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## Introduction

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One of the most striking features of debates around sustainable development has been the manner in which attention has moved from solely focusing on the roles and responsibilities of government towards consideration of the roles and responsibilities of companies. This reflects the dramatic political and economic changes resulting from the fall of the Berlin Wall, the end of the Cold War, the pressures of economic 'globalisation' and the drive to attract foreign investment.

Since the early 1990s, companies have extended their supply chains ever more widely and deeply into the developing countries of Asia, Africa and South America, and have invested in countries that were previously 'off limits' for political or ideological reasons. While this has brought many economic benefits (both to the companies and to the countries in which they have invested), the benefits have not been unambiguously positive. Concern has been expressed about the adverse social and environmental impacts (e.g. global warming, biodiversity loss, resource depletion) of globalisation and the perceived power and influence of corporations *vis-à-vis* national governments. There has also been a heated debate about the proper role, responsibility and level of accountability of corporations in a 'globalised' economy, heightened by examples and allegations of corporate wrongdoing and inappropriate influence on government, both in the developed and the developing countries (see, for example, Balanya *et al.* 2000; Dobbin 1998; Korten 1995; Monbiot 2000; Woolfson and Beck 2005).

The fact that corporate activities have such a powerful and controversial impact on modern societies is important to investors for two reasons. The first is that these factors may affect investment returns. For example, shareholder returns in energy-intensive sectors may be reduced by the introduction of a tax on greenhouse gas emissions. Secondly, investors may have some moral responsibility for the harmful activities of companies and may, therefore, face pressure to correct these activities. For example, it

has been suggested that one of the reasons why companies behave unethically is because of the pressure from investors to put short-term profits ahead of corporate responsibility. It has also been suggested (Monks and Sykes 2002) that another reason for unethical corporate behaviour is that investors fail to hold company boards properly to account for their corporate governance. The question of moral responsibility is of particular importance given that most investment today is conducted by a relatively small number of institutional investors<sup>1</sup> who manage the pensions and saving funds of millions of ordinary people. Therefore, the manner in which these institutional investors (pension funds and fund managers) invest and discharge their responsibilities as the providers of capital and the owners of companies has important consequences for society as a whole.

There is a growing belief that investors, in particular large institutional investors, have a responsibility to work proactively to address the environmental and social impacts of their investments. There have been demands from government as well as stakeholders, such as trade unions, that institutional investors act to ensure the probity of the companies in which they invest (Gribben and Faruk 2004). The rationale for these demands is that active shareholder participation can play a major role in encouraging high-quality corporate governance that will deliver long-term shareholder returns, while also offering the potential to deliver broader societal benefits. Over the past ten years, UK shareholders have used their power quite successfully to: create longer-term incentive structures for directors; increase board independence and executive accountability; create better risk management infrastructure (making it harder for incompetent or self-seeking managers to take unjustifiable risks with the business); and improve the quality of company policy, management systems and disclosures on issues such as climate change, bribery and corruption, supply chain labour standards, human rights and access to medicines.<sup>2</sup> These activities have contributed to important outcomes such as dramatically reduced prices of AIDS medicines, the withdrawal of companies from unhelpful industry lobby groups and improvements in labour conditions in retail supply chains.

1 At the end of 2003, 48.7% of all ordinary shares listed on the UK stock exchange (£666 billion of a total of £1,368 billion) were owned by insurance companies, pension funds and other institutional investors. Investors from the rest of the world held 32.3% of the ordinary shares with individuals holding a further 14.9% (National Statistics 2004). While the specific numbers vary, other countries have seen a similar concentration of assets in the hands of institutional investors (see, generally, Mallin 2004: 66-68; Monks 2001).

2 For a general overview of shareholder activism in Canada, Australia and the US, see Sparkes 2002: 311-65.

There has also been a growing recognition of the materiality<sup>3</sup> of social, ethical and environmental issues to investment decision-making. Examples of where these issues have impacted directly on company financial performance have included litigation (e.g. tobacco, asbestosis, product liability), regulation, taxation and other market instruments, and company failure as a consequence of probity failings (e.g. Enron). As a consequence, several fund managers have announced research programmes to better integrate these issues into their investment activities. Investment analysts have responded by increasing the amount of research they do in this area, and have produced reports on issues such as HIV/AIDS in the southern African mining industry, the effects of the EU's emissions trading scheme on European electricity utility companies, the implications of obesity for food producers and retailers, and the effects of climate change on the insurance sector.

## About this book

### What is responsible investment?

There is a lack of agreement on how responsible investment could be defined. According to Mansley (2000: 3), an initial definition could be something like:

Investment where social, ethical or environmental (SEE) factors are taken into account in the selection, retention and realisation of investment, and the responsible use of the rights (such as voting rights) that are attached to such investments.

However, this is an extremely broad definition and leaves open a number of questions about the scope of these concepts and the manner in which these factors should be taken into account.

This book is being written at a time when the definition and practice of 'responsible investment' is under scrutiny. For a number of years, it has been assumed that the only ethical approaches available to investors were either to shun certain stocks (e.g. 'vice' stocks such as tobacco, gambling, alcohol and pornography) or to invest in certain positive activities (e.g. environmental technology or healthcare). While such approaches have the advantage of appealing to relatively simple conceptions of right and wrong,

- 3 The term 'materiality' is often used to describe the financial significance of specific issues. Information is defined as 'material' if its omission, mis-statement or non-disclosure has the potential to adversely affect decisions about the allocation of scarce resources made by the users of the financial report or the discharge of accountability by the management or governing body of the entity (AASB 1995). There is no real consensus on the level at which an issue becomes 'material', although a general rule of thumb is that companies should disclose events that lead to impacts of greater than 10% on a key financial performance indicator (such as profit, turnover or revenues), whereas impacts of less than 5% are generally not considered material (for useful reviews, see Faux 2002, 2004). However, for environmental events, the level at which 'environmentalists' consider that companies should consider disclosing information is lower (e.g. Faux 2004). That is, many issues that are considered significant by environmental non-governmental organisations (NGOs) or other stakeholders (such as trade unions) are unlikely to be financially material.

they have struggled to become more than a relatively small part of the total investment market (for a further discussion on this, see Chapter 3). The reasons for this are various but include the relatively small proportion of the population that feels sufficiently strongly about such issues to make a positive choice on how its money is invested, and the perception that such investments carry a higher risk than conventional investments. From the perspective of encouraging companies to improve their performance on social, ethical and environmental issues, a blanket refusal to invest in a specific company also means that such investors (given that they represent a relatively small minority of shareholders) have limited ability to encourage higher standards of corporate responsibility (Sparkes and Cowton 2004: 48).

These limitations have created interest in alternative approaches to addressing social, ethical and environmental issues in investment. Two major strategies or responses have emerged. The first, as discussed above, is to enhance mainstream investment processes to explicitly analyse company performance on these issues, and then to incorporate the results into investment decision-making. The second is for investors to use the formal rights and informal influence granted to them as shareholders to encourage companies to pay appropriate attention to the management of social, ethical and environmental issues. Recent years have seen a dramatic increase in the number of investors using one or both of these strategies (see, generally, Eurosif 2003; Mansley 2000; Sparkes 2002), although across Europe as a whole, these investors remain in the minority.<sup>4</sup> The UK has been at the forefront of these changes with some £84 billion of pension fund assets now managed through engagement or shareholder activism mandates (Eurosif 2003: 23).

### Who are the key actors?

The focus of this book is on what is referred to as the institutional market, which is a general term for investments managed or controlled by insurance companies, pension funds and investment managers, and investment managers in pension funds, mutual funds and other pooled investment vehicles. Institutional investors invest on behalf of large numbers of individuals who have their pensions and savings invested in these funds. Most pension funds operate under trust law. This imposes a ‘fiduciary’ obligation on the trustees and fund managers involved to serve the interests of those whose money is invested in these funds—these interests are usually interpreted in exclusively financial terms.

Pension funds may manage their money themselves or may appoint one or more fund managers to do so. In practice, the vast majority of pension funds use external investment managers (or fund managers). Fund managers are specialist organisations that manage the funds of investment intermediaries, particularly pension funds. While investment terms or objectives are agreed with clients, fund managers have the pri-

4 A recent survey estimated that some €336 billion of assets are now managed according to some sort of socially responsible investment strategy, with approximately half of this being shareholder activism (Eurosif 2003: 10). However, with the exception of the UK and the Netherlands, socially responsible investment remains a comparatively modest part of the total investment market and, across Europe as a whole, the share of assets managed in a socially responsible manner remains very small at around 2% (Eurosif 2003: 14).

mary responsibility for day-to-day investment decisions (Monks and Sykes 2002: 12).<sup>5</sup> In general, fund-manager performance is judged over relatively short periods (usually three years in the UK but with more regular, typically quarterly, reviews of performance). Consequently, there may be a significant mismatch between the periods over which fund managers are judged and the longer periods over which investment returns are required by beneficiaries.

Pension funds are advised in the selection and appointment of fund managers, and on a range of other issues relevant to their investments, by firms of investment consultants. The views that these consultants hold about particular managers or about particular investment strategies—including views on the investment relevance of social, ethical and environmental issues—are very important in determining which managers succeed in winning mandates.

### What are the key questions?

To date, there has been little systematic analysis of the implications of these approaches (i.e. shareholder activism and enhanced analysis of social, ethical and environmental issues) for mainstream investment activities. In this book, through providing an account of emerging practice in addressing social, ethical and environmental issues in investment activities, we consider the following questions:

- Do responsible investment strategies actually contribute to improvements in the social, ethical and environmental (SEE) performance of companies?
- To what extent is it in investors' interests to encourage higher standards of corporate responsibility?
- Do responsible investment strategies enhance financial performance for investors?

The vast majority of the contributions to this book are from practitioners (fund managers, corporate governance or corporate responsibility specialists, investment analysts, investment consultants) or stakeholders (trade unions, non-governmental organisations [NGOs]), rather than academic commentators. This was a deliberate choice on our part. The practice of responsible investment has developed rapidly, and there has been little systematic analysis of how practitioners (as opposed to onlookers) actually implement responsible investment, or of how practitioners and stakeholders perceive the role of shareholder activism or enhanced analysis in mainstream investment processes. By inviting practitioners to contribute, we also expected to be able to address the final question above: namely, what are the strengths and weaknesses of current

5 Investment management styles can be divided into 'active' and 'passive'. Active funds are invested on the basis of financial analysis, conducted by fund managers and investment analysts. Some asset managers rely on their own in-house ('buy-side') analysts. Others rely more on research provided by 'sell-side' analysts who are employed by the stockbrokers used by fund managers to buy and sell shares. In contrast, passive management involves closely tracking a specific index (or basket of shares), such as the FTSE 100 (which reflects the collective price performance of the UK's 100 largest companies).

practice, and what are the barriers to making responsible investment a standard part of mainstream investment processes?

## What is the scope of this book?

Given the particularly rapid development of new approaches to responsible investment in the UK in recent years, this book focuses primarily on the UK (although there are also articles from practitioners in the US and Switzerland). However, the lessons learned and conclusions drawn are also generally applicable to other countries, reflecting the increasing influence of the Anglo-American model of share ownership, and the relevance of social, ethical and environmental issues to all companies.

We concentrate our attention on investments in equities and bonds, specifically the relevance of social, ethical and environmental issues to the issuers of, and investors in, shares or debt and the manner in which institutional investors act to influence investee companies to address these issues. Clearly, these issues are also relevant to other investment classes, such as property or direct project investments. However, the manner in which investors analyse these risks and the avenues of influence available to investors are very different to those for equities and bonds, and so are outside the scope of this book.

It is important to note that this book does not focus specifically on the primary purpose of the capital markets: namely, the provision and efficient allocation of capital. This is by far the biggest social contribution of investors and is an essential ingredient of sustainable development. However, as noted above, the outcomes from investment in companies are not unambiguously positive. The focus of this book is on how the negative consequences of institutional investment can be minimised and the positive consequences enhanced.

## Definitions

In the context of a book about investment in company securities (shares and bonds), the terms ‘social’, ‘ethical’ and ‘environmental’ are taken as relating to those aspects of corporate practice that are associated with corporate responsibility and sustainable development.<sup>6</sup> Institutional investors are likely to be particularly interested in those issues that have the potential to materially affect investment performance.

Under the category of ethical issues, we refer to issues such as responsible marketing (or the ethics of marketing), and bribery and corruption. Social issues include supply chain management (or the consequences of supply chain management practices, such as impacts on workers’ health), human rights, workplace health and safety, and community relations. Finally, examples of the environmental issues that may be considered by investors include climate change, chemical emissions, resource consumption and impacts on biodiversity. In practice, these issues overlap significantly. For example,

6 For a more comprehensive overview of the issues that are likely to be of concern to institutional investors, see Sparkes 2002: 117-275 and Mansley 2000: 37-62.

damage to a river ecosystem as a consequence of pollution discharges may also have social or economic consequences by undermining the ability of local populations to obtain fish from the river.

We refer to corporate responsibility<sup>7</sup> (which is also commonly referred to as corporate social responsibility or CSR) as the set of ethical expectations that people have about companies' behaviour. These expectations relate to characteristics such as corporate integrity, honesty, fairness, taking due care of people's health and safety, respect for rights, avoiding environmental harm, accountability and impacts on wider society. We refer to corporate responsibility management as the policies, practices and programmes adopted by companies to address these issues.

Each company varies in the manner in which it manages corporate responsibility, depending on factors such as its size and activities, the particular issues associated with its business activities, stakeholder demands and the company's attitudes and values. Companies may manage these issues as an integral whole or may divide them into areas such as business ethics, environmental concerns, human rights, governance, community and stakeholder relations, and philanthropy. Irrespective of the specific labels that are applied, we wish to emphasise one fundamental point: it is our view that corporate responsibility should be a fundamental part of every company's values, strategies, and governance and management systems.

## Structure

This book is divided into five sections. The first, comprising Chapters 1–3, examines the idea of responsible investment from an economics perspective (Chapter 2) and through a historical overview of the development of responsible investment (Chapter 3). Chapter 2 is of particular importance as the economic dimensions of responsible investment remain relatively under-developed, and one of the opportunities presented by this book is to draw together theory and practice in a more coherent manner. This economics perspective allows us to better understand the potential of, and barriers to, the development of practice, and it assists in analysing the case studies and other material provided by the contributors to this book.

The second (Chapters 4–12) and third (Chapters 13–18) sections of the book consider how social, ethical and environmental issues are taken into account in investment decision-making and shareholder activism respectively. Each section comprises a series of case studies where practitioners present their approach and experience in order to critically evaluate the financial, social, ethical and environmental outcomes from their work.

The fourth section (Chapters 19–31) subjects both the practice and theory to challenge and analysis. Critical perspectives on responsible investment have been obtained from different stakeholders: companies, NGOs, trade unions and academics. The authors reflect on their experiences with responsible investment and examine some of

7 For useful introductions to corporate responsibility and related concepts, see Elkington 1997 and Andriof and McIntosh 2001.

the broader questions, such as the role of investors in promoting sustainable development, the scope and legitimacy of activism and the barriers to responsible investment.

Finally, in the fifth section (Chapters 32–33), we draw together the different strands and themes of the book. Chapter 32 uses the case-study and analytical material presented to test and refine the hypotheses set out in Chapter 2. The chapter also considers the three key questions above (relating to the effectiveness and benefits of responsible investment and investors' interest in encouraging higher standards of corporate responsibility). In Chapter 33, we present some broader reflections around the contribution of responsible investment to sustainable development and the future direction for responsible investment.

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