Ethical Investment—Deconstructing the Myth

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DO AUSTRALIANS want social engineers to control their investments? Clearly some do—as illustrated by the existence and growth of so-called ethical funds.

Judging by the number of advisers jumping on to the ethical bandwagon—including every university in the country, many of the largest investment houses, the accounting profession, industry lobby bodies, philanthropic foundations, government departments and virtually every non-government organization—one gets the impression that ethical investment is the 'next big thing'.

And if its motto—'doing well by doing good'—rings true, it could well be.

The ethical funds industry has been given a huge boost by the *Financial Services Reform Act*—thanks to its friends in the Australian Democrats. The Act, passed in the dying hours of the last Government, imposes disclosure requirements on all funds managers which will, in effect, force them to inquire into the labour, environmental, social and ethical standards of the Australian corporate sector.

Unfortunately, most of the information available on ethical funds is provided by their many promoters and is unreliable. Indeed, there is a conspicuous dearth of independent research, a distinct absence of basic descriptive information.

On examination, most of the claims made by the industry do not stack up in theory or in practice. Indeed, the industry has the hallmarks of Hans Christian Andersen's fable of the Emperor With No Clothes—that is, people loudly touting the merits of ethical investment which in reality are non-existent. Yet few bystanders are willing to disclose the fact for fear of being branded as unethical.

Well, let us be the innocents who expose the naked emperor.

WHAT IS AN ETHICAL FUND?

It should be possible, theoretically, to define an ethical fund objectively on the basis of the criteria it uses to select its investments and on the basis of its own revealed ethics. In practice, this is impossible for the simple but fundamental reason that there is no single, accepted body of ethics in Australia. So ethical funds are self-identified.

Many of the funds are defined by the nature of the businesses in which they do *not* invest. For example, they may refuse to invest in nuclear power, armaments or tobacco. This so-called 'negative' screening is based on the perceived ethics of the activity itself rather than the ethical standards of those conducting it. The negative screen may be wide- or fine-mesh which allows a great deal of ethical flexibility.

If the screen is fine enough then it takes on the characteristics of 'positive' screening, where the fund operates not by exclusion of objectionable activities but by inclusion of desirable activities. These might include firms engaged in environmental improvement, waste recycling or social support.

There is some fuzziness in definition here, as 'positive' screening can also be conducted on the basis of the good behaviour of the management and staff of the corporation being considered for investment. This is not a judgement on their personal ethics but typically on their perceived treatment of customers and employees, compliance with laws, participation in socially acceptable extra-mural activities, annual reporting and general perceptions of honesty and integrity.

In practice, the operation of the positive and negative screens renders the general concept of the ethical fund quite meaningless.

If we consider ethical funds as a group, it is not possible to assert that their investments are in some way purer than the generality of investments.

This is because ethics are multifarious and, consequently, ethical investments **are** the generality of investments. This is shown by the fact that all of the top ASX 250 firms are included in at least one ethical fund or another. In other words, almost any legal business activity will be regarded as ethical by a sufficient group of investors to be included in an ethical fund. As the *Wall Street Journal* has reported 'One person's taboo is another person's sacred cow'.

Individual funds do offer investors a choice if they want to avoid or support certain forms of economic activity. What the ethical fund sector cannot do is provide a comprehensive definition of what is an ethical business nor can it delineate the 'ethical sector' of Australian business.

An ethical fund is therefore not ethical at all in any general sense—merely a vehicle for a more-or-less restricted group of personal preferences. Each ethical fund will have a different ethical set with a range as diverse as the market.

The last point brings into sharp focus the fact that the ethical funds are a self-identified group which have appropriated the mantle of ethics without any objective test. There is no reason why every fund which is run according to some ethical standard—which in practice could mean almost all funds because the Government enforces such standards—should not describe itself as an 'ethical' fund.

This is not to say that so-called ethical funds are illegitimate, merely that they are misdescribed. As a group they reflect the diverse and often conflicting beliefs within our society, which has a wide margin of tolerance for differences in opinion and behaviour.

Ethical funds would be better described as personal preference funds or personal choice funds. This would be a less misleading term and would avoid the discriminatory implication that other funds are not ethical simply because they do not describe themselves as such.

HOW SOUND IS THE ETHICAL SCREENING?

If ethical investment depends on personal preference and can thus comprehend most activities, investors need to choose their fund carefully to ensure that at least it reflects as many of their particular preferences as possible.

For several reasons this is not as straightforward as it seems.

The difficulty of fitting a personal ethical spectrum to discrete portfolio choices is demonstrated by the diverse composition of the ethical funds. Australian Ethical Equities Trust, for example, screens out gambling, tobacco, alcohol, mining and armaments. Hunter Hall has a similar screen, but may invest in alcohol and mining. Westpac Australian Eco Share Fund, on the other hand, invests in mining, energy, alcohol and gaming. Sustainable mining has been termed an oxymoron by environmentalists, but both BHP and Rio Tinto are included in the portfolios of a number of ethical funds. Tobacco seems to be avoided by most ethical funds, except indirectly through the medium of retail trade and hotels where it is generally included.

Another difficulty for investors is that the basis on which funds are rated as ethical is not transparent. For example, the *Corporate Monitor* ratings are explained in general terms but it is not possible to infer the weightings given to different types of business or to assess how much of the analysis is subjective. The precise basis for the Monash University ratings is also not revealed.

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Ethical screening, not surprisingly given its idiosyncratic nature, can throw up startling anomalies:

- Hunter Hall is a highly regarded ethical fund which positively screens for a limited range of investments. Its largest investment is Cussons, a British soap manufacturer. Cussons passes Hunter Hall's 'ethical' screen because it does not test its products on animals. Yet a leading ingredient in many of Cussons' product is palm oil, the production of which, in turn, is a major contributor to the clearing of tropical rainforest.
- AMP is screened out of certain ethical funds because of its investment in Stradbroke Pastoral which has the right to clear large tracts of land. It is penalized for holding these rights, which it has not exercised, thus being categorized ethically with those pastoralists who clear (legally or illegally). Ironically, at the same time, AMP is one of the largest providers of ethical funds in Australia.
- Michael Walsh, a leading analyst and promoter of ethical funds, has questioned investment in stem cell research on the grounds that it is 'controversial' rather than ethically unsound—an example of the precautionary ethical principle?
- The Wilderness Society will not certify Australian native timber under the official stewardship scheme while the Timber Industry Superannuation Scheme, which presumably regards itself as ethical, will not exclude a range of uses, including woodchipping.

Ethical screening would almost certainly eliminate any investment in governments which produce and use armaments, engage in mining and greenhouse activities, promote and run the biggest gambling operations in Australia (lotteries) and reap the biggest profits from the production and sale of alcohol and tobacco and from private gambling.

Indeed, Noel Hyland, Investment Analyst with Australian Ethical Investments stated 'One hesitates to say the Australian Government isn't ethical but according to our criteria it isn't. There are things … Governments do that are excellent like running hospitals but they spend huge amounts of their budgets on roads and defence'.

One final point relates to the trustees of ethical funds. Trustees are legally bound to act in the interests of their beneficiaries, not for social, non-financial causes. There is a risk with ethical funds that trustees could be exposed to claims of acting outside their powers if they sacrifice their beneficiaries' interests for causes promoted by outside interests.

THE FINANCIAL PERFORMANCE OF ETHICAL FUNDS

Sweeping claims are regularly made about the superior financial performance of ethical funds.

A common claim is that screening out 'negative' activities need not reduce the performance of funds. This assumes that the screened investments will yield the same returns as the excluded investments or that the managers of ethical funds are better at picking corporate winners.

The promoters often take it a step further and say that they can and do systematically beat the market. Their assumption is that ethical companies (which they define and identify) are inherently better performers because of the superior integrity of their management and staff.

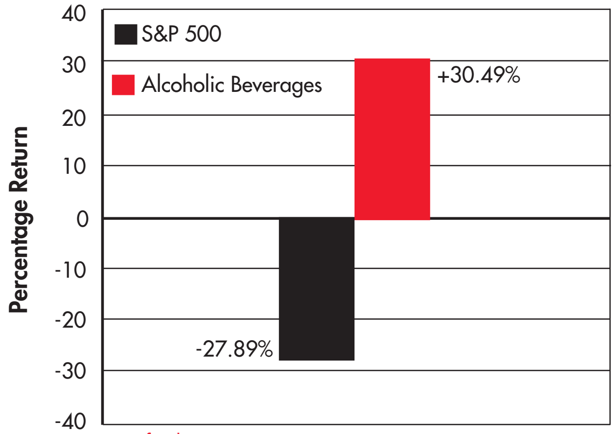
Neither of these propositions is sound in theory or practice.

Indeed, the recent performance of a large group of 'positive' companies (high tech and telcos) has been worse than many of the 'negative' ones (tobacco, mining, alcohol, gambling). Ali and Gold recently undertook one of the first independent examinations of the performance of ethical funds in Australia. Amongst other things, they found that excluding 'sinful' industries—such as alcohol and gambling (which the majority of Australian ethical funds do)—between 1994 and 2001 would have resulted in a performance shortfall of 0.70 per cent per year, reducing the broad market return from 12.7 per cent to 12 per cent. Their data showed that the gap between the sinful industries and the rest of the market grew markedly as the new economy stocks waned.

The result from the US is even starker. As shown in Figures 1 and 2, over the three years from June 1999 to June 2002, alcohol companies outperformed the market (S&P 500) by 58 per cent and gambling stocks outperformed the market by 103 per cent. Defence and tobacco stocks also significantly outperformed the market during this period.

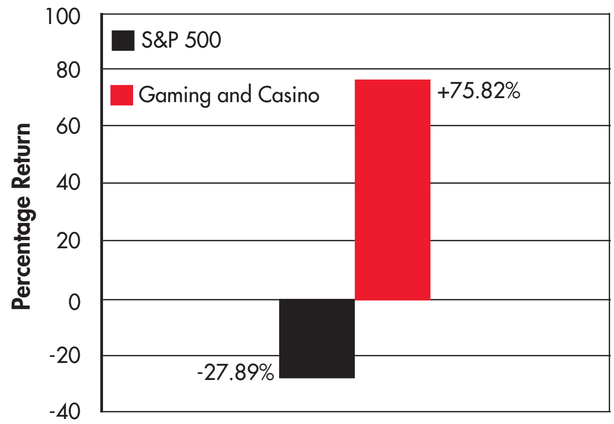
Moreover, there is no convincing evidence that managers of ethical funds are better at picking winners than the other fund managers. This is as theory would indicate. As Michael Knoll has argued, if ethical funds narrow the portfolio choice for non-financial reasons, this will increase the risk for the fund and prevent investment in some potentially high-performing companies.

Figure 1: 3-Year Alcoholic Beverages vs S&P 500 Index (30 June 1999 to 30 June 2002)



Source: www.vicefund.com

Figure 2: 3-Year Gaming and Casino vs S&P 500 Index (30 June 1999 to 30 June 2002)



Source: www.vicefund.com

The second assumption, that 'ethical' firms are inherently more efficient/profitable, is only sustainable in extreme cases where roundly unethical corporations actively engage in fraudulent or illegal activity and are caught and punished or self-destruct. Even such corporations as Enron may successfully pose as highly profitable and ethical. Indeed Enron and WorldCom were favourites of the ethical funds industry in the US.

The vast majority of Australian businesses comply with our laws and act honestly. Across this huge spectrum there will be enormous differences in relative efficiency and ability to take risks and make profits. These discrepancies will be almost entirely unrelated to the multiple shadings of integrity between the pathologically upright and the barely legal. The qualities of efficiency and successful enterprise are likely to be evenly distributed over the integrity spectrum.

One indisputable and significant financial disadvantage suffered by ethical funds is the extra costs they incur to screen investments for non-financial purposes. These can include the external costs of rating services or consultants and/or the costs of in-house teams directly checking, monitoring and auditing the environmental performance, labour standards (local and overseas), compliance history, social contribution and the integrity of executives and staff.

WHAT DO THE FIGURES TELL US?

The available data on ethical funds in Australia covers too short a period for meaningful comparisons to be made or assertions of superior performance to be substantiated.

What the data do show is that most of the ethical funds have experienced significant slides in returns in recent times with some ethically highly rated funds performing particularly badly. This may well be the outcome of investing in apparently ethical sectors such as IT and communications which have proved to be financially risky.

Looking at the last twelve-month period, the S&P/ASX 300 index shows a return of minus 3.82 per cent. The Westpac Monash Eco index shows minus 8.87 per cent and the Ethinvest Environmental index shows minus 12.9 per cent.

Looked at globally for the same period, the Dow Jones Global index shows a negative return of 9.88 per cent compared with a negative 20.23 per cent for the Dow Jones Sustainability Global index. The Australian market generally has performed better than the rest of the world, but its ethical funds seem to have performed relatively badly to about the same degree.

Analysis of the extra cost involved in administering ethical funds suggests an average loading of about 18 per cent, with wide variation of between 4 and 43 per cent.

Longer term data are hard to come by and proper comparison would require at least the full length of an economic cycle. One somewhat more extended comparison by *Corporate Monitor* found that, of the eleven funds it surveyed, four outperformed the ASX 300 index over the past five years. This implies that the majority did worse than the index.

The evidence from the US is that, over the 1990s, ethical investments were often able to match the market with some funds able to beat the market on a consistent basis. This is now, however, proving to be another mirage of a bubble economy.

Ethical funds in the US and in Australia have tended to invest in fashionable companies, in growing industries which, in the 1990s, tended to be socially 'acceptable' industries, such as dotcoms, telcos, and services. As shown above, the leading firms of the 1990s are now leading the market down and the old economy stocks are the rising stars. As a result, most ethical funds are struggling.

The bubble economy, which saw the firms which never made a profit produce price/earning ratios in excess of 100/1, is unlikely to return in the near future. It was these very same claims and investments which allowed the US ethical funds to beat the market. As with the dotcom bubble, the ethical bubble has now burst.

Another claim made by ethical investors is that it provides the capacity to change the world. That is, it allows people to withdraw money from 'unethical' firms (thereby depressing their stock values and raising their cost of capital) and to direct these funds towards 'ethical' firms (thus increasing their value and decreasing their cost of funds).

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Unfortunately for those who have made the sacrifice, there is little empirical evidence that ethical investment has any effect on individual stock prices and thus on the behaviour of firms. Indeed, none of the 'sinful' industries has suffered any adverse impact on price and cost from the efforts of the ethical investment industry.

If there is such uncertainty about the nature and performance of ethical funds, why do they continue to grow? The answer appears to be twofold. First, promoters of ethical funds are many and expert and ethically challenged when it comes to providing facts and performance. Second, investors may receive a 'psychic income' from apparently doing good.

One suspects, however, that as investors become aware that the ethical bubble has burst, the psychic rewards will be overwhelmed by the desire for hard returns.

CONCLUSION

The evidence suggests that ethical funds generally under-perform when compared with the market because they restrict their choice to a narrow, and therefore riskier, range of investments. Moreover, there is no indication that the ethical screens proffered by ethical funds identify better managed or less risky firms.

The debate over performance is clouded by the impossibility of defining a core, let alone a unique, set of ethics that could be used to identify objectively an ethical fund. 'Ethical' funds do not exist as a separate class. Most Australian funds could justifiably claim to be ethical. Self-described ethical funds are no more than personal preference investment vehicles.

The lack of transparency of the various ethical rating systems no doubt stems from, but is not excused by, this problem of definition.

One clear conclusion is that, while the Government's ethical disclosure rules may have little effect on the morality of fund managers or corporations, they will force the generality of funds and corporations to carry the extra costs of reporting and monitoring behaviour—but without winning the moral cachet that goes with 'ethical'.

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