back again towards few. Where the pendulum should most appropriately settle will vary from country to country, era to era, and issue to issue. Global capitalism is possible in a world of local values, but it will look different from country to country. Ultimately it is governments' role to decide which goods should be considered public and which private, and where delivery must rely on private–public partnerships. Governments have the power to make these decisions and must have the longer-term vision to use that power in the public interest.

The rules of the game will have changed only when corporations acknowledge both that they should not unduly influence this debate and that government is in fact best qualified to provide many basic services. Corporations must work with government (and each other) to determine the most appropriate balance between public and private. They must understand that refraining from capitalising on narrow self-interest at the expense of the public good—that is, not blindly seeking tax breaks that cripple local governments, subsidies that distort markets, or monopoly protection that short-circuits competition, for example—is often in their broader self-interest. Only then will real change in the concept of corporate responsibility have taken place.

Institutional investors

If RI is to become more than a niche market within the mainstream investment community, a number of fundamental questions will need to be addressed by institutional investors.

- Should the goal of investing encompass broad benefits to society as well as short-term, price-based returns, and, if so, in what ways?
- Should politics be separated from investment decision-making, and, if so, who is to make this distinction?
- Should the practice of responsible investment be applied across asset classes, and, if so, is this practice the same for all classes?

Should the goal of investing encompass broad benefits to society as well as short-term, price-based returns, and, if so, in what ways?

The answer to this question is crucial for institutional investors bound by fiduciary duties. These fiduciaries include the professional managers of pension funds, mutual funds, trust accounts and others entrusted with management of other people's investments, who are bound by the duties of loyalty and care not to use these funds for their own personal benefit. Fiduciaries should not act so as to harm the best interests of trust beneficiaries or clients. Harm, however, is usually defined in terms of narrow financial measures, not broad societal risks. To redefine the scope of these duties, one might ask whether fiduciaries have an obligation not to act in ways that harm their clients when their investment decisions run fundamental risks to society or the environment. Or, more concretely, do fiduciaries have an obligation to consider the implications of investment decisions for global warming, ozone depletion, human rights abuses, the proliferation of weapons of mass destruction, or other widely recognised ills?

Recently, advocates of the concept of the universal investor have argued that the long-term performance of an economy, not of individual stocks, should drive the fiduciary considerations of large institutional investors, since their investments are so diverse as to represent whole economies (Hawley and Williams 2000; Sethi 2005). Moreover, an

October 2005 study by the law firm Freshfields Bruckhaus Deringer concluded that 'ESG [environmental, social and governance] considerations must be taken into account whenever they are relevant to any aspect of the investment strategy (including general economic or political context)' (Freshfields Bruckhaus Deringer 2005).

This approach, however, can fly in the face of what appears to be the common sense rule of investing—buy stocks that will go up. When oil prices are skyrocketing and oil company earnings soaring, oil stocks help the performance of a portfolio, at least in the short term, no matter what your opinion is of the dangers of the global warming to which they contribute. The fundamental question here is whether the increased purchasing power implied by investment decisions (i.e. appreciation in the value of a portfolio) is in the interests of a beneficiary if the world they are living in has become a demonstrably poorer one because of these same decisions. Little connection has currently been successfully drawn between the long-term interests of individual beneficiaries and the social and environmental risks often implicit in the decisions of a powerful investment world.

The rules of the game will have changed when, either through legal redefinition of fiduciary duties or a changed culture of capital stewardship, fiduciaries act on the understanding that the societal implications of their investment decisions, other than simply price performance, are in fact relevant to the interests of their beneficiaries and clients.

Should politics be separated from investment decision-making, and, if so, who is to make this distinction?[24]

One of the tenets of modern portfolio theory (MPT) is that personal preferences—whether idiosyncratic or political—should not be introduced into investment decision-making (Bernstein 2005). Politics and personal preferences make for bad investing for two reasons. First, MPT advocates believe that politics and personal preference produce suboptimal returns because they blind investment professionals to opportunities to profit. Second, as Milton Friedman argues, they believe that competitive capitalism, including the financial markets, 'promotes political freedom because it separates economic power from political power and in this way enables the one to offset the others' (Reich 2008). That is to say, decisions based solely on financial risk/reward returns not only are the best possible investments, but they prevent government from introducing politics into economic management decisions.

The concern of US and European governments over the rise of so-called sovereign wealth funds (SWFs) is based on the fear of what can happen when politics influence investment decisions. SWFs have emerged as a powerful investment force within the past five years as governments, often those flush with revenues from rising oil prices, have set assets aside to fund national pension schemes or simply as a cushion for a 'rainy day'. These funds are large—among them are those of Abu Dhabi (US$600–800 billion as of 2008), Saudi Arabia (US$300 billion) and Norway (US$350 billion)—and effectively give the governments controlling them the potential to exercise political influence by, for example, acquiring companies controlling strategic materials or taking over foreign firms competing with their domestic industries.

Fearing how these assets might be used, the governments of the United States and Europe have asked these funds to disclose their investments and voluntarily agree not to use their funds to gain political advantage through the marketplace, a request to which the governments of Singapore and Abu Dhabi recently agreed (Thomas 2008). In par-

24 This section introduces a number of interconnected questions related to modern portfolio theory and the relationship between political opinion and investing. These questions are particularly complicated and need to be amplified and discussed in a broad context which, owing to space considerations, cannot be attempted in this essay.

ticular, efforts have focused on increasing the transparency of these SWFs as they become more active players in the financial markets (B. Davis 2008; Wilson 2008).

In an interesting variation on the *mélange* of politics and investing, several northern European pension funds have in effect deliberately chosen to support certain political beliefs by adopting the strategy of seeking to conform certain of their investments to the spirit of international norms and standards expressed in treaties that their governments have signed. The Norwegian sovereign wealth pension fund has an ethical policy that will not allow investment in companies that manufacture weapons of mass destruction, and as of 2007 had eliminated from consideration some two dozen companies involved with nuclear weapons production. Since these international treaties are clearly the result of political processes, it is hard to argue that these funds are not endorsing political stands. But the politics here is based on transnational consensus—these are international treaties—not narrowly defined national goals (OECD 2007).

The question here is whether narrow political self-interest or dishonesty driven by *greed* can be distinguished from political or personal interests that promote *broad-based societal goods*. While advocates of separating politics from investments are correct in asserting that narrow self-interest, or personal dishonesty driven by greed, can distort economies and compromise honest government and financial markets, they are essentially silent on the issue of whether it is possible for larger questions of public interest to be legitimately incorporated into the investment process. The rules of the game will have changed when investors appreciate that some political views—such as those surrounding the elimination of weapons of mass destruction, the universal applicability of human rights, or the sustainable management of environmental resources—are not strictly personal or local and that they can, properly considered, contribute to the rewards of a responsible investment process.

Should the practice of responsible investment be applied across all asset classes, and, if so, is this practice the same for all classes?

Responsible investing has grown over the past 30 years in a piecemeal fashion. The main focus has been on equities—the stocks of large, publicly traded corporations. The prominence of equities is perhaps accounted for by the emphasis within the early RI movement on changing corporate behaviour in positive ways and the desire of religious investors to avoid companies involved in morally questionable lines of business.

As RI has gained wider acceptance, analogous responsible investment disciplines have begun to emerge for other asset classes as well: social venture capital, 'green' real estate, community-oriented micro-lending. In addition, the growth of what the mainstream investment community refers to as 'alternative' asset classes—in particular hedge funds and private equity firms—has prompted protests from some quarters that these players are heartless and socially detrimental in their relentless pursuit of profits. To counter these concerns, the hedge funds and private equity industry have made some attempts to formulate codes of best practice, including the 2007 Walker Report in the UK[25] and calls from pension funds in Europe in 2008 (P. Davis 2008).

Missing to date from a varied set of efforts to address the different social implications of various investment asset classes is a systematic survey of the particular social and environmental benefits that particular asset classes are particularly suited to create. In 2007, the Institute for Responsible Investment at Boston College published a *Handbook*

25 The Walker Report demands private equity transparency. Hundreds of companies owned by private equity funds will have to produce accounts sooner, more often and disclose more information under proposals from banker Sir David Walker. The Walker Report was commissioned by the BVCA, the trade body of the British Private Equity & Venture Capital Association, following widespread criticism by MPs and trade unions of its members' investments (www.walkerworkinggroup.com/?section=10271, accessed 13 May 2008).

on Responsible Investment across Asset Classes in which it pointed out that certain asset classes were naturally suited to address particular social and environmental issues. For example, cash is well suited to address access to capital challenges at a community level; fixed income, because government issues so much of it, is well suited to promote public goods; venture capital is well suited for funding the creation of new business paradigms such as alternative energy or healthcare advances; and public equities are naturally suited to the encouragement of incremental change in large corporations in mature industries (Wood and Hoff 2007). One indication of moves by major institutional investors in this direction came in early 2008 when the US$53 billion French national pension reserve fund announced plans to extend its responsible investment practices to all the asset classes in which it invests (Wheelan 2008).

The landscape of mainstream investment could be said to have truly changed when institutional investors can conceive of responsible investment as a continuum of varying initiatives across asset classes and tailor responsible investments by asset class to be maximally effective in creating positive externalities.

Financial and academic communities

If the financial and academic communities are to fully embrace RI and CSR, they will need to confront a number of substantive questions still unaddressed. Among these are the following.

- Should the value of investments be assessed in terms other than stock price, and, if so, what is the yardstick for such measurement?
- Should responsible investing be legitimised as a key part of the investment process, and, if so, through what means?
- Can individual investors be active enough 'financial citizens' to make responsible investing a reality, and, if not, why not?

Should the value of investments be assessed in terms other than stock price, and, if so, what is the yardstick for such measurement?

Many in today's mainstream financial and academic communities assert that markets are efficient and incorporate all available information into the price of securities. They consequently also believe that the value of an investment to society is adequately measured by its price. Peter Bernstein summarises this argument:

> [T]he best estimates of shadow prices [i.e. intrinsic value] are the prices set in the marketplace, every minute of every trading day. Those prices may not be precisely equal to the shadow prices, but *no other estimate of intrinsic value* is likely to be more accurate than what buyers and sellers agree on in the marketplace (Bernstein 2005, emphasis added).[26]

However, as Robert Monks has pointed out in his recent book *Corpocracy*, classical economics had its roots in moral philosophy. He asks rhetorically, 'Can we judge markets for slaves, prostitution, and weapons of mass destruction solely on whether they are efficient?' But, if efficient markets have no morals, by what other measurement can we value corporations if not these markets? Monks's answer is 'a language of accountability . . . that comprehensively, fairly, and effectively allocates costs and rewards'. Or, as he also puts it, we need a reformed market that will give corporate executives:

26 The question of whether or not markets are efficient in establishing price is beyond the scope of this essay. The authors' concern here, however, relates to the question of whether there are limits to what efficiency can reasonably be expected to price.

> the tools to measure not just profit and loss, but their impact on the larger society, and then give them a whole symphony of relevant languages—from environmental science to moral philosophy—to talk about what their new measures reveal (Monks 2007).

Monks differs in his approach from those who talk about incorporating social and environmental risks and rewards into the stock prices. Clearly, when these risks are relevant to the efficient pricing of stocks they should be incorporated. But some values (e.g. human life, honesty, peace) are effectively impossible to price; and some risks and rewards—such as climate change, distrust of business, future regulation, equal opportunity employment, open and free media or racial discrimination—can only be valued on time horizons or in contexts that are so far in the future or are so diffuse that their relevance to pricing is difficult, if not impossible, to calculate. Lydenberg has argued elsewhere that separating the measurement of these hard-to-quantify risks and rewards from stock price is in fact desirable and that, in effect, parallel and disconnected measurements of social returns can supplement reporting on financial gains and losses (Lydenberg 2007).

The rules of the game will have changed only when values other than price can be, and are, conveyed in ways that are easily understandable and usable by investors and consumers alike. Finding a language to express these values that is as direct and compelling as price, however, is no simple task. Indeed, it is one with which responsible investors themselves have struggled with only limited success to date.

Should responsible investing be legitimised as a key part of the investment process, and, if so, through what means?

The fact that the financial and academic worlds have been slow to establish standards, training and certification for RI reflects their reluctance to recognise its legitimacy. Conversely, RI will become an integrated part of the discipline of investing when professional credentials are required of those who practise it.

The signs of fundamental change will be clear when they come. Professional organisations such as the CFA Institute, the various trade associations for social investing professionals and accounting bodies will develop curricula, educational courses, and certification processes that spell out the needs of RI clients, the skills required of RI investment professionals, and the standards by which the industry operates. In addition, on the academic front, the standard finance curriculum at business schools will need to accept and contend with the broad responsibilities that financial professionals owe to society.

Some initial steps have been taken in this direction. For example, the CFA Research Foundation published in 2005 a manual on corporate governance (CFA Research Foundation 2005) and in April 2006 a research monograph entitled *The Social Responsibility of the Investment Profession* by Julie Hudson of UBS laying out the conceptual framework of modern portfolio theory within which RI is unfolding (Hudson 2006). In 2005 the World Business Council for Sustainable Development surveyed young investment analysts to understand their viewpoints and training received on ESG integration (WBCSD and UNEP Finance Initiative 2005). In October 2008 the CFA Institute Centre for Financial Market Integrity published a manual for investors interpreting ESG factors in the valuation of publicly traded companies (CFA 2008). Under the aegis of the US Social Investment Forum, the Sustainability Investment Research Analysts Network, established in 2004, has developed a number of informal programmes to serve the professional development of its members. In Australia, the Responsible Investment Association Australasia Certification Program was created in September 2005 to 'promote consistent, standardised disclosure and education about responsible investment' by fund managers and advisers. The Kenan-Flagler Business School at University of North Carolina–Chapel Hill has for three years offered a dedicated course on RI as an

MBA elective.[27] However, academic courses directly addressing responsible investment, as listed in the Beyond Grey Pinstripes 2008 survey, were still few and far between.

While these preliminary steps indicate the direction of future change and point anecdotally to programmes under way, at the current time the financial and academic community could do substantially more to promote the study and professionalisation of this industry. When such initiatives are realised, they will indicate that responsible investing has earned a core position in the financial world.

Can individual investors be active enough 'financial citizens' to make responsible investing a reality, and, if not, why not?

In their 2006 book *The New Capitalists*, Stephen Davis, Jon Lukomnik and David Pitt-Watson postulate a class of 'citizen' investors—'tens of millions of working people who have their pensions and other life savings invested through funds in shares of the world's largest companies'—concerned with 'sustainable, *long-term* corporate performance'. This new class of investor wants to profit 'without shifting expense—such as pollution—to society at large' and will 'compel boards and CEOs to operate in a pragmatic new framework' and 'rebalance power to force different means of resolving problems' (Davis *et al.* 2006).

Is this scenario, which necessitates an active, educated, broad-based class of investors who want a social and environmental as well as a financial return, realistic? What would need to happen for such a class of investors to emerge?

A number of substantial, but conceivable, steps would be necessary to create, at a retail level as opposed to the institutional investor level discussed above, a class of individual citizen investors concerned about the long-term well-being of society. For one thing, the story of responsible investing—its purpose, effectiveness and rewards—would need to be told dramatically and forcefully so that it can be simply communicated and understood. In addition, the execution of responsible investing—the opportunities to put theory into action—would need to be widely available and easy to implement.

The burgeoning world of investments in microfinance provides a glimpse of how these developments might take place. In making small, essentially unsecured loans to the poor and economically disadvantaged who have previously been denied access to the mainstream financial system, microfinance tells success stories that are dramatic and easily understood. A US$100 loan to a fruit vendor in El Salvador may free her from the clutches of loan sharks and help lift her out of abject poverty. Interestingly, the microfinance world is finding ways to allow the small investor to quickly and easily match loans with those in need around the world.[28]

Moreover, the concept of social entrepreneurship is an increasingly popular one across a wide spectrum of actors who are working to bridge the gap between non-profit and for-profit organisations and are blurring the traditional line between the two. For example, in the venture capital field the success of such organisations as Social Venture Network illustrates this trend.[29]

The successful pioneering steps that the worlds of microfinance and social entrepreneurship have made will need to be brought to scale and applied in other asset classes such as equities, real estate and fixed income. For all these asset classes, investors will need to have quick and easy access to the social and environmental stories that are implied by their choices—whether it is through websites, newsletters, reports, labels, the press, word of mouth or other means. We are still a long way from providing the simplicity and clarity that will encourage the development of such a class of citizen

27 www.kenan-flagler.unc.edu/assets/includes/popup.cfm?id=722, accessed 12 January 2009.
28 For example, the microfinance organisation Kiva (www.kiva.org, accessed 8 January 2009).
29 www.svn.org/, accessed 8 January 2009.

investors. But we will know the rules of the game have changed when it is as fashionable to talk about the social returns of one's investments as it is to tell tales of making a killing in the market.

The implications of fundamental change

These nine questions imply a number of radical departures from today's norms in the financial and corporate worlds. In the broadest sense, they imply what could be characterised as a reconceptualisation of the ways in which government, corporations, non-governmental and quasi-governmental organisations and individuals collaborate in managing the interplay between markets and public policy.

Do we really want to tinker with how this balance is currently achieved? After all, as the saying goes, 'if it ain't broke, don't fix it'.

One of the implications of the full integration of CSR and RI into the mainstream would be to create a greater, more cooperative role for for-profit corporations in helping to achieve basic social and environmental goals. For those who believe that corporations are already too powerful in this world, already have too much influence, this may appear to be a dangerous step. For them, the role of government, not corporations, should be strengthened.[30]

Put differently, imagining CSR and RI fully integrated into the mainstream necessitates imagining a system of governance different from the traditional one where corporations' relationship to society is defined primarily through legislation, regulation or state ownership.

For-profit corporations are certainly self-interested creatures who will not hesitate to act in their own interests—and at the expense of the public good—when left to their own devices. If CSR and SRI are no more than a sheep's clothing that will allow the uncontrolled reign of multinational corporations in the halls of government, then bringing these practices into the mainstream is an unwise move that will lead to nothing but abuse and harm. Those who wish to address these dangers through traditional governance methods advocate abandoning talk of CSR and RI and instead propose clearly separating public goods and private enterprise onto two sides of a field—with government on the side of providing public goods and corporations set free on the other to pursue private gains. This view maintains that the often diverging interests and antagonistic relationships between these two players should be acknowledged, and a strong fence (i.e. regulation, legislation, ownership control) should be erected between them to make, as the proverb suggests, good neighbours.

However, as should be apparent from the above, the mainstreaming of RI and CSR implies a blurring of the line between government and for-profit corporations. It envisions a cooperative, rather than antagonistic, relationship between the two. Under this model, government and corporations cooperatively approach goods where they lie on a continuum from public to private, deciding in each case which party should play a dominant or subordinate role in providing them. The answer to the question of balance between the public and private—between the regulatory and the voluntary—will vary depending on the goods in question, the history and culture in which the question arises, and the relative capabilities of government and business at that time and place. The goal of government and business under this scenario, however, should be identical—the building of a stable and valuable structure on this field with long-term sustainability.

It is tempting to view these scenarios as mutually exclusive: either companies must be set free to maximise their profits by any legal means or government and corporations must form partnerships to provide societal goods.

30 For an articulate statement of this position, see Reich 2008.

It is fair to say, however, that in the view of many advocates of an increased role for RI and CSR both lines should be pursued simultaneously, and that perhaps a third party—the non-governmental organisation (NGO) and quasi-governmental organisations—should play a prominent role in this dynamic. There will be circumstances where government must act clearly and definitely on a national or global level—for example, workplace safety or ozone depletion—and voluntary, market-driven initiatives are not to be trusted. There will be circumstances where cooperative engagement, rather than legislation, is a viable option: for example, energy efficiency and marketing to those at the bottom of the economic pyramid. There will be times when NGOs and quasi-governmental organisations play an invaluable role in prompting both business and government to greater action: for example, on labour standards in developing countries or corruption and collusion between government and business. Further questions regarding the governance, professionalism and competing agendas of non-governmental organisations and international organisations are important to consider, but beyond the scope of this paper.

Under many circumstances, particularly where actions impose costs on consumers or cut into company profits, corporations need government to create a level playing field, and voluntary initiatives can proceed only haltingly. Under other circumstances, particularly where actions create cost savings for consumers or increase company profits, corporations can be set free to compete in ways that create social and environmental benefits. In some circumstances, both avenues will be pursued simultaneously. For example, to promote the sale of energy-efficient home appliances that may initially cost consumers more but are cost savers in the long run, governments can mandate labels that allow customers to make this calculation and set corporations free to compete voluntarily on these lines. Moreover, government's ability to create and support markets through tax incentives and other subsidies can direct markets through a kind of soft regulation.

In essence, those who favour mainstreaming RI and CSR believe such a flexible and cooperative system is realistic. The relatively strong government support for CSR from national governments in Europe (as opposed to the relatively weak support from US federal government to date) reflects in many ways the historically closer cooperation between government and corporations in that region and the knowledge that government can control corporate behaviour by nationalising companies when regulation fails (for example, the recent nationalisation of Northern Rock bank by the UK government or the nationalisation of financially troubled banks by Scandinavian governments in the 1990s) (Perry 2008). Those who believe efforts to promote RI and CSR have already gone too far and should be dismantled see corporations and governments as fundamentally antagonistic and do not believe that cooperative models can or should be built. Those who believe RI and CSR can and should be pushed further into the mainstream believe these cooperative models are useful and achievable. The truth probably lies between these poles, and will vary according to circumstances.

The above nine questions in effect suggest that a form of tripartite governance (government, corporations, NGOs) can be a useful one, but that it changes the rules of the current games of business and finance. Although its details may still be obscured in the mists of the future and its practicality is still untested, it is possible to see its broad outlines. The promise it offers is a means of harnessing the creative powers of for-profit corporations in ways that complement, not undercut, government's ability to create public goods. Whether we can find our way through those mists remains to be seen. Undoubtedly, however, this will require concerted and cooperative efforts by government, corporations, non-profit institutions and quasi-governmental bodies if we are to proceed down this path. Without these cooperative efforts, fundamental change is unlikely.

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Appendix: nine questions on the future of responsible investment

Corporations

1. Can the widely accepted definition of the role of the corporation as a short-term profit maximising machine be changed, and, if so, how?
2. Will corporations come to recognise that rule-setting by government can enhance their abilities to address social and environmental challenges, and, if so, why?
3. Can corporations work cooperatively with government to define the relationship between these two powerful forces so that the pursuit of private goods does not undercut the creation of public goods?

Institutional investors

1. Should the goal of investing encompass broad benefits to society as well as short-term, price-based returns, and if so, in what ways?
2. Should politics be separated from investment decision-making, and, if so, who is to make this distinction?
3. Should the practice of responsible investment be applied across asset classes, and, if so, is this practice the same for all classes?

Financial and academic communities

1. Should the value of investments be assessed in terms other than stock price, and, if so, what is the yardstick for such measurement?
2. Should responsible investing be legitimised as a key part of the investment process, and, if so, through what means?
3. Can individual investors be active enough 'financial citizens' to make responsible investing a reality, and, if not, why not?