Ethical Investing: Ethical Investors and Managers

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ETHICAL INVESTING: ETHICAL INVESTORS AND MANAGERS

Richard Hudson

Abstract: "Ethical investing" is interpreted in the following paper to be the use of non-financial normative criteria by investors in the choice of securities for their portfolios.

Ethical investors may aim at fulfilling duties they feel they have, possibly including increasing the amount of good in society through the consequences of their buying and selling behavior. The main duties are those of not-profiting from bad corporate behavior and of punishing bad (or rewarding good) firms. The main consequence desired is that managers manage corporations in a more ethical manner. But ethical investors (as opposed to some other kinds of investors who are also interested in normative issues) also aim at receiving returns based on the market risk of their investments.

If the aim of managers is to maximize shareholder wealth, then ethical investors can fulfill their duties or achieve their desired consequences only if their trading activities affect shareholder wealth, i.e., share price. A theoretical argument is presented to show that this trading activity will not affect share price or return. In addition, reference is made to results of empirical studies which show that ethical stocks yield market returns, i.e., that the share price of ethical firms is unaffected by the actions of ethical investors.

If the trading activity of ethical investors fails to affect share price and return, then these investors fail to fulfill any of their goals or to achieve their ends.

0.0 Introduction

The term "ethical investment" is used in this paper to refer to the practice of some investors of deciding which financial securities to hold based on whether the actions of the company that issued the security are ethical in the eyes of the investor.

The individual investor's acts of buying stocks and bonds in ethical companies (and selling those of non-ethical companies) may, in turn, be ethical because, through these acts, the investor fulfills a duty, possibly including increasing the amount of good in the society through the consequences of her acts. The main two duties mentioned in the literature are that of "not-profiting" from immoral business activities, as

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well as that of punishing bad (or rewarding good) firms. Some ethical investors may feel satisfied if they succeed merely in not-profiting or in punishing (or rewarding) firms. All, however, would like their buying and selling activities to lead to changes in managerial behavior. They desire that managers of firms respond to the investor's act by coming to act more ethically in the view of the investor (or they may want managers simply to continue to follow ethical practices that, without the support of the ethical investor, they might have given up).[1]

Much of the ability of ethical investors to fulfill a duty, including affecting corporate behavior, depends on how stock prices and stock returns react to making corporate practices more ethical. Consequently this question is extensively examined. A theoretical argument is developed to show that it is not possible to increase both price and return by adopting ethical (or unethical) corporate policies. It is also claimed that any benefits resulting from the adoption of ethical practices by a previously non-ethical firm accrue to non-ethical shareholders (since ethical shareholders will not hold non-ethical stock). The results of many empirical studies show that returns on ethical stocks are not different from those on non-ethical stocks of the same level of systematic risk.[2] These studies are then referred to in order to support the theoretical argument noted earlier.

If ethical investment cannot affect stock returns or prices, then, although ethical investors should make a rate of return related to systematic risk, they will not have any effect on corporations, and thus cannot punish bad (or reward good) corporations or affect corporate behavior. In addition, given the interlinked nature of the economy, ethical shareholders will also fail to avoid profiting from unethical corporate activities.

The final section looks at an argument in the literature that ethical investment could affect the weighted average cost of capital (WACC), and thereby have an effect on corporate behavior. This argument is rejected, leaving us with the view that the actions of ethical investors in buying or selling stock do not have any effect on corporate behavior, nor do these actions fulfill any duties.

0.1 The Ethical Investor

Many terms are used to refer to the practice of using ethical criteria in choosing financial securities for one's investment portfolio. Schueth lists "social investing, socially responsible investing, ethical investing, socially aware investing, socially conscious investing, green investing, value-based investing, and mission-based or mission-related investing" (2003: 184).[3] In this paper, the term "ethical investing" will be used. It will refer to the use of a wide set of decision criteria for investors in financial securities which are based on some non-financial normative considerations.[4]

It is important to distinguish "ethical investment" from other practices such as socially directed investment (Sparkes 2001) or investor activism. The ethical investor is interested in earning a return related to the level of systematic risk of the investment, while in socially directed investment, the investor is willing to accept below-market rates of return in order to contribute to certain forms of economic activity or to economic activity undertaken by certain groups in certain regions.[5] The ethical investor is also not an activist. Instead of raising issues at annual general meetings (AGMs) of shareholders, she expresses her favor or disfavor at management decisions by buying or selling stock in the corporation. Angel and Rivoli (1997) talk of these investors as using Hirschman's "exit" instead of his "voice" (see Hirschman 1970). Lewis and Mackenzie (2000) speak of "passive market signalling," whose efficacy they doubt. The ethical investor, like non-ethical investors, is thus anonymous. She chooses her stocks or mutual funds by applying ethical criteria (as well as financial criteria), but she doesn't speak except indirectly through her buying and selling of stock.

Ethical investors can have many different views about ethics, and, indeed, even those who are ethical contrarians and form portfolios of "sin stocks" (tobacco, alcohol, armaments) can be said to be expressing their values through their choice of securities for their investment portfolios. Schwartz (2003) points out that a lot of what passes for "ethical" investment seems to him to be more social or political. Indeed many of the issues discussed in relation to ethical investment, such as concern with workers' rights, the environment, treatment of women and minorities, treatment of workers in developing countries (the issue of the use of sweatshops), "fair trade," etc., may have a somewhat left-wing socio-political cast.[6] But all that we are requiring of ethical investors is that they use non-financial normative criteria in their choice of stocks.

Lewis and Mackenzie, in a series of papers, have attempted to examine what ethical investors actually believe and do. As could be expected, their picture of the ethical investor is much more complex than what is presented above. They show that investors who buy units in ethical mutual funds are often also shareholder activists, protesting at AGMs, and they may also invest in socially directed investment vehicles (see Mackenzie and Lewis 1999). They have differing ethical beliefs, and are often fairly inarticulate about these beliefs and have a hard time explaining the relation of their beliefs to their investment choices (Mackenzie and Lewis 1999: 441). Some seem confused about financial issues. Lewis and Mackenzie report that many believe that their investment in ethical stocks will give below market returns (2000: 187). Most of those who invest ethically apparently also invest in what they consider non-ethical and even unethical companies (such as armament manufacturers). They do so for various reasons: Mackenzie and Lewis (1999) report that there are financial reasons (particularly diversification), as well as other reasons harder to classify, such as that some of the non-ethical stocks were received as inheritances or that they had bought the stocks prior to arriving at their current beliefs.

In this paper, we shall abstract from these confusions and instead assume that an ethical investor is someone who holds a portfolio of securities, all of which meet some ethical criterion held by the investor. Ethical investors do this because they feel duty-bound both not to profit from unethical corporate behavior and to punish unethical (or reward ethical) companies. In addition, they seek to change corporate behavior, making it more ethical, thereby making this a better world.

Whatever the ethical investor's ethical goals are, she still seeks a return on her investment. The investor may even have some fiduciary responsibilities, as would be the case for those managing a pension fund or an endowment fund. But even if the investor is a single individual, we shall assume she wants a return that is adequate compensation for taking on the level of systematic risk that the investment brings with it: i.e., she wants a market return.[7]

There are, then, three goals of the ethical investor: 1. make an acceptable rate of return, 2. fulfill duties of not-profiting from unethical corporate activities and of punishing bad (or rewarding good) companies, and 3. affect corporate behavior causing corporations to act more ethically. All ethical investors hold all three, but some ethical investors may feel satisfied if they could attain the first two.

The problem we are considering is whether the ethical investor can achieve these three goals by investing ethically.

0.2 What Do Ethical Investors and Corporate Managers Do?

Ethical investors choose to buy stocks that meet some ethical criterion, and they divest themselves of stocks that fail to meet the criterion. Investors can research stocks themselves, or they can buy recommendations by various groups, or they can buy into ethical mutual funds offered by many investment firms. In all cases, someone does research on a firm's activities to see if they pass or fail some ethics test.[8] Often one talks of negative or positive screens used to screen in or out the stocks of different companies. In addition to the use of screens, ethical criteria can be used to affect the composition of the portfolio by assigning relative weights to individual stocks based on some measure of corporate ethics instead of on market capitalization (value-weighted) or some other weighting scheme.

In standard finance theory, the main duty of corporate managers is to maximize shareholder wealth (i.e., to maximize share price).[9] If share price is equal to the discounted future cash flows investors will receive, then managers should take all actions to increase those cash flows within the law and ethical custom. Generally this means they should identify and take on projects that are worth more than they cost. This is the capital budgeting decision. But they may also be able to squeeze more cash flow out of the assets they have by setting up better policies and procedures. And it might be possible that they can obtain more money out of the assets by skillful handling issues in financing and accounting, particularly if they can reduce taxes and thus provide more cash for shareholders by providing less for the government. If managers were to come to believe that "ethics pays," they might change their capital budgeting, management decisions, accounting and financing activities in order to become more ethical. As Jensen (2002) notes, the goal of shareholder wealth maximization is an end, but this end does not contain within itself any information about how it is to be attained. Jensen even claims that it is probable that responding to stakeholder concerns is essential in order to maximize shareholder wealth. If managers are right that ethics does pay, then cash flows to the firm would increase when managers act ethically, while if they are wrong, cash flows might decrease.

1.0 *Returns for Ethical Investors*

Returns from holding stock consist of price appreciation (capital gains)[10] and dividends. We shall simply speak of returns, noting that most of the return for holding stock usually comes from price appreciation (which can, of course, be negative).

The question here is whether ethical investment strategies yield lower ("ethics costs"), higher ("ethics pays"), or the same returns as other, more traditional, strategies. We assume all ethical investors care about returns, and those who invest the funds of others have an ethical duty to get returns at least as high as can be attained through non-ethical investing strategies (for a given level of systematic risk). Determining whether ethical investors get market returns is somewhat complex, so we will go through how gains from ethical behavior on the part of the firm can make their way to shareholders, and we will look very briefly at what empirical studies have shown.

1.1 *For Whom Does "Ethics Pay"?*

Since ethical investors, as defined above, want a market return (a return based on the systematic risk undertaken), it is important to investigate what the ethical investor can expect from her investment. Unfortunately, there seems to be a lot of confusion about what it would mean for ethics to pay for the investor, as opposed to what it would mean for ethics to pay for the corporation.

It is clear that in many cases, the level of profits firms can achieve is affected by whether they act ethically or not. Ethical business practices may result in higher profits because workers work harder, customers become more loyal and may even be willing to pay higher prices, suppliers work hard to ensure prompt delivery of quality supplies, and communities support the firm.[11] Or ethics may cost as workers are accorded high wages, suppliers get higher prices, customers get lower prices, and money is spent on communities which could have been used in the firm.

That firms can change earnings by being ethical does not tell us what happens to shareholders—it doesn't say what happens to shareholders' returns. There is an important difference between gains for the firm and gains for the investor. From the view of the manager of the firm, it may make sense to adopt ethical business practices if these will permit the firm to develop greater cash flows from the assets it employs. But from the view of the shareholder, all that counts is risk and return. If ethical policies are effective at increasing profits, then the value of the firm will go up in order that the return be the same as for other firms with the same systematic risk. This means the price of the firm will go up. As Boatright notes (1999b: 111), assuming the market will fail to price the value ethics brings to the firm is to assume a very serious market inefficiency.[12] But the gains to ethics, which may be real in certain circumstances, will occur only when a firm moves from an unethical to an ethical policy—this is when the price will change. Only the investors who were there just before the policies were adopted gain (or lose). Once price has adjusted, returns reflect only systematic risk.

1.2 Price-Return Relation

Proponents of ethical investment sometimes claim that social performance and financial performance of firms are positively related. Studies of this relationship use several different measures of financial performance—both accounting and market-based measures.[13] The two most important market-based measures are stock price and stock return. These two variables (price and returns) work in opposite directions.

To explain this issue, let's take the example of an all-equity financed no-growth firm which pays out all economic earnings as dividends. Since the firm has the same asset base every year, its expected economic earnings per share will remain forever unchanged. The present value of these earnings, i.e., the price of the share, can then be calculated using the perpetuity formula, yielding:

$$P = EPS / r$$

where P is the price of the share, EPS is the earnings per share, and r is the required rate of return. The rate of return, r, is determined by the systematic risk of the cash flows received by the investors.

It is possible that when a firm adopts ethical practices for the first time, its earnings increase. But, subsequently, earnings should stabilize, unless the firm continues to adopt ever newer ethical (and profitable) practices. Thus there is an immediate change in earnings, followed by stable earnings at the new higher level. For example, suppose that under the old practices, EPS = \$10 and the required rate of return was 10 percent. Then the price of the stock would be \$100 ($P = EPS / r$, so P = \$10 / 0.10 = \$100). If the new practices result in an expected EPS of \$11, then the price jumps to \$110 (\$11 / 0.10 = \$110) and stays there (the earnings, too, stay where they now are, at \$11). Similarly if the ethical practices cost the company so that EPS drops to \$9, then the new price drops to \$90 (\$9 / 0.10 = \$90) and stays there as long as the firm continues with its practices. In other words, even if ethics pays for the firm, it pays only once for the investor, but, eventually, returns stay where they were. Those who owned the stock before it became ethical will win when the price rises, but these will not be ethical investors, since, presumably, the firm was non-ethical prior to adopting the ethical policies which increased earnings.

It is also possible that the adoption of ethical practices by management will have no effect on earnings, but will affect risk, thereby affecting the required return. If systematic risk decreases, then so does the required return, and vice versa. In our example above, if ethical practices reduced risk, then the required return would decrease too, and the stock price would rise. For example, if the required return dropped to 9 percent, then the price of the stock would rise to \$111.11 (\$10 / 0.09 = \$111.11). Here return drops permanently, because risk is reduced by the new ethics policies. Those who owned the stock before it became ethical will win when the price rises, but these will not be ethical investors, since, presumably, the firm was non-ethical prior to adopting the ethical policies which decreased required returns. Notice that the price increase, when there are no changes to earnings, occurs because of the decline in expected returns.

The third element of our formula concerns the price of the stock. Changes to the policies of the firm can clearly affect earnings and risk. The price change is merely the result of these real changes, and it is hard to see any other reason for the price to change. But suppose that the price of a stock were to change because of increased demand for ethical stock. (We will return to another version of this argument in section 3, below.) Let's say that the company announces it is adopting new ethical policies, and that suddenly all of the ethical mutual funds buy shares for their portfolios. And let's suppose that there are no changes to expected earnings or risk. If P, the price of ethical stock, rises without any corresponding change to earnings, then r, the required rate of return, decreases, despite the fact that risk is unchanged. For example, if the price rises to \$110, without a change to EPS, then, for purely mathematical reasons, the expected return must decrease: it will drop to 9.09 percent ($P = EPS / r$, so $r = EPS / P$, $r = \$10 / \$110 = 9.09$ percent). Those who owned the stock before it became ethical will win when the price rises, but these will not be ethical investors, since, presumably, the firm was non-ethical prior to adopting the ethical policies which resulted in increased demand. In the future, however, those who own the stock which costs \$110 will get a lower return, which will be lower than the return on similar stock with the same systematic risk. Anyone who buys the stock after the corporation becomes ethical will not become as wealthy as she would have if she had invested in a non-ethical firm.

1.3 Question of Returns: Does Ethics Pay?

Whether ethical investment pays is important for the ethical investor, who, we are supposing, wants to get a market return while still living her values. More important for our analysis here, however, is why it would pay, even if all it pays is the risk-related rate of return we expect from all stocks.

It is hard to make an argument that ethical stock would yield higher returns than other stocks. As we have seen above, even if a firm could generate higher cash flows by being ethical, the stock market would price those cash flows in such a way that returns would be the same on ethical stock as on other stock. Some ethical investment proponents seem to want to find that ethical investments have higher returns. Thus Diltz (1995) claims that firms which take environmentally friendly actions have higher returns. But if returns on one kind of stock are consistently high over time, while risk is the same as for a reference portfolio, then the stock is underpriced. Rational investors will not consistently underprice a stock, and there is no reason one can give why they should.

It is even hard to make an argument that ethical investment would "cost" by making returns be lower. Once again, the rather hard-nosed investors on Wall Street would drive the price of the ethical stock to where it should be according to its systematic risk, even if the adoption of ethical policies resulted in lower cash flows being generated. But ethical investment could cost the ethical investors for other reasons. The main reason often cited is the cost of diversification. Ethical shareholders are subject to diversifiable risk if the list of ethical stocks is too small or if the ethical stocks are all concentrated in a small number of sectors of the economy.[14] In addition, ethical investment requires research into whether the corporation can count as ethical. This research has a cost which non-ethical investors do not have to bear, because they don't care about whether the corporation is ethical or not. And, also, ethical investors may trade more than other investors if corporations' level of ethicality is not stable. Finally, ethical investors may buy mutual funds in order to avoid having to do research, but mutual funds may generate fairly large transactions costs (fees).[15]

The theoretical arguments are fairly clear that investment in the stock of ethical companies should yield returns based merely on the investment's level of systematic risk, although there may be some additional transactions costs or costs of lack of diversification. But we have to be careful about believing the theory in finance. Theories seem unable to always account for what happens on security markets. In fact, economists are good at coming up with stories that justify what empirical studies find. The efficient markets hypothesis itself is reputed to be a response to the surprising finding in the 1950s that security price changes seemed to follow a random process. More important, then, than vague theories are the empirical results that come when the data are examined.

1.4 Empirical Studies of Returns on Ethical Stock

There have been many studies which attempt to determine whether portfolios of ethical stock have higher or lower risk-adjusted rates of return than other stock. Often finance academics and professionals speak of ethics being "priced": high returns for ethical stocks mean that ethical practices are priced in a negative way (the stock is underpriced—it sells for less than what it is worth), while low returns mean that ethical practices have led the market to overprice the stock. Return and price are simply two sides of the same coin—referring to one automatically refers to the other. Since vast amounts of data on returns have been available since the mid to late 1960s, comparisons of returns on ethical stock to those on non-ethical should be easy.

Some individual studies have shown higher returns, some lower, while many show no discernable difference. But as Boatright says, "The research to date has failed to find any statistical difference in the returns of SRI firms" (1999b: 110; by "SRI" firms, Boatright is referring to socially responsible firms). Kurtz points out that many event studies, some of which dealt with ethical investment, have suffered from severe methodological shortcomings and are unreliable (1997: 40). Problems have also been caused by short time frames, failure to account for various well-known stock market "effects" (such as the size effect), and failures to choose a reference portfolio with an appropriate level of systematic risk.

Kurtz notes his surprise that, "despite apparently unavoidable diversification costs, the universe of SRI stocks does not appear to have systematically underperformed the market portfolio in recent years, on either a nominal or risk-adjusted basis" (1997: 70). Hamilton, Jo, and Statman report:

> Our results indicate that the market does not price social responsibility characteristics. Investors can expect to lose nothing by investing in socially responsible mutual funds; social responsibility factors have no effect on expected stock returns or companies' cost of capital. (1993: 66)

Rivoli (2003) and Heinkel, Kraus, and Zechner (2001) also accept the findings that returns on ethical stocks are not discernibly different from returns on other stocks of the same level of systematic risk.

The empirical results, then, are fairly clear: ethical investments yield returns similar to those of other investments of the same risk level. In a way this is good news for the proponents of ethical investment: ethics doesn't "cost" anything, so even those with fiduciary responsibilities (such as endowment funds) can invest with their values.

2.0 Punishing Unethical (Rewarding Ethical) Corporate Behavior

One of the main goals of ethical investing is to punish corporations who act badly, and, conversely, to reward those which act ethically. The question is whether ethical investors' act of buying and selling stock can punish or reward corporations.

Investors generally buy stock on the secondary market. In other words, they buy stock from some other investor—not directly from the corporation which issued the stock often years earlier. Although the investor may feel she is putting her money "into" the company, in fact, the corporation usually does not receive the investor's money at all. And although the ethical investor is attempting to act ethically by buying or selling stock, she does so quietly without making any announcement. Her transactions get buried in the large number of transactions on security markets. Generally, the managers of the firm are completely unaware of the views or even of the identities of small shareholders.

The only way the ethical investor could punish (or reward) a firm would be if her buying and selling activity affected share price. Managers, we assume, want to maximize share price, so they would be punished if their unethical behavior were to adversely affect price. But, as we have seen, the ethical investor, by selling her shares, has no effect on earnings or systematic risk. Similarly, when an ethical investor buys stock in an ethical firm, nothing happens to share price or return. All the real activities of the firm—production, sales, management policies—remain the same after she completes her stock transaction. As long as there are other investors on the market, willing to buy her shares or to sell her their shares, nothing happens. And, as was shown above, the empirical evidence is that stock prices (and returns) are not affected by the activities of ethical investors.

2.1 Profiting from Unethical Activity

Unfortunately, the result that ethical investment pays the same returns as other investments of the same risk level also means that ethical investors cannot avoid profiting from unethical corporate activity.

One goal of ethical investors is to profit only from ethical activity, and not from the unethical activity of companies. By avoiding buying stock in cigarette companies, munitions firms, and distilleries, one can "not-profit" from sin. But the standard finance theory about the generation of security returns is that the level of expected returns for individual stocks depends on general market movements. If we were to accept the Capital Asset Pricing Model (CAPM), the expected return on a stock is a function of the risk-free rate plus a risk measure (beta) specific to a particular stock times the expected risk premium on the market (the amount by which the expected return on the market index exceeds the risk-free rate).[16] But this means that the expected return on any individual stock is a function of the expected returns on all the stocks on the market (and, indeed, the risk measure beta is itself based on the covariances of the returns on the individual stock with the returns on the market). So the expected return to the ethical investor depends on the expected returns on all other stocks and the risks of all the other stocks, including the stocks of cigarette companies, munitions manufacturers, and distilleries.

It should not be surprising that it is impossible for the ethical individual to withdraw from society and its evils entirely. Even when one buys ethical stock, the interrelations of firms on the market are such that all are linked to all. Entine criticizes corporate social responsibility research for remaining at "the first level of corporate activity" (2003: 356). For example, one might include a bank stock in one's ethical portfolio, judging that banks would at least pass a negative screen (they don't pollute, they don't make cigarettes or weapons, etc.). But banks also don't release very much data on their operations, so, as Entine (2003) points out, one generally doesn't know if part of the bank's profits come from loans to cigarette companies. Even if there are no direct dealings between one's favorite "ethical" company and unethical companies, there are indirect linkages throughout the economy. Some of the depositors in the bank are cigarette company managers, or some of the deposits come from sales made by ethical companies to cigarette company managers. Finance theory, through the CAPM, tells us that companies profit when the economy is going well, and that investors get these profits. But each company's profits depend on how all are doing. The situation is even more complex than what Entine (2003) is indicating. If one goes deep enough into the origin of each dollar of profit of ethical firms, one is bound to discover some link to unethical firms.

If ethical stocks paid out returns to ethical investors in a way that was unrelated to how the rest of the economy was doing, then we might doubt the linkages between ethical and non-ethical returns. But the empirical evidence seems to show that shareholders in ethical and non-ethical firms get similar risk-adjusted returns.

3.0 Influencing Managers: An Agency Argument

Managers of corporations may be influenced by anything which affects either shareholder wealth or, as Jensen and Meckling (1976) showed, managerial comfort. Shareholder activists, by threatening to raise embarrassing questions at AGMs, can occasionally get managers to agree to actions that, originally, they didn't want to agree to. Consumers, by threatening or actually carrying out boycotts of the products of the firm, can affect the cash flows that managers could otherwise generate, and thus cause managers to change their actions. Activists may, through detailed analysis, convince managers that, say, environmentally friendly production methods actually pay. Governments, by passing laws or adopting regulations (including sentencing guidelines), can also affect the expected cash flows to firms, thereby affecting managerial actions.

If managers were viewed as full human beings, rather than as individuals in roles, then one might appeal to their sense of morality to try to get them to push the firm in a more ethical direction. Ethical investors, however, because they are silent and have no personal contact with managers, do not make appeals to managers: they simply sell their stock in "bad" companies and buy stock in "good." The problem for ethical investors who want to change the behavior of firms is to figure out how simply buying and selling stock, quietly and anonymously on the major security markets, would affect managerial decisions.

Jensen (2002) is one of the very few who make an agency argument about managerial response to ethics. (The response he outlines, however, isn't particularly ethical.) He claims that if boards of directors accept stakeholder views, managers will consider stakeholder interests because they then can hide their poor performance behind a set of incomparable measures. This agency argument depends, however, on board reaction. Naturally, if the shareholders of a firm believe that the task for management is to satisfy stakeholders, and not primarily shareholders, then they may elect a board with this belief. By organizing—buying stock and voting their beliefs—a group of ethical investors could replace a board of an unethical company with new directors who share their values. This, however, takes us beyond our rather restrictive view of the ethical investor and too close to shareholder activism. Our main assumption is that the ethical shareholder is someone who quietly expresses her values by buying stock, and who doesn't use her voice to change board views. In any case, the board must already share her views for her to buy the stock—the ethical investor buys stock in companies that are already ethical.

3.1 The Weighted Average Cost of Capital

All other attempts to show that the activity of ethical investors in buying and selling stock can affect managerial decisions use the idea that the buying and selling activity will affect share price. We saw earlier that this is a difficult argument to make. There is a particular version of the argument which deals with effects on the weighted average cost of capital.

This argument is that because of increased demand, ethical stocks will become relatively more expensive, and because ethical shareholders boycott the stock of non-ethical companies, those stocks become relatively less expensive. Or, we could say that the market is segmented into two groups of investors: one group consists of ethical investors willing to hold only ethical stocks, and the other consists of all the other investors (who we will call "non-ethical investors"), who are willing to hold any stock. Angel and Rivoli (1997), Rivoli (2003), and Heinkel, Kraus, and Zechner (2001) work out what happens when the market is segmented in this way.

They find that market segmentation changes relative prices. The price of non-ethical stock drops because only some shareholders are willing to hold it, and the price of ethical stock then is relatively higher. Since managers have as their first responsibility to maximize share price, they would respond to these market signals and change their behavior (decisions). As Heinkel, Kraus, and Zechner (2001) point out, ethical managers will continue to be ethical, managers who could become ethical costlessly will do so, and others will calculate if the price of reform is less than the expected increase in share price from becoming reformed. Eventually some companies will find that it just doesn't pay to reform—cigarette companies may find the only reform acceptable to the ethical investors is to go out of business. We could then say that ethical investors make a difference: at least some firms will really start to act more ethically, although they will do so only to maximize shareholder wealth.

A central question which is affected by the change in share price is the number of new projects to accept. An investment project in real assets (property, plant, and equipment, etc.) is acceptable if the discounted cash flows generated by the project are higher than the initial cost of the project. The discount rate used is the "weighted average cost of capital" (WACC): a weighted average of the cost of debt capital and the cost of equity capital to the firm. The higher the WACC is, the more projects will be rejected.

If the buying and selling activity of ethical investors affects share price (making ethical stock sell for a higher price than non-ethical stock), then, since earnings are unaffected, required returns for ethical stock will be lower than the returns required for non-ethical stock (price and return change in opposite directions). Rivoli (2003) and Heinkel, Kraus, and Zechner (2001) emphasize this direction of change. Hamilton, Jo, and Statman (1993) note that the firm's cost of capital will change if ethics is priced (if returns differ due to the firm's ethical performance). Wall (1995), Angel and Rivoli (1997), and Heinkel, Kraus, and Zechner (2001) argue that if there are two firms (one ethical, one non-ethical) with the same WACC prior to the pricing of ethics, after ethical performance is priced, the WACCs will change so that the ethical firm would have a lower WACC than the non-ethical. The relatively lower WACC for ethical firms means they will accept more projects, while the relatively higher WACC for non-ethical firms means they will accept fewer.

The argument, then, is that by affecting share price, the presence of ethical investors will have consequences for the real economy: more managers will adopt ethical practices and the "ethical" sector of the economy will expand more than the non-ethical. This means also that the ethical investor succeeds in punishing non-ethical companies and rewarding ethical companies by divesting or buying shares, even though these actions are done on the secondary market. And it means that the ethical investor returns are somewhat (but not completely) separated from the non-ethical part of the economy, so that the ethical investor might have some claim about avoiding profiting from unethical corporate behavior.

3.2 Does Ethical Investment Affect Managers' Actions?

Heinkel, Kraus, and Zechner, who talk of "green investment," try some simulations, using an econometric model they construct, to see what happens if there are investors who invest ethically. They attempt to guess at values which might reasonably prevail for important variables. They conclude that:

> Our paper indicates, in an equilibrium model, that social investing can impact a firm's environmental and other ethical behaviors. An important factor determining the number of reformed firms is the fraction of the population that boycotts socially irresponsible firms. We calibrate our model with empirically

> reasonable parameters and find that roughly 25% green investors are necessary to overcome a firm's cost of reforming. However, existing empirical evidence indicates that roughly 10% of investable funds are invested socially responsibly. In our model, a 10% fraction does not encourage firms to go clean, but does raise the economy-wide cost of capital. (2001: 447)

The 10 percent figure for funds invested ethically is hotly contested by Entine (2003), who claims that the figures published by SIF (the Social Investment Forum—the source Heinkel, Kraus, and Zechner cite [2001: 445]) are wildly overstated—that any mutual fund using any non-financial measure (even governance questions such as the percentage of outside directors) gets counted by the SIF as a socially responsible fund (Entine 2003: 361). Thus while Heinkel, Kraus, and Zechner (2001) are saying that the number of ethical investors would have to increase by a factor of 2.5 to cause firms to reform, the case is probably even worse.

Heinkel, Kraus, and Zechner (2001) do claim that the boycott of the stock of non-ethical firms by ethical investors can change the economy-wide cost of capital even if green investment represents only 10 percent of total investment. This means that returns to green firms should be lower than returns to non-green ("neutral") firms. But they report that studies generally show no difference in returns (2001: 447). If there is no difference in returns between "green" and "neutral" firms, then "green" investment makes no difference, currently.

Angel and Rivoli (1997) also note that it is conceivable that ethical and non-ethical investors will segment the market, permitting the relative prices of stock to change. But they also note that there is no evidence of differential returns (1997: 59), although they claim that it is possible that the effect would be seen only in certain classes of firms (1997: 61).

If it is the case that returns on ethical and non-ethical stock, adjusted for level of risk, are the same, then the buying and selling activity of ethical shareholders is having no effect on corporations. Ethical investors do not punish bad companies or reward good, they do not avoid profiting from the bad parts of the economy, and they do not affect managers' actions.

4.0 Conclusion

We have looked at the case where the ethical investor wants her investment to yield a market return while simultaneously permitting her to fulfill certain ethical duties and to effect certain ethical consequences. The duties are not to profit from bad corporate actions and to punish bad (or reward good) firms, and the desired consequence of the buying and selling activity of the ethical investor is to affect managers' actions, making them more ethical.

In our assumptions, the investor has ethical beliefs upon which she wants to act. The managers of firms, on the other hand, do not. Their objective is to maximize shareholder wealth. The main question then is whether the ethical investor can succeed in her ethical goals through quietly buying or selling stock. The answer provided in this paper is that she cannot.

Notes

1. Rivoli (2003) talks of ethical investors' "making a difference" or "making a statement" to refer to the distinction of those who hope to change business behavior (those who want to "make a difference") and those who want to do the right thing even if it won't necessarily change business behavior ("make a statement"). Naturally, even those who want to make a statement want to make a meaningful statement, that is, they aim at consequences. Those who want to "not-profit" from unethical business activity do want to "not-profit," and those who want to reward (or punish) companies want to actually succeed in rewarding (or punishing).

2. In what follows, I will use the term "market return" to refer to an expected return which is based on the level of market risk (or of systematic risk). An expected "market return" on a stock whose returns are riskier than those of the market index would, of course, be higher than the returns on the index.

3. Cowton lists the following as being similar or related terms to "socially responsible" investment (1998: 181): ethical, social, green, alternative, divergent, targeted, creative, development, strategic.

4. Dembinski, Bonvin, Dommen, and Monnet (2003), in an article translated from French, point out the difference in French between "*placement*" and "*investissement*," where "*placement*" refers to investing in financial assets (such as stocks or bonds), while "*investissement*" refers to investing in real capital items (such as property, plant, or equipment). We are referring here only to financial investment, not to real investment.

5. I am using Sparkes's (2001) expression "socially directed investment" to refer to investments where the rates of return are expected to be below the market rates offered for similar investments. Other terms are often used, such as "economically targeted investment." Watson says economically targeted investments are "capital projects that are expected to provide economic benefits to the economies of the regions in which they occur" (1994: 69). Watson (1994, 1995) talks of ERISA policies on economically targeted investments. Mackenzie and Lewis (1999) talk of "alternative investments" or "social investment" to refer to non-standard ethical investment vehicles, rather than of ethical mutual funds. They talk of the "attempts by various ethically motivated ventures to raise capital by appealing directly to small investors" (1999: 440), and their main example is of a Christian-based group which makes loans in third-world countries, returning a low rate of interest to investors of "perhaps 3 percent below the building society rate for similar investments" (1999: 441). Travers says, "There are actually three ways that an investor can go about investing in a socially responsible manner: 1) through investment only in companies that pass restrictive screens, 2) through shareholder activism designed to change the way in which a company does business, and 3) through direct investment in the community" (1997: 51).

6. For an example of one way of interpreting the meaning of "ethical," see the description of the methodology of the KLD Broad Market Social Index at www.kld.com/benchmarks/BMSImthd .html.That the criteria are "ethical" is sometimes contested. See Schwartz (2003) or Entine (2003). Critics sometimes complain that the criteria are really based on left-liberal socio-political views, rather than truly ethical views. Also, critics claim that the "ethical" views are incoherent, and that different ethical investment funds with apparently the same values come to different judgments about which stocks count as ethical (see particularly Entine [2003]). Naturally, people with different views have different ethics—Schwartz (2003) notes that those whose ethics are religiously based are bound to differ simply because the religions differ on their values. We will abstract from such problems.

7, D'Antonio, Johnsen, and Hutton note the very common view that "socially responsible investors . . . [a]re willing to put their money where their heart is, but still demand no less of a financial return (or not significantly less) than they might get with traditional investment vehicles" (1997: 80). As they note later (84): "*Performance* has been hotly debated, researched, and analyzed. The basic question since SRI began is whether financial sacrifices have to be accepted when one engages in SRI. It appears the answer is no." As noted above, an "adequate return" means a return consistent with the amount of systematic risk of the investment.

8. Entine notes the extremely sloppy and arbitrary work done, he claims, by some major ethical investment research firms.

9. For this discussion, we will abstract from agency problems. This statement of managerial duties is clearly the standard shareholder position taken in academic finance, and is not a stakeholder view. Generally, the ethical investment literature takes the view that the shareholder is ethical, and that the manager is a *homo economicus*.

10. If share price falls, then the price appreciation is negative, and the capital "gain" becomes a capital "loss."

11. Frank (1996) shows that graduates of Cornell would demand more to work for a tobacco firm than for the Cancer Society.

12. One might think that ethical investors might be better at determining which stocks are on the verge of adopting ethical policies—policies which will result in an increase in share price—and thus could buy the stock just before it became "ethical." Ethical investors might have better "ethical imagination" or ethical sensibility. This would require an important market inefficiency. The issue here is not that of recognizing what is or isn't ethical. Instead it is a question of predicting the actions of managers. If ethical investors can predict which firms will take on ethical projects which pay, then why can't other investors? In any case, ethical investment, as practiced, particularly by ethical investment funds, assesses firms' current practices, not the practices they might develop in the future. And, in general, in finance, no convincing evidence has ever been found that anyone—even investment professionals—can beat the market on a regular basis.

13. Griffin and Mahon (1997) have a good review article of the work done on measuring the social performance / financial performance relationship. Their Table 2 (pp. 12–13) gives a good summary of the very many financial performance measures (including "Share price" and "Returns to portfolios," on p. 13) which have been used in the literature.

14. Ethical shareholders are always subject to diversifiable risk since the screens will always eliminate some stocks, and the only way to be completely diversified is to buy a little bit of every stock on the market (i.e., to buy the market index). By definition, ethical shareholders cannot buy the market index. In practical terms, however, almost all diversifiable risk is eliminated if one buys "enough" different stocks. Kurtz (1997) deals with this question.

15. These fees are often expressed in "basis points," i.e., hundredths of a percent. While the numbers may look small to some, the loss of part of one's return to cover such transactions costs clearly does reduce overall return, which becomes particularly noticeable over time due to compounding (the failure to gain future returns on these sums).

16. Kurtz (1997) notes that if we use Arbitrage Pricing Theory (APT), that the return on ethical stock will be affected by the various factors in the version of APT we are using, which means, once again, that business activity in our economy is interlinked, and formal avoidance of certain sectors of the economy (by not buying stock in them) does not mean that one can really successfully avoid the effects of economic activity in those sectors.

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