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UNIVERSITY OF GLASGOW

**The Performance and Rationale of European Ethical
Funds: An Ethical Perspective**

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Thesis submitted for Doctor of Philosophy

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Faculty of Law & Financial Studies

2002

Abstract

This dissertation examines whether ethical investment funds are good investments in comparison with other stock market investments for individual investors. Firstly, the financial performance of ethical funds was analysed using traditional risk adjusted performance measures. Performance was first compared with market benchmarks and then in comparison with other funds using a ‘matched pair’ approach (Luther, Matatko and Corner 1992; Mallin, Saadouni and Briston, 1995; Gregory, Matatko and Luther, 1997). This analysis indicated that the financial performance of ethical funds was not significantly different from market benchmarks and other funds. It was therefore concluded that ethical funds were good investments financially.

A second empirical study used field research to examine the policies and processes of ethical funds. Two complementary strategies for dealing with ethical issues were identified; screening and engagement. Screening involves the use of exclusionary and/or positive ethical criteria in the stock selection process. This study indicated that ethical funds had a number of processes in place to address ethical issues. These processes included ethical screening; ethical advisory committees; specialist ethical researchers and use of other organisations. In terms of the policies and processes employed by ethical funds they were “good” investments compared to other funds. This confirms previous findings that ethical funds, although not a “panacea” were an improvement over other funds and that some ethical funds engaged with firms on ethical issues (Cowton, 1999; Mills, 2000; Friedman and Miles, 2001).

Finally, ethical theory and Church perspectives are employed in a tentative analysis of whether ethical funds are good investments ethically (Mackenzie, 1997). This preliminary analysis made it clear that some ethical funds would not be good investments in a moral sense for certain investors. For example, religiously motivated investors might require funds to employ certain ethical criteria and/or processes in order to consider a fund a good investment in a moral sense. Although ethical funds provide investors with an ethical opportunity they are not always “good” investments in a moral sense (Moore, 1988; Sparkes, 2001).

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For where your investment is there your heart will be also (Luke 12:34)

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Chapter 1 Introduction

1.1 Background

This dissertation investigates the emerging area of so called “ethical” investment funds.¹ Ethical (or socially responsible) investment funds have been a rapidly growing phenomenon in Europe in recent decades. In 1964 there were no ethical funds available for public investment anywhere in Europe. Indeed, the first ethical fund available to private investors, Ansvar Aktiefond Sverige, was only launched in Sweden in 1965. It was followed by Svenska Kyrkans Värdepappersfond in 1980.² However the sector remained very small in Europe until the late 1980’s. Only 19 ethical retail funds existed in Europe prior to 1989 (Merlin Research Unit, 1993; NPI, 1995; Carlson, 1999) and of these 13 were based in the UK (Sparkes, 1995).³

The first ethical retail fund in the UK was launched in June 1984 and since then the growth of this sector has been spectacular.⁴ For example, in May 1992 UK ethical funds held assets of £400 million, while by June 1996 the assets of UK ethical funds had increased to £1.1 billion. In June 1998 there were 303,000 unit holders in 38 ethical funds with assets of £2.2 billion (EIRiS, 1997;1998b). By June 2001 the number of unit holders had grown to 492,000 in 60 ethical investment funds with assets of £4.0 billion, according to EIRiS (2002). The geographical coverage of ethical funds is also growing. For example, the first such funds in Finland and Spain were launched as recently as in 1999. Figure 1.1 shows that there were 160 ethical funds in Europe at the end of 1999 and 252 in June 2001.⁵ The assets of these 252 ethical funds amounted to 15.1 billion Euros. However, there is also scope for further growth since domestic ethical funds were not available for private investors in Greece, Ireland and Portugal in June 2001 (Bartolomeo and Daga, 2002). Furthermore, pension

¹ Ethical funds employ non-financial ethical criteria for security selection and therefore some companies are excluded from their portfolios for ethical reasons, see section 1.3 Definitions.

² The term “private investors” refers to individuals as opposed to the term “institutional investors” which refers to organisations. For institutional investors such as Churches and Charities ethical investment has been available longer because they have the money to get financial institutions to tailor the investments for them (Melton and Keenan, 1994).

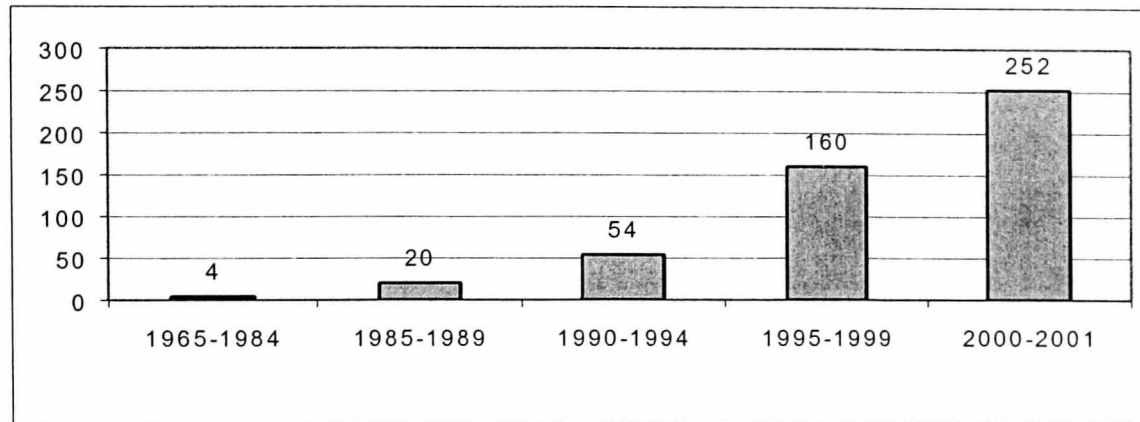
³ A retail fund refers to a fund, which is available to any individual investors.

⁴ Up until 1989, ethical funds were only available in Scandinavia, France and the UK within Europe. The first German ethical fund was launched in 1989 and the first Dutch fund in 1990.

⁵ The growth rate for ethical funds between 1999 and 2001 was 3 times higher than for all funds in Europe (Bartolomeo and Daga, 2002).

funds in many European countries have also started to invest with ethical criteria (UKSIF, 2000).⁶ Some authors have argued that ethical investment by pension funds could greatly increase the size and influence of the ethical investment sector (Friedman and Miles, 2001).

Figure 1.1 Ethical Retail Funds Launched in Europe 1965-2001

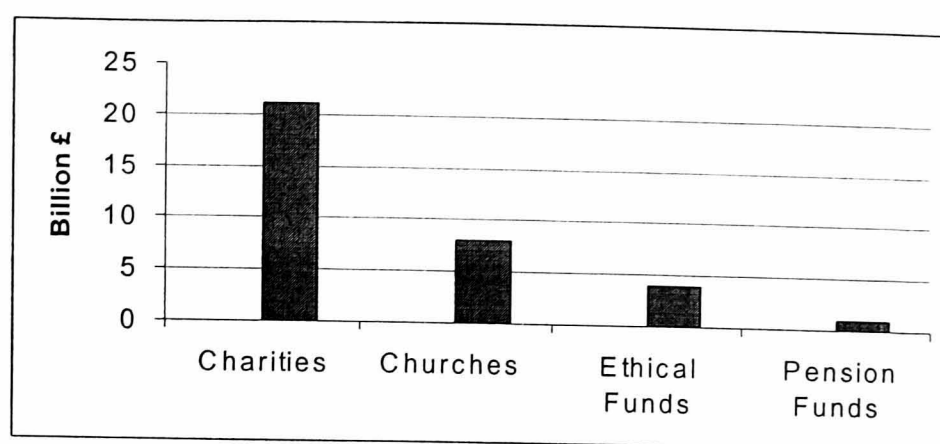


Source: Bartolomeo and Daga (2002). The last column is dated June 2001.

This dissertation focuses on ethical funds available to the public. It is however worth noting that many institutional investors also have ethical policies for their stock market investments. Many of these institutional investors have employed ethical criteria in their investments several decades before retail ethical funds were established. For example, The Church of Scotland Trust has operated an ethical policy since 1932; The Church of England has had ethical criteria for some of its funds at least since 1948 and the Methodist Church has employed ethical screens for its investments since 1960 (Church of Scotland, 1988; Sparkes, 1995). Assets managed by UK Churches under an ethical policy amounted to around £8.0 billion in 2001. Charities had £21.0 billion invested ethically in 2001, but £15.0 billion of these charity funds only avoided investment in tobacco firms (EIRiS, 2002). UKSIF (2000) identified 2 UK pension funds with assets of around £1.0 billion which invest ethically and 8 other pension funds invested a small proportion of their assets in ethical funds.⁷

⁶ For example, Norway, Sweden, The Netherlands and the UK (EIRiS, 1998c; UKSIF, 2000; Bayon, 2001b). In the USA some pension funds have employed ethical criteria and engaged firms on ethical issues for many years (Melton and Keenan, 1994).

Figure 1.2 UK Stock Market Investments with Ethical Criteria in 2001



Sources: UKSIF (2000), Eiris (2002), and interviews with the Methodist Church. Ethical investments by Churches are briefly considered in Chapters 2 and 11.

Figure 1.2 thus presents a figure of £34.0 billion invested on the London Stock Exchange with some ethical constraints in 2001. This figure would increase to at least £200 billion if pension funds mentioning ethical or socially responsible investment and/or engagement in their policy statements would be considered “ethical” (UKSIF, 2000). Sceptics such as Guptara (2000) have claimed that some of these ethical investment policies adopted by pension funds after new disclosure regulation in the UK in July 2000 are rather vague at best.⁸

In other European countries the situation is different from that which pertains to the UK. In continental Europe there are not as many charities as in Britain. Charities are thus not as significant “ethical investors” in continental European markets as they are in the UK. One reason for this is that the state has a greater role in the social welfare systems in these countries. On the other hand some state related organisations would invest some of their assets ethically (EIRiS, 1998c). However, as with the UK, Church investors have played a role in ethical investment in the European countries by investing ethically themselves and by helping to launch many of the early ethical funds.⁹

Despite the growing interest in ethical funds from investors, the number of academic studies of such funds has been limited. Research into ethical funds has

⁷ The pension funds of Shropshire County Council and London Borough of Waltham Council.

⁸ Some publications employing different definitions of “ethical investment” present higher amounts than the £34.0 billion in Figure 1.2 (Sustainability, 2000; UKSIF, 2000).

tended to focus on UK funds alone irrespective of whether fund performance (Mallin, Saadouni and Briston, 1995), ethical criteria (Perks, Rawlinson and Ingram, 1992), case studies of individual ethical funds (Mackenzie, 1997) or the interplay between corporate disclosure and ethical funds have been studied (Harte, Lewis and Owen, 1991).¹⁰ This dissertation aims to contribute to this existing literature by studying ethical funds in the UK and from 7 other European countries.¹¹

The remainder of this Chapter is structured as follows. The next section presents the research question(s). Section 1.3 provides further motivation for the research question(s). Section 1.4 will provide some definitions. Section 1.5 will outline the different research methods employed in the dissertation. Section 1.6 will highlight some of the limits of this dissertation, while Section 1.7 will provide a map of the thesis by briefly discussing each Chapter. Finally, some conclusions are offered in section 1.8.

1.2 Research Question

This dissertation aims to increase our understanding of the phenomenon of ethical funds by analysing the following general research question: **Are European ethical funds “good” investments for an individual investor?** This question is examined primarily in comparison to other stock market investments. The general research question is analysed through three empirical subquestions and one philosophical question. First, the dissertation examines whether ethical fund financial performance is significantly different from market benchmarks. The second empirical question investigates whether ethical fund performance is significantly different from a sample of “matched pair” funds.¹² Third, the processes and strategies adopted by ethical funds in order to integrate ethical concerns into the investment processes are studied in order to evaluate how they

⁹ For example, the Church of Sweden has around £420 million invested ethically and launched an ethical retail fund in 1980 (Church of Sweden, 1996). See also; Church of Finland (1999).

¹⁰ See also: Luther, Matatko and Corner (1992); Luther and Matatko (1994); Gregory, Matatko and Luther (1997) on performance. Other field studies include Cowton (1999) and Friedman and Miles (2001). All these investigations focus on UK funds.

¹¹ These countries are: Belgium, Finland, Germany, Norway, Sweden, Switzerland, the Netherlands and the UK.

¹² The investigations into the financial performance of ethical funds may also be of interest to institutional investors such as charities, churches and pension funds.

differ from those of other funds. Finally, ethical theory and Church doctrine are considered in a tentative analysis of whether these funds are a “good” investment from an ethical point of view. Table 1.1 summarises the research questions and some important publications.

Table 1.1 Research Questions and Key Publications

Are Ethical Funds “good” investments	Key Publications
Compared to stock market benchmarks?	Luther <i>et al.</i> , (1992) Luther & Matatko (1994)
Compared to other funds?	Mallin <i>et al.</i> , (1995), Gregory <i>et al.</i> , (1997)
In terms of investment policies and processes?	Perks <i>et al.</i> , (1992), Mackenzie (1997) Cowton (1999), Friedman and Miles (2001)
In an ethical sense?	Wesley (1760), Frankena (1963), Church of Scotland (1988), Bible (1998), Mills (2000b)

The risk adjusted returns of the ethical funds are seen as the primary determinant of the “goodness” of the investment in the first two empirical questions about financial performance. The third empirical question evaluates the “goodness” of the investment primarily by examining how extensive the policies and processes employed by ethical funds are. The wider field of “ethical investment” is considered when the fourth question of whether ethical funds are “good” investments in an ethical sense is analysed. This last enquiry is not only an empirical question, it is also a philosophical and a theological question.

1.3 Motivation for the Research Questions

Ethical funds typically claim to provide a competitive return, while simultaneously addressing ethical concerns (Carlson, 1999; Murray Johnstone, 2000; Holden & Meehan, 2001). This claim of similar returns to other funds would seem to be inconsistent with modern portfolio theory if these ethical concerns result in a significantly smaller investment universe (Kahn, Lekander and Leimkuhler, 1997). It is therefore of interest to examine if there is a cost to “ethical” investment in the stock market and if such a cost exists, to establish its magnitude. This dissertation investigates empirically whether unit holders of ethical funds have to pay a premium for the ethical strategies employed. If there is no significant cost to integrating some ethical concerns into stock market investments, then there is no financial reason for not extending ones’ ethical

values into stock market investments. If there is a cost to investing in ethical funds, investors can decide for themselves whether or not it is worthwhile to invest in ethical funds depending on their own views. It has also been argued by some that management of ethical and social considerations may improve the economic returns of firms (Bruyn, 1987; Feldman, Soyka and Ameer, 1997; Antonio, Johnsen and Hutton, 2000). Previous research has produced different conclusions on this issue of ethical fund performance.

This issue of the cost (or benefit) of investing in ethical funds is more topical than ever since recent regulatory changes have provided many Europeans with the opportunity to invest in ethical pension funds directly. Pension funds also have the opportunity to invest some of their assets in ethical funds. Indeed, some UK pension funds have done just that (UKSIF, 2000). Since 3 July 2000 all UK private sector pension funds have been legally obliged to disclose whether ethical issues are considered in their overall investment policy or not. The new regulation requires all trustees to add the following two considerations to their fund's investment policy:

(i) the extent (if at all) to which social, environmental or ethical considerations are taken into account by trustees in the selection, retention, and realisation of investments; and (ii) the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments.

This regulation is about consideration and disclosure, not about compulsion, but research has demonstrated that some pension funds have incorporated ethical considerations into their investments principles as a result of this change (UKSIF, 2000; Sparkes, 2001). The University Superannuation Scheme is an example of a British pension fund which has adopted an ethical policy (UKSIF, 2000). The question of whether ethical funds are "good" investments financially would thus seem topical for both private and institutional investors. Although financial performance is important in evaluating ethical funds, it has also been argued that addressing ethical concerns is an essential characteristic of such funds (Sparkes, 2001). The latter two research questions explore these issues.

Ethical funds claim that they consider ethical issues relating to how the financial returns are generated by their investee firms (Friends Provident, 1998). Therefore, it is relevant to investigate to what extent the ethical policies and processes employed by ethical funds differentiate them from other funds.¹³ These policies and processes are investigated using a field study approach. This research provides insights into the stock selection processes which generate the outcomes in the financial performance studies. Such field research into ethical funds has been advocated by Lewis and Cullis (1990), Harte *et al.* (1991) and Friedman and Miles (2001). The findings then inform an analysis of whether ethical funds are “good” investments in an ethical sense.

Individuals fortunate enough to have surplus funds face the question of how to use their money. At the same time, various ethical theories claim that ethics must be applied to all areas of life, including investments (Jacob, 1979; Boatright, 1999; Warburton, 1999; Cowton, 2002). Institutional investors such as Christian Churches have therefore integrated some of their ethical values into their investment strategies for many decades.¹⁴ More recently Charities and pension funds have also started to adopt ethical policies when allocating their monies (EIRiS, 2002). Indeed, these Churches and NGOs have encouraged their members to invest in ethical funds (Church of Scotland, 1988; EIRiS, 2000; Mayo and Doane, 2002). It has also been demonstrated that ethical issues themselves are important to most individuals who choose to invest in ethical funds (Inskeep, 1992; Lewis and Mackenzie, 2000; Woodward, 2000). Furthermore, EIRiS (1998b; 1999b) argues that the majority of people in Sweden and the UK want their pension fund to operate an ethical policy if it does not significantly reduce the financial return. Ethical funds is therefore an area where both ethical and financial theory are relevant (Lewis and Cullis, 1990). Mackenzie (1997) suggested the use of ethical theory and Church

¹³ It has been suggested that some ethical funds may be “conventional funds in disguise” (Bauer, Koedijk and Otten, 2002).

¹⁴ These investments are used for staff salaries and pensions and maintenance of buildings. Many local Churches have no funds to invest (Laughlin, 1988; Church of Finland, 1999).

doctrine for evaluating ethical funds.¹⁵ This recommendation is followed in Chapter 11, where ethical funds are analysed from a moral point of view.

1.4 Definitions

The term “ethical fund” actually includes investments with a diverse set of aims and objectives.¹⁶ Some funds do not hold shares in firms which operate in, for example, the alcohol, pornography, tobacco and weapon industries, while others avoid the purchase of equities of firms with poor environmental track records. A number of ethical funds also employ positive ethical criteria emphasising investment in companies with a good record in community involvement and provision of positive products and services (EIRiS, 1998). What characterises these funds is that the maximisation of the financial returns is not their sole aim. Rather, they offer investors the chance to invest in a menu of securities which might accord more with their ethical beliefs and values. Whatever these differences, this dissertation defines as ethical those funds **which, in addition to conventional financial criteria, in their security selection also employ one or more ethical criteria such that some companies are excluded from their portfolios for ethical reasons.** These funds also marketed themselves as “ethical” or “environmental”.¹⁷ Similar definitions are offered in EIRiS (1998) and Bartolomeo and Daga (2002). All funds which do not meet this definition are grouped together as “non-ethical” funds. Ethical funds are sometimes referred to as “socially responsible”, “sustainable”, “green” or “environmental” funds. If such funds meet the definition above they are included here as ethical funds for the purpose of this dissertation. There are also funds donating some proportion (generally less than 2%) of their annual returns to charity. Such funds are not considered ethical unless they also implement some ethical criteria when selecting securities. Further information on these different types of ethical funds is supplied in Appendix 1.1.

¹⁵ The Churches are the largest ethical investors in many countries and were involved in launching many of the sample ethical funds (Sparkes, 1995; Church of Finland, 1999).

¹⁶ Rockness and Williams (1988), Harte, Owen and Lewis (1991), Perks, Rawlinson and Ingram (1992), Gray, Owen and Adams (1996), Mackenzie, (1997), EIRiS (1998), Cowton (1999) and SustainAbility (2000) have investigated issues such as the criteria employed by ethical funds for security selection and the operation of such funds.

¹⁷ The UK Ethical funds in Chapters 6, and 9 were classified as ethical by EIRiS and Standard & Poor’s Micropal. The Belgian and Dutch funds were classified as ethical by Ethibel and VBDO. The German and Swiss funds were labelled ethical by Deml and Baumgarten (1998).

It was noted in section 1.2 that ethical investment in the stock market is undertaken by many actors other than the ethical funds available to the public, which are the primary focus of this dissertation. Examples of such institutions include some Charity, Church and pension funds which employ ethical criteria in their investment process. In addition to the debate about what an ethical fund is, there is a discussion about the meaning of the wider term of “ethical investment”. For example, Shepherd (1999) argues that “Ethical investment means exercising responsibility as investors for the social and environmental consequences of wealth creation (p.1)”.¹⁸ She further argues that in addition to the ethical criteria mentioned in the definition of an “ethical fund” provided in this section, ethical investment embraces “shareholder influence and socially responsible venture capital and property investment”. Thus Shepherd (1999) makes it clear that, in her view, ethical investment is neither limited to the stock market nor to investment in firms.¹⁹

A second definition is provided by Cowton (1999) who defines ethical investment as “a set of approaches which include social or ethical goals or constraints as well as more conventional financial criteria in decisions over whether to acquire, hold or dispose of a particular investment”. This definition specifically mentions ethical goals in addition to financial aims for the investment. Three components of ethical investment are identified in a document by the Catholic Bishops (1992). These are (i) avoiding participation in harmful activities (ii) actively pursuing good and (iii) using shareholdings for social stewardship. These approaches are used by ethical funds and will be discussed at greater length in Chapters 9 and 10. The second strategy of “actively pursuing good” can be implemented by investing in firms which meet positive ethical criteria and by “alternative investments”. Typical examples of such alternative investments include low cost housing for the poor, financing fair trade and small scale enterprises (CEIG, 1992; Melton and Keenan, 1994). These alternative investments are not chosen because of financial returns, but because they “produce some truly significant social good” and/or express

¹⁸ Penny Shepherd was at the time executive director of the UK Social Investment Forum (UKSIF). Most of the UK ethical funds are UKSIF members.

¹⁹ Similar views are put forward by Domini (2001) and Lydenberg (2002).

concern for the poor (Catholic Bishops, 1992). Because this dissertation focuses on ethical funds, which invest primarily on stock markets, these alternative investments will only be considered briefly in Chapter 11.²⁰

Some authors have claimed that investment in unit trusts is not ethical, regardless of the type of fund involved, while others have argued that the term “ethical investment” should be reserved primarily for investments made by charities, churches and NGOs in accordance with their ethical aims (Moore, 1988; Anderson *et al.*, 1996; Sparkes, 2001). By contrast, other sources define “ethical investment” as virtually synonymous with ethical funds (Cooper and Schlegelmilch, 1993; Cowton, 1994; New Oxford Dictionary of English, 1998).

There are thus many conflicting views on the definition of “ethical investment”. The view at the outset of this dissertation is that while ethical funds can be defined as “ethical investments”, this does not automatically mean that all ethical funds are ethical investments.²¹ The importance of the definitions of ethical investment provided by Shepherd (1999) and others is that they explicitly recognise that ethical funds and investment in company shares are only one part of “ethical investment”. For this dissertation a modified version of the definition of ethical investment provided by Cowton (1999) is adopted with some qualifications.²² **Ethical investment is a set of approaches which include ethical or social goals as well as more conventional financial criteria in decisions over whether to acquire, hold or dispose of a particular investment.** The following qualifications apply. Firstly, the terms “social” or “ethical” include environmental considerations. Secondly, the set of approaches include “alternative investments” which are also referred to as “community investment” or “socially directed investment” (Catholic Bishops, 1992; Domini, 2001; Sparkes, 2001). Thirdly, ethical investment considers the interest of both the investor and the investee; the personal and economic welfare of both are

²⁰ Such alternative investments are often pursued by organisations which are not firms such as The Ecumenical Development Co-operative Society (Church of Scotland, 1988). All major Churches have also directly engaged in such alternative investments (Melton and Keenan, 1994).

²¹ This question will be analysed further in Chapter 11 using ethical theory and Church doctrine.

²² The words “or constraints” are dropped from the original definition because viewing ethical goals merely as a constraints to financial goals can imply the financial aims are always primary in ethical investment and this can be problematic from an ethical point of view (Dobson, 1993).

important (Bruyn, 1987). Finally, the main use of the term “ethical investment” in this dissertation refers to investment in company shares, but ethical investment can comprise investment in many other things such as education, real estate and organisations other than firms (Church of Scotland, 1988; Shepherd, 1999). Different theories of what is ethical are outlined in Chapter 3, therefore the meaning of ethical will not be considered further in this Chapter.

This analysis leads to a discussion of the meaning of the term investment itself. The New Oxford Dictionary of English (1998) defines **investment** as (i) “**the action or process of investing money for profit or material result**” and (ii) “**a thing that is worth buying because it may be profitable or useful in the future**” and (iii) “**an act of devoting time, effort, or energy to a particular undertaking with the expectation of a worthwhile result**”. The first part of the definition is the typical use of the word investment in finance and would apply to any stock market investments. For example, Copeland and Weston (1988) argue that in a simple economy, the decision not to consume now in order that more can be consumed in the future is the same as investment. A similar definition with a stronger emphasis on money and a more explicit recognition of risk is provided by Sharpe, Alexander and Bailey (1999). Furthermore, they distinguish between real (or capital/productive) investment and financial investment (Bruyn, 1987; Church of Scotland, 1988; Sharpe *et al.*, 1999). **Real investment** refers to committing resources to purposes such as the construction of buildings or the provision of industrial or commercial equipment such as machinery. Such resources have to be held back from immediate consumption and firms raising such capital often either borrow from banks or issue securities on the stock exchange. **Financial investment** refers to buying securities traded on a stock exchange. Examples of such securities include debt or equity issued by firms or bonds issued by governments and local authorities. When funds are subscribed for a new issue there is often some corresponding real investment, but most trading in these listed securities is in existing or “old” shares without any related capital investment. Unit trusts including ethical funds typically engage in financial rather than real investment.²³ The second part of

²³ By contrast alternative or socially directed investment is often capital investment directly into physical assets such as housing for the disadvantaged (CEIG, 1992).

the definition is also relevant for this dissertation as ethical funds are expected to deliver future benefits for their unit holders. The third part is interesting since it makes clear that consumption and money are not necessarily a part of investment. The investment may consist solely of time and effort. It could (to some extent) embrace charity which involves “helping those in need” on a voluntary basis, although charity does not necessarily require a result as investment does. This dissertation adopts the New Oxford Dictionary definition with the clarification that a “material/worthwhile result” can include desirable ethical outcomes. For further discussion on ethical and social issues and investments see Bruyn (1987); Church of Scotland (1988) and Owen (1990).

1.5 Methods Employed

This dissertation aims to investigate whether ethical investment funds are “good” investments for an individual investor, primarily in comparison to other stock market investments. This question is partitioned into two empirical research areas. The first area examines whether ethical funds are “good” investments financially. This is done using well established quantitative risk-adjusted performance measures. The second area examines the ethical fund processes which generate the outcomes observed in the first area. This second study of the processes underpinning ethical fund operations employs qualitative field research to examine whether ethical funds are “good” investments when compared with other stock market investments in terms of their ethical criteria and their processes. Finally, some ethical theories are presented, assumptions underpinning these theories are outlined and the theories employed to evaluate whether ethical funds are “good” investments in terms of various ethical perspectives.

1.6 Scope of the Dissertation

This dissertation focuses mainly on stock market investments or financial investments. Furthermore, this dissertation focuses on ethical retail funds and deals only briefly with ethical funds managed by institutional investors. Church investors are considered briefly in Chapters 2 and 11, because such religious investors have influenced the ethical criteria adopted by ethical retail funds and various denominations had a role in establishing many of the sample funds.

The research undertaken focuses on Europe and the following countries in particular: Belgium, Finland, Germany, Norway, Sweden, Switzerland, The Netherlands and The UK. Ethical funds from other countries are only briefly mentioned. From these countries 43 ethical funds have been studied in depth, the main focus of the investigations was on funds launched before January 1996. A few exceptions to this rule were allowed, in the field study because most European ethical funds existing in 2002 were only launched in 1999 or later (Bartolomeo and Daga, 2002).

1.7 Plan of Thesis

The remainder of this dissertation is structured as follows. Historical information about the development of ethical funds in Europe, the ethical criteria they employ in security selection and some key support organisations are presented in Chapter 2 as background for the empirical investigations and later ethical analysis. A number of ethical theories are presented in Chapter 3. One such theory, utilitarianism is the ethical foundation of much economic theory including portfolio theory (Markowitz, 1991; Boatright, 1999). Economists, philosophers and theologians have pointed out severe problems with utilitarianism (Hay, 1989; Geisler, 1994; Warburton, 1999). Other ethical theories such as Kantian ethics and the Judeo-Christian ethic of agapism are also presented in Chapter 3.²⁴ These theories are employed in Chapter 11 to analyse the philosophical and theological question of whether ethical funds are good investments from a moral point of view. Chapter 3 also reflects on financial markets and ethics. Chapters 1-3 thus serve as background and an introduction to the rest of the dissertation. These Chapters form part A of the dissertation.

The first research area of this dissertation, which studies the financial performance of ethical funds forms section B of the dissertation. This section begins with a literature review of fund performance studies in Chapter 4. This literature review focuses particularly on studies which developed the performance measures employed in this dissertation and on studies of ethical

²⁴ Frankena (1963) presents agapism as a Judeo-Christian love based ethic. Agape is a Greek word for love in the context of a lasting relationship.

fund performance. The method and the performance measures employed to analyse ethical fund performance are outlined in Chapter 5. Ethical fund performance is evaluated by risk adjusted performance measures against an international, UK and domestic benchmarks in Chapter 6. In order to mitigate any benchmark problems ethical funds are compared against non-ethical funds of similar age, size and investment universe in Chapter 7. Both the stock selection and the market timing ability of ethical and non-ethical funds are also evaluated in Chapters 6 and 7. The quantitative study of ethical fund financial performance comprising Chapters 4-7 form section B of the dissertation. This section thus provides answers to the two empirical research questions about ethical fund financial performance.

The second research area of the dissertation which studies the policies and processes of ethical funds forms part C of the dissertation. This part begins with an introduction to the field study in Chapter 8. This Chapter also details some philosophical assumptions underpinning the theories in Chapter 3 and the research in Chapters 6-7 and 9-10. A section of Chapter 8 also details the different assumptions underpinning the agape based ethic and the Church perspectives employed in Chapter 11. The detailed method of the qualitative study is presented in Chapter 9. This Chapter also presents some findings from the field study including the main strategies and ethical criteria employed by the sample funds. Further research results regarding the processes employed by ethical funds, their limitations and possible conflicts between ethical and financial aims are outlined in Chapter 10. The qualitative section comprising Chapters 8-10 answers the question of whether ethical funds are good investments in comparison to other stock market investments in terms of policies and processes for dealing with ethical issues. These Chapters form section C of the dissertation.

This dissertation employs both quantitative and qualitative research in order to answer the research question(s). Such an approach has been advocated by Jick (1979); Yin (1994); Silverman, (1997) and used in accounting and finance by Mallin (1995); Gillan, Kensinger and Martin (2000) and Christie and Marshall (2001). Methodological issues are discussed further in Chapters 8 and 9.

The last part of the dissertation provides a tentative analysis of the fourth question of whether ethical funds are good investments from an ethical point of view. Ethical theories and Church doctrine are employed in Chapter 11 to analyse whether ethical funds were a “good” investment from a philosophical and theological point of view. Such an approach has been advocated in Mackenzie (1997) and is based on the history of ethical funds (Melton and Keenan, 1994; Sparkes, 1995; Hancock, 1999) the culture of the countries studied (Johnstone and Mandryck, 2001; Stulz and Williamson, 2001) and findings from the field study. Finally, the dissertation is concluded in Chapter 12 which brings together the issues raised in previous Chapters in order to answer the research question(s). These two Chapters form section D of the dissertation.

1.8 Conclusions

This Chapter and Chapter 2 provide an introduction to the research area of this dissertation; ethical investment funds in Europe. This dissertation is multidisciplinary due to the nature for the research area and research questions. It draws on literature from accounting, finance, philosophy and theology. Because of the multidisciplinary nature of the subject there are many different definitions of “ethical investment”. Some of these definitions were discussed and definitions for for this dissertation were provided. This research on “ethical funds” seems timely because of the reforms of pension investments in Europe and the general increase in interest in “ethical” investment on the stock market. The next Chapter provides a history of ethical funds in Europe.

Chapter 2 History and Criteria of Ethical Funds

2.1 Introduction

The previous Chapter introduced the research area of ethical investment funds and provided some definitions that are employed in the literature. This Chapter builds on that foundation by tracing the historical development of this form of investment. In order to be able to understand the ethical fund research area one has to be familiar with the roots of this investment category. In addition to secondary sources; this Chapter also summarises interviews with key people and organisations in this field of investment, especially two key individuals: Charles Jacob and Tessa Tennant. Charles Jacob was the originator of the concept for the first UK ethical fund, Stewardship, dating back to 1973 while Tessa Tennant was co-founder of the Merlin Ecology Fund in 1988, the oldest environmental fund available in Europe.²⁵ The insights supplied by both of these individuals should supplement the literature on how ethical funds came to be established and why they have grown so quickly over the last two decades.²⁶

Although European developments in the ethical fund sector are considered, the current Chapter has a UK focus. This choice is motivated by the fact that the UK has a longer history of ethical funds than most other countries. In addition, the UK has the largest number of ethical funds in Europe with far more assets under management than in any other European country (Avanzi, 1999).

The structure of this Chapter is as follows; in the next section the roots of ethical funds are presented. Section 2.3 provides a history of the ethical funds, while section 2.4 considers the development of some organisations associated with the sector. The various ethical criteria employed by the funds are discussed in section 2.5. Finally, conclusions are offered in section 2.6.

²⁵ Friends Provident Stewardship founded in June 1984 is the oldest ethical fund in the UK and with more than £680 million under management in early 2001 it is the largest ethical fund in Europe. Jupiter Ecology launched in April 1988 as Merlin Ecology is the oldest environmental fund in Europe and one of the largest with £130 million under management (Pridham, 2001). The Merlin Ecology fund has since 1989 been known as the Jupiter Ecology fund.

²⁶ An oral history approach was followed “by providing a first-hand account from someone who witnessed and experienced specific events...can make the written record come alive” (Collins and Bloom, 1991). The method is presented in Chapter 9 and results from interviews of ethical fund managers are provided in Chapter 10.

2.2 The Roots of the Ethical Fund Sector

In Europe, as in North America, the ethical investment movement has its roots in the Judeo-Christian tradition (Simpson, 1991; Harrington, 1992; Melton and Keenan, 1994; Sparkes, 1995). There is a substantial amount of instruction on ethical issues relating to economic matters in the book of Deuteronomy, dating back more than 3000 years (Gorringe, 1989). Famous examples of Christian groups who followed this instruction and invested ethically include the Methodists and the Quakers (Hancock, 1999; Shepherd, 2000).²⁷ In the UK, for example the two insurance companies Friends Provident (FP) and National Provident Institution (NPI) were established by Quakers in 1832 and in 1835.²⁸ These two institutions are leading providers of ethical funds.²⁹

Friends Provident was originally solely a Quaker institution and for more than 140 years avoided investments in alcohol, gambling and tobacco following Quaker beliefs. Shares in these sectors are often termed “sin stocks” due to the views of many church investors (Kinder *et al.* 1993; Melton and Keenan, 1994; Mackenzie, 1997a). In addition Friends Provident avoided investment in armaments following pacifist Quaker beliefs. In 1980 the board of Friends Provident, which was by then mostly secular, removed the restriction on investments in alcohol, gambling and tobacco.³⁰ This process continued and in 1983 the restriction on investments in armaments was abolished. In 150 years Friends Provident had moved away from its roots to the extent that its ethical investment policy was abandoned. Three Quaker directors resigned as they did not agree with these decisions.³¹ In order not to break the link with the “Friends”³² completely the board decided to set up the first UK ethical fund;

²⁷ An early issue was slavery in North America. By 1784, all Quaker meetings declared that every member who persisted in owning slaves would be disowned or dismissed from the society. This was a costly and unusual stance at the time (Melton and Keenan, 1994, p.171).

²⁸ The name Friends Provident comes from the Society of Friends, that is the Quakers.

²⁹ According to Boyle (1999) Friends Provident Stewardship was the largest ethical fund in Europe, while Mackenzie (1997) reports that in 1996 more than half of the UK assets in ethical funds were in the Stewardship range of funds. According to EIRiS (1998), 4 of the 32 ethical funds available in the UK in 1997 were provided by NPI and the main Global Care fund had more than £200 million under management in early 2001, making it one of the UK’s largest ethical funds (Pridham, 2001).

³⁰ Until 1918 the board was comprised solely of Quakers and up to 1975 it was requirement that the majority of the board of Friends Provident were Quakers (Mackenzie, 1997).

³¹ FP had 2 Quaker directors left at the end of the year 2000 (interview with FP 16.10.2000).

³² The Quakers call themselves Friends.

Stewardship. This allowed Friends and other investors concerned about ethical issues to “invest ethically” while not requiring Friends Provident as a whole to adhere to these principles (Mackenzie, 1997).³³ The first ethical fund in the UK was thus launched by Friends Provident in June 1984.

Similarly, Methodists have taken a strong stance avoiding products related to addictions such as alcohol and tobacco, while evangelical Christians have opposed gambling for many years (Kinder and Domini, 1997).³⁴ These decisions go back to a sermon on “the use of money” by John Wesley, which was first published in book form in 1760. In this sermon a number of areas to be avoided were mentioned including activities that harm the health of the body or the mind. Indeed, Wesley points out that Christians “may not engage or continue in any sinful trade” (p.579). The Methodist Church in the UK set up a fund in 1960 which avoided investments in sectors such as: armaments, alcohol, gambling and tobacco.³⁵

Similarly the Church Commissioners of the Church of England have employed some ethical criteria³⁶ when deciding on their investments since 1948, but again this was mainly available for Church funds (Sparkes, 1995). In 1999 the funds managed with ethical criteria for the Church of England totalled £6.5 billion (Church of England, 2000).³⁷ The funds managed for the Church of Scotland have similar ethical criteria to those employed by the Church of England and the Church of Scotland Trust dates back to 1932 (Church of Scotland, 1988). In total Churches and Charities had £23.5 billion invested ethically in 1999 compared to £3.2 billion in the ethical funds (Sparkes, 1999). Indeed, it has been suggested that one motivating factor for financial institutions when launching

³³ This is identified as a major ethical problem in Lang (1996) which details holdings in tobacco and weapon companies by other Friends Provident funds (p.62-63).

³⁴ According to Kinder *et al.* (1993) the first fund in the world with ethical criteria, The Pioneer fund which was launched in 1928 “served evangelical Protestants in the United States who opposed consumption of alcohol and tobacco”(p.13) and avoided gambling (Harrington, 1992).

³⁵ This fund was not available to the general public (Jacob, 1996). The assets of this fund amounted to £10 million in 1972 and £527 million in 1994 (Sparkes, 1995, p.176), while total assets in all ethical funds in July 1994 amounted to £700 million (EIRiS, July 1997).

³⁶ The criteria included avoidance of: alcohol, armaments, gambling, newspapers, pornography and tobacco, but some defence contractors were allowed (Church of England, 1998). In 2000 the Church of England sold its holdings in British Aerospace (EIRiS, September, 2000).

³⁷ The assets of all UK ethical funds at the time was £2.6 billion (EIRiS, December, 1999).

ethical funds may have been to enhance their ability to compete for Church and Charity funds (Cowton, 2000).

Other suggested influences on the growth of ethical funds relate to changes in society in terms of institutionalisation of share ownership (Simpson, 1991).³⁸ The institutionalisation relates to the fact that direct individual share ownership has diminished dramatically in the UK (Sparkes, 1995), while institutional shareholdings have increased. This has led to a monitoring problem for individuals. If one holds shares in a few companies some monitoring may be possible, but if one has invested in a few unit trusts there may be hundreds of companies which are changing continually. Monitoring becomes difficult and this may for some result in a desire for an assurance that the investment process is handled in “an ethical manner”.³⁹ Another factor is the rise of non-governmental organisations (NGOs), particularly those concerned with the environment and human rights (Kinder and Domini, 1997; Shepherd, 2000). Some of these NGOs have recently advised their members to invest in ethical funds (EIRiS, 2000). These will be briefly considered in the next section which examines the history of the ethical funds in greater depth.⁴⁰

2.3 A History of Ethical Funds in Europe

The first ethical fund in Europe which was available to all investors was Ansvar Aktiefond Sverige in Sweden. This fund, which still exists today, was established in 1965 by the insurance company Aktie-Ansvar. Some Churches in Sweden such as the Baptists and the anti-alcohol movement were involved in the start up of this fund (Aktie-Ansvar, 1999).⁴¹ This Swedish fund is six years older than the US based Pax World fund, set up in 1971 by Methodists and Quakers and sometimes mistakenly referred to as the first ethical retail fund.⁴²

³⁸ See Appendix 2.1 for the changes in UK share ownership.

³⁹ The portfolios of some (ethical) funds such as Friends Provident Stewardship and CIS Environ contain more than 100 companies.

⁴⁰ Local authority pension funds and institutions related to trade unions have also had some influence on “ethical investment in the stock market”. As the ethical investment conducted by these institutions in most cases is more narrow in focus and of a more recent origin than the ethical funds they will not be considered in this Chapter (Melton and Keenan, 1994).

⁴¹ Aktieansvar was the insurance company of the anti-alcohol movement, hence the avoidance of alcohol was important. The tobacco and weapons criteria reflected concerns of the Churches.

⁴² Indeed, other American Christians such as Evangelicals and Quakers had launched ethical funds in 1928 and in the 1950’s, but these funds were not widely known to be ethical funds (Melton and Keenan, 1994, p.38).

The Church of Sweden has also been a pioneer in the development of ethical investment funds. Together with the financial institution, Robur, the Church of Sweden launched Svenska Kyrkans Värdepappersfond (Church of Sweden Equity Fund) in 1980. This fund is available to the public and is thus the second oldest ethical fund in Europe. The fund avoids investments in the alcohol, armaments, gambling and tobacco industries.⁴³

The first ethical fund in France, Nouvelle Strategie was started in 1983 by Nicole Reille, the finance officer of the Notre-Dame Order in Paris. It mainly served the needs of the Catholic Church and Quakers but non-religious investors were also encouraged to invest in the fund. This fund avoided “sin stocks”, pornography, weapons and nuclear power in addition to employing some positive criteria (NPI, 1995: Politische Ökologie, 2000).

In Germany some of the early ethical funds were launched by local Church banks (Kirchenbanken). Examples include the KD Fonds Ökoinvest launched in 1991 and the Luxinvest Oekolux ethical fund founded in 1992 (Deml and Baumgarten, 1998, p.57,181). The theologian and Greenpeace activist Dr Homolka was involved in the launch of the ethical fund HYPO Umweltfonds in 1990 aimed at Church investors and the environmental movement, but this fund was later merged with the oldest environmental fund in Germany, HYPO Eco tech, which was launched in April 1990 (Deml and Baumgarten, 1998, p.179).

In the Netherlands the first ethical fund available to the public was ABF het andere beleggingsfonds; it was launched in October 1990. As in Sweden, the demand came from the Churches – which still directly own 25% of the fund assets of ABF – and the environmental movement.⁴⁴ Table 2.1 provides the names and launch years of some of the first ethical and environmental funds in Europe. The table shows that ethical funds became common in Europe only in the 1990’s and that ethical funds are older than the environmental funds.

⁴³ The Church of Sweden and Robur have launched at least four other ethical funds in addition to Svenska Kyrkans Värdepappersfond. An indication of the significance of the ethical matters for these early Swedish funds may be that Aktie-Ansvar and the joint venture between the Church of Sweden and Robur only offer ethical funds; ethical funds are not seen as a niche product along many non-ethical funds.

⁴⁴ These points emerged in an interview with Mr Engelsman, President of ABF in October 2000

Finland provides an example of how recent the history of ethical funds is outside the Anglo-American world. The first two ethical funds were both launched in 1999. Gyllenberg Forum was launched after 5 years of planning by the small asset management company Gyllenberg. The Church of Finland had been a long time customer and pledged to invest in the fund. The second ethical fund Leonia Arvo was also launched in co-operation with the Church of Finland by the bank, Leonia; in addition to avoiding “sin” stocks the fund only invests in companies included in the Dow Jones Sustainability Index. The main investor in the Finnish ethical funds is the Church of Finland (Kuisma, 2001).

Another example is Spain where the first environmental technology fund: Tren was launched in 1993 and the first ethical fund: Fondo Etico was launched in 1999. Fondo Etico was developed by the independent broker firm Ab Asesores, which was later taken over by Morgan Stanley Dean Witter. This fund is promoted by a fair-trade organisation similar to Oxfam in the UK.⁴⁵

Table 2.1 A List of the First European Ethical and Environmental Funds

COUNTRY	TYPE OF FUND	FINANCIAL INSTITUTION	NAME OF FUND	START YEAR
Sweden	Ethical fund	Aktie-Ansvar	Aktiefond Sverige	1965
France	Ethical fund	Association Ethique et Investissement	Nouvelle Strategie	1983
UK	Ethical fund	Friends Provident	Stewardship	1984
UK	Environmental	Merlin / Jupiter	Ecology	1988
Sweden	Environmental	Carlson	Världsnaturfonden	1988
Luxembourg	Bond fund	Luxinvest	Securarent	1989
Norway	Environmental	Skandia / Vesta	Grønt Norge	1989
Scotland/UK	Ethical fund	Scottish Equitable	Ethical	1989
Germany	Environmental	Hypobank	Eco-tech	1990
Netherlands	Ethical fund	ABF	Het Andere Beleggingsfonds	1990
Switzerland	Environmental	Credit Suisse	Oeco Protec	1992
Belgium	Environmental	KBC	Eco fund	1992
Spain	Environmental	Tren	Tren	1993
Finland	Ethical fund	Gyllenberg	Forum	1999
Spain	Ethical fund	Ab Asesores	Fondo Etico	1999

The first column refers to the country where the fund was launched, while the third refer to the name of the fund.⁴⁶ The table only lists the first ethical and/or environmental fund of a country.

⁴⁵ The Catholic Church had invested ethically prior to this. Initial criteria of Fondo Etico included avoiding: military, nuclear power and tobacco. Later babymilk sales in the 3rd world and transgenic animals were added (personal communication with Pau Vidal, Fondo Etico).

⁴⁶ In two cases, the funds and their names have been changed: Vesta Grønt Norden initially invested only in Norway and was first called Skandia Grønt Norge, while Oeco Protec was

In the UK, Charles Jacob, who became the first Methodist fund manager in 1972, had been asked by many other Methodists about the possibility of investing ethically in the late 1960's and early 1970's.⁴⁷ At this time there were no ethical funds available to the public in the UK. Jacob had studied developments in America where Methodists and Quakers had set up the PAX World Fund in 1971, motivated by concerns relating to the armaments industry and the Vietnam war (Harrington, 1992; Kinder and Domini, 1997).⁴⁸ The first application to the Department of Trade for the establishment of an ethical unit trust in the UK was made in 1973 by Charles Jacob, Jeremy Edwards and Richard Rowntree.⁴⁹ The fund carried the name of "Stewardship" from the parable of the talents in Matthew's Gospel (Matthew 25:14-19). The proposal was turned down, because of a possible conflict between capital and conscience; the fund would have invested in companies which were "of benefit to the community". As a result, sectors such as armaments, breweries, gambling, tobacco and companies with a substantial involvement in countries with oppressive regimes (eg, at that time, South Africa) were excluded from the investment universe. The original proposal also detailed an engagement approach: "By using votes and influence to support and provide encouragement to companies fulfilling a useful purpose" (Stewardship Fund Proposal 1973).⁵⁰

A new application was submitted in 1976, but this was also turned down by the Department of Trade and Industry for the same reason as the first, a perceived conflict between ethical and financial objectives. In 1978 a third application was made, this time supported and despatched under the signature of Sir

initially an environmental technology fund but has now adopted a best in class approach and been renamed CS Eco-efficiency. Merlin merged with Jupiter in 1989 and the Skandia funds are now called Vesta. Funds marked with * are registered in Luxembourg. Ab Asesores was later acquired by Morgan Stanley Dean Witter.

⁴⁷ As Jacob (1996) reports: "Indeed it was the Church's attitude to investments that had a profound effect on my thinking which was accentuated as various ministers and others approached me seeking the means to invest in a similar ethical fashion."

⁴⁸ The Pax World Fund was registered 1970 and launched in 1971 (Harrington, 1992). It was one of the first ethical funds in North America. No Wall Street financial institution was willing to launch this fund (Jacob, 1991).

⁴⁹ Jeremy Edwards was later active with the Henderson Ethical fund that was launched in 1991.

⁵⁰ The original Stewardship proposal dated 24.9.1973 is presented in Appendix 2.2.

Nicholas Goodison, Chairman of the London Stock Exchange.⁵¹ After considerable work and a lot of correspondence preliminary approval was given in 1979. As the Stewardship fund was to be a joint venture between Sir Nicholas Goodison's firm – Quilter Goodison – and Charles Jacob's – Linvest Securities – a further delay in launching the fund was caused by the difficulties in finding a suitable fund manager. Due to rapid expansion of funds under management and minor health problems Charles Jacob was unable to be the manager of Stewardship, as he was the investment manager for the Central Finance Board of the Methodist Church from 1972-1987. In 1983 Friends Provident agreed to launch a Stewardship fund and the fund was launched in June 1984. Charles Jacob was on the committee of reference for this fund from 1984-1999 and has been described as the father of Stewardship (Sparkes, 1995). Initially City colleagues were sceptical. Some of them suggested that the fund will, “never get pass £2 million” and called the Stewardship fund “the Brazil fund”, because the idea was so “nutty”.⁵² Early in 2001 the fund was the biggest ethical fund in Europe with £680 million in the original fund and £1.4 billion in the Stewardship range of funds (Pridham, 2001). As the Stewardship fund is the biggest and the oldest ethical fund in the UK it has had a major impact on the industry (Mackenzie, 1997). Indeed many of the fund managers interviewed for Chapter 9 mentioned that it was used as a benchmark against which they judged their criteria, processes and performance.⁵³

Examples of other early UK ethical funds with a religious background include the Credit Suisse Fellowship Trust; the Allchurches Amity and the NPI Global Care funds. Credit Suisse based their Fellowship fund which was launched in 1987 on 40 years of experience in investing money for religious organisations with ethical restrictions (Simpson, 1991). The Allchurches Amity fund launched in 1988 was offered through the Ecclesiastical Insurance Group (EIG) which was founded in 1887 to meet the financial needs of the Church of England and

⁵¹ Sir Nicholas Goodison retained an interest in the area through the TSB Environmental Investor fund, launched in 1989. The first environmental fund to be launched by a major bank (Jacob, 1991). This fund is now called the Scottish Widows Environmental Investor.

⁵² These quotes are taken from an interview with Charles Jacob, November 2000. According to the WM Company (1999) the Stewardship fund had outperformed the Financial Times All Share Index from 1984-1999.

its clergy.⁵⁴ NPI had been founded by Quakers in 1835 and launched its first ethical fund in 1991. However, it was not before the environmental research team from Jupiter Ecology moved to NPI in 1994 that a strong emphasis on the ethical funds started with three more ethical funds launched within 2 years.⁵⁵

A second key influence on ethical investment was the environmental movement. The movement increased in strength and received increasing media coverage during the 1980's. Important events included the Bhopal toxic gas calamity in 1984, the Chernobyl disaster in 1986,⁵⁶ publication of the influential Brundtland Report in 1987 and a speech by the Prime Minister Margaret Thatcher in which the environment was given more prominence in 1988. Indeed, Shepherd (2000) argued that the increase in combined UK membership for Greenpeace and Friends of the Earth from 50000 in 1981 to 550000 in 1993 may have been a factor contributing to the growth of ethical investment funds. However, research by Friends Provident into the profile of investors in their ethical funds, showed that members of these environmental groups were not significant as investors in the Friends Provident ethical funds.⁵⁷ The 1980's witnessed the rise in "ecological and ethical" consumerism and ethical funds can be seen as a part of this movement (Harte *et al.* 1991; Gray *et al.* 1996). These and other factors may have contributed to the launch of many environmental funds in Europe in the late 1980's and early 1990's.⁵⁸

Tessa Tennant had studied the American scene by developing methods for evaluating company environmental performance for a leading US ethical fund research organisation in the latter half of 1980's. She returned to the UK in 1987 with the idea of starting an environmental fund. After some planning the first environmental fund in Europe, – Merlin Ecology which became Jupiter Ecology

⁵³ It is argued in Mackenzie (1997) that "...in attempting to understand how ethical unit trusts work in the UK there is no better place to start than Stewardship" (p.62).

⁵⁴ Indeed, a part of any surplus generated by EIG goes to the Church of England (Lang, 1996).

⁵⁵ One reason for the move was disillusion with the attitude towards ethical investment the Chairman of Jupiter had at that time. A second reason was that the chief investment officer at NPI was very positive and had promised support for the ethical funds (Sparkes, 1995, p.48). This support did not fully materialise as the individual was fired for sexual immorality.

⁵⁶ Simpson (1991) argued that environmental disasters was a key influence for the rise of the ethical investment movement in the 1980's.

⁵⁷ Personal correspondence with Charles Jacob, July 2001.

⁵⁸ For example, Elkington and Hailes (1988) *The Green Consumer Guide* sold a million copies.

in 1989 – was established in April 1988 by Tessa Tennant, Derek Childs and Francis Miller.⁵⁹ Another environmental fund, the CIS Environ Trust, was launched by the Co-operative Insurance Society in 1989.⁶⁰ Similar developments quickly followed in other European countries; for example Carlson Världsnaturfonden was established in Sweden in 1988. In Norway two environmental funds were launched in 1989; Skandia Grønt Norge (now Vesta Grønt Norden) and Skandia Miljøinvest (now Vesta Miljøinvest). The first environmental funds in France – Biosphere and Natio-fonds Environment – were launched in 1990. In Germany two environmental funds were launched in 1990; Hypobank Eco Tech and Focus Umwelttechnologie. In Switzerland the first environmental fund, Credit Suisse Oeko Protec, commenced operations in 1990. This fund changed name to CS Eco-efficiency in 1997. The first environmental fund in Belgium, the KBC Eco Fund started in 1992. Table 2.2 below lists some ethical funds with a link to Churches or environmental groups.

Table 2.2 Ethical Funds with Links to Church or Environmental Groups

Aktie Anvar	Link to Baptist and other free Churches
Svenska Kyrkans VP fond	Partly owned by Church of Sweden
Carlson Världsnaturfonden	Co-operation with WWF in Sweden
SEB Miljö	Link with WWF in Sweden
Banco Ideella Miljö	Link to various environmental organisations
Banco Miljö	Co-operation with the Natural Step (Sweden)
Banco Samarit	Link to various Church groups in Sweden
FP Stewardship	Link to Quakers and Methodists
Allchurches Amity	Owned by Church of England
Murray Ethical World Fund	Religious investors key customer group
NPI Global Care	Link to Quakers and WWF
KD Fonds Ökoinvest	Set up by Evangelische Kreditgenossenschaft Kassel, a co-operative protestant credit union
Luxinvest Ökolux	Launched in co-operation between two German protestant banks and BfG Luxinvest
ABF Het Andere Beleggingsfonds	Founded by the Dutch Council of Churches, The Dutch platform of environmental groups
Nouvelle Strategie	Affiliated with the Catholic Church & Quakers
Fondo Etico	Link to Intermon, a fair trade organisation
Gyllenberg Forum	Close co-operation with the Church of Finland
Leonia Arvo	Co-operation with the Church of Finland

Sources: NPI (1995); Deml and Baumgarten (1998) and interviews for the dissertation.

⁵⁹ Two environmental funds were launched in Denmark in 1987; Danske Invest Miljø and Miljø DK Invest, but these funds no longer exist (Natuvårdsverket, 1998).

A number of conclusions emerge from this brief history of the development of the ethical fund sector: First, the demand for these investment vehicles came primarily from Churches and the environmental movement. Religious investors had demonstrated that values could be integrated into the investment process before any ethical funds were available to the public. Indeed, some of the more recent ethical funds may have been launched to enable financial institutions to compete for Church and Charity funds.⁶¹ The environmental movement contributed with a number of new ethical criteria reflecting their values and a more active engagement approach.

Second, the launching of these funds was demand driven rather than supply driven. There was demand from individual and institutional investors, but major financial institutions were reluctant to provide such funds (Melton and Keenan, 1994).⁶² A few key individuals with strong personal values were decisive for the establishment of ethical investment funds in the UK and small independent financial institutions launched the first ethical funds in Sweden and The Netherlands. Indeed, most investment professionals were suspicious initially and many large financial institutions still have no such ethical funds.

Finally, Simpson (1991) and Harte *et al.* (1991) have argued that demographic factors may have been important as the “ young radicals” of the 1960’s now for some time have had money to invest and may wish to consider ethical issues when deciding where to put their savings. Societal changes in the form of increased institutionalisation of stock markets, in particular increased shareholdings by insurance companies, pension funds and unit trust and a simultaneous decline in direct individual share ownership may also have

⁶⁰ CIS Environ was one of Europe’s largest environmental funds with £153 million in the portfolio in May 2000 (CIS Manager’s Report, 31.5.2000).

⁶¹ Although Charities can’t invest directly in ethical funds for legal reasons and some Churches have their own funds .

⁶² One practitioner mentioned that it is difficult for banks to exclude themselves, while another practitioner mentioned that a problem for the large banks is that the companies excluded by ethical funds tend to be among their major clients. When banks have launched funds they have often been environmental funds such as the TSB Environmental Investor and KBC Eco Fund.

contributed to the growth of ethical investment funds as individuals were no longer monitoring the companies directly to the same extent (Simpson, 1991).⁶³

2.4 The Development of Some Key Organisations

An early issue for ethical investors was apartheid in South Africa. To address the concerns relating to lending and investing in South Africa a group called Christian Concern for South Africa (CCSA) was founded in the UK in 1973.⁶⁴ This group campaigned and lobbied banks and investors on the South Africa issue; members of this group were later involved in founding the Ethical Investment Research Service (EIRiS) and subsequently the Ecumenical Committee for Corporate Responsibility (Sparkes, 1995; Mackenzie, 1997).⁶⁵ At around the time the CCSA was established, the Church Commissioners of the Church of England and the Methodists founded the Church Investment Group to exchange views on ethical investment and related issues; it was open to all Church investors (Jacob, 1996). In 1998 when this group had its 25 year anniversary it comprised 10 denominations with assets exceeding £5 billion compared to the £2.2 billion in ethical unit trusts at the time (Church Commissioners, 1998; EIRiS, July 1998; Shepherd, 2001).⁶⁶

One of the organisations which has had the biggest influence on ethical funds in the UK is the Ethical Investment Research Service (EIRiS). In the late 1970's, young Quakers demanded that the Society of Friends adopt a more extensive ethical investment policy: "Responsible Investment – a Challenge for Quakers" was published in 1980 (Harte, 1992; Sparkes, 1995). At the same time, the Reverend Elliot Kendall (Methodist) and Reverend Trevor Jepson from the Rowntree Charitable Trust, were particularly active in seeking ethical information on companies. Some other charities also needed information on the ethical conduct of certain firms. This demand for information led to the formation of EIRiS in 1983 with Peter Webster as Director (Sparkes, 1995).

⁶³ Especially local authority pension funds, university and union funds have been prone to consider ethical issues (Melton and Keenan, 1994), while the lack of interest from major banks and investment houses has been notable (Sparkes, 1995).

⁶⁴ This followed the publication of a report advocating shareholder action on companies operating in South Africa by the British Council of Churches (Mackenzie, 1997).

⁶⁵ Some activists in CCSA had hoped that EIRiS would actively campaign and engage in shareholder activism. As this did not happen ECCR was founded 6 years later (Simpson, 1991).

Since then EIRiS has provided a service to investors in general and to the ethical funds in particular by supplying research on companies and detailing their involvement in different areas such as tobacco and weapons production. EIRiS researches every company in the Financial Times All Share Index and also other firms held by client ethical funds.⁶⁷ EIRiS was initially set up by grants from the Church of England, the Church of Wales, the Methodists, the Presbyterian Church of Ireland and the Society of Friends and charities such as Oxfam, the Rowntree Charitable Trust and the Rowntree Social Services Trust (Mackenzie, 1997), but EIRiS has been self financing since 1992. The majority of the UK ethical funds use the services of EIRiS.⁶⁸ Penny Shepherd, executive director of UK Social Investment Forum said: "As EIRiS is the largest and longest established independent provider of ethical investment research, it is not surprising that the issues researched by them have had a major influence on the criteria adopted by many UK ethical investment funds".

EIRiS has a number of partner organisations in other countries such as Ethibel in Belgium, which conducts similar research to EIRiS and is used by most Belgian ethical funds.⁶⁹ Some of the key organisations for the ethical investment movement in Europe are listed in Table 2.3 below.

Table 2.3 Some Key Organisations

ORGANISATION	ABBREV	COUNTRY OF ORIGIN	START YEAR
Church Investors Group		UK	1973
Ethical Investment Research Service	EIRiS	UK	1983
Pensions and Investment Research Consultants	PIRC	UK	1984
Christian Ethical Investment Group	CEIG	UK	1988
The Ecumenical Committee for Corporate Responsibility	ECCR	UK	1989
UK Social Investment Forum	UKSIF	UK	1991
ETHIBEL (Corporate social responsibility research)	ETHIBEL	Belgium	1992
Association of Investors for Sustainable Development	VBDO	Netherlands	1995
European Social Investment Forum	EUROSIF	Europe	2001

In the first column this table lists some important organisations for the ethical investment movement in Europe. The **Abbrev** column lists the abbreviations by which the organisations are known.

⁶⁶ In addition to Christian groups, Jewish investors attended the meetings (Jacob interview).

⁶⁷ EIRiS researches a substantial number of European and North American companies in addition to UK firms (interview with Niaz Alam, EIRiS, November 2000).

⁶⁸ Clients listed in EIRiS 2000 annual review included at least 16 UK ethical fund providers.

⁶⁹ Some 13 of the 15 ethical funds in Belgium use Ethibel according to EIRiS Ethical investor July 2000. Personal correspondence with Ethibel and an interview with KBC, Brussels, 2000.

Around the same time as EIRiS was founded, discussions were taking place at the West Midlands County Council about the investment policies of local authority pension funds. This led to the foundation of the Pensions Investment Research Centre in 1984 (later Consultants) (Mackenzie, 1997).⁷⁰ PIRC advises local authority and other funds on investment and co-ordinates shareholder action campaigns (Sparkes, 1995). In 1990 PIRC launched the UK Environmental Investment Code which is provided in Appendix 2.3.

The role of the Churches in fostering ethical investment has continued in the UK. Two UK organisations which were set up to promote ethical investment are the Christian Ethical Investment Group (CEIG) and the Ecumenical Committee for Corporate Responsibility (ECCR). CEIG was set up in 1988 to promote a stronger ethical investment policy in the Church of England.⁷¹ ECCR was founded in 1989 and together with CEIG and PIRC initiated one of the first shareholder resolutions in the UK on an environmental issue at the Shell AGM in 1997.⁷² Both CEIG and ECCR have hosted a number of conferences and produced reports on corporate responsibility and other issues related to ethical investment.

The UK Social Investment Forum (UKSIF) was set up in 1991, to promote ethical investment in the UK.⁷³ It was also inspired by the US Social Investment Forum which was founded in 1987 (Sparkes, 1995). The objectives of UKSIF include information sharing, education and the provision of a forum for discussing matters relating to socially responsible investment. Most financial institutions in the UK with an ethical fund are members of UKSIF. In May 2000 UKSIF published a new policy on: “What makes a good ethical fund”. This short policy does not endorse any particular approach or criteria. Instead it demands openness and honesty in advertising, criteria, policies and processes

⁷⁰ PIRC grew out of an investment advisory unit for the Standing Conference of Local Authority Pension Fund Investment and became a separate company in 1986 (Sparkes, 1995).

⁷¹ CEIG assisted the Bishop of Oxford when he mounted his legal challenge to the investment policy of the Church of England in 1991 (Sparkes, 1995).

⁷² ECCR members include: The Church of England, The Methodist Church, Scottish Episcopal Church, The Society of Friends, United Reformed Church and more than 80 other members including ethical fund providers Friends Provident and Scottish Equitable (ECCR, 2000).

⁷³ With Charles Jacob, Tessa Tennant, Peter Webster among others as directors.

from the ethical funds (UKSIF, 2000b). UKSIF was active in launching the European Social Investment Forum (EUROSIF) in 2001.

In the Netherlands ethical investors have organised themselves in the Association of Investors for Sustainable Development (VBDO). VBDO was started in 1995 to engage with company management and participate at the annual general meetings of companies. Indeed, one ethical fund manager argued that VBDO thus speaks for the ethical funds in the Netherlands at shareholder meetings; prior to 1995 the Dutch ethical funds did not have a co-ordinated voice at company AGMs. VBDO represents the Netherlands in EUROSIF.

In addition to the ethical funds themselves, therefore, a number of support organisations and umbrella groups have developed not only in the UK, but throughout Europe. Some of these such as the ECCR and the UKSIF have been modelled on their American counterparts.⁷⁴ The interaction of these groups helps characterise what is currently termed the ethical investment or the socially responsible investment community. In conclusion it is clear that values relating to the Judeo-Christian tradition and the environment movement have had a crucial role in the establishment of ethical investment funds in Europe in general and in the UK in particular. As one fund manager described the start of his ethical fund: “It was an initiative from the council of churches, the national environmental movement and some congregations”.

2.5 Ethical Criteria

According to Fama (1970) the primary role of the stock market is allocation of ownership of the economy’s capital stock. If allocation of ownership is a major role of stock markets, then ethical criteria can be employed to ensure that sectors considered to be problematic on ethical grounds are avoided.⁷⁵ This is referred to as the investment ethic problem (Mackenzie, 1997).

As was mentioned earlier, various church groups have employed criteria such as excluding the “sin” stocks associated with alcohol, gambling and tobacco when

⁷⁴ The American counterparts are Interfaith Centre for Corporate Responsibility (ICCR) founded in 1971 and the US Social Investment Forum (Harrington, 1992).

⁷⁵ For example, a lung cancer charity may wish to avoid tobacco stocks.

selecting investments (Church of Scotland, 1988). These screens can be seen as a tool to implement the Christian doctrine of putting God first (Kinder and Domini, 1997). It goes back to the commandment: “Love the Lord your God with all your heart with all your soul and with all your strength” in Deuteronomy 6:5; this was mentioned by Jesus as the greatest commandment in Matthew 22:37 and the first commandment in the ten commandments “Thou shalt have no other gods before me” (Exodus 20:3). Because of the risk that products such as alcohol and tobacco or habits such as gambling may develop into addictions which become more important than God and the harm caused by addictions such as alcoholism religious investors have tended to avoid investments in companies in these sectors (Kinder *et al.* 1993, p.73-74).⁷⁶ In a survey of a random sample of 250 US mutual fund presidents Buzby and Falk (1978) found that 11 of the 102 respondents avoided companies selling alcohol or tobacco.

Religious groups in general and denominations such as Mennonites and Quakers in particular have tended to avoid investments in the armaments sector (Kinder *et al.* 1993, p.83).⁷⁷ For the first US ethical funds, the Vietnam war was a particular concern.⁷⁸ These funds offered investors the possibility of holding a reasonably diversified portfolio while avoiding issues of concern such as the armaments industry. There has always been some tension in regard to what is ethical between different groups. Thus in a survey of non-ethical US funds it was found that none of them employed armaments as a criterion and in a list of ethical concerns it was classified as relatively unimportant (Buzby and Falk, 1978). However, this differs from European ethical funds for which the most common exclusionary screen was tobacco, followed by weapons manufacturing and military contracts (Avanzi, 1999). Indeed, an earlier European study reported that weapons, the nuclear industry and tobacco were the most common

⁷⁶ John Wesley, the founder of Methodism stated that “we may not sell anything which tends to impair health. Such is...spirituous liquors.” (Wesley, 1760). This links to God’s claim on the body “your body is a temple of the Holy Spirit” (1 Corinthians 6:19). The Church of Scotland Trust avoids companies in alcohol, gambling and tobacco (Church of Scotland, 1988).

⁷⁷ For example Catholic investors have also avoided weapons (Catholic Bishops, 1992).

⁷⁸ In the USA religious investors had put forth more than 220 defence related shareholder resolutions after the Vietnam war (Melton and Keenan, 1994, p.182).

negative investment criteria (NPI, 1995). A list of common ethical criteria is provided in Appendix 2.4.

The first ethical funds which all had Christian roots operated mainly exclusionary screens. For example the first ethical funds in Europe (Ansvär Aktie Sverige; Svenska Kyrkans Värdepappersfond and FP Stewardship) avoided investments in alcohol, tobacco and weapons.⁷⁹ Other common criteria among religious investors and ethical funds include oppressive regimes and pornography. Indeed, in a survey of Lutheran clergy Inskeep (1992) identified these criteria as those with the greatest support among the respondents.⁸⁰ A provost at a Quaker college was under no illusion that their ethical investment policy would stop these activities, but he stated that “We are seeking oneness between ourselves and our Lord” (Hamilton *et al.* 1993).

The issue which perhaps united activists in different campaigning organisations, Church investors and other ethical investors more than any other was human rights. This manifested itself in the avoidance of oppressive regimes in general and South Africa in the 1980’s in particular.⁸¹ Avoiding “companies whose income was largely derived from countries which would adopt a policy of apartheid” was a criterion in the Stewardship fund proposal from 1973. Similarly, Merlin Ecology, the first UK environmental fund, also avoided companies with an involvement in South Africa. This was one of the most common avoidance criteria in the UK (Harte *et al.* 1991). Indeed among students and universities it was the top issue of concern at the time (Perks *et al.*, 1992). In America it was the most common negative screen (Rockness and Williams, 1988). The South Africa screen was dropped by most ethical funds after Nelson Mandela became the President of South Africa in 1994, but oppressive regimes, child labour and other criteria related to human rights are still common among ethical funds in Europe.⁸²

⁷⁹ Svenska Kyrkans Värdepappersfond and FP Stewardship also avoided investments in gambling. In addition Stewardship had a number of other ethical criteria.

⁸⁰ With the exception that environmental and community criteria got more support than alcohol.

⁸¹ In America South Africa was a criterion for Catholic investors (Catholic Bishops, 1992) and American Church Shareholders filed 30 resolutions in 1979 on South Africa (Purcell, 1979).

⁸² According to EIRiS (1998), 18 of 32 UK ethical funds had human rights abuses as a negative criterion. In addition, all ethical funds in Belgium and the Netherlands covered by the interviews

The environment was identified as a common concern for UK ethical funds by Perks *et al.* (1992). They found that 8 of 17 UK ethical funds had environmental protection as a part of their policy statement and 8 funds also stated that that a “positive commitment to the environment” was part of the policy. Indeed, in a survey of student representatives, 91% supported care of the environment as a positive criterion while 86% agreed that pollution and recycling should be considered in investment decisions. This result confirmed an earlier UK finding by Harte *et al.* (1991), where the researchers found “a poor environmental track record” to be crucial in avoiding companies while environmental awareness was one of the top positive criteria. In a study of 80 European ethical funds NPI (1995) identified environmental protection, recycling and emission reduction as the most common positive investment criteria. Similar results in America were obtained by Rockness and Williams (1988). In their investigation, all the 6 ethical funds which responded to the question on the ethical criteria which they employed highlighted environmental protection. In an earlier survey of US (non-ethical) mutual fund presidents, pollution of the environment emerged as a top ethical concern, although only one fund actually employed it as an investment criterion; financial issues were seen as more important (Buzby and Falk, 1978).

Some ethical funds are purely environmental and do not consider other ethical issues,⁸³ but often the difference between environmental and ethical funds is not substantial as both employ a similar set of negative and positive criteria (Gray *et al.*, 1996; Mackenzie, 1997).

Ethical funds with roots in the environmental movement brought in new ethical criteria such as nuclear power and positive criteria relating to the environmental performance of companies.⁸⁴ The nuclear power criterion links to concerns such as: accidents, disposal of nuclear waste, decommissioning the plants themselves, a link to nuclear weapons and the violent nature of the process itself (Schumacher, 1993; EIRiS, 1998). However, others have argued that nuclear

in Chapter 9 had either a human rights or a child labour criteria. Third world people and repressive regimes were important concerns to UK ethical investors (Woodward, 2000).

⁸³ A UK example is the Scottish Widows (formerly TSB) Environmental Investor fund.

power is “arguably the least destructive power source in relation to the environment” (Anderson *et al.*, 1996).

For example the first UK environmental fund, the Merlin Ecology fund prospect stated as its objective that: “The Fund will seek to provide long-term capital appreciation, together with a growing income, by investing world wide in companies that are either directly engaged in pollution control or which demonstrate a positive commitment to the long-term protection and wise use of the natural environment” (Merlin, 1988).⁸⁵

The first Swedish environmental fund, Carlson Världsnaturfonden, avoided investments in the automobile, chemical and paper industries on environmental grounds. This fund has worked together with the World Wide Fund for Nature (WWF) since 1988 and it had as an objective not to invest in companies which were not in line with the mission statement of the WWF. Environmental funds such as Jupiter Ecology and ethical funds such as NPI Global Care have attempted to evaluate company environmental performance. This strategy has resulted in the “best in class” approach which attempts to identify the best companies in a sector in terms of environmental performance (NPI, 1997). Similar approaches to security selection related to eco-efficiency have been employed by the Bank Sarasin Oekosar fund and Sustainable Asset Management in Switzerland.

Shareholder activism and engagement with companies on ethical issues were also suggested in the early stages of this sector; for example, it was proposed in the original Stewardship fund proposal from 1973. However, in contrast to the US where Shareholder activism has been an integral part of many ethical funds since the 1970’s (Travers, 1997; Bayon, 2001) most of the UK ethical funds have chosen not to vote on ethical issues (EIRiS, 1999). One reason for the lack of shareholder activism in the UK is that it is much easier to launch a resolution in the US and that religious investors have been much more active in the USA

⁸⁴ Other environmental criteria include: climate change, environmental prosecutions, genetic manipulation, intensive farming and pesticides, pollution, ozone depletion and tropical hardwood (EIRiS, 1988, Hancock, 1999).

(Purcell, 1979; Simpson, 1991; Sparkes, 1995). Fund voting and other issues regarding ethical fund operations are explored further in Chapter 10.

Regarding positive criteria Richard Rowntree wrote to the Financial Times in 1984 that: “the initial plans for a Stewardship trust have always been clear that the essential criteria must be the positive aim of investing in companies, the bulk of whose products, services and operations are of benefit to the community rather than the negative withdrawal from specific activities.” (Mackenzie 1997a, p.64). Similarly, supporting positive change has been an objective for the Jupiter Ecology fund from the start (Harte, Lewis and Owen, 1996).

In a survey of UK ethical funds, concern with employees, benefit to society and benefit to the environment were the main areas for positive criteria identified (Perks *et al.*, 1992). A later UK study identified; Community involvement, Environmental initiatives and reporting, Equal opportunities and Positive products as common areas for positive ethical criteria (EIRiS, 1998). Equal opportunities and Positive products were also identified as the most common positive criteria among US ethical funds (Rockness and Williams, 1988).

Finally, a number of concerns have been identified regarding ethical fund criteria. It has been pointed that there is insufficient information in company annual reports to actually implement some of the screens of the ethical funds.⁸⁶ This difficulty may be a concern as Harte *et al.* (1991) established that annual reports were generally used by ethical funds in making investment decisions and Rockness and Williams (1988) have suggested that a lack of information on company environmental and social performance may be an important reason for excluding companies from ethical funds. Another problem is that the ethical policies of funds are often vague and general. This problem is compounded by the fact that exact definitions for the same ethical criterion may vary widely between funds (Perks *et al.*, 1992).⁸⁷ Furthermore it has been suggested that

⁸⁵ In 1988, the Merlin Ecology fund avoided companies involved with South Africa and in the armaments, nuclear power and tobacco industries. In addition there were positive criteria relating to environmental products, resource use and waste management (Merlin, 1988).

⁸⁶ Specifically, Perks *et al.* (1992) argued that environmental information provided in annual reports tended to be “selective, partial, unquantified and not subject to external verification”.

⁸⁷ For example, a pacifist may not be satisfied with a weapon screen that excludes companies with more than 10% of turnover arising from weapons manufacturing. Interviews with ethical

ethical criteria in some cases may be overly simplistic (Anderson *et al.*, 1996). Concerns have also been raised that the primacy of financial performance for ethical funds may be detrimental to the ethical or environmental performance (Harte *et al.*, 1996).

2.6 Conclusions

This Chapter has presented some background information and historical detail about the growth of the ethical investment funds in Europe. It was argued that Church investors and the environmental movement have had a key role in the development of ethical investment funds and supporting organisations. Religious investors have attempted to put their beliefs into practice by employing exclusionary screens in areas such as alcohol, armaments, gambling and tobacco. One can conclude as Gray *et al.* (1996) that “in the UK...religious groups were to the fore in the development of the social investment movement...” (p.246). The ethical criteria employed by the first European ethical funds were the same as those which Church investors had employed for some time for their investments (Sparkes, 1995; Church of Sweden, 1996). These institutional ethical funds operated for Christian Churches were however not available for private investors. There was thus a demand for ethical funds for private investors, not only from members of such Churches, but also from adherents of other types of ethics and members of non-governmental organisations (Simpson, 1991).

Investors inspired by the environmental movement have avoided sectors such as nuclear power and they have attempted to evaluate company environmental performance. Both Church investors and ethical investors in the environmental movement were united in the concern for human rights. This was particularly clear in the case of apartheid in South Africa. Other factors such as institutionalisation of stock markets, demographic factors and developments in America may also have contributed to the development of ethical investment funds (Simpson, 1991).

fund managers and a brief analysis of ethical fund marketing literature indicates that the exact definitions of ethical criteria may be unknown to many investors in these funds.

There are many examples where companies have improved their practices as a result of pressure from ethical funds (EIRiS, 1999a). Nevertheless, reservations have been raised on the capability of ethical funds to achieve positive change as they are seen as one part of “eco or ethical consumerism” and thereby also the current system (Owen, 1990; Gray *et al.*, 1996). Furthermore, the ethical funds amounted to a very small part of total UK equities (Perks *et al.* 1992). This may change however as 59% of 171 UK pension funds had incorporated ethical aspects into their investment policy as a result of the new law on pension disclosure (UKSIF, 2000). Other concerns such as the vague ethical policies by some funds and differing definitions of the same ethical criterion between ethical funds were identified by Perks *et al.* (1992). It has also been asserted that employing ethical criteria alone may be too simplistic as a tool for ethical investment (Anderson *et al.* 1996). Indeed it seems as if one important aspect of many US ethical funds – shareholder activism – has been largely absent among European ethical funds until the late 1990’s. The manifestation of ethics in practice and the processes employed for security selection by ethical funds is therefore explored further in Chapter 10.

Commercial motives also played a part in the establishment of ethical funds. Indeed, Anderson *et al.* (1996) suggest that ethical funds might be called “investments reflecting investor’ opinions” (p.4) and Harte *et al.* (1996) established that although ethical and environmental considerations were important for ethical funds the financial performance seemed to be primary. Therefore, it seems to be the case that the development of ethical funds arose from a complex interaction of religious and secular influences (Kinder and Domini, 1997).

Finally, despite potential problems it can be argued that “ethical funds, by starting to move away from the exclusive emphasis on short term financial self interest prevailing at the moment in Western economies, do begin to point a way forward towards practical change...in encouraging investors to have a personal interest in and commitment to the projects in which they are investing” (Harte *et al.*, 1991). The next Chapter will outline some ethical theories which will be employed to analyse ethical funds in Chapter 11.

Chapter 3 Ethics and Markets

3.1 Introduction

The previous Chapter considered the history of ethical investment funds and related advisory organisations in Europe. The ethical criteria employed by these funds were also discussed. The current Chapter presents some normative ethical theories which are relevant for an analysis of ethical funds. Some of these theories are employed in Chapter 11 of this thesis to analyse the findings from interviews with ethical fund managers. This Chapter thus lays a framework to analyse the question of whether ethical funds are “good” investments from an ethical point of view for an individual investor. The Chapter also considers how these theories relate to finance theory in general and capital market theory in particular.

Ethical theories such as utilitarianism and egoism have influenced economic theory in general and finance theory in particular (Mill, 1895; Bentham, 1988; Hay, 1989; Dobson, 1993). It will be argued in this Chapter that utilitarianism and ethical egoism are problematical theories from a normative point of view and that they are incompatible with an ethic deriving from the Judeo-Christian tradition such as agapism (Hay, 1989; Geisler, 1994).⁸⁸ Agapism is an element in the ethical investment strategies of a number of Churches, insights from this ethic are considered further in Chapter 11. (Wesley, 1760; Church of Scotland, 1988; Church of Finland, 1999). Mainstream finance theory based on utilitarianism is argued to provide valuable insight into the financial performance of ethical funds. However, “mainstream financial utilitarianism” is argued to be insufficient on its own for a complete ethical analysis of ethical investment funds (Dobson, 1993). Therefore some other ethical theories are also presented in this Chapter. Some of these theories will be employed in the analysis of ethical funds in this Chapter and in sections B and D of this dissertation.

⁸⁸ Agapism is a love based theistic ethic. It has been argued that Lutheran and Methodist ethics are based on it and that many Churches share the agape ethic (Maquarrie and Childress, 1997).

It will also be argued that ethical theories derived from Judeo-Christian ethics such as agapism and particularly the Wesleyan application of it is relevant for an analysis of ethical funds. Indeed, as the previous Chapter indicated Wesleyan and Quaker ethics have influenced the establishment of ethical funds in the UK and the USA.⁸⁹ Lutheran variants of agapism have influenced the establishment of ethical funds in Finland and Sweden.⁹⁰ Indeed, in their policy document on ethical investment the Church of Finland specifically states that it will take an active role in developing ethical funds (Church of Finland, 1999). The previous Chapter demonstrated that the Church was both involved in the launch of the first two Finnish ethical funds and the largest investor in these funds. Some of the ethical criteria such as the avoidance of alcohol, pornography and tobacco were directly based on church doctrine (Wesley, 1760; Kinder and Domini, 1997). This Christian influence was found to be present also when the empirical work for the dissertation was carried out.⁹¹ Furthermore, a Christian perspective provides one framework for analysing whether ethical funds are a “good” investment from a particular moral viewpoint (Mackenzie, 1997).

This Chapter also draws on the work of Mackenzie (1997) who investigates what he calls “the investment ethic” and “the corporate harm” problems from a perspective of business ethics and the community of practitioners. The investment ethic problem refers to the problems associated with investing in companies with unethical practices.⁹² The corporate harm problem relates to the fact that many corporations are involved in harmful practices and analyses what might be done to achieve positive change (Mackenzie, 1997). Ethical theories are relevant for analysing the investment ethic problem whereas section 3.3 of this Chapter on ethics and markets briefly considers the corporate harm problem. Stock markets and ethics will also be considered. The next section

⁸⁹ Methodist Christians were involved in establishing the first UK and US ethical funds and have been active in UKSIF since its inception (Kinder *et al.* 1993; Sparkes, 1995; Hancock, 1999).

⁹⁰ The Evangelical Lutheran Church in Finland was involved in establishing the two first ethical funds in Finland. The Church of Sweden (Lutheran) established some ethical funds in 1980. Other Church investors in France, Germany, Sweden, the Netherlands and the UK have also been pioneers in ethical investment (Deml and Baumgarten, 1998; NPI, 1995).

⁹¹ See: Friends Provident (1998); Aktie-Ansvar (1999); Banco (1999); Gyllenberg (1999); Ecclesiastical (2000); Förenings-sparbanken (2000); Leonia (2000) and Chapter 10.

⁹² A similar notion is the ‘evil company’ principle according to which one should never invest in an evil company (Irvine, 1987; Larmer, 1997).

briefly presents some ethical theories, while section 3.3 discusses markets and ethics. Finally, some conclusions are offered.

3.2 Ethical theories

Philosophers are often the first to admit the limited role which ethical theories actually play in guiding individual behaviour (Kant, 1907).⁹³ Indeed, Warburton (1999) argues that philosophy may not be capable of altering people's beliefs about right and wrong. Many authors would also claim that substantial agreement on most issues does not exist in ethics (Frankena, 1963; Mackenzie 1997; Warburton, 1999). Others such as Kant (1907) would claim that there is a universal ethic valid for everyone. Proponents of Christian ethics may also claim that the example and teaching of Jesus Christ is relevant for everyone.⁹⁴

A key issue relates to the separation thesis, which is sometimes employed to suggest that there is no link between ethics and business (Werhane and Freeman, 1999). The separation thesis states: X is a business decision which has no ethical content and Y is an ethical decision with no business content. However, some researchers argue that the separation thesis is bankrupt because "every economic decision is embedded in a belief system that presupposes some basic values" and assert that "ethical issues are as much an integral part of economics and commerce as accounting and finance" (Werhane and Freeman, 1999, p.2). This thesis has been put more simply in accountancy in terms of ethical issues by Gray *et al.* (1996): "It's nothing to do with me? It is everything to do with all of us". The present Chapter argues that ethics applies to investments just as it applies to other areas of life (Boatright 1999; Cowton, 2002). From a deontological ethical point of view there is a duty to consider moral issues when making investment decisions. From an agape based ethical view the impacts of the investments on others must be considered. This section outlines these ethical theories.

⁹³ "We do not need science and philosophy to know what we should do to be honest and good, yea even wise and virtuous" and "...we see how great an advantage the practical judgement has over the theoretical in the common understanding of men." (Kant, 1907, p.24).

⁹⁴ As it is phrased in Oslington (2000) "if the Gospel is true then it is true for all".

Four main categories of ethical theories relating to ethical obligation are considered; deontological theories, teleological theories, egoistic theories and agapism (Frankena, 1963). These are established ethical theories covered in many philosophical textbooks (Lacey, 1996; Warburton, 1999). It has been claimed that ethical funds represent a mix of religious and secular influences (Kinder and Domini, 1997). Therefore some philosophical ethical theories and an ethical theory originating from the Judeo-Christian tradition are presented in this Chapter (Frankena, 1963; Church of Scotland, 1988; Church of Finland, 1999; Calkins, 2000).

Although these four theories are presented separately here they may not always be mutually exclusive in practice.⁹⁵ For example, a deontologist may still pay some attention to consequences and be influenced by love in his/her behaviour. Similarly, selfish considerations may influence even the most ethical agapist. The main reason for choosing these theories is that teleological and egoistic theories have had a strong influence on economic and finance theory (Hay, 1989; Dobson, 1993). Kantian deontological ethics has influenced a stakeholder theory of the corporation (Evan and Freeman, 1988). Agapism is seen as relevant for an ethical analysis of the funds because it informs the investment strategy of the Churches that pioneered the ethical funds mentioned in Chapter 2 (Wesley, 1760; Church of Scotland, 1988; CEIG, 1992; Church of Finland, 1999).⁹⁶ Indeed, these ethical theories form the basis of three different investment philosophies. Utilitarianism informs the shareholder value model, Kantian ethics informs the stakeholder model and agapism a wider social responsibility model (Church of Finland, 1999). There are other normative ethical theories, but they will not be considered in detail.⁹⁷ The emphasis is mainly on ethical theories originating from the countries considered in the empirical analysis and an Agape based Christian perspective. Authors on ethics and finance such as Dobson (1993) and Boatright (1999) have also emphasised

⁹⁵ According to Gill (1999) one example of a theologian employing different types of ethical arguments –consequential, deontological and pragmatic– was Luther (1524).

⁹⁶ These Churches are major investors in many of the ethical funds and many ethical fund managers are members of a Church, see Chapters 10 and 11.

⁹⁷ For example, virtue based ethics, sometimes called neo-Aristotelianism, because its key philosopher was Aristotle (Warburton, 1999). Recently, (deontological) ethics based on Rawl's

deontological, Kantian and utilitarian ethics. Agapism in accountancy has been employed by Molyneux (2001). The theories in this Chapter are presented in Appendix 3.1.

3.2.1 Deontological Ethics

Deontological ethics is a duty-based ethics. Indeed, deontology is the study of the nature of duty and obligation. According to this ethic everyone has an obligation to do what is right.⁹⁸ The motive for an action is of crucial importance in some deontological ethics, particularly for Kant (1907).⁹⁹ Duty is prior to value and at least some duties such as promise keeping are independent of values (Lacey, 1996). An important aspect of deontological ethics is that it is not just the consequences that matter, but whether an action is intrinsically right or wrong. The Judeo-Christian ethic of being obedient to God can be seen as one example of deontological ethics (Warburton, 1999).¹⁰⁰

Examples of philosophers advocating some form of deontological ethics include Kant, Prichard, Ross, Rawls and perhaps Socrates (Childress and Maquarrie, 1987; Frankena, 1963). In the dialogue described in *Crito*, Socrates employs rule deontological reasoning when he argues why he ought not to escape from prison, although he was facing a death sentence. An example of an academic perhaps advocating a form of deontological ethics in the sense that he argued for “general rules of morality” was Adam Smith. His morality assumed the existence of God (Smith, 1853).¹⁰¹

In deontological ethics, the duty to do what is right is thus more important than the consequences, even when the result, as in the case of Socrates, leads to

and rights based ethics have become popular. The ethics of pragmatism has also been employed in accounting (Childress and Maquarrie, 1997; Boatright, 1999; Dick-Forde, 2000).

⁹⁸ Deontology can have other meanings. Bentham used it to designate his utilitarian ethic. For Roman Catholic theologians it refers to a special professional ethics (Macquarrie and Childress, 1997). Academics such as Gray following Sartre use it to designate integrity.

⁹⁹ But Rashdall (1924) argued that: “It does not follow that the desire to do one’s duty must always be the sole and exclusive motive of right conduct” (Macquarrie and Childress, 1997).

¹⁰⁰ It has been argued that many theologians are deontologists (Maquarrie and Childress, 1997).

¹⁰¹ “Without this sacred regard to rules, there is no man whose conduct can be much depended on (Smith, 1853, p.230). He also emphasised certain virtues such as justice and beneficence and he argued “That the sense of duty should be our sole principle of conduct, is nowhere the precept of Christianity” (p.244).

harmful consequences for one self. An example of a finance academic taking a deontological approach to ethical issues in finance is provided by Dobson (1993). He emphasises the importance of motive as opposed to consequences and argues that “a truly ethical individual...would never sacrifice honesty for material gain” (Dobson, 1993, p.60). He argues that ethics is a fundamental motivation and should not be merely a constraint for achieving some other objective. In accounting a deontological position has been taken by Gray *et al.* (1996). They believe in a duty to respect the natural environment of the planet and to account for those actions for which one is held responsible (p.38).

Deontological theories divide into, act deontological theories (situation ethics) and rule deontological theories. Act deontological theories arose as a reaction against the ethics of traditional rules (Frankena, 1963). Act deontological theories maintain that the basic judgements of obligation are all purely particular ones such as: “In this situation I should do so and so”. Act deontological theories don’t allow that a general rule may supersede a well taken particular judgement (Frankena, 1963).

Existentialism is an example of an act-deontological theory (Frankena, 1963). Important themes in existentialism are humanity and the notion of being. In existentialism humans are free and must make choices. The reality and nature of freedom is a major concern in existentialism (Lacey, 1996). The main argument for act deontological theories is that all situations are unique. The problem with this argument is that even if situations are unique, moral judgements are not just particular to a situation, but implicitly general.¹⁰² Another problem with act-deontological theories is that “it is practically impossible for us to do without rules” and “rules are needed in the process of moral education” (Frankena, 1963, p.22). Therefore, Frankena (1963) concludes that “act deontological theories are untenable in principle” (p.23).

¹⁰² Moral judgements imply reasons, which can’t apply in one case only. If they apply in one case, they apply in all similar cases (Frankena, 1963, p23). Indeed, some generalise the ethical criteria adopted by ethical funds. For example, Anderson *et al.* (1996) in their criticism of ethical funds argue: “Who are these people to say that I should not...gamble if I wish” (p.3). They thus acknowledge that if gambling is unethical for some, it may be wrong for them also.

Rule deontological theories maintain that there is a non-teleological standard which consists of one or more rules such as: We always ought to tell the truth or we ought to keep agreements. There are a number of problems with rule deontology. First, which rules are we to follow in the first place. Second, what if different rules conflict? Finally, there is the problem of exceptions to rules. No deontologist has presented a conflict – and exception – free system of rules about what we are to do (Frankena, 1963, p.23).

An attempt to construct a system without such conflicts was presented by Kant (1907). He argued that there is essentially only one basic principle: The categorical imperative, which gives a base for a universal ethics. The first form of the categorical imperative states: “Act only on the maxim which you can at the same time will to be a universal law”. For example, Kant used the categorical imperative to argue that one ought not to make deceitful promises or to commit suicide. Equally he argued that one ought to help others. He claimed that this applies to all human beings (Kant 1907, p.47-49). The maxim would thus hold for everyone in a similar situation. In contrast to some recent philosophers Kant thus believed in universal ethics valid for everyone. The practical imperative is: “So act as to treat humanity, whether in thine own person or in that of any other, in every case as an end withal, never as means only” (Kant, 1907, p.56). These imperatives and Kant’s ethic was based primarily on reason.¹⁰³

The imperative(s) has similarities with the Golden Rule: “Do unto others as you would have others do unto you” (Boatright, 1999).¹⁰⁴ Kant believed in universal moral rules that are valid for everyone and emphasised the importance of a will to do what is right (Boatright, 1999). The good will was important to Kant because he believed that all humans *a priori* have some notion of ethics, of what is right.¹⁰⁵ Kant acknowledged that humans do not necessarily act ethically even if they know what is right, and hence “good will” is important for providing the motivation to act in an ethical manner.

¹⁰³ A modern philosopher with a similar notion of respect for human beings is Rawls (1971).

¹⁰⁴ The Golden Rule is based on Jesus’ teachings (Matthew 7:12 and Luke 6:31), although similar rules can be found in Judaism and other traditions (Macquarrie and Childress, 1987).

¹⁰⁵ “For reason recognizes the establishment of a good will as its highest practical destination” (Kant, 1907, p.14).

Frankena (1963) argues that the categorical imperative works well in the case of not lying, but that it may be less persuasive in other cases; in addition, there may still be some situations where conflicts in duties arise. Kantian ethics has also been criticised for failing to provide guidance on what to do in the first place, for disregarding emotions and for ignoring the consequences of actions (Warburton, 1999). Kant did put forth beneficence and doing good to the neighbour as duties (Midgley, 1983). Nevertheless, Kantian ethics has been criticised by philosophers and theologians alike for overemphasising rationalism (Reichmann, 1994).¹⁰⁶

A further problem with deontological ethics is that a strong emphasis on duty may lead people to serve someone like Hitler (Bonhoeffer, 1978). In conclusion, it is argued that deontological theories may take other people seriously but do not necessarily take the promotion of “good” seriously enough (Frankena, 1963). Ethical dilemmas may arise to which deontological theories provide no obvious solution. In the next section, teleological theories will be examined. In contrast to deontological ethics which focus on duty and motive, teleological ethics emphasise consequences and utility. Table 3.1 contrasts deontological and teleological ethics.

Table 3.1 Features of Deontological and Teleological Ethics

Deontological Ethic	Teleological ethic
Rule determines the result	Result determines the rule
Rule is the basis of the act	Result is the basis of the act
Rule is good regardless of result	Rule is good because of result
Result always calculated within the rules	Result sometimes used to break rules

Source: Geisler (1994)

3.2.2 Teleological Ethics

In this section one teleological ethical theory, utilitarianism will be briefly presented and critically examined. This is done because many articles in section B of this thesis and some of the empirical work in Chapters 6 and 7 draws on some form of financial utilitarianism. It is therefore important to be aware of the limitations and problems of utilitarianism.

¹⁰⁶ Kant did not deny the value of religious knowledge. Indeed, he said that: “The existence of the Bible is the greatest blessing which humanity ever experienced” (Blanchard, 2000).

In teleological theories (*telos* means end and *logos* discourse or study), the basic or ultimate criterion of what is morally right, wrong or obligatory is the non-moral value brought into being (Frankena, 1963; Macquarrie and Childress, 1997). Examples of such non-moral value include happiness, money pleasure and welfare (Frankena, 1963; Friedman, 1970; Bentham, 1988; Markowitz, 1991; Maquerrie and Childress, 1997). The best known teleological theory is utilitarianism or ethical universalism (Warburton, 1999). Although some of the component ideas of this ethic date back to ancient Greece, utilitarianism is attributed to English philosophers such as Bentham and J.S.Mill (Lacey, 1996). As the consequences of actions are seen as more important than actions themselves teleological theories such as utilitarianism are also labelled consequentialist ethic. The final appeal of this philosophy is the principle of utility, which is also known as “the greatest happiness principle” or the amount of “good” produced relative to the “bad” (Mill, 1895, p.6).¹⁰⁷ Happiness is “good” according to Bentham (1988), who related happiness to “the sovereign masters of mankind; *pain* and *pleasure*” (p.1). Bentham asserted that “It is for them alone to point out what we ought to do” and “the standard of right and wrong...are fastened to their throne”.

The utilitarian approach implies that it is possible to measure what is good and bad or happiness in a quantitative way. Indeed, it has been argued that if there are difficulties in measuring what is good and bad it constitutes a serious objection to utilitarianism (Frankena 1963). Furthermore, it has been argued that “calculus of intrinsic value in purely quantitative terms is not possible (Frankena, 1963, p.74). There are different forms of utilitarianism such as act and rule utilitarianism.¹⁰⁸ In act utilitarianism, the utility arising from a particular act is the essence, whereas in rule utilitarianism the key is not which action has the greatest utility, but which rule has.

¹⁰⁷ The **principle of utility** is; “that principle which approves or disapproves of every action whatsoever, according to the tendency which it appears to have to augment or diminish the happiness of the party whose interest is in question” and by **utility** is meant “that property in any object, whereby it tends to produce benefit, advantage, pleasure, good or happiness, (all this in the present case come to the same thing)” or to prevent “pain, evil or unhappiness to the party whose interest is considered” (Bentham, 1988, p.1-2).

¹⁰⁸ There are other forms such as motive and trait utilitarianism (Frankena, 1963; Lacey, 1996).

Negative utilitarianism suggests that individuals should only aim to remove evil, not to produce good (Lacey, 1996). A particular problem with negative utilitarianism is that the removal of all pain and suffering could be achieved by killing all sentient life. If this could be done in way which did not inflict much pain it would be the morally correct action according to negative utilitarianism. However, such an action can not be acceptable (Warburton, 1999).

In teleological ethics different views may be taken on what is good in a non-moral sense. One teleological theory – hedonism – identifies good with pleasure as Bentham did, whereas in finance good is sometimes identified with money (Dobson, 1993). Indeed, McGoun (1997) claims that the “behavioural assumption in economics is utility maximisation” and that the “behavioural assumption in finance is wealth maximisation” (p.98). For example, Markowitz (1991) addresses his work to investors who: “want “return” to be high ... and prefer more of it to less” (p.6).¹⁰⁹ The best known advocate of financial utilitarianism is perhaps Friedman (1970). He argues that the moral responsibility of business corporations is to increase its profits as long as its done “without deception or fraud”.¹¹⁰ A basic decision rule in utilitarianism is to choose the option which produces the greatest amount of good [sometimes defined as happiness] for the greatest number of people (Frankena, 1963). Indeed, the decision that maximises welfare in utilitarianism is the “morally” right one (Maquerrie and Childress, 1997). The challenge in finance is that sometimes the only people considered are the shareholders. As relatively few individuals have substantial shareholdings (Table 3.2). There is a risk that the welfare of a small minority is maximised rather than the welfare of all, because of the habit of treating income as a measure of welfare (Gray, 1990b).

A positive aspect of utilitarianism is that it might be possible to include animals in the utility calculations and thus move away from an anthropocentric view of ethics, but in practice utilitarianism has tended to be man-centered (Blanchard,

¹⁰⁹ Markowitz (1991) notes that: “The appropriate definition of return may vary from investor to investor” (p.6), thus leaving open the possibility of environmental and social returns.

¹¹⁰ Even Friedman admits to other duties such as obeying laws and abstaining from fraud and deception. From a philosophical point of view Friedman’s argument is flawed (Jacobsen, 1991).

2000). An objection against utilitarianism is that two acts or rules may produce the same utility although one involves lying or other unjust actions. Yet these two options would be morally equal in the utilitarian framework. Indeed, the just option might have a slightly lower score and thus be rejected as “less ethical” than the dishonest option (Frankena 1963). Utilitarianism may also sanction other immoral actions such as the death penalty for innocent people if the overall result was less crime (Warburton, 1999).¹¹¹ Another difficulty for utilitarianism relates to the difficulty of knowing what we ought to do. It may also be difficult to separate acts and their consequences. We can’t know all the consequences of our actions in advance and much may depend on what others do (Gray, 1990; Lacey, 1996).¹¹² Another criticism of utilitarianism is that it fails to account fully for different tastes and values (Statman, 2000). Utilitarianism has tended to focus on self and failed to consider community values. (Hay, 1989). At best individual utilities can be aggregated to find a social optimum (Copeland and Weston, 1988). When a social optimum is found it is then implemented. It would have to be imposed as many individuals are likely to disagree with the policies.

Act utilitarianism would make life challenging for strict followers as decisions would be accompanied by complex calculations. Greek philosophers such as Socrates rejected consequentialist ethics, Plato and Aristotle did not agree with hedonism and no-one who believes in absolute duties can accept utilitarianism as a satisfactory ethical theory on its own (Frankena, 1963; Warburton, 1999).¹¹³ Others have argued that Mill and any consequentialist must be bankrupt on the question of “the worth of the agent” (Midgley, 1983). It has been argued that utilitarianism was a reaction against deontological ethics and can be seen as an attempt to corrupt the “strict laws of duty” (Kant, 1907, p.25). Indeed, Kant (1907, p.25-26) argues that (emphasis added):

It has also been shown that some of the assumptions underpinning Friedman’s argument are incorrect (Chryssides and Kaler, 1993; Gray *et al.*, 1996).

¹¹¹ Indeed, more extreme forms of utilitarianism may advocate putting mood altering drugs such as ecstasy in the water supply to increase happiness as the right moral action (Warburton, 1999). Free drugs available to all was an element in the utopia presented in Huxley (1994).

¹¹² Other problems are; what time horizon should be adopted in evaluating the consequences and which consequences should be considered, only economic or also environmental and ethical.

¹¹³ Greek philosophers like Socrates, Plato and Aristotle emphasised intellectual virtues, while Nietzsche emphasised power and Augustine and Aquinas that God is good (Frankena, 1963).

Against all the commands of duty which reason represents to man as so deserving respect, he feels in himself a powerful counterpoise in his *wants and inclinations*, the entire satisfaction which he sums up under the name of *happiness*...Hence there arises a natural dialectic, i.e a disposition to argue against these strict laws of duty, and to question their validity...and if possible to make them more accordant with our wishes and inclinations, that is to say *to corrupt* them at their very source, and entirely to destroy their worth —a thing which even common practical reason cannot ultimately call good.

Some philosophers and theologians reject utilitarianism as it may permit lying, breaking of promises and other actions which many might consider immoral (Lacey, 1996; Warburton, 1999).¹¹⁴ For example, Midgley (1983) argues that the maxim ‘one should always deceive others when convenient’ fits well with Benthamite utilitarianism (p.83).

Utilitarianism is of particular interest for this dissertation as it has provided a theoretical basis for economics (Hay, 1989; Boatright, 1999). Indeed, it has been argued that in “normative questions, there will be an appeal to some weak form of utilitarian calculus” and that early economists borrowed their concept of man from the utilitarian theory of Bentham (Hay, 1989, p.91,105). Cost-benefit and marginal analysis are formulations of utilitarianism (Boatright, 1999). Other formulations of utilitarianism include the “rational choice theory” presented in Markowitz (1959; 1991). In Markowitz (1990; 1991) utility functions are discussed in the context of investment portfolio management.¹¹⁵ Authors such as Statman (2000) have suggested that ethical funds are galling to some investors “because it mixes the utilitarian features of money with the value expressive features of social responsibility”.

It is not surprising that economic theory has roots in utilitarianism since J.S.Mill played a vital part in developing both (Hay, 1989). Similarly, the indifference curve and portfolio theory analysis commonly used in finance draws on utilitarian roots and the same ‘rational economic man’ assumptions

¹¹⁴ Dr Eskola of the Finnish Theological Institute argued that utilitarianism is incompatible with Christian ethics, interview, 2001. The same point is made by Hay (1989) and Blanchard (2000). The Church of Scotland (1988) argued that the end never justifies the means.

¹¹⁵ Markowitz (1990) mentioned that “if we delegate the management of our investments to a supercomputer...the computer should act as if it sought to maximize expected utility for some game as a whole.”

(Hay, 1989; Boatright, 1999).¹¹⁶ It has been argued that viewing ethics in the context of wealth maximisation is a brand of hedonism. This financial hedonism has “resulted in a fatal dilution of ethical precepts”, in which “ethics is forced into the subservient and ambiguous role of supporting some fundamental materialistic objective” (Dobson, 1993).¹¹⁷ It has also been suggested that utility maximisation is “illegitimate” as it implies that other values are ignored or merely regarded according to the maximand. This leaves little or no room for ethical considerations (Thielemann, 2000). There seem to be substantial problems with utilitarianism as a normative ethical theory. It is therefore argued that it is valuable to employ other theories in addition to utilitarianism in an ethical evaluation of ethical funds. In the next four Chapters an analysis of the financial performance of ethical funds is conducted. This analysis has some utilitarian roots and is therefore claimed to be relevant only for the question whether the ethical funds are a “good” investment in a financial sense. The question of whether ethical funds are a “good” investment in ethical sense is addressed by a second investigation in Chapters 9 – 11.

3.2.3 Ethical Egoism

It was noted that act deontological theories represented a reaction against the ethics of traditional rules. Another reaction against traditional ethics was ethical egoism. Ethical egoism is a more narrow form of utilitarianism in which the only basic obligation of an individual as a moral agent is to promote for her/himself the greatest possible balance of good over evil.¹¹⁸ An example of ethical egoism related to finance is the expected utility maxim (Markowitz, 1991). The maxim asserts that “an individual should act as if (1) he attaches numbers, called their utility, to each possible outcome, and (2) when faced with chance alternatives he/she selects the one with the greatest expected value of utility”. An adherent to the expected utility maxim might consider a choice other than that with the highest utility as irrational (Markowitz, 1991, p.219).¹¹⁹

¹¹⁶ Examples of the use of indifference curves are provided by Copeland and Weston (1992).

¹¹⁷ An example of how deeply imbedded utilitarianism is in finance is provided by Shefrin and Statman (1993). They assert that: “Policymakers operate as if they have utility functions that depend on both efficiency and fairness. They construct an efficiency/fairness framework in much the same way as portfolio managers construct a mean/variance framework” (p.23).

¹¹⁸ It is thus an ethic of self love (Frankena, 1963).

¹¹⁹ Some claim that other objectives than profit maximisation are immoral (see: Jacobsen, 1991).

Indeed, Markowitz (1991) recognizes the fact that many investors do not behave according to the expected utility maxim, but he chooses to believe that these investors are irrational and the maxim is good (p.210, 218-221). Whilst Markowitz (1991) argued that his formulation of utility did not refer to pleasure, pain and hedonism, the “alternative” he offered is money (p.208, 245, 258). Ethical egoism was advocated by Nietzsche (Frankena, 1963).

Ethical egoism may partly overcome one problem with deontological ethics and utilitarianism. This flaw relates to the assumption of human nature. Deontological and teleological theories would seem to lose some force if human beings were not good by nature.¹²⁰ Where would the motivation to act ethically come from in the first place, especially if acting ethically might lead to a less attractive financial outcome? An “enlightened form” of ethical egoism might thus seem to be a more realistic descriptive – not normative – theory if it was assumed that human beings were not good by nature, which is the view often taken in finance.

As a descriptive theory ethical egoism might be able to describe a reality in which people put money and themselves ahead of others better than Kantian ethics or utilitarianism.¹²¹ Those who employ ethical egoism tend to assert that it is how people behave (Frankena, 1963). Perhaps this is why it is a common position in economic theory. Another reason may be that assumptions of ethical egoism may facilitate quantitative model building (Markowitz, 1991, p.210). Concerns have been expressed that theoretical modelling of people as egoists may have a negative effect on people’s behaviour. If people believe that others are egoists their behaviour may become more egoistic (Dobson, 1993). Furthermore, it has been argued that thinking of humans and animals as machines may lead individuals to treat people as such (Schumacher, 1973).¹²²

¹²⁰ At least on the implementational and motivational levels.

¹²¹ The fact that people may act as if they had adopted a form of egoism does not mean that ethical egoism would be an acceptable normative ethical theory, that people lie and murder does not provide any moral justification for these acts. (Frankena, 1963; Dobson, 1993).

¹²² In Markowitz (1991) the term “rational man” is used synonymously with “a perfect computing machine” (p.206, 229, 234), although he makes explicit that neither exist (p.206).

It must be remembered that ethical egoism is an ethical theory, not a trait of character. Even if an ethical egoist acts consistently with the theory his/her actions do not necessarily appear to be selfish. This depends on what he/she thinks his/her best long term interests are, and whether he/she thinks that honesty is the best policy.¹²³ The ethical egoist may hold any theory of what is good or bad. They have often been hedonists identifying the good with happiness and happiness with pleasure. This is similar to the route normally taken in economic theory where it is often assumed that each person seeks to maximise his own utility and benefit as measured merely in monetary terms (Hay, 1989; Boatright, 1999). Those who advocate such financial egoism often argue that it also leads to maximum benefit to society and that it is therefore ethical even in a normative sense.¹²⁴ However, shareholders in major corporations do not always consider only financial issues. Some investors also consider environmental and social issues when investing in a company (Ethical Performance, September 2001).

Many aspects of finance theory such as agency theory, asset pricing and utility theory have elements of ethical egoism.¹²⁵ For example, it is assumed that “people are greedy” in utility theory and asset pricing (Copeland and Weston, 1992, p.80,194).¹²⁶ Agency theory assumes that the only utility an outside owner derives from owning shares in a company is the effect on monetary wealth and that all people maximise utility (Jensen and Meckling, 1976). The existence of ethical funds and other avenues for ethical investment would seem to violate this assumption. More problematic than the assumption of greed is perhaps that the axioms regarding people’s behaviour in agency theory and utility theory are contradictory. In the analysis of Jensen and Meckling (1976) the assumptions of utility maximising behaviour of an entrepreneur seem difficult to reconcile with

¹²³ Adherents of deontological/motivist ethics would still claim this is unethical as the motive is not right (Dobson, 1993).

¹²⁴ See Gray *et al.* (1996) for a description of this view and Jacobsen (1991) for a rebuttal of it.

¹²⁵ Utility functions postulated for consumers in economic theory are usually “solely egoistical and self-regarding, although they would not have to be” (Hay, 1989). An example of this is provided in Copeland and Weston (1992, p.98, 103), although they do mention that “mathematical utility theory have been shaken by empirical evidence” and that people do not actually behave as the axioms would postulate (p.102).

¹²⁶ The Capital Asset Pricing Model has been derived from utility theory (Roll and Ross, 1980).

the assumptions that the shares of the entrepreneur have no voting power and that the salary of the entrepreneur is kept constant.

In utility theory it is difficult to see how the axioms of comparability, transitivity and strong independence could be valid simultaneously. It would seem unlikely that everyone would be indifferent regarding different options as the strong independence axiom postulates. This would be irrational and yet everyone is assumed to make rational decisions (Copeland and Weston, 1992).

A common misconception is that Adam Smith advocated ethical egoism, but in fact the opposite is true. Indeed, Smith (1853) wrote about our neighbour:

To disturb his happiness merely because it stands in the way of our own, to take from him what is of real use to him merely because it may be of equal or more use to us...is what no impartial spectator can go along with (p.119).

Adam Smith considered ethics and economics as inseparable and The Theory of Moral Sentiments as important as the Wealth of Nations (Sacks, 2000). Indeed, Smith recognised the necessity of both legal and moral constraints in the pursuit of self-interest (Skinner, 1993). Smith was concerned with the whole man and self-interest was presumed to be governed by moral law (Gray, 1990b). Furthermore, Smith linked morality to God when he argued that “those important rules of morality are the commands or laws of Deity, who will finally reward the obedient, and punish the transgressors” (Smith, 1853, p.232).

The problem with egoism is that it fails to consider other people (Frankena, 1963), let alone non-human life. Both egoism and utilitarianism as normative theories are largely incompatible with the Judaic-Christian tradition and ethical egoism is also incompatible with Kantian ethics (Frankena, 1963; Hay, 1989). As King Solomon put it: “He who trusts in himself is a fool, but he who walks in wisdom is kept safe” (Proverbs 28:26).

Finally, the strongest critique of ethical egoism as a normative ethical theory comes from accounting and finance academics who claim that:

Despite the power of neoclassical analysis and the insights it generates...it of necessity lacks completeness of vision and that lack, most importantly contains the ethical element (Gray, 1990, p.17)

The hedonistic individuals invoked by financial-economic theory are, by definition, unethical (Dobson, 1993, p.57)

When we make the assumption that we behave rationally, we suggest that we act as an animal motivated only by economic concerns (Frankfurter, 1994).¹²⁷

It is important to note here that it is logically possible to accept the use of mean and variance and either accept or reject the expected utility maxim (Markowitz, 1991). In this dissertation the expected utility maxim as a normative statement is rejected and egoistic ethical theories are rejected as a normative foundation for morality. A Christian ethic rather than any teleological theory is adopted as normative. This leads to a third ethical theory, agapism.

3.2.4 Agapism

Agapism, or the ethics of love, is a third normative ethical theory.¹²⁸ Agapism holds that there is only one basic ethical imperative, to love.¹²⁹ This theory “has been and still is widely accepted especially in Judaic-Christian circles” (Frankena, 1963).¹³⁰ For example, it has been argued that the ethics of the Lutheran and Methodist Churches draws on agapism, while Calkins (2000) has written on the “primacy of love in Christian ethics from a Catholic perspective (Macquarrie and Childress, 1997).¹³¹ Specifically, agapism is mentioned as an element in the ethical investment strategy of Lutherans, Methodists, Quakers and Presbyterians (Wesley, 1760; Church of Scotland, 1988; Church of Finland, 1999; Marrs, 2002). Frankena (1963) presents the following quotation from the Bible as the basis of agapism:

¹²⁷ Dobson goes further and argues that a materialistic value system emphasising wealth maximisation encourages us to cheat, lie and steal as we will maximise our wealth by doing so if we can get away with it. Adopting a position of ethical egoism doesn't automatically involve cheating, stealing or wealth maximisation. This depends on whether the person considers these actions to be in his self-interest and this will depend on his theory of value (Frankena, 1963).

¹²⁸ *Agape* is a Greek word for love, implying a lifelong relationship. The English word charity comes from it through the Latin translation of *agape* to *caritas* and the old French form of it, *charité*. Love, charity and mercy are mentioned 280, 20 and 261 times in the Bible (KJV).

¹²⁹ For a Biblical motivation of Agapism see for example 1 Corinthians 13 and John 3:16.

¹³⁰ Sometimes Christian ethics is classified as a deontological ethic on the grounds that the duty is to obey God's will (Warburton, 1999). One should note that “God is love” 1 John 4:8 is preceded by “God is Light” 1 John 1:5 which refers to God as a God of justice (Isaiah 30:18).

Thou shalt love the Lord thy God with all thy heart, and with all thy soul, and with all thy mind. This is the first and greatest commandment. And the second is like unto it, Thou shalt love thy neighbour as thyself. On these two commandments hang all the law and the prophets (Matthew 22:37-40).

In context of ethical investment the Church of Finland (1999) use the same quotation and the golden rule: “Do to others what you would have them do to you” (Matthew 7:12). Frankena (1963) claims that agapism “depends in an essential way on certain theistic beliefs and experiences” and that it cannot therefore be the only form of morality, although it may be the highest form of morality (p.45).¹³² There is an important point to Frankena’s “objection” to agapism in that Christian ethics is a relational ethic (Macquarrie and Childress, 1997; Reichmann, 1994). The relationship with God through His Son Jesus Christ is vital to a Christian (Northcott, 1996).¹³³ Indeed, theologians such as Bonhoeffer (1978) have argued that love is “the revelation of God in Jesus Christ”. Therefore it would seem logical that an atheist may have a different ethic from a Christian believer.¹³⁴ The view that a theological ethic could not be universally valid is contested in Hay (1989, p.60) in which he notes that prophets such as Amos and Ezekiel and pronounced God’s judgement on nations surrounding Israel and that such judgement would have been intolerable if God’s standards had no relevance for people other than His own. Furthermore, attempts to restrict God’s moral rule to the people of God denies God’s sovereignty (Hay, 1989). Churches often argue that (at least some of) their ethic is universal (Church of Finland, 1999). The law of love, or agapism can be justified on theological grounds, although it may be difficult to justify by logic alone.¹³⁵ If one believes or experiences that God is love, then one must conclude that one ought to love (Frankena, 1963). Good acts done by adherents of an agape based ethic are not done to merit anyone’s favour, they are merely a response to the grace of God.

¹³¹ Interview with Dr Timo Eskola at Finnish Institute of Theology, January, 2001.

¹³² This relates to assumptions of reality and knowledge, which are discussed in Chapter 8.

¹³³ The passage from Matthew 22 is quoted from Leviticus 19:18 and Deuteronomy 6:5 in the Hebrew Bible and hence agapism would seem to be compatible with Judaism also. The same passage can also be found in Mark 12:29-30, see also Luke 10:25-28.

¹³⁴ Enderle (1993) claims that the Bible offers ethical teaching and that a Christian may receive help on the motivational level from hearing the Word of God, doing God’s will, following the example of Jesus, and by considering our accountability to God at the last judgement.

¹³⁵ In theology arguments have to be reasonable rather than rational.

A key point with Christian ethics is that the economy's ultimate end is to serve humankind and not vice versa (Calkins, 2000). It is recognised that whilst the author has a preference for agapism as a normative ethical theory, he and perhaps most, if not all human beings have often failed to live up to this ethic.

Christian ethics will be considered more specifically in Chapter 11, in which an agape based theology as a framework for ethics will be considered (Oslington, 2000). As mentioned in Chapter 2, Wesley (1760) provided guidelines for investing. A systematic policy for ethical investment was provided in Church of Finland (1999) and a more recent UK evaluation of the ethicality of various forms of investment including ethical investment funds was provided by Mills (2000). The contributions of these authors and the doctrines of different Churches on investment are considered further in Chapter 11.

It has been argued that "Christian moral teaching has dominated western understanding of morality...even atheistic ethical theories are heavily indebted to it" (Warburton, 1999, p.40). For example, it has been argued that utilitarianism was an attempt to extend the Christian doctrine of agape into humanocentric philosophy (Macquarrie and Childress, 1997). It has also been argued that authors such as Karl Marx and to a lesser extent Adam Smith substituted socio-political egalitarianism for religion's altruism (love) and insistence on serving others (Calkins, 2000).

Finally, to conclude section 3.2, it seems necessary to invoke theories other than those of finance in an ethical analysis of ethical funds. This requirement stems from the fact that much of mainstream finance theory seemed to be based on utilitarianism or its narrower form of ethical egoism which on their own may not be the best theories with which to evaluate ethical investment (Hay, 1989). For example, academics such as Gray (1990b) have argued in relation to environmental problems that "Neo-classical economic thinking and analysis...got us into the mess. Both economics and accounting will need to be substantitively reconstructed if they are to help get us out of it" (p.384). Indeed, it has been claimed that "financial-economic theory...explicitly excludes ethics" (Dobson, 1993). Business ethicists such as Boatright (1999)

have concluded that “If finance theory is purely technical...we should look elsewhere for the guidance that would make the world ethically a better place” (p.128). It would therefore seem insufficient to rely only on the teleological ethical theories on which finance theory draws in an analysis of “ethical investment”. The ethical theories presented in this Chapter will be used for further analysis of ethical funds in Chapter 11.

Alternative theories such as deontological ethics or a Judeo-Christian ethic such as agapism may be more promising for an evaluation of the ethical aspects of investment. This is consistent with the finding in Chapter 2 that different Churches and individual Christians played a key role in establishing ethical funds in many European countries and the USA employing the same ethical criteria which Churches had used for their own investments many years earlier (Melton and Keenan, 1994; NPI, 1995; Sparkes, 1995). There is also a substantial literature in theology concerning “ethical investment” and wealth, this will be developed further in Chapter 11.

3.3 Markets and ethics

According to Fama (1970) the primary role of a stock market is the allocation of ownership of the capital stock. A stock market thus provides an investor with the possibility to choose what to own. Others have claimed that asset markets are an “insurance market” (Cochrane, 2000). For some investors the financial result of the investments may be the only objective with the investment. For others it provides an opportunity to integrate their ethical values and their investments. One way of achieving the objective of integrating values into the investment process is by investing in ethical funds (Woodward, 2000). This ties in with the investment ethic problem of avoiding certain companies and activities (Larmer, 1997; Mackenzie, 1997). It is further argued that “knowingly providing the resources by which a company will engage in wrongdoing is immoral” and that “simply approving of immoral action is immoral” (Larmer, 1997). Investors who do not wish to divorce their values from their investments can integrate their values into the investment decision by implementing various ethical criteria as a part of the investment process.

However, the effectiveness of positive ethical criteria may be limited because it has been shown that even if the stock markets were strong form efficient in the Fama (1970) sense, investment decisions may still be suboptimal (Shefrin and Statman, 1993; Dow and Gorton, 1997).¹³⁶ This is so because stock prices have no role in the allocation of equity capital since managers have discretion in determining the level of investment (Dow and Gorton, 1997). Furthermore, it has been argued that lenders exert substantial influence over firms and that their interests may differ from those of the shareholders (Stiglitz, 1981). Because of the secondary nature of the stock market it is not clear that even a perfect ethical portfolio supports the desired companies because the funds normally do not provide these companies with any capital unless the fund invests in an initial public offering or a new emission. Another problem is that most ethical funds restrict their investments to companies listed on a stock exchange and thereby many small firms developing environmental technologies or showing social progressiveness are excluded from investment. Therefore it has been argued that the direct environmental and social impacts of investing in ethical funds are limited (Natuvårdsverket, 1999; Friends Provident, 2001).

There are also alternative theories to the efficient market hypothesis such as the hyperreal markets theory, which argues that the connection between the stock market and the “real” economy to some extent has been lost and that stock markets have started to resemble a hyper real game (McGoun, 1997). This weaker connection between the stock market and the “real” economy may be partly due to the changes which have taken place in share ownership in the UK as table 3.2 demonstrates. Table 3.2 shows the decline in the shares owned directly by individuals and charities in the UK from 61.4% of the stock market in 1963 to 16.6% in 1999. Furthermore, institutions and overseas investors increased their share from 32.3% to 81.2%.

¹³⁶ However Grossman and Stiglitz (1980) show that when the efficient market hypothesis is true and information is costly, competitive markets break down. Instead they propose a model with some informed and some uninformed investors and argue that because information is costly “prices cannot perfectly reflect the information which is available” (p.405). In any case it has been argued that efficiency is often confined to the economics of a particular unit and thus partial, leaving society in general to pay for unintended consequences (Handy, 1997).

Table 3.2 Changes in UK Share Ownership

	1963 (%)	1981 (%)	1999 (%)
Individuals and Charities	61.4	30.4	16.6
UK institutions and overseas investors	32.3	61.8	81.2

Sources: Sparkes (1995) and Office of national statistics 2000. A more comprehensive version of this Table is presented in Appendix 2.1

It has therefore been argued that stock markets have changed so that materialistic values have become more dominant as a result of factors such as; the computerisation of the stock markets, the change in share ownership (institutionalisation) and globalisation (Greider, 1997; McGoun, 1997).

It is however claimed that there are indirect benefits for the companies in ethical funds such as goodwill, positive publicity and perhaps more patient owners (Naturvårdsverket, 1999). It has also been argued that any increase in the cost of equity for corporations avoided by ethical investors is likely to be small (Angel and Rivoli, 1997).¹³⁷ Thus it would seem unlikely that ethical funds would significantly affect the share prices of large corporations. They might have a larger impact on the share price of smaller pioneering and listed companies as these are often held by many ethical funds (Hancock, 1999).

It is therefore necessary to examine the investment processes of the ethical funds to see whether the ethical funds provide some other indirect support to the investee companies and whether there are mechanisms to promote ethically desirable behaviour and discourage unethical activities. Indeed, it has been claimed that ethical funds are potentially powerful allies to those working within the environment, health and safety departments of corporations. Ethical funds may perhaps overcome the separation thesis to some extent (Werhane and Freeman, 1999); it is therefore likely that proponents of the thesis that ethics should not be considered in business will not be supportive of ethical investment funds. However, opponents of the thesis will disagree. Religious investors have

¹³⁷ It has been argued that even the widely supported South African boycott did not significantly affect share prices of corporations with operations in South Africa (Teoh, Welch and Wazzan, 1999). However, Angel and Rivoli (1997) argue that large scale divestment of sectors such as tobacco may lower firm value in these sectors and that this may not be picked up by event studies such as Teoh *et al.* (1999).

not seen ethics and investment as separate (Church of Scotland, 1988). Indeed, it has been argued that mere financial return on investment is not “an adequate rationale for shareholder decisions”; various ethical investment strategies must be pursued as a complement to the fiduciary duties (Catholic Bishops, 1992; Church of Finland, 1999).

An investigation of the manifestation of the ethics may also provide insights into whether ethical funds to some extent can overcome the separation thesis (Werhane and Freeman, 1999). This will be investigated in Chapter 9 and 10 through a number of interviews with ethical fund staff.

There is, however, a further problem regarding to how ethical the investment funds are which relates to the macro or system level. For example, Suranyi (1999) argues that the stock market fosters unsustainable patterns of development,¹³⁸ while Lindblom (1982) suggests that the values prevalent in business oppose positive social development. Other problems relate to the privileges which the market gives the strong over the weak and the promotion of short term interest over the long term (Centre for Theology and Public Issues, 1992). Indeed, stock markets would seem to fail to satisfy the requirement of utilitarianism in providing the greatest good for the greatest number because individuals directly own only a small fraction of it. It would seem as though ordinary people and marginal groups such as the homeless and refugees receive little if any benefit from the stock markets.

According to Greider (1997) the lack of accountability resulting from global unregulated markets may ultimately prove harmful for all market participants. Some authors have also claimed that global free market competition may lower standards, particularly in regards to environmental and social issues (Greider, 1997; Handy, 1997).

¹³⁸ It has been argued that stock market participants ignore environmental information. For example, Kjellman and Granlund (1998) showed that among Finnish fund managers environmental policy was seen as least important of 26 items considered in valuing a firm.

It has been argued that market exchange motivated solely by efficiency and advantage violates Kantian ethics because people are treated just as a means rather than an end (Evan and Freeman, 1988; Thielemann, 2000). Concerns have also been raised regarding the effects of asymmetric information, overreaction, manipulation and lack of fairness on stock markets (Power, 1992; Shefrin and Statman, 1993; Kindleberger, 1996; Boatright, 1999).¹³⁹ As this dissertation focuses on the individual and to a lesser extent the organisational levels these systemic questions will only be considered briefly here. They do however suggest that there are ethical issues involved with any stock market investments which cannot be completely solved by investing in ethical funds.

The question about whether the pursuit of wealth for its own sake has become the goal of society in detriment to other values has often been raised (Hay, 1989). If wealth maximisation has become a goal in society, to what extent is it linked to the fundamental doctrine of maximising shareholder value in finance? (Boatright, 1999). It has been argued that the result of ignoring non-financial issues is that utility maximisation reduces to wealth maximisation (McGoun, 1997). This may lead to a situation in which “Money is the secular God of the world” and a “financial culture that has nothing to do with the underlying economy of things” (McGoun, 1997). It has been argued that fund managers often prefer to be passive in terms of the companies in their portfolios, especially in ethical matters as they may want to sell the shares of a company quickly for financial reasons and there rarely is commitment to long term investment (Naturvårdsverket, 1999).

At the heart of this question of pursuing wealth as an end is the importance attached to the profit motive. For example, Jacobsen (1991) argues that while profit seeking is not unethical per se, it becomes immoral when it decreases the quality of life (p.204).¹⁴⁰ Christian ethics have traditionally been sceptical of

¹³⁹ A number of attributes relating to an ideal “fair” stock market is listed by Shefrin and Statman (1993). These include; freedom from coercion, equal information, equal processing power, freedom from impulse, efficient prices and equal bargaining power.

¹⁴⁰ One expert interviewed for this dissertation argued that “if you do not accept the profit motive don’t invest in the stock market, full stop”.

profit seeking as the sole objective of enterprise (Luther, 1524). It has been argued that:

the financial community have broken loose from constraints of the past and from the values of a society which did not have the making of money out of money as its number one priority (Centre for Theology and Public Issues, 1992).

From a Kantian perspective an objective such as maximising share holder value or profits should never be an end in itself. Ethical duties would always take priority over purely financial aims. Of interest for this dissertation is the extent to which the stock market has contributed to the worst income inequality in the UK in 40 years (SustainAbility, 2001). Dollar millionaires control a third of the world's wealth and the incredible rise in the number of millionaires and the wealth they control is attributed to the stock market in general and share options in large companies in particular (Economist, 2001). It is not necessarily problematical in itself that the stock markets have helped to create many new millionaires; the problem is that these windfall gains have sometimes been unmerited (Economist, 2001). However, it would seem as one could argue from all the ethical theories that the current situation where the 200 richest investors have as much wealth as the poorest 2.25 billion investors is unjust (Blanchard, 2000, p.510). It is argued that from the point of view of a Judeo-Christian ethic such as agapism maximising shareholder value and profits without considering environmental, ethical and social issues is unethical. Similar conclusions from other perspectives have been presented in Gray (1990) and Dobson (1993). Indeed, it will be argued in sections C and D of the dissertation that for evaluating ethical funds, ethics, risk and return are all relevant.

It has also been argued that there is a "destructive feature of the market", but these "externalities" are ignored as it is not beneficial to internalise them from a utilitarian point of view (Thielemann, 2000).¹⁴¹ Finally, it has been claimed that the market place benefits from obscuring when we have enough of what it can provide (Jacobsen, 1991). Propaganda and forceful means may be employed by firms to promote their own interests (Beder, 1997; Collison, 1998).

It is argued in Horrigan (1987) and Boatright (1999) that modern finance theory may have some harmful ethical and financial consequences. For example, managers employing the Capital Asset Pricing Model (CAPM) may not pay sufficient attention to unique risk, which may be vital to customers, employees and suppliers to a firm.¹⁴² It was also argued that CAPM and option pricing theory may be disruptive of the stock market as volatility may increase as a result of less concern for unique risk and a higher option value resulting from increased volatility of shares. This leads Boatright (1999) to conclude that finance theory is “incomplete” and that a world in which investors pursue their own interest guided by finance theory alone would not be “a nice place ethically” (p.128). Because of the ethical problems with financial markets and finance theory it is argued that while financial performance measures may be relevant for an analysis of ethical funds, these measures are not sufficient for an ethical analysis. Since these funds are explicitly ethical funds, ethical issues must also be considered when analysing them.

If stock markets and finance theory are a cause of economic inequality, drive unsustainable development and have destructive and ethically problematic features, this may make investments in stock markets – even in ethical funds – less attractive from an ethical point of view. It would make direct investments in activities perceived to be ethical and sustainable seem to be more attractive, but such an investment strategy is likely to result in lower expected returns.¹⁴³ Lower financial returns for some part of an individual’s wealth in return for environmental or social benefits would be consistent with some deontological or agapist ethic, but may be more difficult to reconcile with some forms of egoism and financial utilitarianism.

On the other hand it has also been argued that the UK market economy has delivered higher living standards and fostered creativity and enterprise within Britain (Centre for Theology and Public Issues, 1992; Sacks, 2000). Despite

¹⁴¹ Thielemann (2000) argues for market restraints to limit the negative effects of competition, and advocates that on a personal level this means refraining from utility maximisation.

¹⁴² The CAPM was used to estimate the cost of equity by 74% of 392 Chief Financial Officers (Graham and Harvey, 2001). This rate was used even to evaluate overseas projects.

¹⁴³ For example Professor Alan Lewis indicated at an UKSIF seminar in London that investment in the lending co-operative Shared Interest was more ethical than investment in ethical funds.

many drawbacks it allows freedom of choice for many and promotes efficiency (Church of Scotland, 1988). Capital markets provide opportunities to exchange intertemporal consumption among individuals (Copeland and Weston, 1988). Financial markets can also serve to control risks (Cochrane, 2000). The same authors also point out that the market system depends on virtues such as co-operation and trust which are not produced by the market (Centre for Theology and Public Issues, 1992; Sacks, 2000). It is argued that these virtues arise mainly in families, communities, congregations and voluntary organisations (Sacks, 2000). A need for laws and regulations for investment and financial institutions is recognised (Church of Scotland, 1988). It has also been argued that the markets can be our servant rather than our master (Handy, 1997). Teleological (consequential) arguments are often used by both proponents and opponents of the market economy. An evaluation of the market economy is however beyond the scope of this dissertation. Therefore these issues were only briefly considered here.

3.4 Conclusions

A conclusion from this Chapter is that if the objective is to evaluate ethical funds from other perspectives than the purely financial, some ethical theory is necessary. Indeed, it is argued that while financial performance measures may be relevant for evaluating ethical investments in general and ethical funds in particular these financial measures are not sufficient for an ethical analysis (Frankena, 1963; Geisler, 1994; Mäkelä, 1998). Ethical reasoning must be an explicit part of the evaluation. The argument presented here and continued in later Chapters of the dissertation is that at least for “ethical investment” it is necessary to consider ethics in addition to risk and return. Arguably the risk-return framework is based on a variant of one ethical theory, utilitarianism (Markowitz, 1991; Boatright, 1999). This Chapter demonstrated that there are problems with this theory which may not be compatible with other ethical theories such as Kantian ethics and Christian ethics (Hay, 1989; Geisler, 1994; Boatright, 1999). Therefore, four groups of ethical theories were presented; deontological, teleological, egoistic and agapist. It has also been argued by both philosophers and theologians that duties, consequences, motives and the action itself must be evaluated in an assessment of the ethicality of an action (Mäkelä,

1998; Wright, 2001). These theories will be used further in Chapter 11 of the Dissertation. One aim of this Chapter was thus to provide a framework for later analysis of ethical funds from an ethical point of view.

It was seen that different ethical theories may generate different insights. It seemed that teleological theories were not fully satisfactory, and some weaknesses in egoism and utilitarianism were identified. One such weakness was that “noble” ends might justify unethical acts. Kantian ethics on its own also seemed to be insufficient to evaluate ethical funds, because Kantian ethics seem to have had no relevance for the criteria, establishment and operation of those ethical funds studied in this dissertation. Indeed, it has even been argued that market exchange itself may violate Kantian ethics (Thielemann, 2000).

The history and criteria of ethical funds presented in Chapter 2 indicated that a Christian ethic did seem to provide insights into the establishment of many pioneering ethical funds, explaining some of the ethical criteria and practices employed by ethical funds. The perspective which will be developed further is an agape based Christian ethic. This ties in with the cultural/religious background of the countries in this investigation and the fact that religious investors were a major customer group for at least 15 of the sample funds.¹⁴⁴ It is therefore acknowledged that the analysis in Chapter 11 of this dissertation may not be generalisable outside of the sample.

It was argued that the nature of the stock market is such that the support investors provide to companies by investing in an ethical fund may be rather indirect. It was also argued that it is unlikely that actions taken by ethical funds alone would substantially alter share prices of companies. Therefore, it was argued that the extent to which ethical values are integrated into the investment processes may provide some insights into how beneficial investments ethical funds are from an ethical point of view.

¹⁴⁴ Christians were involved in starting the first ethical funds in Finland, France, Holland, Sweden, the UK and the USA. Ethical criteria such as alcohol, gambling, tobacco and weapons were related to the doctrine of different Church groups (Kinder and Domini, 1997). In terms of asset under management the funds with a Christian influence represented a majority.

It was also argued that there are some ethical issues with stock market investments which can't be completely avoided by investment in ethical funds. These issues arise due to the possible role stock markets have played in fostering profit maximisation in the short term as the main corporate objective, at the expense of some ethical issues and the environment. This dominance of materialistic values may have played a role in increasing economic inequality and the unsustainable development in the 1990's (UNEP, 2000). Researchers such as Horrigan (1987) have suggested other objectives for the firm such as "ecological harmony with its environment" and "survival of the firm".

However, it is also recognised that investment decisions have a return and risk dimension in addition to the ethical dimension (Markowitz, 1990). This financial performance dimension is investigated in the next Section. As Markowitz (1991) noted, mean and variance can be employed in portfolio analysis, although one does not accept the expected utility maxim or more generally utilitarianism or consequentialist ethics. The view of humans and ethics advocated by the teleological theories are considered to be partial at best in this dissertation. Because the next four Chapters to an extent are based on financial utilitarianism it is argued that the potential ethical problems relating to this approach must be acknowledged explicitly.

The next four Chapters will analyse whether ethical funds are good investments from a financial point of view, while Chapters 9-10 will investigate how ethical policies of the funds are manifested in practice and how ethical values are imbedded in the investment processes. Chapter 8 will consider assumptions relating to reality, knowledge, human beings and theology. Chapter 11 will employ the ethical theories presented in this Chapter in an analysis of ethical funds. Finally, some Church ethical teaching on investment will be considered in Chapter 11, while conclusions are offered in Chapter 12.

Chapter 4 A Review of the Literature on Ethical Fund Performance

4.1 Introduction

The previous Chapter presented ethical theories which could be used for evaluating ethical funds from an ethical point of view. This Chapter reviews previous studies on fund performance with a focus on investigations of ethical funds. The Chapter serves as an introduction to Chapters 5, 6 and 7 which outline the method adopted, describe the data used and detail the empirical investigations into the financial performance of ethical funds employed in this dissertation. The objective of these investigations is to address the question of whether ethical funds are “good” investments financially.¹⁴⁵ This is achieved by comparing ethical fund performance with the returns available from market benchmarks and the gains which were on offer from similar non-ethical funds.

The structure of this Chapter is as follows. First, some background details about evaluating fund performance in general is presented. Second, historical developments in fund performance evaluation are reviewed focusing on those measures employed in the empirical investigations. These measures are presented in Chapter 5. Third, some more recent developments and studies in fund performance evaluation are briefly discussed before turning to how this body of knowledge has been applied to ethical funds in section 4.4. Section 4.5 explores some of the differences between ethical and non-ethical portfolios, while Section 4.6 presents the expectations for the empirical studies based on the literature. Finally, in section 4.7 some conclusions are offered.

The studies of fund performance presented in this Chapter are based on mean variance portfolio analysis which was developed in Markowitz (1952, 1959) and the pioneering work on asset pricing theory by Sharpe (1964), Lintner (1965) and Mossin (1966).¹⁴⁶ The basic result from this analysis is that the expected return from any well-diversified fund is a function of its risk: the higher the risk,

¹⁴⁵ Eg whether ethical funds perform as well as their non-ethical counterparts and market benchmarks with financial criteria.

¹⁴⁶ A notable exception is Guerard (1997). He uses a cross sectional regression model and examines the returns of a number of simulated ethical investment universes.

the larger the return which an investor would expect to earn.¹⁴⁷ The breakthrough in Markowitz's early work was to measure risk using the standard deviation of security returns. Later researchers such as Sharpe (1964) and Lintner (1965) independently built on this idea by developing a relative measure of risk; they derived the notion of a security's Beta which is simply its volatility of returns relative to the volatility of return earned by all assets in the market.

One of the first areas where this approach was empirically examined involved managed funds. A number of investigations attempted to evaluate the financial performance of managed funds by comparing the returns earned by the investments with their risks. However, some investigations of funds have attempted to analyse why some funds can earn abnormal returns, for example, Treynor and Mazuy (1966) were the first to conduct a study on market timing. Market timing or forecasting refers to utilising information about the general movements of the stock market to earn superior returns.¹⁴⁸ Furthermore, they provided a way for decomposing the market forecasting and security selection aspects of performance. Another market timing model was developed by Henriksson and Merton (1981).

In his comment on Jensen (1968), Farrar (1968) argued that at least six factors must be considered when a fund's financial performance is evaluated. These factors were:

1. Market return,
2. Market related risk,
3. Security related risk,
4. Managerial skill, involving market forecasting,
5. Managerial skill, involving security selection, and of course
6. Luck.

For the purposes of this dissertation another factor must be added, in the context of ethical funds:

¹⁴⁷ Investors are assumed to be well diversified, they will be awarded for nondiversifiable risk.

¹⁴⁸ For example, a fund manager with superior market timing ability anticipating a downturn in the market may increase the amount of bonds and low beta stocks in the portfolio to ensure better performance than the market index when stock markets fall.

7. Ethical expertise in security selection.¹⁴⁹

The next four chapters will consider these factors, focusing particularly on evaluating the performance resulting from security selection and market forecasting/timing; the risks relating to markets or securities as well as the importance of luck are only briefly addressed. Ethical expertise in security selection is considered in Chapter 10.

The problems involved with the factors of market risk and return for fund performance evaluation have been discussed by Roll (1978). He demonstrated that performance measures related to the security market line were sensitive to the proxy used for the market portfolio, indeed he argued that the tests ultimately only provide information about the market index employed. Authors such as Bierman (1998) have discussed security related risks. Studies of fund performance, which combine many of the categories above proposed by Farrar (1968) make it difficult to determine the source of superior/inferior performance. This is why market timing models were developed by Treynor and Mazuy (1966) and Henriksson and Merton (1981) to distinguish performance arising from security selection and market forecasting. All studies described in this chapter use either one of these market timing models or at least one of the following risk adjusted fund performance measures: Treynor, Sharpe and Jensen. All these measures will be presented in Chapter 5 and employed in the empirical investigations in Chapters 6 and 7.¹⁵⁰ The ethical expertise factor will be investigated through interviews in Chapters 9 and 10.

4.2 Pioneering Studies

This section examines the studies in which the traditional performance measures were developed. The first investigations to comprehensively address the risk adjusted returns earned by funds were Treynor (1965) and Sharpe (1966). In

¹⁴⁹ Ethical funds need to select securities with good ethical and good financial performance and integrate these two components in the investment decision (Stone, 2000, p.82).

¹⁵⁰ Many other performance measures such as: the Treynor and Black (1973) Appraisal Ratio, The Positive Period Weighting Measure developed in Grinblatt and Titman (1989), The M^2 presented in Modigliani and Modigliani (1997) and approaches based on Stochastic Dominance such as Woodward (1983), and many other measures have not been used in ethical fund performance evaluation and are therefore not considered in this dissertation.

these studies what became known as the Treynor and Sharpe measures were introduced and tested. The most common performance measure in the literature was introduced by Jensen (1968). This study is considered in more detail as the Jensen alpha measure has been used in almost all subsequent studies outlined in this Chapter and according to Ippolito (1993) this pioneering work was the most influential study of fund performance. Finally, some early European fund performance studies employing these measures are considered. These early studies are summarised in Table 4.1.

Table 4.1 Early Studies of Fund Financial Performance

Study	Year	Results
Treynor	1965	Treynor measure first introduced. Average US Fund performance similar to DJIA index ¹⁵¹ .
Sharpe	1966	Sharpe measure developed. American Fund and DJIA index performance was similar.
Jensen	1968	Jensen measure first presented. US funds underperformed Standard & Poor 500 index net of expenses.
McDonald	1973	French funds produced superior risk adjusted returns as measured by Treynor, Sharpe and Jensen measures.
Farber	1975	European fund performance no different from Eurosyndicat Index according to the Jensen measure.
Ward and Saunders	1976	Early application of Treynor, Sharpe and Jensen to UK funds, which underperformed the market.

The first column refers to the author, the second column refers to the year it was published and the third column reports the main result of the investigation.

One of the first risk adjusted fund performance measures was developed by Treynor (1965). He analysed the performance of American mutual funds for the 1953-1963 period and documented that 8 of 20 mutual funds had a higher Treynor measure than the Dow Jones Industrial Average (DJIA) Index. The Treynor measure which is a reward to market risk ratio was first introduced in this paper. While the Treynor measure is not as common as the Sharpe or the Jensen measure, it is still widely reported in academic studies.¹⁵²

¹⁵¹ DJIA Index is an abbreviation for the Dow Jones Industrial Average index.

¹⁵² Allen and Tan, 1999; Bal and Leger, 1996; Gjerde and Sættem, 1991; Mallin, Saadouni and Briston, 1995; Khorana and Nelling, 1997; M'Zali and Turcotte, 1998; Sandvall 1999; Liljebloom and Löflund, 2000 among others employ the Treynor measure.

One of the most influential fund performance studies was Sharpe (1966).¹⁵³ He analysed the performance of 34 US mutual funds between 1953-1964 employing the Treynor and Sharpe measures. The Sharpe measure is a reward to total risk ratio. The Sharpe measure for the DJIA was 0.67 and the average fund ratio was 0.63. He found that 19 funds outperformed the DJIA gross of expenses while 15 underperformed it. Sharpe concluded that funds with lower expense ratios tended to be better for policy holders and that the size of a fund did not appear to influence fund performance. This finding regarding fund size has been confirmed in later studies by Grinblatt and Titman (1994) and Gregory, Matatko and Luther (1997).¹⁵⁴

In his seminal study, Jensen (1968) analysed the performance of 115 US mutual funds between 1955-1964; for 56 of these funds he had annual data from 1945-1964. The Jensen measure evaluates the returns earned by a fund compared to the risk adjusted returns achieved on a benchmark portfolio. The average Jensen measure was -0.4% per year, gross of expenses and five of the funds had outperformed the market at the 5% level. By contrast, the average alpha net of expenses was -1.1% per year for the 1945-1964 period. For the 1955-1964 subperiod the average Jensen measure was relatively higher, -0.1% per year gross of expenses (55 funds earned a positive Jensen alpha while 60 achieved a negative alpha). There are a number of limitations to this analysis. First, Jensen did not know the expense ratios prior to 1955.¹⁵⁵ Instead, he assumed they were the same as those in 1955 and noted that this assumption might have caused a downward bias in his estimated measure of fund performance. Second, Jensen underestimated fund performance by assuming that all dividends were reinvested in December each year. However, most funds paid dividends on a quarterly basis, which would have increased the actual returns by a small amount.¹⁵⁶

¹⁵³ Sharpe (1968) has been quoted in 191 American academic articles between 1971 and 1990 according to Ippolito (1993).

¹⁵⁴ The sign of the size variable varied with the time period in Liljeblom and Löflund (2000).

¹⁵⁵ The combination of management fees, administrative and other expenses divided by fund size is referred to as the expense ratio.

¹⁵⁶ Some authors have quoted Jensen (1968) in support of the efficient market hypothesis and implied that fund managers are unable to outperform a market benchmark, but Mains (1977) and Ippolito (1993) have questioned these conclusions.

4.2.1 Early European Studies

European investigations of fund performance tended to appear later and initially replicated the US investigations undertaken by Treynor, Sharpe and Jensen. An early study of continental European fund performance was conducted by McDonald (1973). He studied the performance of 8 international French funds within the time period 1964-1969, employing the Sharpe, Trynor and Jensen measures. The funds outperformed a French market portfolio by all the measures. Similar results were obtained with a two index model incorporating the Standard & Poor 500 index in addition to the French index. The author concluded that the French market seemed to be inefficient at the time.

McDonald's early work was built upon by Faber (1975), which was one of the first studies to examine the performance of funds from several European countries. He analysed the performance of 27 international European funds from 6 countries between 1963-1971, using the Jensen measure. With the Eurosyndicat European index¹⁵⁷ as a benchmark he reported that the average Jensen measure of all the funds was positive, but when the Standard & Poor 500 index was employed as the market index the funds on average underperformed. This result occurred as 10 of the sample funds invested only in Europe, while American stocks outperformed their European counterparts in the period investigated.

One of the first studies to apply the Jensen, Sharpe and Treynor measures to UK funds was Ward and Saunders (1976). They evaluated the performance of 49 UK funds against the FT 650 index using annual data for the 1964-1974 period. Most funds underperformed the market. Therefore Ward and Sunders (1976) concluded that their findings seemed to support stock market informational efficiency for the London Stock Exchange.

The question of benchmark sensitivity documented by Faber (1975) for European funds has remained an issue throughout the research on fund performance. One of the possible reasons why funds appear to perform poorly in these empirical investigations is that measures of fund performance assume that

the risk is held constant throughout the test period whereas, in practice, managers may alter the risk to time the market movements. A further limitation of the early studies was the use of annual data, which led to very few observations per fund. This use of annual data may have been particularly problematic in market timing studies (Treynor and Mazuy, 1965).

4.3 Market Timing and Developments

This section considers the developments in fund performance evaluation as they relate to the methods used in Chapters 6 and 7. In particular it focuses on studies in which the market timing models of Treynor and Mazuy (1966) and Henriksson and Merton (1981) have been used. The timing models are discussed in detail in Chapter 5. Table 4.2 summarises some fund performance studies focusing on market timing ability.¹⁵⁸

The performance measures employed in the pioneering studies in this area did not offer any insights into the source of superior or inferior performance. Later investigations have addressed this issue by employing models, which can distinguish between (i) macro forecasting skill, or the ability to forecast market movement and use this ability to earn superior returns and (ii) micro forecasting skill, or the ability to select undervalued securities. A fund attempting to earn superior returns by timing the market should increase its beta when share prices go up and decrease it when share prices go down. Perverse timing implies that funds have a higher beta in bear markets and a lower beta in bull markets. Successful market timing would imply that the opposite should be the case.

¹⁵⁷ The Eurosyndicat Index was an index of the European capital market based on 120 securities.

¹⁵⁸ Summaries of fund performance studies of a more general nature can be found in Ippolito (1993), Elton and Gruber (1995) and Allen and Tan (1999).

Table 4.2 Market Timing and Other Studies of Fund Performance

Study	Year	Result
Treynor and Mazuy	1966	First market timing measure introduced. US mutual funds unable to time the market.
Roll	1978	SML based performance measures shown to be sensitive to choice of market index. ¹⁵⁹
Henriksson and Merton	1981	Dummy variable regression to measure market timing ability first introduced.
Henriksson	1984	US Funds did not exhibit timing ability, but some had significant microforecasting ability.
Cumby and Glen	1990	International US funds underperformed market and were not able to time the market.
Eun, Kolodny and Resnick	1991	International US funds outperform US market but were not able to time the market.
Gjerde and Saettem	1991	Norwegian funds exhibited positive market timing ability. Performance measured by Sharpe, Treynor, Jensen similar to market.
Black, Fraser and Power	1992	Time varying beta method employed. Many UK funds significantly outperformed market.
Fletcher	1995	UK funds exhibited stock selection ability but no market timing ability.
Bal and Leger	1996	Weak evidence of superior performance of UK funds by Jensen and Treynor measures.
Ferson and Schadt	1996	Negative performance for US funds with traditional performance and timing measures. Performance neutral with conditional models.
Sandvall	1999	Some evidence of positive market timing ability by Finnish funds.
Allen and Tan	1999	Performance persistence found for UK funds. Jensen measure conveyed information on future performance.
Liljeblom and Löflund	2000	Finnish fund performance not sensitive to benchmark. No evidence of timing ability.
Bollen and Busse	2001	US funds exhibited positive market timing ability when daily data was employed.

The first study to examine the market timing abilities of funds was Treynor and Mazuy (1966). They concluded that only one American fund out of the 57 in their sample showed any signs of market timing in the 1953-1962 period using annual data, the evidence of timing was not statistically significant at the 5% level. Their findings raised doubts about the benefit of research undertaken by funds. Whilst many subsequent studies (Cumby and Glen, 1990; Gjerde and

¹⁵⁹ SML = Security Market Line.

Saettem 1991; Liljeblom and Löflund, 2000) have confirmed these original findings, other studies have provided some evidence of positive market timing ability, suggesting that funds may be able to recoup their research costs.¹⁶⁰

The Treynor and Mazuy study has been criticised by Ippolito (1993) on the grounds that it is difficult to test for timing with only 10 observations per fund. He also criticised the test as being inefficient, on the basis that the timing ability of the individual funds was tested, but no investigation of whether funds as a whole showed evidence of timing was undertaken. More recently, Ferson and Warther (1996) have suggested that one reason why funds might not exhibit any evidence of market timing ability as measured by the Treynor and Mazuy (1966) approach relates to money flowing into these funds. When the public anticipate that security returns will increase, perhaps they invest in funds which increases the funds' cash balances and as a result betas decline. This may explain why funds seem to have low market exposure when expected market returns are high.

A second approach to investigating market timing has been developed by Henriksson and Merton (1981). They have introduced another timing measure in which a dummy variable assesses the macro forecasting ability of a fund manager instead of the quadratic term used in the Treynor and Mazuy approach. Studies using the Henriksson and Merton approach have reached similar conclusions to those using the Treynor and Mazuy approach; either the sample funds have no timing ability or only negative ability. One reason for these negative results may be that most of these studies utilised low frequency data such as annual or monthly data. It was shown by Bollen and Busse (2001) that the market timing ability of 230 US mutual funds improved substantially when daily data was employed instead of monthly data.¹⁶¹

¹⁶⁰ The initial studies were seen as support for the efficient market hypothesis, whilst the more positive studies (Kon, 1983; Lee and Rahman, 1991; Sandvall, 1999 and Wermers 2000) lend more support to informational efficiency in the Grossman and Stiglitz (1980) sense.

¹⁶¹ Henriksson (1984) and Liljeblom and Löflund (2000) found no timing ability with the Henriksson and Merton model, whereas Sandvall (1999) found some evidence of positive timing ability. Ferson and Schadt (1996) found that the incorporation of lagged information variables largely removed the negative timing coefficients.

4.3.1 Other Studies

Another area which has received much attention by researchers is benchmark sensitivity. In a widely cited study, Roll (1978) argued that performance measures relating to the security market line of the capital asset pricing model (CAPM) are sensitive to the choice of benchmark index. This led to a number of studies considering benchmark sensitivity such as Grinblatt and Titman (1994). Standard CAPM and arbitrage pricing theory (APT) benchmarks were compared in Lehman and Modest (1987), they found fund performance to be sensitive to the choice of asset pricing model and different specifications of the APT.

A number of more recent studies such as Black, Fraser and Power (1992) and Ferson and Warther (1996) have employed models which allow for time varying risk. Indeed, Ferson and Schadt (1996) and Sandvall (1999) argued that fund performance improved when evaluated with conditional models.

4.4 Applications to Ethical Funds

This section reviews how the measures and methods developed in earlier fund performance studies have been applied to ethical funds. The focus is especially on studies which directly compare ethical and non-ethical investment funds.

Table 4.3 Ethical Fund Performance Studies

Study	Year	Results
Luther, Matatko And Corner	1992	15 UK ethical funds performed as well as market index by Jensen and Sharpe measures.
Hamilton, Jo and Statman	1993	Performance of 32 US ethical funds no different from large random sample of ordinary funds.
White	1993	11 US and 5 German Ethical funds under-performed benchmarks between 1990-1993.
Luther and Matatko	1994	Performance of 9 UK ethical funds no different from small company benchmark in the 1985-1992 period.
Mallin, Saadouni, And Briston	1995	Performance of 29 UK ethical funds similar to Ordinary funds as measured by Jensen, Sharpe and Treynor during 1986-1993.
WM Company	1996	Strong performance by the <i>FP Stewardship fund</i> , UK ethical indices performed well.
Guerard	1997	Constrained investment universes performed as well as unconstrained in the US between 1987-1996.
Gregory, Matatko, And Luther	1997	Performance of 18 UK ethical funds similar to Ordinary funds. Size, age and ethical status of fund did not explain fund performance.
M'Zali and Turcotte	1998	Mixed results compared to market for 12 US and 6 Canadian ethical funds in the 1994-1997 period.
Reyes and Grieb	1998	Performance of 15 US ethical funds no different from peer indices by Sharpe measure.
EIRiS	1999	UK Ethical indices perform as well as market Benchmarks between 1990-1999.
WM Company	1999	Similar performance between charity, ethical and Unconstrained indices in the UK.
Abramson and Chung	2000	Evidence that ethical investment is style neutral. No Significant cost to a passive ethical approach.
Antonio, Johnsen And Hutton	2000	Combinations of American ethical bond and equity indices outperformed conventional indices.
Cummings	2000	Performance of 7 Australian ethical funds no different from small, industry and market indices.
Statman	2000	31 US ethical funds and an ethical index perform no different from 62 non-ethical funds and 2 indices.
Naturvårdsverket	2001	10 Swedish and 3 Norwegian ethical funds perform as well as similar ordinary funds.
Bauer, Koedijk And Otten	2002	No significant difference between 103 US, UK and German ethical funds and conventional funds.

The first column reports the authors of the study, the second column refers to when the study was published. The Third column reports the main result of the investigations.

Early studies of UK ethical fund performance only compared ethical funds with market-wide benchmarks such as the Financial Times All Share Index. For example in the first published article on this topic in the UK, Luther, Matatko

and Corner (1992) provided weak evidence that ethical funds outperformed the Morgan Stanley Capital International Perspectives Index from inception to 1990 by the Jensen measure. The performance compared to the Financial Times All Share Index was neutral by the Sharpe and Jensen measures.

In a subsequent study, Luther and Matatko (1994) addressed some of the concerns raised in this early work. Since the ethical funds tended to invest a larger part of the funds in smaller companies with lower dividend yields, they argued that a small company index should be employed as a market proxy for ethical funds in addition to a broad based stock market index. The authors investigated the sensitivity of their findings to the benchmark index examined; the findings demonstrated that ethical funds performed much better when evaluated against a small company benchmark, than when only the Financial Times All Share index (FTSEALL) was used.

The study of Mallin, Saadouni and Briston (1995) overcame the benchmark problem of the early studies by using a matched pairs analysis in their UK investigation. They compared the performance of a group of ethical funds with a sample of non-ethical funds, matched on the basis of age and size. They studied the returns earned by 29 UK ethical funds and 29 UK non-ethical funds between 1986-1993 using the Jensen, Sharpe and Treynor performance measures and concluded that a small majority of funds from both groups underperformed the market as measured by the FTSEALL index. Ethical funds performed as well as their non-ethical counterparts and better than the non-ethical funds when the Jensen performance measure was used. Specifically, 4 ethical funds and 4 of the non-ethical funds had positive alphas, which were significant at the 5% level. These findings were remarkable, since Luther *et al.* (1992) argued that ethical funds have a large number of small companies in their portfolios and yet Gregory, Matatko and Luther (1997) had shown that these small companies performed substantially worse than large firms between 1989-1993.

A more recent study of UK ethical fund performance by Gregory *et al.* (1997) adopted a matched pair approach which was similar to that used in the Mallin *et al.* (1995) investigation. They compared the performance of a smaller sample of

18 UK ethical funds with 18 non-ethical UK funds between 1986 and 1994. They also employed a size-adjusted measure of performance. An analysis of their results revealed that one ethical and two non-ethical funds had a negative Jensen measure which was significant at the 5% level. There was no significant difference between the returns earned by the ethical and non-ethical funds, and both groups underperformed the FTSEALL benchmark index. Their cross-sectional analysis examined possible variables that might influence each fund's Jensen measure and concluded that the age of a fund appeared to be an important factor for an adjusted Jensen measure, whereas the size of a fund and its ethical status were not significant.¹⁶²

In the UK, EIRiS (1999) compared ethical indices to the Financial Times All Share Index using a simulation approach. The general result was that there was not a significant difference in performance. UK charity funds with ethical screens were compared with unconstrained charity funds by The WM Company (1996, 1999), no difference in performance was found.

A Swedish study for Natuvårdsverket (2001) confirms the earlier results of Mallin *et al.* (1995) and Gregory *et al.* (1997). Using both the Sharpe and Treynor measures, 13 Swedish and Norwegian ethical funds outperformed 13 similar non-ethical funds matched by age, size and geographical investment universe. However, the time period studied was only 3 years from July 1997 to June 2000 and the difference in performance was not statistically significant. The study also indicated that the ethical funds had a lower risk than the ordinary funds, but again the difference was not statistically significant.

UK results mirror the findings of studies which analyse the performance of US ethical funds. For example, Hamilton, Jo and Statman, (1993) examined the performance of a sample of 32 American ethical funds, using the Jensen measure. The 32 ethical funds were compared with 170 ordinary funds over the ten-year period 1981-1990. The average return for the ethical funds was found

¹⁶² None of the factors were significant in explaining the Jensen measure, but the age of a fund was significant in explaining an adjusted Jensen measure.

to be higher than the average returns for the “ordinary” funds, allowing the authors to conclude that: “[i]nvestors can expect to lose nothing by investing in socially responsible mutual funds” (p.66). This finding was later confirmed by Reyes and Grieb (1998), when they compared the performance of 15 American ethical funds with peer indices using monthly data from 1986 to 1995. The Sharpe ratio was employed to measure fund performance and no significant difference in performance between the two groups was documented. Using monthly data from 1994 to 1997, M’Zali and Turcotte (1998) compared the performance of 18 American and Canadian ethical funds with 10 non-ethical funds which were managed by the same financial institutions. They employed the Sharpe and Treynor measures to assess fund performance and demonstrated that 4 of the ethical funds outperformed the market index. However, the majority of all funds underperformed the Standard & Poor (S&P) 500 and the Toronto Stock Exchange (TSE) 300 market indices. The findings of the more recent American studies are in line with Rudd (1979) and Grossman and Sharpe (1986) and a recent Australian study by Cummings (2000), who also reported little or no cost for “ethical investment”.

Finally, Statman (2000) compared the performance of 31 American ethical funds with 62 non-ethical funds between 1990 and 1998. Each ethical fund was compared with two matched funds selected on the basis of the size of the fund. Statman used the Jensen measure and a modified Sharpe measure. He concluded that “the ethical funds in the study performed better than conventional funds of equal asset size, although the difference was not statistically significant (p.38)”. Both groups of funds underperformed the market both by raw returns and risk adjusted returns. For the ethical funds the underperformance may have been due to poor performance by smaller companies during the time period studied. Statman also found that the Domini 400 Social index performed as well as the S&P 500 index. This was in line with Antonio, Johnsen and Hutton (2000) who found that different combinations of ethical equity and bond indices performed at least as well as their conventional counterparts. Earlier Guerard (1997) had

reached the same conclusion that an investment universe constrained by ethical criteria performed as well as an unconstrained investment universe.¹⁶³

This section has attempted to summarise the studies on ethical fund performance and in particular those using the ‘matched pairs’ technique, as this approach will be adopted in the empirical investigation in Chapter 7. While the results of different investigations into ethical fund performance are not in complete agreement, it appears as if there is no significant penalty for investing in ethical funds. Indeed, some evidence suggests that the risk adjusted performance of certain ethical funds may outperform comparable funds which do not have any ethical criteria for selecting the equities which they include in their portfolios. This question is addressed using data on European funds over a recent time period in Chapters 6 and 7.

4.5 Differences between Ethical and Non-ethical Funds

This section reviews some possible differences between ethical and non-ethical funds that has been suggested in the literature. Ethical funds can never focus only on risk and return, they will always have to consider ethical issues. Indeed, Statman (2000) argues that an ethical fund “mixes the utilitarian features of money with the value expressive features of social responsibility”. In a literature review on factors affecting ethical fund performance, Kurz (1997) argues there are a number of factors which make ethical portfolios different from their non-ethical counterparts. Some of these possible factors are listed in Table 4.4. The most obvious general difference is that ethical funds select securities from a smaller investment universe than their non-ethical counterparts.¹⁶⁴

¹⁶³ A simulation approach to measuring ethical fund performance in the UK was adopted by EIRiS (1999). The results provided weak evidence that the ethical portfolios outperformed the FTSEALL. American studies have reported that the Domini 400 Social Index has outperformed the S&P 500 index. This indicates that there is no significant penalty in the form of lower risk-adjusted returns associated with investing in ethical funds which restrict themselves to “socially responsible securities”. More recently Nicholls (1999) highlighted that the newly formed Dow Jones Global Sustainability Index outperformed the Dow Jones Global Index by 41% over the five year period 1995-1999, but see Luck and Wood (1992) for different results.

¹⁶⁴ Interviews with fund managers conducted for this dissertation revealed that some ethical funds have approved less than 100 companies for investment. If modern portfolio theory holds one would expect lower risk adjusted returns for such funds. One British academic pointed out that if fund managers are generally unable to beat the market, some ethical criteria may even enhance performance, this point was also made by Guerard (1997).

Table 4.4 Differences Between Ethical and Nonethical Funds

Factor	Ethical Funds	Impact vs nonethical fund
Size Effect	Smaller companies	Depends on economic cycle
Cyclical/uncyclical	Uncyclical	Depends on economic cycle
Sector bias	Service companies	Depends on economic cycle
Dividend yield	Lower dividends	Neutral?
Portfolio turnover	Slower	Poor market timing
Fund Age	Younger funds	Higher risk?
Fund Size	Smaller funds	Composition of portfolio can be altered quicker

Source: adopted and modified from Travers (1997).

The exact impact of an ethically constrained investment universe is far from clear. In the UK, studies by EIRiS (1999) and the WM Company (1996, 1999) have demonstrated that there is no significant difference when the performance of various ethical indices are compared with those of an unconstrained benchmark. In America authors such as Kahn, Lekander and Leimkuhler (1997) and Rudd (1979) have shown that ethical criteria relating to the tobacco industry and South Africa are unlikely to have any material affect on a fund's financial performance. Indeed, Grossman and Sharpe (1986) demonstrated that a "South Africa-free" portfolio outperformed an unconstrained benchmark. In an American study between 1987 and 1996 it was shown that portfolios with a number of ethical criteria outperformed unscreened portfolios (Guerard, 1997). Empirical evidence generally document no significant difference in returns generated by ethical investment universes, indices and portfolios compared to non-ethical counterparts. According to portfolio theory one would expect at least those ethical funds with substantial screens to have a different efficient frontier from non-ethical funds. On the other hand many authors have argued that good environmental management and progressive ethical policies may be a proxy for management quality (Feldman, Soyka and Ameer, 1997; WBCSD, 1997; Edwards 1998). If this was the case, the positive effect of selecting securities according to ethical criteria might counterbalance a possible negative effect arising from a smaller investment universe.

Perhaps the most relevant difference for financial performance between ethical and non-ethical funds is the size of the companies that are included in the

portfolios. The “size effect” was first highlighted in the US by Banz (1981) and in the UK by Dimson and Marsh (1986). Both studies have demonstrated that small companies earned a higher risk-adjusted return than expected. Other studies have indicated that the size effect varies over time. An investigation by Luther and Matatko (1994) has shown that ethical funds have a small company bias,¹⁶⁵ while Rudd (1979) demonstrated that an effect of a South Africa screen was a bias towards smaller companies. If there is a significant small company effect it is to be expected that ethical funds would be more sensitive to it than non-ethical funds. Ethical funds would tend to perform better in comparison with non-ethical funds when small company shares perform better than large company shares.¹⁶⁶

Two other factors, lower dividend yield and more long term investment, may also be related to the size effect. Many ethical funds invest in environmental pioneers or innovators of green technology. These companies tend to be relatively young and fast growing with a high demand for capital investment; therefore they may pay smaller dividends than firms in less environmentally friendly sectors (Luther and Matatko, 1994). The portfolio turnover may also be lower for ethical funds partly, because of the small company bias and partly because some ethical funds engage with companies in their portfolios and the encouragement of best practice in various ethical matters requires long term relationships.¹⁶⁷ Ethical funds tend to be smaller and younger than the average unit trust. Chapters 6 and 7 will study whether size, age or ethical status of a fund explains the Jensen measures of a fund.¹⁶⁸

Another factor which can affect performance is that ethical funds may have a higher exposure to noncyclical companies than non-ethical funds. Many of ethical funds avoid or underweight cyclical industries such as the chemical

¹⁶⁵ Interviews with fund managers for this dissertation revealed that a minority of the ethical fund managers also were small company fund managers. Scottish Equitable was an example.

¹⁶⁶ An example was provided by Stephanie Howard, the fundmanager of the Credit Suisse Fellowship ethical fund. She mentioned in a presentation in London 22.6.1998 that her research expertise is small stocks and that the fund is 65% weighted towards small companies.

¹⁶⁷ Fund managers interviewed for the dissertation indicated that the portfolio turnover was slower for ethical funds than for the average non-ethical fund managed by the same institution.

¹⁶⁸ Other factors may include difference of P/E and P/B ratios of companies in ethical portfolios (Kurtz, 1997) and different motivations of personnel working for ethical and non-ethical funds.

industry, energy utilities, mining, oil and paper for ethical reasons. Generally, environmental criteria tend to lead to a bias towards service industries and an avoidance of heavy industry and some manufacturing firms. Ethical funds may be overweighted in sectors such as education, environmental technology, information technology and telecommunications. This does not automatically affect financial performance in a material way, as studies of sector funds have found them to have similar performance to other equity funds (Khorana and Nelling, 1997) and it has been shown that ethical investing based on a value strategy can also yield competitive returns (Abramson and Chung, 2000).¹⁶⁹ Nevertheless, one might expect that ethical funds with a strong sector bias to be riskier in terms of total risk than other equity funds.¹⁷⁰

Finally, these differences may be mitigated by the fact that many financial institutions have model portfolios which are then tailored to various client needs. Indeed, Travers (1997) reports that US based international ethical funds on average: “include 89% of the holdings of the unrestricted portfolios (p.56)”.¹⁷¹ In summary, there are many reasons to why ethical fund performance may differ from a broad based market benchmark or other funds. However, due to institutional reasons, these differences may not translate into significant different *ex post* performance between ethical and non-ethical funds.

4.6 Summary of Previous Studies and Motivation of Current Investigation

This section summarises the expectations for ethical fund performance based on previous empirical studies. Table 4.5 summarises the performance in comparison with a broad based market index and non-ethical funds.

¹⁶⁹ Khorana and Nelling (1997) found sector funds moderately riskier than other funds as measured by total risk, but the systematic risk was similar to other funds. Indeed, aggressive growth funds and small company funds were found to be riskier than sector funds. The good performance by some ethical funds and indices have sometimes been attributed to a growth strategy (high P/E stocks with low dividend yields such as technology stocks). A Value strategy would include more low P/E and P/B stocks (low growth mature industries).

¹⁷⁰ Frankfurter (1994) argued that from a universe of 1200 companies the most diversified efficient portfolios often contain no more than 60-70 companies and that some efficient portfolios may have around 30 companies in the portfolio. The average ethical fund was found to include more than 50 companies and no ethical fund had less than 30 companies in it.

¹⁷¹ A casual comparison of portfolio holdings of ethical funds and non-ethical funds managed by the same institution revealed some similarities in portfolio holdings.

Table 4.5 Summary of Ethical Fund Performance Studies

Performance Categories	Result Compared with Market Benchmark	Result Compared with Matched Non-ethical Funds
Raw return	<i>lower than market</i> ¹⁷²	<i>No significant difference</i>
Studies supporting	Mallin; Statman	Hamilton; Mallin; Naturvårdsverket
Risk	<i>No significant difference</i>	<i>No significant difference</i>
Studies supporting	Hamilton; Reyes & Grieb; Naturvårdsverket; Statman	Gregory; Mallin; Naturvårdsverket; Statman
Risk adjusted returns	<i>No significant difference</i>	<i>No significant difference</i>
Studies supporting	Hamilton; Luther, Luther & Matatko; Reyes & Grieb	Gregory; Mallin; Naturvårdsverket; Statman
Market timing	<i>Not studied</i>	<i>Not studied</i>

The Table refers to the following studies; Gregory *et al.*, (1997); Hamilton *et al.*, (1993); Luther *et al.*, (1992); Luther and Matatko (1994); Mallin *et al.*, (1995); Naturvårdsverket (2001); Reyes and Grieb (1998) and Statman (2000).

Based on previous research, it is expected that the raw returns earned by ethical funds may be lower than the market or non-ethical funds, but this difference is not expected to be significant.

A number of previous studies have documented similar levels of volatility between ethical funds and market benchmarks. All studies report average ethical fund betas of less than unity. This contrasts with factors from the previous section which would lead to an expectation of ethical funds being more risky than the market.¹⁷³ More surprisingly, a number of studies have documented lower risk for ethical funds than their non-ethical counterparts as measured by fund beta (Mallin *et al.*, 1995; Gregory *et al.*, 1997) whilst Naturvårdsverket, 2001 found both a lower beta and lower standard deviation for ethical funds. This difference has generally not been significant and therefore the expectation is that ethical fund risk is no different from the market or non-ethical funds.

The risk adjusted returns earned by ethical funds have in most studies on average been lower than the market, but not significantly different. A number of studies have indicated that ethical funds may have similar or even better performance than non-ethical funds on a risk adjusted basis. Therefore, it is not

¹⁷² No different from market in Luther *et al.* (1992).

expected that the risk adjusted performance would significantly differ from a market benchmark or similar non-ethical funds.

The balance of evidence regarding market timing ability seems to suggest that fund managers generally have no timing ability. This macro forecasting ability is expected to be worse for ethical funds, as they may have to sell shares for ethical reasons due to breach of ethical criteria. Additional factors which may make successful market timing more difficult for ethical funds are that small company stocks may be less liquid and that ethical funds generally hold stocks for a longer time.

There are a number of reasons why an analysis of ethical fund performance is worth undertaking.¹⁷⁴ First, it is important for society to determine whether funds can invest ethically without sacrificing a significant portion of the risk-adjusted returns. For example, the pension fund of BT employees with £30 billion under management and the pension fund for university academics in the UK which is worth £22 billion,¹⁷⁵ have recently adopted ethical policies; their ability to pay pensions in the future is a topic of concern for a large number of their contributors. Indeed, the question of whether there is significant difference in performance between ethical and non-ethical investment products may be of interest for many stakeholder groups (Nicholls, 2000).¹⁷⁶

Second, new ethical investment products such as ethical index funds and ethical pension funds have recently been launched by National Provident Institution (NPI) in the UK. A study of these funds is therefore topical as consumers can now choose between ethical and non-ethical investments for most investment

¹⁷³ Small company bias and young age of ethical funds and portfolio theory.

¹⁷⁴ A vast literature has studied the returns earned by non-ethical funds since the late 1960s. These studies have focused on the ability of fund managers to outperform the market by (1) selecting undervalued securities and (2) varying the composition of their portfolios to take advantage of bull and bear markets. The initial conclusion of this literature suggested that fund managers were not able to outperform a passive strategy of investing in a broadly based index (Sharpe, 1966; Jensen, 1968; Henriksson, 1984; Lehman and Modest, 1987). More recent evidence is less pessimistic however, since it suggests that some funds can outperform the market once risk changes are incorporated into the analysis (Ippolito, 1989; Gjerde and Sættem, 1991; Black, Fraser and Power, 1992; Fletcher, 1995; Sandvall, 1999).

¹⁷⁵ According to NAPF Yearbook 2001.

products. At present few comparisons of the performance of ethical and non-ethical funds have been undertaken, especially for continental European ethical investments.

Third, it was argued in the previous section that ethical funds differ from their non-ethical counterparts in a number of ways. The most obvious difference is that because of the criteria which they employ, ethical funds select securities for inclusion in their portfolio from a restricted investment universe. Another difference is that some ethical funds exhibit a bias towards investment in smaller companies.¹⁷⁷ Larger firms may place more emphasis on profits and maximising shareholder wealth than some of their smaller sized counterparts. This may be partly due to the fact that the non-ethical funds focusing solely on maximising returns tend to focus on the large companies.

A final reason for examining ethical fund performance is that these investments have spread throughout continental Europe and to date little research has been undertaken on these newer funds; most investigations have focused on UK and US ethical funds using conventional performance evaluation methods. This study considers ethical and non-ethical funds from seven countries and addresses the benchmark problem by employing different benchmarks in Chapter 6 and by adopting a matched pairs approach in Chapter 7.

4.7 Conclusions

This chapter has deliberately taken a very narrow view, focusing on how funds investing in bonds and stocks perform with different measures. Only, financial performance studies related to the empirical investigations in Chapters 6 and 7 have been considered. The questions relating to whether ethical funds are “good” investments in terms of ethical criteria are explored in Chapters 9-10. Most studies tend to compare fund performance with a broad based market index and/or rank funds compared to each other based on various measures.

¹⁷⁶ Indeed, in May 2001 there were 32 ethical pension funds offered by UK financial institutions compared to 14 in 1996 (EIRiS 1996, ethical performance, May 2001).

¹⁷⁷ See Luther, Matatko and Corner (1992), Luther and Matatko (1994), Gregory, Matatko and Luther (1997).

The pioneering studies employing risk adjusted performance measures and timing models tended to document negative or at best neutral performance of funds compared to market benchmarks. Benchmark sensitivity was documented early on. Studies of ethical fund performance indicated neutral performance compared to market benchmarks and neutral or even superior performance compared to non-ethical funds.

It was argued that ethical portfolios differ from non-ethical portfolios in a number of ways, most notably the size of the companies in the portfolios and a sector bias resulting from ethical criteria. It was also argued that ethical funds tend to be smaller and younger than the average equity fund. Based on previous empirical evidence, it was expected that these differences would generally not result in significant *ex post* differences in performance when comparing matched pairs of ethical and non-ethical funds. Market timing may be an exception, as there appears to be reasons to why ethical fund managers may be less able to time the market than non-ethical fund managers. In comparison with a broad based market benchmark, it was expected that ethical funds may have lower raw and risk adjusted returns, but based on previous empirical evidence this difference is not expected to be significant. Neither ethical nor non-ethical funds were expected to be able to time the market.

Finally, it must be emphasised that although it is beyond the scope of this investigation any investor -whether ethical or not- has other investment options than those based on securities such as bonds and stocks. Art, commodities, real estate, saving/lending and in the case of ethical investment, charity would at a minimum have to be evaluated as alternatives in a complete evaluation of “good” investment. Chapter 11 presents a broader analysis employing ethical theory to investigate whether ethical funds are good investments ethically.

Chapter 5 Data and Method

5.1 Introduction

The previous Chapter presented studies of fund performance in general and ethical funds in particular. This Chapter reviews the data and describes the method used when investigating the financial performance of ethical funds. The Chapter is structured as follows: first, the data and time period of the investigations are presented. Second, the Method section reviews the performance measures employed, the matched pair approach adopted and some of the key characteristics which may influence fund performance. Finally, a number of conclusions are offered. Details about the funds and descriptive statistics for the fund returns are presented in several tables in Chapters 6 and 7.

5.2 Data and Time Period

This section reports on the data employed in the empirical investigations. The financial performance of a sample of 80 funds were examined from January 1996 to December 1998. There were four main reasons for this short time period. First, the number of continental European ethical funds with performance and dividend data available prior to 1996 was too small for a meaningful investigation (Deml and Baumgarten, 1988). Second, data for the Norwegian and Swedish funds was bought from a commercial source which charged per observation for the daily data information supplied, thus any extension of the time period would have involved extra costs. Third, the short time period may be an advantage if one is interested in evaluating the recent performance of fund managers as management changes over time, as do the management staff who operate these funds.¹⁷⁸ It is more likely that the fund managers have changed over long time periods and this may alter fund performance. In addition, this sample provides an updated check on previous

¹⁷⁸ From a practical point of view it can be noted that, in Finland, only one of the mutual funds in existence in 1998 had the same fund manager for more than five years. Since staff turnover in the industry seems to be high it may be difficult for funds to maintain an identical investment policy over the long term. (Talouseläma, 1998, p.87). Treynor (1965) suggests that “a sweeping change in personnel constituting fund management, for example, might be accompanied by a sudden shift in fund performance (p.66)”.

UK studies.¹⁷⁹ Finally, such time periods are common when fund performance is evaluated among practitioners.¹⁸⁰

What this study does offer, however, is – as far as I can establish from the literature – the largest sample of ethical funds studied by the end of 2001. In addition, it is the only study of which I am aware of ethical fund performance covering several different European countries. Some 156 weekly observations from 1996 to 1998 are examined for 40 ethical and 40 non-ethical pairs of funds matched by age, investment universe and sector. For each fund, returns were calculated according to equation [1]:

$$r_{jt} = Ln \left(\frac{P_{jt} + D_{jt}}{P_{jt-1}} \right) \quad [1]$$

where r_{jt} is the return earned for fund j over week t , P_{jt} is the price of share j in week t , D_{jt} is the dividend paid for the fund in that week and P_{jt-1} is the price in the preceding week. These weekly returns were adjusted for currency differences with the pound Sterling and then logged to help reduce the effect of any skewness in the return distribution (Strong, 1992). Therefore, a UK outlook was adopted in this dissertation; all returns are converted into pound Sterling when analysing financial performance. This conversion has the advantage of facilitating greater comparison between the various funds because currency differences are accounted for in the analysis. In addition all ethical funds were evaluated against a domestic benchmark in their home currencies as a robustness check, these national results are reported in Appendixes to Chapter 6.

An advantage with the weekly data is that the dividends are assumed to be reinvested very close to the actual date on which they are paid; most of the early studies assumed all dividends were paid at yearend. This data frequency may also facilitate a study of whether managers engage in market timing on weekly

¹⁷⁹ The time periods studied by Mallin *et al.* (1995) and Gergory *et al.* (1997) end in 1993 and 1994 respectively.

¹⁸⁰ For example Morningstar, one of the best known organisations evaluating fund performance use 3 years of data to estimate Jensen and Sharpe measures for funds (Sharpe *et al.*, 1999, p.723), while Standard & Poor's report fund performance for 1, 3 and 5 years. Shorter time periods are common for ethical funds as many of them had existed for less than 3 years in 2001.

basis. For example, Bollen and Busse (2001) show that tests of market timing with the two models employed in this dissertation based on daily data was more powerful than those utilising monthly data.

The sample included open-ended funds from 7 countries, although just under half of the funds in the final selection operated in the UK; 36 UK funds, 22 Swedish funds, 8 German funds, 4 Dutch funds, 4 Norwegian funds, 4 Swiss funds and 2 Belgian funds were included for analysis. Of the sample of 80, 76 were pure equity funds, while 4 were balanced funds investing primarily in stocks. Of this sample, 40 were “ethical” and 40 were “non-ethical” funds. The main goal of this sample selection policy was to include the entire population of European ethical funds in existence with performance and dividend data available from January 1996 to December 1998. The final sample included more than 50% of the ethical funds in the 7 countries studied in January 1996.¹⁸¹ Ethical funds do exist in other European countries, but information was not available for these portfolios on a consistent basis throughout the whole time period and so they were not examined.¹⁸²

Weekly price data were gathered for every Wednesday to mitigate for anomalies, especially the well known weekend effect. Dividend information were also collected. Details for Hypobank Ecotech was supplied by Micropal while all other data were obtained from Datastream, Six, The Unit Trust Yearbook 2000 and from some of the funds directly.

¹⁸¹ For example, 86% of the Swedish, 63% of the UK and 50% of the Belgian ethical funds existing in January 1996 are included (Merlin 1993; EIRiS 1997; Naturvårdsverket 1998; Ethibel 1999).

¹⁸² For most European countries there is no data on ethical fund performance prior to 1996. For example, the first ethical funds in Finland and Spain were launched in 1999 (EIRiS, July 2000). France had ethical funds earlier, but Datastream and Micropal did not have data for these funds (Personal communication with Datastream and Micropal).

5.3 Market Returns and the Risk Free Rate

One of the most difficult areas in evaluating fund performance is the choice of an appropriate proxy for a market portfolio (Roll, 1977, 1978). To address this problem two strategies were employed. First, a number of different market indices were used to evaluate ethical fund performance. Second, a matched pairs approach was adopted in which ethical funds were compared to “non-ethical” funds of similar age and size and with similar geographic investment universes. The primary market index selected for the dissertation was the Morgan Stanley Capital International World Index (MSCIWI), which included securities from 49 countries.

There are a number of reasons why the MSCIWI index was selected. First, many of the European ethical funds invest internationally and the MSCIWI which includes a large selection of firms from 49 countries was thought to be a more suitable benchmark for these funds than a national or a European index.¹⁸³ Second, discussions with European fund managers revealed that the MSCIWI index is used by some practitioners in the ethical fund sector as a benchmark against which they evaluate their own performance.¹⁸⁴ Thirdly, this index includes a higher proportion of smaller firm shares than the Financial Times All Share Index, because it incorporates firms from many of the smaller stock markets in the world; it is therefore a more appropriate measure of comparison since the ethical funds also contain a higher number of small firm shares (Luther and Mataka, 1994; Gregory *et al.*, 1997).

Of course, this choice of index is far from perfect; it suffers from the limitations that the average firm size of its constituent equities is still larger than that of the funds included in the sample; it is probably not the favoured means of comparison for most UK funds¹⁸⁵ and it does not consider returns earned by European bonds which some funds might invest in. Nevertheless, it was chosen as the most appropriate benchmark for the purposes of the dissertation. Again,

¹⁸³ The index included securities from: Australia, Canada, Japan and the USA in addition to European countries, many ethical funds invest in these countries.

¹⁸⁴ Interviews with ASN in Holland, Bank Sarasin in Switzerland and Storebrand in Norway revealed that their ethical funds employed the Morgan Stanley World Index as a benchmark.

as with the fund data the index returns were converted into Pounds sterling and calculated according to equation [1].

Since a number of studies have demonstrated that benchmark sensitivity may be a problem (Lehmann and Modest, 1987; Luther and Matatko, 1994), three other benchmarks were also employed for the analysis of ethical funds. Firstly, as the dissertation adopts a UK perspective all ethical funds have also been evaluated using the Financial Times All Share Index (FTSEALL) as a market benchmark.¹⁸⁶ Secondly, all ethical funds have been evaluated against a national benchmark to mitigate problems relating to exchange rates. In particular, for the UK the FTSE All Share Index, for Sweden the Affärsvärlden General Index, for Germany FAZ General Index, for Norway Oslo Stock Exchange General Index, for Belgium Brussels All Share Index, for the Netherlands CBS All Share General, For Switzerland the Swiss Market Index.

Thirdly, all UK funds were evaluated against a two index benchmark (Gregory *et al.*, 1997) incorporating the FTSEALL index and the small company index FTSE Small Cap Index.¹⁸⁷ All this index data were obtained from Datastream.¹⁸⁸ While the index choice is a problem in fund performance studies, it is worth bearing in mind a quote from Roll and Ross (1984) “The market index should not be ignored, but neither should it be worshipped...it would be wrong to ascribe too much importance to it.” (p.23).

The JP Morgan Global Government Bond Index was selected as a proxy for the risk free rate. This index contains government bonds from 13 countries, all of

¹⁸⁵ Two reasons for this are that some UK ethical funds invest predominantly in the UK and the FTSE indexes have a strong position in the UK.

¹⁸⁶ In a similar manner to this investigation, US based international, regional and country funds were evaluated from an international and a US perspective by the Morgan Stanley Capital International World Index and the S&P 500 index by Eun *et al.* (1991).

¹⁸⁷ This index includes 414 of the smallest shares in terms of market capitalisation from the All Share Index. Thus all the top 250 companies are excluded from this index.

¹⁸⁸ For future studies the Dow Jones Sustainability Indices (DJSI) may provide more appropriate benchmarks for the international ethical funds. There are three main reasons why these indices were not used. Firstly, they were only launched in 1999/2000. Secondly, they may not be an appropriate benchmark for non-ethical funds. Finally, they were not available from Datastream. The FTSE4GOOD indices which are being launched in June 2001 may provide another attractive benchmark for future studies. By the year 2002 UK, European and International variants of this index will be available

which are included in the MSCIWI index.¹⁸⁹ The aim was to get an international rate which would include both the sample countries and a majority of the countries in which the ethical funds invest. It is recognised that this is not the optimum choice, since such an index is not entirely risk free. Ideally, one would want to have a world risk free rate, reflecting the base rates in all countries, or at least those countries in which the sample funds invest. One alternative might have been to follow Farber (1975) and calculate a weighted average based on government bonds in the sample countries. Another possibility employed by McDonald (1973) and Cumby and Glen (1990) would have been to use a one month domestic interest rate. Indeed, this approach has also been taken for all the ethical funds in this investigation. In the case of UK and Sweden, one-month T-bills were employed and for the other countries one month interbank rates, these rates were converted to weekly rates. Finally, the return on a UK T-Bill was employed as a one month risk free rate for all ethical funds when the FTSEALL benchmark index was used as a market proxy. This was motivated by the UK perspective adopted in the present investigations.¹⁹⁰ All interest rate information was obtained from Datastream.

Thus it was reasoned that a combination of an international rate, a UK rate and different national rates would be sufficient for the purposes of this dissertation. It is recognised that benchmark sensitivity is a factor which limits the generalisability of the findings, but it is hoped that the use of 4 different benchmarks and the matched pair approach will help to mitigate this problem.

5.4 Method

This section considers the different methods employed in Chapters 6 and 7. The section is structured as follows. First, the risk-adjusted Sharpe, Treynor and Jensen measures are considered. Second, the Treynor-Mazuy and Henriksson-Merton market timing models are presented. Finally, some factors which may influence fund performance are discussed.

¹⁸⁹ The countries were: Australia, Belgium, Canada, Denmark, France, Germany, Japan, Italy, Netherlands, Spain, Sweden, UK and the USA.

¹⁹⁰ This is not optimal for continental funds, but authors such as Eun *et al.* (1991) and Naturvårds-verket (2000) have also used the same approach.

The remainder of section 5.4 presents the traditional risk adjusted fund performance measures starting with the Sharpe measure (Sharpe, 1966). The Sharpe reward to risk measure, which estimates the ratio of the average return to the standard deviation of the fund return was estimated according to equation [2]:

$$SHARPE = \frac{\bar{r}_j - \bar{r}_f}{\sigma_j} \quad [2]$$

Where, \bar{r}_j is the average weekly return earned by the fund j in the 156 weeks in 1996-1998 and \bar{r}_f is the average return earned by a risk free asset. σ_j is the standard deviation of the weekly returns of fund j. The higher the Sharpe measure the better the fund performance.¹⁹¹ The Sharpe measure is most relevant for those investors for whom the fund constitutes a substantial part of their overall assets and is recommended by Moskowitz (2000, p.1701) for studying the volatility of a fund manager's portfolio.

However, there are a number of problems with the Sharpe measure. For example, this ratio has been criticised because it focuses on total risk (standard deviation) rather than market risk (as measured by the fund beta); portfolio theory suggests that the unique risk of a security should be diversified away in a large fund and only the remaining undiversifiable risk should be priced by the market. Standard deviation also does not consider the direction of the volatility. Many investors may not mind deviations as long as the returns they earn are above the average; thus the equal weighting of positive and negative deviations may be unsuitable for these investors.¹⁹²

Second, if the assumption of equal lending and borrowing rates is violated it may lead to false inferences for the Sharpe, Treynor and Jensen measures (Elton and Gruber, 1995, p.654-656). It has also been suggested that the Sharpe and Treynor measures may not be unbiased test statistics (French and Henderson, 1985). Third, it does not consider market timing. Finally, it builds on the

¹⁹¹ As long as average $r_j > r_f$. If this is not the case the measure may reward higher risk.

¹⁹² Semi variance addresses this problem, but has hardly been used in performance evaluation due to computational difficulties (Melnikoff, 1998, p.96).

Markowitz's mean variance paradigm, which assumes that the mean and standard deviation are sufficient for evaluating portfolio performance. Ethical investors may be interested in ethical aspects of the portfolio. As Sharpe (1994) puts it: "When such considerations are especially important, return mean and variance may not suffice"(p.50). The positive aspects of the Sharpe measure are that it is less dependent on the asset pricing model than the Treynor and Jensen performance measures and that it may be a better measure for ranking ethical funds as it does not depend on beta or the CAPM. It may also be helpful for investors who choose their first fund especially if that represents a large part of the assets of the investor as the Sharpe ratio focuses on the unique risk of the particular fund. The Sharpe measure has also been shown to have better statistical properties than the Treynor measure (Jobson and Korkie, 1981). If the investor has many other assets the Treynor measure which focuses on market risk may be more appropriate.

The Treynor measure which calculates the ratio of the average return to the Beta of the fund (β_j) was estimated according to equation [3] :

$$TREYNOR = \frac{\bar{r}_j - \bar{r}_f}{\beta_j} \quad [3]$$

where, β_j is estimated by equation [4] below and r_f is the return earned by a risk free asset (Treynor, 1965).¹⁹³ A problem with using beta as the risk measure is that various market benchmarks will result in different fund betas and thus different rankings of the same funds. It has also been suggested that betas differ depending on whether returns are measured on a daily, weekly or monthly basis (French and Henderson, 1985). However, the Treynor measure is particularly relevant for investors with many other assets as it uses market risk to adjust the returns. A higher Treynor measure implies better performance as long as the average $r_j > r_f$.¹⁹⁴ It has been argued that The Treynor measure is better for ranking portfolios relative to each other because; "one wants to know what the

¹⁹³ Sometimes the Treynor measure is referred to as the Reward to Volatility ratio (RVOL), The Sharpe measure is also called the Reward to Variability ratio (RVAL). The Jensen measure is sometimes called Jensen alpha, differential return or alpha. These names will not be used.

¹⁹⁴ If average $r_f > r_j$ the measure rewards higher risk as a higher β reduces the numerator.

increment in expected return due to security selection will be, *after* the systematic risks have been equalized...by mixing in risk free assets...my own [Treydor] measure has this property whereas Jensen's measure ...does not" (Treydor, 1968, p.418). It may thus be most relevant in Chapter 7 where ethical fund performance is judged using matched pairs of non-ethical funds.

It is worth noting that a fund with a Treynor measure indicating superior performance may have a low Sharpe measure. The reason is that the portfolio may have substantial non-market risk ignored by the Treynor measure. Therefore, rankings with these measures may differ.¹⁹⁵ A major shortcoming with all these measures is that they do not consider market timing ability by fund managers. The Treynor measure suffers essentially from the same problems as the Jensen measure, which are considered in the next section.

According to Treynor (1968), the Jensen measure is especially appropriate for evaluating a group of funds against market benchmark. The Jensen measure assesses whether a fund has outperformed or underperformed a market portfolio by testing whether the constant (alpha) in equation [4] is significantly different from zero.

$$r_{jt} - r_{ft} = \alpha_j + \beta_j (r_{mt} - r_{ft}) + \mu_{jt} \quad [4]$$

Where r_{mt} is the return earned by the market portfolio and r_{ft} is the return earned by a risk free asset. The term α_j is the alpha of fund j, denoting the difference in return of the fund compared to the expected return from the Security Market Line (SML),¹⁹⁶ while β_j is the beta of fund j, representing its market risk. Finally, μ_{jt} is a random error term.

If markets are informationally efficient, fund managers should, on average, have no superior investment skill. The Jensen measure of a fund should be zero and a positive or negative measure would indicate superior or inferior performance

¹⁹⁵ However, many studies have found a high correlation between these measures (French and Henderson, 1985; Mallin *et al.*, 1995; Bal and Leger, 1996; Liljeblom and Löflund, 2000).

¹⁹⁶ It gives the exact vertical distance at origin between the ex-post security market line and the ex post characteristic line of the fund j.

compared to the benchmark. The Jensen measure for the benchmark index is zero by default. The Jensen measure is commonly used by practitioners and is reported by Standard & Poor's Micropal, Morningstar and other companies supplying information on fund performance. Following other academic studies this alpha is called the Jensen measure in this dissertation (Gregory *et al.*, 1997).

There are at least eight major criticisms of the Jensen measure of fund performance. Firstly, as Roll (1978) has argued and many empirical studies have shown, all performance measures based on the security market line will be sensitive to the choice of benchmark used and it is impossible to get a true measure of the market portfolio which would include such factors as human capital (Fama and Schwetz, 1977; Sharpe *et al.*, 1999).

Secondly, the Jensen measure may indicate poor performance when the manager possesses and utilises superior timing information, because the least square estimator of beta is an upward biased estimate of the expected value of beta and this causes the Jensen measure to be downward biased (Dybvig and Ross 1985; Cumby and Glen 1990; Lee and Rahman 1990).

Thirdly, the Jensen measure does not address the issue of fund diversification; for example a fund with 2 securities may have the same Jensen measure as one with 200 securities (Treynor, 1968).

Fourthly, the measure assumes that the fund is fully invested. The Jensen measure treats funds as if they had invested 100% in securities. All funds are required by law to hold some cash.

Fifthly, the measure assumes that the fund policy remains constant and that the beta of a fund is constant over time (Elton and Gruber, 1995). Sixth, it has been suggested that a fund may have to generate excess returns of up to 12% annually, before they are detected as significant at the 5% level. The statistical power of these tests is thus rather weak (French and Henderson, 1985).

Seventh, there may be other factors influencing fund performance, which are not captured by the traditional single index model and even if no other factors influenced fund performance the relationship would not necessarily be linear as the model assumes (Ross and Roll, 1984; Elton *et al.*, 1993; Fama and French 1992, 1995, 1998).

Finally, the Jensen measure rests on the validity of CAPM framework. The CAPM assumptions are troublesome (Elton and Gruber, 1995) and one is especially so in the context of ethical funds.¹⁹⁷ The model assumes that “all investors are able to choose among portfolios solely on the basis of expected returns and variance of returns” (Jensen, 1968, p.390). Indeed, surveys have shown that ethical issues are more important than risk and return for some of the investors in ethical funds (Inskeep, 1992; Lewis and Mackenzie, 2000).

These weaknesses are addressed in the following way in the empirical investigations of this thesis. The benchmark problem is addressed by considering raw returns, using different benchmarks, employing the Sharpe measure and adopting a matched pair approach. The timing aspect is considered by employing two market timing models. The third and fourth points are to some extent investigated by interviews of ethical fund managers, which are reported in Chapter 9.¹⁹⁸ Time varying risk has not been investigated in any study of ethical fund performance. As Black, Fraser and Power (1992) have shown, the risk of UK funds may change over time. It is recognised that this is another limitation which must be considered when interpreting the results. The

¹⁹⁷ The CAPM assumes that: (1) Investors are risk-averse individuals who maximise the expected utility of their end of period wealth; (2) investors are price takers and have homogenous expectations about asset returns that have a joint normal distribution; (3) there exists a risk free asset such that investors may borrow or lend unlimited amounts at the risk free rate; (4) the quantities of all assets are fixed; (5) all assets are marketable and perfectly divisible; (6) asset markets are frictionless and information is free and simultaneously available to all investors; (7) there are no market imperfections such as taxes, regulations or restrictions on short selling. (Copeland and Weston 1988, p.194). None of these assumptions hold in reality, Markowitz (1990) calls these assumptions “surreal”.

¹⁹⁸ The interview findings presented in Chapter 9 indicated that most ethical funds had not changed their policies in the time period studied.

seventh point is to a limited extent addressed by employing a two-factor benchmark for the UK funds and the non-linear timing model.¹⁹⁹

Finally, due to the inability of the quantitative models to capture the ethics dimension interviews with ethical researchers were also conducted. These findings are analysed in Chapters 9 and 10. The next section presents the market timing models employed in Chapters 6 and 7.

5.4.1 Market Timing Models

The previous performance measures do not give insights into the source of superior or inferior performance (eg why a fund has earned superior or inferior returns). Some authors have proposed models, which would be able to distinguish macro forecasting skill, or the ability to predict market movements and micro forecasting skill or the ability to pick winner shares. Researchers such as Black, Fraser and Power (1992) have demonstrated in a UK context that if fund managers are timing the market, equation [4] may be mis-specified because the Beta coefficient is being held constant in the regression whereas it varies in practice; the resulting alpha term may be incorrectly estimated and wrong inferences about fund performance may be drawn. Equations [5] and [6] which were developed by Henriksson and Merton (1981) and Treynor and Mazuy (1965) overcome this difficulty and may yield additional insight into ethical fund performance.

The second part of the empirical analysis of the financial performance of the funds investigates whether ethical fund managers varied the composition of their portfolios according to whether a bull market or a bear market was anticipated. For example, if they expected the market return to rise, they might have increased the Beta of the portfolio such that the fund performs better than the index while if they expect the market to fall they might have reduced the Beta of the fund so that it declined by less than the fall in the market portfolio. This is an unexplored topic in the context of ethical funds, since no academic study has

¹⁹⁹ Some studies such as: Lehman and Modest (1987) have addressed this by employing APT based models. Others such as Daniel *et al.* (1997) and Wermers (2000), created hypothetical portfolios based on the equity holding of the funds. This has not been done for ethical funds.

published results on the market timing ability of ethical fund managers. If the funds adopt a longer term perspective than their “non-ethical” counterparts this may show up as poor market timing. Also, ethical funds may not exhibit positive market timing skills because they buy and divest shares for non-financial reasons which may result in poor financial market timing. The measure for market timing, reported in chapters 6 and 7 is based on Henriksson and Merton (1981) and Henriksson (1984). Analysis by a second measure developed by Treynor and Mazuy has also been conducted for all 80 funds and these results are reported in appendix 6.6, 6.7 and Appendix 7.4.

Henriksson and Merton (1981) introduced a timing measure in which a dummy variable is measuring the timing ability of a fund. In this model, the investor is assumed to forecast whether the stock market return is higher than the risk free rate or vice versa. Henriksson and Merton (1981) suggest the following equation for measuring a fund’s market timing ability:

$$r_{jt} - r_{ft} = \alpha_{2j} + \beta_{2j}(r_{mt} - r_{ft}) + D_j[(r_{mt} - r_{ft})] + \eta_{jt} \quad [5]$$

where the coefficient D_j captures the market timing ability of the fund manager; if D_j is positive, it suggests that the manager is increasing the risk profile of the portfolio when a bull market occurs. D_j is a dummy variable with a value of 0 when $r_{mt} > r_{ft}$ and -1 when $r_{mt} < r_{ft}$. η_{jt} is a random error term. The model has been criticised by Cumby and Modest (1987) for its weak ability of detecting market timing skill if the sample size is small and for rejecting a hypothesis of no market timing ability too often when heteroscedasticity is present in the data (Lee and Rahman, 1990). As Chapter 4 reported, this equation may be misspecified due to conditional information (Ferson and Schadt, 1996; Ferson and Warther, 1996).²⁰⁰ However, in a recent study of Finnish funds, Sandvall (1999) concluded that the Henriksson-Merton model results were more stable when

²⁰⁰ The traditional unconditional models ignore the dynamic behaviour of returns. For example expected returns may be higher at the beginning of economic recovery. Conditional performance models add lagged information variables to the traditional models (Ferson and Warther, 1996).

conditional variables were added to the model than the Treynor and Mazuy model, which is considered next.

The first study to examine the market timing abilities of funds was Treynor and Mazuy (1965). They proposed another test (equation [6]) to examine whether a fund manager was timing the market:

$$r_{jt} - r_{ft} = \alpha_{3j} + \beta_{3j}(r_{mt} - r_{ft}) + c_j[(r_{mt} - r_{ft})^2] + \xi_{jt} \quad [6]$$

where the coefficient c_j captures the market timing ability of the fund manager; if c_j is positive, it suggests that the manager is increasing the risk profile of the portfolio when a bull market occurs. ξ_{jt} is a random error term.

Both timing models suffer from the limitation that shifts in the market risk of a portfolio are associated with evidence of market timing, whereas it may simply reflect changes in the economic cycle. When the stock market declines, the prices of high beta stocks will decline by more than their low beta counterparts; therefore the weight of the latter will increase in the portfolio, *ceteris paribus*. This increase can lead to a situation in which the beta of the portfolio is low prior to a bull market and high prior to a bear market, although the manager has not engaged in any activities to time the market. This may favour actively managed funds in general and mixed funds in particular in times when the economic cycle shifts. Because of this these models may present only estimates of market timing. Shifts in the portfolio risk could also reflect a change in investment policy rather than market timing. Nevertheless they are the most frequently employed timing models in the fund performance literature and they will therefore be applied to study the market timing ability of ethical funds for the first time. Another contribution is the use of weekly data in a market timing study. Bollen and Busse (2001) showed that previous market timing studies may have been too negative due to the use of low frequency (monthly) data.

Most of these measures are based on ordinary least square (OLS) regression equations and the Microfit 4.0 econometrics package has been used for all the analysis. Some Robust regression analysis using Minitab was conducted in cases

when the non-normality of the residuals could have been a problem (in many cases there was no problem). The results from the Robust regressions were similar to those obtained by OLS, indicating that non-normality of residuals was not a problem in this present study. Tests for autocorrelation were conducted in all cases with the Durbin-Watson and Lagrange Multiplier tests using Godfrey's test statistic. Tests for heteroscedasticity were carried out by examining the homoscedasticity assumption using the Engle (1982) test statistic.²⁰¹ To mitigate the problems of heteroscedasticity and autocorrelation corrected t-values based on the Newey-West (1987) procedure using four lags due to the weekly data are reported in all tables. In the cross sectional regressions in which autocorrelation was not a problem, t-values have been corrected by the method introduced by White (1980) for heteroscedasticity. The Friedman nonparametric test comparing ethical and non-ethical funds was computed by using the SPSS packages.

5.4.2 Matched Pair Approach

A recent approach to evaluate ethical fund performance in comparison to “non-ethical” funds with similar characteristics is called the matched pair approach. To overcome the benchmark problem Mallin *et al.* (1995) developed the matched pair approach. UK Ethical funds were matched with non-ethical funds based on size and age. This approach was also used by Gregory *et al.* (1997), while Travers (1997) argued that it “seems more than reasonable to compare performance to other active portfolios with similar mandates”(p.55). This approach may also suffer less from survivorship bias than would a simple comparison of only ethical funds as any survivorship bias should have a similar effect on both groups.

This approach has been adopted in Chapter 7 where 40 ethical are matched with 40 non-ethical funds from the same 7 countries. As in previous research, age and size of the funds were employed as matching criteria. Tests indicated that there was no significant difference on average between the ethical and non-ethical

²⁰¹ If autocorrelation was detected a 12th order LM test was also performed to study the order of the autocorrelation. See: Pesaran and Pesaran (1997), p.86-87, 116, 401-404.

funds in respect to these criteria in the present investigation.²⁰² Geographic investment universe was also a criterion, thus funds investing in the domestic market were matched with domestic funds and international funds with international funds. All 80 funds invested in equities and were actively managed.²⁰³

5.5 Factors Influencing Fund Performance

The current section reviews some factors which may influence ethical fund performance. The only study of which I'm aware to extensively examine this topic for ethical funds is Gregory *et al.* (1997). They found weak evidence that the age of the fund could explain an adjusted Jensen measure, whereas the size variable and a dummy variable for ethical funds were insignificant. Employing cross sectional regression they sought to explain the Jensen measure with the following equation [7]:

$$Jensen \ Measure = \lambda_0 + \lambda_1 SIZE + \lambda_2 ETHICAL + \lambda_3 AGE + e \quad [7]$$

The Size variable refers to the size of the fund and was measured in millions of pound Sterling. The size is of interest as it has been used as a matching criteria in all matched pair studies. Several studies have suggested that size may affect performance due to economies of scale and more able fund managers. The Ethical variable was a dummy variable which took the value of 0 if ethical and 1 otherwise. If this dummy variable had been significant it would have provided evidence for a difference in performance between ethical and non-ethical funds. The Age of a fund was also measured by months since inception and e was a random error term.²⁰⁴ A variant of equation [7] will also be employed in Chapter 7 for the 80 funds included in this investigation. As these regressions are

²⁰² In particular two tailed t-tests and the non-parametric Friedman test were employed. Although there was not a significant difference between the groups, the ethical funds were on average smaller and younger than the non-ethical funds.

²⁰³ A few sample funds also invested a smaller amount in bonds. Bond and index funds were excluded from the sample.

performed both for ethical funds and for the entire sample, it constitutes another robustness check on the matching of the ethical and non-ethical funds. A similar investigation was performed by Liljeblom and Löflund (2000). They found fund size and expense ratios of funds to be insignificant in explaining the Jensen measure for Finnish funds in the 1991 to 1995 period.²⁰⁵

5.6 Conclusions

This Chapter has presented the data and method which are employed in the empirical investigations of ethical fund performance in chapters 6 and 7. Shortcomings related to benchmarks and data availability were identified. The various performance measures also suffer from a number of weaknesses. Some of these weaknesses may be mitigated by the use of different benchmarks and performance measures. The matched pair approach may also alleviate some of the problems. It is recognised that the results must be interpreted with some caution in light of these shortcomings. Finally, some factors which may affect fund performance were considered.

²⁰⁴ Gregory *et al.* (1997) operationalised this by using a dummy variable for Age using a 48 months of age to distinguish between young and old funds.

²⁰⁵ Size and expense ratio were significant at the 10% level. Larger funds had a higher Jensen measure whereas funds with a higher expense ratio had a lower Jensen measure.

Chapter 6 The Financial Performance of European Ethical Funds

6.1 Introduction

Chapter 4 presented previous studies of fund performance with a focus on studies of ethical funds, while Chapter 5 presented fund performance measures. Relatively few published studies have investigated the financial performance of European ethical funds. These studies have focused primarily on UK funds, involved small sample sizes and covered fairly short data sets which typically span one to eight years in length. They also tend to use low frequency data such as monthly observations and employ conventional performance measures which were developed by academics examining the returns earned by “non-ethical” funds in the late 1960s; in particular, the Jensen measure, which evaluates the returns earned by a fund relative to the risk of the fund and the return achieved on a benchmark portfolio, the Sharpe measure which is a reward to total risk ratio and the Treynor measure which is a reward to market risk ratio are used in these investigations.

One of the questions raised about such funds in these studies is whether their ethical investment strategies are only achieved by foregoing some of the return which investors might otherwise have obtained by placing their funds elsewhere. This investigation also addresses this issue; it examines the financial performance of European ethical funds over a recent three year period from 1996 to 1998. Formally three questions are investigated in this Chapter. First it examines whether ethical funds provide the same financial return as an international benchmark portfolio.²⁰⁶ Second, this Chapter studies whether ethical funds have market timing ability. Third, the Chapter examines whether the Jensen measures of performance are related to specific attributes of the funds. The structure of the Chapter is as follows. In section 6.2, some information about the ethical funds and descriptive statistics for the fund returns are presented. The results of the study are analysed and discussed in sections 6.3, 6.4 and 6.5. Finally, some conclusions are offered in section 6.6.

²⁰⁶ Results from analysis with domestic and UK benchmarks are presented in Appendix 6.1-6.3.

6.2 Summary Information and Descriptive Statistics

A sample of 40 European ethical funds was selected for inclusion in this study. This represents a large proportion of such funds which existed prior to 1996 and for which three years of data on both returns and dividends were available. There was a good geographical mix of funds in the sample although there were more funds in the final selection which operated in the UK than elsewhere; 18 UK funds, 11 Swedish funds, 4 German funds, 2 Dutch funds, 2 Norwegian funds, 2 Swiss funds and 1 Belgian fund were included for analysis.²⁰⁷ The funds chosen had a mix of aims and targeted different investment universes.²⁰⁸ They also varied in size ranging from a low of £2.1 million for the FOCU Fund to a high of £473.0 million for the FPSE Unit Trust; this latter fund is the biggest ethical fund in Europe. Most ethical funds had a market value of less than £50 million. Information on the sample funds is provided in Table 6.1.

²⁰⁷ Obviously, ethical funds do exist in other European countries, however data were not available for these portfolios on a consistent basis throughout the whole time period.

²⁰⁸ The most significant difference is that some funds invested only in their home country, whilst others invested globally. The ethical criteria employed by different ethical funds also varied widely. Finally, two funds, Oekosar and Equitable Ethical invested in bonds to such an extent that they are classified as mixed funds, whilst the others are equity funds.

Table 6.1 Summary Information About the Sample Ethical Funds

FUND	CODE	COUNTRY	INVESTMENT UNIVERSE	START DATE	SIZE 31.12.98
Abbey Ethical Trust	ABBE	UK	UK	Oct-87	40.4
Aberdeen Ethical	ABER	UK	International	Sep-92	6.7
ABF Andere Beleggingsfond	ABFA	Netherlands	International	Oct-90	35.0
Aktie Ansvar Sverige	AKTA	Sweden	Sweden	1965	32.7
Allchurches Amity	ALLC	UK	UK	Feb-88	35.3
ASN Aandelensfonds	ASNA	Netherlands	International	Mar-93	68.2
Banco Hjälpfond	BHJA	Sweden	Sweden	Oct-95	11.3
Banco Humanfond	BHUM	Sweden	Sweden	Jun-90	137.1
Banco Ideella Miljöfond	BIDM	Sweden	Sweden	Dec-92	24.9
Banco Miljöfond	BMIL	Sweden	Sweden	Sep-94	5.7
Banco Samarit Fond	BSAM	Sweden	Sweden	Feb-94	33.8
CIS Environ Trust	CISE	UK	International	May-90	146.3
City Acorn Ethical	CITY	UK	International	Nov-88	3.9
Clerical Medical Evergreen	CLEM	UK	International	Feb-90	18.3
Commercial Union	COMM	UK	International	Apr-92	24.0
Equitable Ethical	EQUI	UK	Int. mixed	Jan-94	17.7
Family Charities Ethical	FAMI	UK	UK	Mar-82	9.5
Focus Umweltechnologie	FOCU	Germany	International	Oct-90	2.1
Framlington Health fund	FRAM	UK	International	Apr-87	71.4
Friends Provident Stewardship i.	FPSI	UK	UK	Oct-87	73.6
Friends Provident Stewardship u.	FPSE	UK	UK	Jun-84	473.0
Hypobank Ecotech	HYPO	Germany	International	Apr-90	18.2
Jupiter Ecology	JUPE	UK	International	Mar-88	61.2
KBC Eco-fund	KBCE	Belgium	International	Mar-92	3.0
KD Fonds Ökoinvest	KDOE	Germany	International	Aug-91	2.8
Luxinter Ökolux	LUXI	Germany	International	Feb-92	37.2
NPI Global Care Income	NPI	UK	UK	Jul-95	31.0
NPI Global Care Pension	NPIP	UK	International	Mar-94	45.4
Oekosar (Bank Sarasin)	OEKO	Switzerland	Int. mixed	Feb-94	51.4
Orbitex Health and Biotech	ORBI	Switzerland	International	Jun-91	12.1
Robur Miljöfonden	ROBU	Sweden	Nordic	Jan-96	36.6
Scottish Equitable Ethical	SCOT	UK	UK	Apr-89	44.9
SEB Miljöfond	SEBM	Sweden	International	Oct-91	37.5
Sovereign Ethical Fund	SOVE	UK	UK	May-89	19.8
TSB Environmental	TSB	UK	UK	Jun-89	21.8
Världsnaturfonden	VARL	Sweden	Sweden	May-88	20.9
Wasa Miljöfond	WASA	Sweden	International	Dec-90	10.4
Wasa U Hjälpfond	WASU	Sweden	International	Jan-96	5.5
Vesta Grønt Norden	VGRN	Norway	Nordic	Nov-89	33.4
Vesta Miljøinvest	VMIL	Norway	International	Dec-89	2.1

This table provides summary information about each fund in the sample. It provides the code, country of origin and geographical investment area of each fund. The year and month in which each fund commenced operations and the fund size as at 31.12.98 in millions of British pounds is also given. For one fund, AKTA, the month is unknown and July is an estimate of the month. For another fund, ORBI it was not possible to obtain the size as at 31.12.98, instead the size reported for this fund is from 30.8.99. The fund assets totalled £1.8 billion.

A possibility for survivorship bias exists because not all funds are included in the sample data. Unsuccessful funds tend not to survive, and their exclusion from this sample may lead to an upward bias in performance for surviving funds of 0.1 to 4.0% on average per year in fund returns (Malkiel, 1995; Liljeblom and Löflund, 2000). Allen and Tan (1999) argued that it is difficult to eliminate survivorship bias and findings reported in studies such as Grinblatt and Titman, (1989) suggest that the likely impact of survivorship bias is small. Survivorship bias is not likely to significantly influence the findings of this investigation in a positive direction because the current study does include unsuccessful funds.²⁰⁹ Fund failure was not a major reason for omitting portfolios from the sample. Also the relatively short time span covered when a lot of these funds were new means that few ethical funds failed during this period.

A number of descriptive statistics were calculated for the return series of each ethical fund over the whole three-year period. The mean (MEAN), the standard deviation (SDEV), minimum (MIN), maximum (MAX), skewness (SKEW) and kurtosis (KURT) are reported in Table 6.2. Several points emerge from an analysis of these descriptive statistics. First, the average returns varied widely across the ethical funds. A Swedish fund, Världsnaturfonden (VARL), performed best earning a mean weekly return of 0.35 %. This was closely followed by NPI Global Care Pension Fund (NPIP), TSB Environmental investor fund (TSB), Banco Hjälpfond (BHJA) and KBC Eco-Fond (KBCE) which all achieved an average weekly return above 0.30%. The worst performance was recorded by a Norwegian fund Vesta Grønt Norden (VGRN). This portfolio earned a negative return on average for a British investor, throughout the 3-year period.²¹⁰ Second, the overall average weekly return of the ethical funds in the sample was 0.16% which was less than the return of 0.21% earned by the MSCIWI index from 1996 to 1998. Indeed the index had a higher

²⁰⁹ One of the sample funds, COMM was discontinued in 1999 and another fund ORBI changed policy and became a sector fund. COMM, blamed the performance of environmental technology shares for the fund closure (personal correspondence). Neither fund performed well with any measure. In the UK one ethical fund was discontinued in the sample period and 3 ethical funds were discontinued between 1993-1996. According to EIRiS there were 38 ethical funds in the UK in October 1998 (EIRIS, 1996,1998; MacKenzie, 1997).

²¹⁰ This fund also had a negative Jensen measure with a Norwegian benchmark.

return than 29 of the funds in the sample. However, this higher return for the index was achieved with a higher total risk (as measured by standard deviation).

Third, the returns of some ethical funds were volatile over the period. For example Friends Provident Stewardship Income (FPSI) had the lowest total risk among the funds with a standard deviation of returns of 0.0108. By contrast the Framlington Health Fund (FRAM) had more than three times that amount of volatility at 0.0346. The volatile nature of some ethical fund returns were confirmed by the maximum and minimum values; the spread for these was higher for some of the funds than for the MSCIWI index over the period studied. The highest spread 0.2967 was found for a Swedish fund, Ansvar Aktiefond Sverige (AKTA), which compares with a spread of 0.1424 for the MSCIWI index. Finally, the returns of all 40 ethical funds and the MSCIWI displayed negative skewness.

Table 6.2 Descriptive Statistics for the Fund Returns

FUND	MEAN	SDEV	MIN	MAX	KURT	SKEW
ABBE	0.00092	0.0145	-0.0567	0.0401	2.7160	-1.0515
ABER	0.00107	0.0150	-0.0632	0.0430	3.1197	-1.1215
ABFA	0.00117	0.0158	-0.0557	0.0552	1.5850	-0.1661
AKTA	0.00283	0.0315	-0.1371	0.1596	6.1237	-0.2669
ALLC	0.00156	0.0136	-0.0442	0.0401	1.2986	-0.6964
ASNA	0.00117	0.0158	-0.0557	0.0552	1.5850	-0.1661
BHJA	0.00327	0.0287	-0.0933	0.0872	1.2519	-0.5083
BHUM	0.00283	0.0288	-0.0865	0.0854	0.9392	-0.4499
BIDM	0.00275	0.0288	-0.0856	0.0846	0.9257	-0.4466
BMIL	0.00137	0.0254	-0.0819	0.0719	1.2998	-0.6900
BSAM	0.00282	0.0287	-0.0861	0.0855	0.9674	-0.4487
CISE	0.00216	0.0145	-0.0579	0.0519	3.5075	-0.7077
CITY	0.00107	0.0200	-0.0745	0.0632	1.6569	-0.2939
CLEM	0.00120	0.0206	-0.0725	0.0677	2.3527	-0.8428
COMM	0.00090	0.0221	-0.0994	0.0813	5.8558	-0.5318
EQUI	0.00118	0.0207	-0.0560	0.0639	0.9719	-0.3624
FAMI	0.00163	0.0160	-0.0746	0.0410	4.6846	-1.2179
FOCU	0.00133	0.0212	-0.0707	0.0599	1.3261	-0.4947
FRAM	0.00049	0.0346	-0.1708	0.0849	4.5877	-1.2537
FPSI	0.00135	0.0108	-0.0342	0.0350	1.5764	-0.4212
FPSE	0.00203	0.0126	-0.0476	0.0380	2.3450	-0.7879
HYP0	0.00082	0.0226	-0.0981	0.0968	3.5434	-0.0919
JUPE	0.00169	0.0183	-0.0806	0.0529	3.7013	-0.9921
KBCE	0.00307	0.0195	-0.0659	0.0520	1.2987	-0.6340
KDOE	0.00124	0.0226	-0.0863	0.0652	2.3426	-0.6427
LUXI	0.00076	0.0249	-0.1106	0.0719	2.5794	-0.8258
NPI	0.00212	0.0158	-0.0589	0.0506	2.1967	-0.6913
NPIP	0.00348	0.0158	-0.0586	0.0522	2.3028	-0.7099
ROBU	0.00086	0.0248	-0.0791	0.0985	2.1013	-0.1962
OEKO	0.00054	0.0144	-0.0465	0.0399	0.9905	-0.5057
ORBI	-0.00033	0.0293	-0.1405	0.0690	2.8976	-1.0540
SCOT	0.00172	0.0158	-0.0674	0.0521	4.7740	-1.0860
SEBM	0.00084	0.0225	-0.0742	0.0533	0.9524	-0.5465
SOVE	0.00168	0.0178	-0.0844	0.0483	4.2248	-1.0963
TSB	0.00343	0.0198	-0.0839	0.0691	3.3905	-0.4599
VARL	0.00353	0.0278	-0.0911	0.0826	1.3758	-0.4734
WASA	0.00069	0.0206	-0.0805	0.0592	1.2680	-0.5853
WASU	0.00210	0.0202	-0.0527	0.0494	0.4728	-0.5522
VGRN	-0.00067	0.0312	-0.1623	0.1303	6.0503	-0.5663
VMIL	0.00113	0.0247	-0.0726	0.0707	0.5385	-0.5302
AVERAGE	0.00159	0.0212	-0.0800	0.0665	2.4419	-0.6291
MSCIWI	0.00207	0.0218	-0.0798	0.0626	1.9301	-0.6719

Descriptive statistics for the 40 ethical fund returns and the Morgan Stanley World Index. This table shows the average weekly rate for each fund (MEAN), the standard deviation (SDEV), minimum (MIN) and maximum (MAX) returns. A measure of skewness (SKEW) and kurtosis (KURT) is provided in the final columns. The data for all funds is weekly Wednesday to Wednesday, dividends fully reinvested from 1996 to 1998, 156 observations are available for each fund, except for ROBU which has only 152 observations, because it was started in January 1996.

6.3 Performance Results for the Ethical Funds

Conventional measures of fund performance are reported in Table 6.3 for the 40 ethical funds in the sample. The Sharpe, Treynor and Jensen measures are included in this table while the rankings of the funds according to these measures are provided in Table 6.5. An analysis of the Sharpe measures indicates that 15 ethical funds outperformed the MSCIWI index. On average, however, the index outperformed the typical fund with a Sharpe measure of 0.111. There was a wide range in the ratios studied. The top three funds were all from the UK; NPIP, TSB, and FPSE while the fourth best fund was KBCE from Belgium. These funds all had Sharpe measures above 0.175 while the bottom two funds had ratios under 0.002.

The good performance of the UK ethical funds is partly due to the strengthening of the British pound in the time period. Another factor may be that 7 of the 11 Swedish funds restricted their investments to Sweden, while one Swedish and one Norwegian fund limited themselves to investing only in the Nordic countries. By contrast half of the UK funds invested globally and even the UK domestic funds had a much larger number of securities to choose from than their non-UK counterparts. In addition the UK funds were older, on average, and may have had a great deal more expertise in the selection of ethical securities for inclusion in their portfolios. These findings are similar to Reyes and Grieb, (1998). They reported that there was no significant difference between the Sharpe measures of 15 ethical funds and the market benchmarks they employed.

A very different picture of performance emerges when the Treynor measures are studied. Some 27 of the 40 funds have Treynor ratios greater than that of the MSCIWI index. Indeed, 6 of the funds (ABFA, CITY, FPSE, NPIP, ROBU and TSB) have ratios which are more than twice the value of 0.0024 which was recorded for the benchmark portfolio. Since the main difference between these two measures is the type of risk examined, it must be concluded that the ethical funds have higher standard deviations, but lower Beta values relative to the MSCIWI index employed. A similar conclusion was reached by Bal and Leger (1996); they reported that UK funds outperformed the market with the Treynor measure, but the results were less favourable for the funds when the Sharpe

measure was employed. On the other hand, Liljeblom and Löflund (2000) reported similar results with both Sharpe and Treynor measures for Finnish funds; for their longest time period of 4 years the funds seemed to outperform the market with both measures. Finally, White (1993) reported that most ethical funds in his sample underperformed the market with the Treynor measure.

The remaining columns of Table 6.3 provide the results from estimating equation [5.4] -the Jensen measure of performance. Some 29 funds had a positive alpha while the remaining funds had a negative alpha value. Of the 29 funds which outperformed the market 14 were UK based while 8 operated in Sweden. A check on the t-values indicates that two of the alphas are significant at the 5% level: ASNA from the Netherlands with the highest Jensen measure of 0.003 and NPIP from the UK. In fact, 15 ethical funds outperform the market as measured by all the three performance measures. The first hypothesis that investors investing in ethical funds earn similar risk adjusted returns as those investing in an international index could thus not be rejected. The results of this European-based study therefore confirm the findings of previous Australian, US and UK investigations that investors in ethical funds suffer no appreciable loss in return per unit of market risk from restricting their investment universe to ethical securities rather than investing in a benchmark portfolio (Luther *et al.*, 1992; Hamilton *et al.*, 1993; Reyes and Grieb, 1998; Cummings, 2000).

For individual ethical funds it can be noted that similarly to the current investigation Mallin *et al.* (1995) also documented good performance for the Friends Provident Stewardship ethical funds, while Gregory *et al.* (1997) documented good performance for the CIS Environ Trust. On the other hand funds such as Scottish Equitable Ethical and Sovereign Ethical had negative Jensen measures in Mallin *et al.* (1995) and Gregory *et al.* (1997) but positive measures in the current investigation. It seemed as if some leading players such as the Friends Provident Stewardship funds have had consistent positive performance (WM Company, 1996; 1999), while for many ethical funds the financial performance seemed more volatile.

Table 6.3 An Analysis of the Financial Performance of the Sample Funds

Fund	Sharpe	Treydor	Jensen			
			Alpha	T-value	Beta	Adj. R2
ABBE	0.088	0.0028	0.00017	0.116	0.457	0.28
ABER	0.095	0.0025	0.00004	0.040	0.570	0.46
ABFA	0.097	0.0112	0.00120	1.326	0.136	0.03
AKTA	0.101	0.0030	0.00074	0.460	1.051	0.41
ALLC	0.141	0.0037	0.00067	0.671	0.515	0.42
ASNA	0.097	0.0020	0.00322	2.367	0.761	0.37
BHJA	0.126	0.0035	0.00125	0.784	1.024	0.44
BHUM	0.110	0.0031	0.00081	0.514	1.019	0.43
BIDM	0.108	0.0030	0.00025	0.175	1.030	0.52
BMIL	0.068	0.0022	-0.00007	-0.036	0.780	0.30
BSAM	0.110	0.0031	0.00082	0.517	1.014	0.42
CISE	0.174	0.0047	0.00123	1.103	0.533	0.45
CITY	0.071	0.0099	0.00107	0.538	0.144	0.01
CLEM	0.076	0.0021	-0.00021	-0.174	0.729	0.55
COMM	0.057	0.0020	-0.00026	-0.143	0.627	0.28
EQUI	0.074	0.0020	-0.00031	-0.281	0.762	0.59
FAMI	0.124	0.0038	0.00026	0.172	0.525	0.45
FOCU	0.079	0.0036	0.00056	0.430	0.462	0.22
FRAM	0.025	0.0017	-0.00082	-0.278	0.508	0.13
FPSI	0.158	0.0046	0.00049	0.430	0.369	0.41
FPSE	0.189	0.0060	0.00107	0.751	0.401	0.39
HYP0	0.052	0.0017	-0.00081	-0.828	0.675	0.35
JUPE	0.112	0.0035	0.00063	0.389	0.582	0.36
KBCE	0.176	0.0044	0.00155	1.907	0.775	0.66
KDOE	0.071	0.0024	0.00001	0.010	0.654	0.37
LUXI	0.045	0.0017	-0.00051	-0.358	0.668	0.33
NPI	0.157	0.0041	0.00100	1.003	0.611	0.58
NPIP	0.243	0.0063	0.00235	2.359	0.611	0.58
OEKO	0.062	0.0035	0.00027	0.339	0.258	0.15
ORBI	0.001	0.0000	-0.00198	-1.156	0.825	0.36
ROBU	0.049	0.0087	0.00087	0.349	0.140	0.00
SCOT	0.131	0.0043	0.00090	0.570	0.482	0.28
SEBM	0.053	0.0019	-0.00024	-0.156	0.634	0.24
SOVE	0.114	0.0045	0.00058	0.365	0.452	0.26
TSB	0.191	0.0050	0.00195	1.797	0.754	0.47
VARL	0.140	0.0041	0.00167	1.057	0.953	0.40
WASA	0.051	0.0018	-0.00027	-0.173	0.586	0.23
WASU	0.122	0.0037	0.00094	0.825	0.665	0.36
VGRN	-0.010	-0.0008	-0.00120	-0.484	0.409	0.06
VMIL	0.060	0.0024	0.00009	0.047	0.618	0.20
Average	0.100	0.0036	0.00051	NA	0.623	0.35
MSCIWI	0.111	0.0024	0.00000	NA	1.000	NA

This table provides an analysis of the performance of the sample funds. The first column gives the code of the fund. The second and third columns report the Sharpe and the Treynor measures. The remaining columns report the results of the Jensen alpha and its t-value, the fund beta and the adjusted coefficient of determination (Adj R2). The reported t-values are adjusted for autocorrelation and heteroscedasticity with the Newey-West procedure using 4-lags. Values in **Bold** are significant at the 5% level. For one fund, HYP0 Friday data was used due to data availability.

Finally, results from estimations with the UK and the national benchmarks are considered.²¹¹ Average values for the calculations with UK and national benchmarks are reported in Table 6.4. Full results for each fund and all the indices are reported in Appendices 6.1, 6.2 and 6.3. The results are broadly similar to those reported for the international (MSCIWI) benchmark in Table 6.3 for the Sharpe measure. Of the sample funds 17 had a higher Sharpe measure than a UK benchmark, while 19 funds had a higher Sharpe measure than a national benchmark. The results were less similar when the performance was studied with the Treynor measure; 13 funds had a higher Treynor measure than a UK benchmark, while 22 funds had a higher Treynor measure than a domestic benchmark.

The greatest difference between the benchmarks arose with the Jensen measure. Compared to national benchmarks, 6 funds had significantly positive Jensen measures at the 5% level, while only 1 Jensen alpha was significantly positive against a UK benchmark. These differences for the Treynor and Jensen measures may be due to differences in fund betas against the different benchmarks; the average fund beta estimated with a national benchmark was 0.64 while, the average beta estimated from a UK benchmark was 0.71. Many fund performance studies document average Betas substantially below unity. One possible explanation for this may be fund cash holdings. The difference between the international and the national results may also support the argument that currency risk may influence the performance results (De Santis and Gerard, 1998)²¹² and lend weight to the suggestion that a multi-index model should be employed, (Elton *et al.*, 1993). In this investigation a two-index model similar to Gregory *et al.* (1997) is employed in Appendix 6.5. Finally, the average adjusted coefficient of determination rose from 0.35 with the international benchmark to 0.42 for a UK benchmark and improved further to 0.52 for the domestic benchmarks.

²¹¹ In particular the FTSEALL index was employed for the UK funds, the Affärsvärlden General index for the Swedish funds, The FAZ General index for German funds, for Norwegian funds the Oslo Stock Exchange General index, for Belgian funds the Brussels All Share index, for Dutch funds the CBS All Share general index and for Swiss funds the Swiss Market index.

²¹² Although currency risk was important for some markets during some periods they concluded that: "For the equity markets, the average premium for currency risk appears to be only a small fraction of the average total premium when we look at the entire sample".

Table 6.4 Average Values with Other Benchmarks

	Sharpe	Treynor	Jensen	Beta	Adj. R ²
UK average	0.021	0.0003	-0.0004	0.708	0.42
National average	0.070	0.0023	-0.0001	0.636	0.52

This Table presents the average values with the UK and the national benchmarks for the Sharpe, Treynor and Jensen measures. The last two columns present the average betas and adjusted R²'s. The full results are reported in Appendix 6.1-6.3.

The rankings of the various funds according to the different measures are shown in Table 6.5. The one picture to emerge from this table is the difference in portfolio ratings for some funds depending on which performance measure is employed. In particular the Swedish funds perform better when only raw returns are considered, lending support to the argument by De Santis and Gerard, (1998) that currency risk may be important. Overall the results are relatively similar across the different performance measures.²¹³ The correlation between the Treynor and Sharpe rankings is 0.74, while the correlation between the Treynor and Jensen rankings is higher at 0.81. The correlation between the Sharpe and the Jensen rankings is 0.78.²¹⁴

²¹³ Table 6.5 also reveals how different the performance of Norwegian and Swedish ethical funds are despite the fact that both countries are Scandinavian. This may support the conclusion of Booth and Martikainen (1999) of weak economic relationships within the markets of the Scandinavian countries.

²¹⁴ Similar but higher correlations are reported in Appendix 6.4 for the performance measures with the UK benchmark.

Table 6.5 Ranking of the Ethical Funds with Different Measures

Fund	Sharpe	Jensen	Treynor	Return
ABBE	23	26	25	30
ABER	22	28	26	29
ABFA	20	8	1	25
AKTA	19	17	23	7
ALLC	8	18	15	18
ASNA	21	1	31	26
BHJA	11	6	18	4
BHUM	17	16	22	6
BIDM	18	25	24	9
BMIL	29	30	29	19
BSAM	16	15	21	8
CISE	5	7	7	10
CITY	27	9	2	28
CLEM	25	31	30	23
COMM	32	33	33	31
EQUI	26	35	32	24
FAMI	12	24	14	17
FOCU	24	21	17	21
FRAM	38	38	36	38
FPSI	6	22	8	20
FPSE	3	10	5	13
HYPO	34	37	35	34
JUPE	15	19	19	15
KBCE	4	5	10	5
KDOE	28	29	27	22
LUXI	37	36	37	35
NPI	7	11	13	11
NPIP	1	2	4	2
OEKO	30	23	20	37
ORBI	39	40	38	39
ROBU	36	14	3	32
SCOT	10	13	11	14
SEBM	33	32	34	33
SOVE	14	20	9	16
TSB	2	3	6	3
VARL	9	4	12	1
WASA	35	34	35	36
WASU	13	12	16	12
VGRN	40	39	39	40
VMIL	31	27	28	27

	<i>Sharpe</i>	<i>Jensen</i>	<i>Treynor</i>
<i>Sharpe</i>	1		
<i>Jensen</i>	0.780	1	
<i>Treynor</i>	0.734	0.811	1

Finally, a modified alpha was estimated with the two-index benchmark employed by Gregory *et al.* (1997). The results for the funds with this model improved both in terms of performance and significance and were similar to those reported by Gregory *et al.* (1997). With the size adjusted alpha measure 5 of 18 UK ethical funds had significant positive performance. The average adjusted coefficient of determination was 0.71. These results are reported in Appendix 6.5.

6.4 Market Timing Results for the Ethical Funds

In the second part of the empirical analysis, equation [5] was estimated for each fund to examine (i) whether fund managers were timing the market and (ii) how the funds performed once this timing was taken into account in the study. The results from this investigation are shown in Table 6.6; the alpha measure of fund performance as well as the coefficient on the market timing variable (D_j) are provided. A number of conclusions can be drawn from the data in this table.

First, it seems as if managers have timed the market in the wrong direction; 38 of the 40 timing coefficients were negative and 13 of these were significantly negative at the 5% level. The negative timing coefficient implies that Beta is being reduced when the markets go up. Ferson and Schadt (1996) have provided evidence that this perverse timing may be due to the fact that more cash flows into funds in bull markets and since cash is a low risk (beta) asset the fund Beta is reduced and this surplus cash may therefore show up as poor market timing. In addition the ethical funds buy and sell shares for non-financial reasons and often adopt a longer term perspective than their “non-ethical” counterparts which may make it more difficult for them to time the market in an appropriate way (SustainAbility, 2000). However, in the majority of cases, the negative D_j coefficients are not significantly different from zero.

Second, a comparison of the average adjusted R^2 values between Table 6.3 and Table 6.6 reveals that the adjusted coefficient of determination increases from 0.35 to 0.37 once the timing variable is added to equation [5]. In 30 cases the inclusion of a timing variable improves the fit of the regression equation resulting in a higher adjusted R^2 for the Henriksson Merton model. Indeed, the

adjusted R^2 is clearly higher for the simple model [4] only in 3 cases of 40. This may indicate that it is insufficient to evaluate ethical fund performance with the Jensen measure alone and that other variables, such as a market timing variable may be necessary to more fully explain ethical fund performance.

Third, perhaps the biggest change in results between equation [4] and equation [5] is that a large percentage of the alpha values switch from being negative to being positive; some 10 funds' alphas change sign from negative to the positive, providing some evidence of outperformance over the market portfolio in terms of stock selection. This finding would seem to indicate that the poor financial performance by some ethical funds may be due to market timing problems rather than stock selection difficulties. Indeed 38 funds had a positive alpha in the timing model, 16 of these significant at the 5% level indicating some success in stock selection, but poor market timing ability.²¹⁵

²¹⁵ The results from estimating the Henriksson Merton model with national benchmarks supports these conclusions as 22 timing coefficients were significantly negative at the 5% level, while 17 selection coefficients were significantly positive. These results are reported in Appendix 6.6.

Table 6.6 The Henriksson Merton Measure of Timing Ability

Fund	Alpha	T-value	Beta	D	T-value	Adj R2
ABBE	0.00259	1.70	0.272	-0.328	-1.81	0.29
ABER	0.00221	1.92	0.406	-0.293	-2.35	0.48
ABFA	0.00323	2.23	-0.017	-0.274	-1.65	0.04
AKTA	0.00402	1.45	0.801	-0.445	-1.55	0.42
ALLC	0.00174	1.31	0.433	-0.146	-1.31	0.42
ASNA	0.00833	4.77	0.373	-0.691	-4.11	0.41
BHJA	0.00317	1.23	0.878	-0.260	-1.05	0.44
BHUM	0.00251	0.94	0.890	-0.229	-0.91	0.43
BIDM	0.00090	0.38	0.980	-0.088	-0.41	0.52
BMIL	0.00511	2.10	0.387	-0.701	-3.15	0.33
BSAM	0.00240	0.90	0.894	-0.215	-0.85	0.42
CISE	0.00357	3.02	0.355	-0.316	-2.19	0.46
CITY	0.00358	1.93	-0.048	-0.345	-1.16	0.02
CLEM	0.00145	0.91	0.603	-0.224	-1.51	0.55
COMM	0.00185	1.04	0.467	-0.286	-1.28	0.28
EQUI	0.00168	1.14	0.610	-0.269	-1.69	0.59
FAMI	0.00227	1.45	0.437	-0.222	-1.26	0.36
FOCU	0.00499	2.86	0.126	-0.600	-3.13	0.26
FRAM	0.00640	2.16	0.501	-1.121	-3.78	0.50
FPSI	0.00267	1.87	0.181	-0.232	-1.67	0.21
FPSE	0.00355	2.23	0.224	-0.283	-1.80	0.25
HYPO	-0.00234	-1.18	0.785	0.206	0.91	0.35
JUPE	0.00485	3.18	0.263	-0.570	-3.60	0.40
KBCE	0.00329	2.67	0.643	-0.235	-1.53	0.66
KDOE	0.00476	2.96	0.294	-0.642	-3.61	0.41
LUXI	0.00485	2.76	0.262	-0.724	-3.26	0.37
NPI	0.00232	1.94	0.511	-0.178	-1.28	0.58
NPIP	0.00371	3.04	0.508	-0.183	-1.53	0.58
OEKO	0.00221	1.96	0.111	-0.262	-1.85	0.16
ORBI	0.00629	2.42	0.197	-1.119	-5.36	0.44
ROBU	-0.00049	-0.17	0.247	1.160	0.18	0.56
SCOT	0.00318	1.77	0.310	-0.308	-1.41	0.29
SEBM	0.00581	3.08	0.175	-0.819	-4.73	0.29
SOVE	0.00266	1.54	0.295	-0.282	-1.44	0.27
TSB	0.00267	1.75	0.700	-0.097	-0.61	0.47
VARL	0.00366	1.46	0.802	-0.269	-1.07	0.40
WASA	0.00336	1.76	0.310	-0.491	-2.12	0.25
WASU	0.00411	2.03	0.425	-0.429	-1.83	0.37
VGRN	0.00366	1.08	0.040	-0.657	-1.71	0.07
VMIL	0.00606	2.91	0.165	-0.808	-3.92	0.23
Average	0.00332	1.86	0.420	-0.357	-1.80	0.37

This table reports the results of the Henriksson-Merton market timing regression according to equation [5]. The alpha gives a measure of stock selection ability. The D coefficient is a measure of the market timing ability of the fund. The t-values are all adjusted with the Newey-West procedure to mitigate problems with autocorrelation and heteroscedasticity. The Adj. R2 gives the adjusted coefficient of determination.

These findings using the Henriksson Merton approach were supported by similar results obtained from the timing model proposed by Treynor and Mazuy (1965). Using the Treynor and Mazuy model, 15 funds had a significantly negative timing coefficient, while 8 funds had a significantly positive stock selection coefficient.²¹⁶ The similarity of the results with these two models was demonstrated by the fact that 12 funds had a significantly negative market timing coefficient with both models and 6 funds had a significantly positive stock selection coefficient with both models.

6.5 Explaining Fund Performance

Finally, an attempt was made to explain the Jensen measure of fund performance estimated in equation [4] by cross sectional regression according to equation [7]. The results for equation [7] is reported in Table 6.7, with t-values adjusted according to White (1980) in order to mitigate against the problem of heteroscedasticity.

Several conclusions can be drawn from these results. It seems as if size is positively related to good fund performance as measured by the Jensen alpha. The coefficient for the Size variable was positive and significant for the model at the 10% level; indeed in a model where only fund size and age were used to explain the Jensen measure, size was significant at the 5% level (t-value was 2.21).²¹⁷ This seems logical since one would expect good performance to attract more investment into the fund. There appears to be a negative but insignificant relationship between age and the Jensen measure. Surprisingly, neither the universe nor the country dummy variables are significant in explaining cross sectional variations in the alpha measures. However the relatively small number of mainland European funds in the sample prevents a more detailed analysis of any “country” effect which might be present in the sample. Caution is warranted in interpreting all of these cross sectional results as the sample was small, the model is only partial and the R^2 's were very low, on average they were 4-5%.

²¹⁶ This second timing model was also employed for all funds using both a global and domestic benchmark. These results are reported in Appendix 6.7 and 6.8.

²¹⁷ Fund-size was also significant at the 5% level in a model used to explain the Treynor-Mauzy timing measure. These results are reported in Appendix 6.9.

Table 6.7 Cross-sectional Regressions explaining Fund Jensen Alphas

Jensen alpha explained	Intercept	Size	Age	Universe
Coefficient	0.000693	0.000002165	-0.000001545	-0.000241
t-value	(2.41)	(1.83)	(-0.83)	(-0.78)

This table reports the results of the regression explaining the Jensen Alphas of the ethical funds. All reported t-values are adjusted for heteroscedasticity according to White (1980). The Size variable is measured as size of funds as at 31.12.1998. The variable Age is measured as age of funds in months since inception until 31.12.1998. Universe is a dummy variable with a value of 0 for funds investing in the home country and 1 for funds investing globally. R^2 was 5%.

6.6 Conclusions

This Chapter has investigated the financial performance of 40 European ethical funds. A significant number of these funds (18) are based in the UK while the remainder operate in Sweden (11 funds), Germany (4 funds), Netherlands (2 funds), Norway (2 funds), Switzerland (2 funds) and Belgium (1 fund). The main finding is that whilst most funds seemed to outperform the benchmark index as measured by the Jensen and the Treynor performance measures this difference is not statistically significant. With the Sharpe measure the index slightly outperformed the average fund. The results generally seemed to be robust across benchmarks, although Swedish funds performed better with the Jensen measure when a national benchmark was employed. Also, UK fund performance improved when a small company index was included in the model.

The results of this investigation therefore support the findings of studies by Hamilton *et al.* (1993); Mallin *et al.* (1995); Gregory *et al.* (1997) and Reyes and Grieb (1998) in that there does not appear to be a significant penalty for investors who choose to place their money in ethical funds. The hypothesis that ethical funds provide similar risk adjusted returns as the benchmark was not refuted; indeed 15 funds had a better performance than the international benchmark as measured by all three traditional performance measures.

A second major finding of this study is that any poor financial performance for ethical funds seemed to originate from poor market timing ability rather than poor stock selection skills. Indeed the measures for stock selection were positive for 38 of the 40 funds, whilst the same 38 ethical funds had a negative timing

coefficient. None of the ethical funds studied displayed any evidence of a significant positive market timing ability. This finding was robust across models and benchmarks. Similar findings were reported by Fletcher (1995) for UK funds and Liljeblom and Löflund (2000) for Finnish funds with the Henriksson Merton model. They also reported that the timing coefficients tended to be negative, while the selection coefficients tended to be positive for their sample funds.

There was some evidence of a country effect when analysing the performance of the different European funds. For example UK funds performed well relative to their mainland European counterparts. This conclusion would be in line with the results of Eijgenhuijsen and Buckley (1999).²¹⁸ However, a larger sample of funds is required before any statistically significant differences in performance can be uncovered; when variables for the country in which the fund was based were added to the cross sectional analysis the coefficients were not significant. In fact, the only variable which played a significant part in explaining fund alphas at the 5% level was fund size.

Despite a number of limitations this Chapter has addressed a topic which is growing in importance among European investors, the performance of ethical funds. Because of data availability problems this investigation considers a relatively short time span and examines a fairly small number of funds.²¹⁹ Nevertheless, it makes a contribution to the existing literature by expanding the number of ethical funds studied and by investigating the ability of managers of these funds to time the market. The next Chapter will analyse ethical fund performance in comparison with similar non-ethical funds.

²¹⁸ In their paper the UK pension funds achieved the highest returns compared to other European countries and UK, Sweden and Belgium did well when country equities were regressed on a world portfolio.

²¹⁹ Malkiel (1995) and Wermers (2000) included all US mutual funds in their analysis, while Mallin *et al.* (1995) analysed a smaller sample of ethical funds over a longer 8 year period.

Chapter 7 A Matched Pair Analysis of Fund Performance

7.1 Introduction

In the previous Chapter it was established that the sample of ethical funds seemed to perform as well as various market benchmarks on a risk adjusted basis. This Chapter takes a different approach and investigates the comparative financial performance of the 40 ethical investment funds from seven European countries with a matched group of “non-ethical” funds. The matching in this investigation was done by age, country, size and investment universe of the fund. The Chapter therefore extends the matched pair approach to ethical fund performance developed in Mallin, Saadouni and Briston (1995) and Gregory, Matatko and Luther (1997) to a European level.

The main advance on the empirical analysis in the previous Chapter, therefore, is that 40 funds which do not explicitly consider ethical criteria in security selection are added to the sample. Thus the question of whether ethical funds are good investments financially is addressed, by comparing the performance of ethical funds with their non-ethical counterparts. All funds which did not meet the definition of an ethical fund were grouped together as “non-ethical” for the purposes of this Chapter.²²⁰

Most of the empirical investigations that employ a market portfolio as a benchmark against which to judge fund performance encounter difficulties in deciding on the appropriate benchmark to use. For example, Travers (1997) argued that: “It seems more reasonable to compare performance to other active portfolios with similar mandates”(p.55). This point was raised in the previous Chapter where several different benchmarks were employed to counter the argument that any results were benchmark specific. This Chapter adopts a different approach by directly comparing the financial stockmarket performance of an ethical fund with another fund that is matched on a number of characteristics.

²²⁰ A non-ethical fund is not automatically unethical, see Chapter 9.

One of the questions which prior studies have raised is whether the ethical investment strategies adopted by funds are achieved by foregoing some of the return which subscribers might otherwise have obtained by investing in non-ethical funds. If ethical funds are a “good” investment financially, there should not be a significant difference in risk adjusted returns between the two groups.²²¹ This investigation also addresses this issue; it examines the financial performance of European ethical and non-ethical funds over a recent three-year period from 1996 to 1998. The benchmark problem (Roll, 1977, Roll, 1978; Grinblatt and Titman, 1994; Luther and Mataka, 1994) is mitigated by a direct comparison of 40 matched pairs of ethical and non-ethical funds. The lack of ethical fund performance research in European countries other than the UK, is also addressed by including funds from six other countries in the analysis of this Chapter. The present investigation also employs a larger sample of ethical funds than any previously published study and examines a more recent data set than other studies such as Allen and Tan (1999) and Liljeblom and Löflund (2000).

Formally, four empirical questions are addressed. First the Chapter examines whether the funds – whether ethical or not – provide the same risk-adjusted financial return as the international benchmark portfolio outlined in Chapter 5. Second, it investigates whether the financial performance of ethical and non-ethical funds differ to a significant extent. Specifically, one might expect that non-ethical funds outperform their ethical counterparts since they operate without the same investment constraints (Rudd, 1981).²²² Third, the Chapter studies whether the market timing ability of ethical and non-ethical funds differ; non-ethical funds are expected to be more adroit at timing market trends, since ethical funds may buy and sell stocks for non-financial reasons. Finally, an attempt is made to explain what factors affect the fund performance. In particular, factors such as the age of the fund, the size of the fund and the ethical status of a fund are considered.

²²¹ Even if ethical funds would have significantly lower risk adjusted returns, they may still be “good” investments financially for those investors for which the ethical benefit achieved is worth more than the sacrificed risk adjusted returns (Inskip, 1992).

²²² Although some previous studies such as: Mallin *et al.* (1995); Gregory *et al.* (1997); Statman (2000) and Naturvårdsverket (2001) indicated that ethical fund performance may be neutral.

The remainder of this Chapter is organised as follows. Summary information and descriptive statistics for the sample funds are provided in the next section. The results of the study are analysed in sections 7.3 to 7.6, while section 7.7 offers a number of conclusions.

7.2 Summary Information and Descriptive Statistics

This section presents summary information and some descriptive statistics for the sample funds. Summary information for the funds are reported in Tables 7.1 and 7.2. In particular, the name of each fund in the sample, the code of the fund derived from its name, the country for each fund, the size of each fund as of 31.12.1998 in millions of pounds Sterling and the start date of each fund are reported in these Tables.²²³

The average ethical fund was 9 years old and valued at £44 million. The average age for a typical non-ethical fund was 10 years and its average size was £54 million. For 75% of the pairs of funds the difference in age was less than 3 years, while for 90% of the pairs the differences in size was less than £40 million. These differences in age and size were not significant at the 5% level. This matching on size and age is similar to the pairing employed by Mallin *et al.* (1995) and Gregory *et al.* (1997), but with the added complexity of the sample being chosen from seven countries rather than just one. The sample in this study was also matched for investment universe. However, because of the less mature nature of some of the continental European capital markets, the matching was not as good for some of the European funds as for the UK ones.

²²³ The ethical fund information was already discussed in Chapter 6, but is repeated to allow the reader to compare it with the matched sample.

Table 7.1 The Sample Funds

ETHICAL FUND	CODE	COUNTRY	NON-ETHICAL FUND	CODE	COUNTRY
Abbey Ethical Trust	ABBE	UK	Sovereign Income	SOVI	UK
Aberdeen Ethical	ABER	UK	Cavendish Worldwide	CAVE	UK
ABF Andere Beleggingsfond	ABFA	Netherlands	Ing Bank Global	INGG	Netherlands
Aktie Ansvar Sverige	AKTA	Sweden	Handelsbanken Utlandsfonden	HAUT	Sweden
Allchurches Amity	ALLC	UK	Credit Suisse Growth Portfolio	CSGP	UK
ASN Aandelensfonds	ASNA	Netherlands	Postbank Aandelenfonds	POST	Netherlands
Banco Hjälpfond	BHJA	Sweden	SEB Allemansfond Chans/Risk	SEBA	Sweden
Banco Humanfond	BHUM	Sweden	Länsförsäkringar Wasa Sverigefond	WASS	Sweden
Banco Ideella Miljöfond	BIDM	Sweden	Länsförsäkringar Wasa Allemansfond	WAAA	Sweden
Banco Miljöfond	BMIL	Sweden	Handelsbanken Radiohjälpfond	HARA	Sweden
Banco Samarit Fond	BSAM	Sweden	SE Bankens Allemansfond småbolag	SEBS	Sweden
CIS Environ Trust	CISE	UK	HSBC European Growth Fund	HSBC	UK
City Acorn Ethical	CITY	UK	City Financial International Fund	CITI	UK
Clerical Medical Evergreen	CLEM	UK	Sunlife of Canada Worldwide Growth	SUNC	UK
Commercial Union Environmental	COMM	UK	Consistent Unit Trust	CONS	UK
Equitable Ethical	EQUI	UK	Dresdner RCM International Equity	DRGE	UK
Family Charities Ethical	FAMI	UK	Guardian Income	GUAR	UK
Focus Umweltechnologie	FOCU	Germany	Nordinvest Wekanord	NORW	Germany
Framlington Health fund	FRAM	UK	Lloyds Bank Continental Europe	LLOY	UK
Friends Provident Stewardship inc.t.	FPSI	UK	Henderson UK Capital Growth Fund	HEND	UK
Friends Provident Stewardship un. t.	FPSE	UK	Equitable high income trust	EHIT	UK
Hypobank Ecotech	HYP0	Germany	Walser Aktien International	WALS	Germany
Jupiter Ecology	JUPE	UK	Scottish Life Worldwide	SCLW	UK
KBC Eco-fund	KBCE	Belgium	CERA Invest Emerging Markets	CERA	Belgium
KD Fonds Ökoinvest	KDOE	Germany	Nordinvest Global	NORD	Germany
Luxinter Ökolux	LUXI	Germany	ADIG Fondiro	ADIG	Germany
NPI Global Care Income	NPI	UK	AES UK General Unit Trust	AESU	UK
NPI Global Care Pension	NPIP	UK	Baillie Gifford European Small Cos	BAIL	UK
Oekosar (Bank Sarasin)	OEKO	Switzerland	UBS Equity inv. Global Select	UBSE	Switzerland
Orbitex Health and Biotech	ORBI	Switzerland	UBS Lux Equity Mid Caps Europe	UBSM	Switzerland
Robur Miljöfonden	ROBU	Sweden	Handelsbanken Bofonden	HABO	Sweden
Scottish Equitable Ethical	SCOT	UK	Laurence Keen Income & Growth	LAKE	UK
SEB Miljöfond	SEBM	Sweden	Länsförsäkringar Wasa Globalfonden	WASG	Sweden
Sovereign Ethical Fund	SOVE	UK	Scottish Equitable UK Blue Chip	SCEU	UK
TSB Environmental	TSB	UK	Martin Currie UK Growth	MCUG	UK
Världsnaturfonden	VARL	Sweden	SE Bankens Global	SEBG	Sweden
Vesta Grønt Norden	VGRN	Norway	DNB Realinvest	DNBR	Norway
Vesta Miljøinvest	VMIL	Norway	Vesta Horisont	VHOR	Norway
Wasa Miljöfond	WASA	Sweden	Banco Global	BGLO	Sweden
Wasa U Hjälpfond	WASU	Sweden	Handelsbanken Seniorbofond Aktie	HASA	Sweden

This table provides summary information about each fund in the sample. It provides the name of the fund, the code of the fund and the country of the fund. The first three columns present the ethical funds and the three latter columns report the same information for the non-ethical matched pair funds. 36 funds were from the UK, 22 from Sweden, 8 from Germany, 4 from the Netherlands, 4 from Norway, 4 from Switzerland and 2 from Belgium.

Table 7.2 Summary information About the Sample Funds

ETHICAL CODE	START DATE	SIZE(£) 31.12.98	INVESTMENT UNIVERSE	NONethical CODE	START DATE	SIZE (£) 31.12.98	INVESTMENT UNIVERSE
ABBE	Oct-87	40.4	UK	SOVI	May-87	39	UK
ABER	Sep-92	6.7	International	CAVE	Jul-94	5.4	International
ABFA	Oct-90	35.0	International	INGG	Oct-89	128.1	International
AKTA	1965	32.7	Sweden	HAUT	1959	97.8	Sweden
ALLC	Feb-88	35.3	UK	CSGP	Jul-88	59.5	UK
ASNA	Mar-93	68.2	International	POST	Mar-92	223.2	International
BHJA	Oct-95	11.3	Sweden	SEBA	Apr-95	23.4	Sweden
BHUM	Jun-90	137.1	Sweden	WASS	Dec-90	135.5	Sweden
BIDM	Dec-92	24.9	Sweden	WAAA	Jan-90	34.6	Sweden
BMIL	Sep-94	5.7	Sweden	HARA	Mar-95	3.4	Sweden
BSAM	Feb-94	33.8	Sweden	SEBS	Apr-95	21.8	Sweden
CISE	May-90	146.3	International	HSBC	Mar-88	129.6	Europe
CITY	Nov-88	3.9	International	CITI	Aug-86	3.3	International
CLEM	Feb-90	18.3	International	SUNC	Apr-87	16.6	International
COMM	Apr-92	24.0	International	CONS	Mar-88	23.9	International
EQUI	Jan-94	17.7	International	DRGE	Feb-95	15.5	International
FAMI	Mar-82	9.5	UK	GUAR	Sep-87	11.1	UK
FOCU	Oct-90	2.1	International	NORW	Jun-69	9.3	International
FRAM	Apr-87	71.4	International	LLOY	Nov-86	73.6	Europe
FPSI	Oct-87	73.6	UK	HEND	Jan-87	76.8	UK
FPSE	Jun-84	473.0	UK	EHIT	Dec-84	426.7	UK
HYP0	Apr-90	18.2	International	WALS	Feb-92	49.8789	International
JUPE	Mar-88	61.2	International	SCLW	Oct-87	60.3	International
KBCE	Mar-92	3.0	International	CERA	Jun-94	13.09	International
KDOE	Aug-91	2.8	International	NORD	Jan-91	17.8	International
LUXI	Feb-92	37.2	International	ADIG	May-87	23	International
NPI	Jul-95	31.0	UK	AESU	Jul-92	31.5	UK
NPIP	Mar-94	45.4	International	BAIL	Oct-93	45.8	Europe
OEKO	Feb-94	51.4	Int. mixed	UBSE	Jun-68	42.3	International
ORBI	Jun-91	12.1	International	UBSM	Jan-95	30.6	Europe
ROBU	Jan-96	36.6	Nordic	HABO	Oct-87	48.6	Sweden
SCOT	Apr-89	44.9	UK	LAKE	Oct-89	25.4	UK
SEBM	Oct-91	37.5	International	WASG	Dec-90	39.6	International
SOVE	May-89	19.8	UK	SCEU	Nov-89	16.1	UK
TSB	Jun-89	21.8	UK	MCUG	Mar-88	22	UK
VARL	May-88	20.9	Sweden	SEBG	1993	37.8	International
VGRN	Nov-89	33.4	Nordic	DNBR	Oct-83	75.4	Norway
VMIL	Dec-89	2.1	International	VHOR	Nov-94	12	Nor/Internat
WASA	Dec-90	10.4	International	BGLO	Jul-88	12.5	International
WASU	Jan-96	5.5	International	HASA	May-91	5	International

This table provides the code for each fund, the year and month in which each fund commenced operations and the fund size as at 31.12.98 in millions of British pounds. For three funds, AKTA, HAUT and SEBG, the month is unknown and July is an estimate of the month. For five funds, NORD, NORW, ORBI, UBSE, UBSM, it was not possible to obtain the size as at 31.12.98, instead the size reported for these funds is from the last 3 months in 1998, due to the end of the fiscal year for these funds.

The average weekly return, the standard deviation of these returns and the beta for each fund is reported in Table 7.3. The average weekly returns earned by the ethical funds was 0.16% which was slightly lower than the mean of 0.18% achieved by their non-ethical counterparts. However, this difference is not significant at the 5% level. In fact the MSCIWI index outperformed both groups over the test period with its mean return of 0.21%. The highest return of 0.45% was achieved by HSBC, a non-ethical fund. This high return was associated with high levels of risk as the volatility of the fund was 0.024 compared to 0.022 for the index and the average of 0.021 for the ethical funds in the sample. The best ethical fund, NPIP, had a return of 0.35% with a volatility of only 0.0158 and a beta of just 0.61. Two ethical funds ORBI and VGRN achieved negative returns of -0.03% and -0.07% for a British investor over this period. However, non-ethical funds had a greater incidence of negative returns over the period with five of them recording negative mean values (ADIG, BAIL, CERA, DNBR and VHOR).

This picture of lower risk for the ethical funds is strengthened by an analysis of the standard deviations: the average value for the non-ethical funds was 7.8% higher than the corresponding figure for the ethical funds. This difference is significant at the 5% level using a one tailed t-test, since the p-value is 0.03. The ethical funds also had lower systematic risk; the average beta for ethical funds was 0.62 compared to 0.79 for their non-ethical counterparts. Indeed 10 non-ethical funds had betas of 1.00 or more compared to only 5 of the ethical funds. Again this difference in Beta risk was significant at the 5% level between ethical and non-ethical funds according to a one sided t-test (t-value was 1.69). Mallin *et al.* (1995) reported similar conclusions; 5 of the 29 non-ethical funds in their sample had beta values that were greater than unity, whereas all ethical funds had beta estimates below 1.00.

Table 7.3 Descriptive Statistics for the Funds

FUND	MEAN	SDEV	BETA	FUND	MEAN	SDEV	BETA
ABBE	0.0009	0.0145	0.46	SOVI	0.0014	0.0158	0.60
ABER	0.0011	0.0150	0.57	CAVE	0.0005	0.0186	0.12
ABFA	0.0012	0.0158	0.14	INGG	0.0039	0.0254	1.01
AKTA	0.0028	0.0315	1.05	HAUT	0.0023	0.0222	0.84
ALLC	0.0016	0.0136	0.51	CSGP	0.0020	0.0175	0.72
ASNA	0.0012	0.0158	0.76	POST	0.0038	0.0237	0.92
BHJA	0.0033	0.0287	1.02	SEBA	0.0036	0.0288	1.01
BHUM	0.0028	0.0288	1.02	WASS	0.0020	0.0305	1.09
BIDM	0.0027	0.0288	1.03	WAAA	0.0024	0.0297	1.02
BMIL	0.0014	0.0254	0.78	HARA	0.0022	0.0296	1.03
BSAM	0.0028	0.0287	1.01	SEBS	0.0021	0.0261	0.83
CISE	0.0022	0.0145	0.53	HSBC	0.0045	0.0242	0.90
CITY	0.0011	0.0200	0.14	CITI	0.0001	0.0227	0.84
CLEM	0.0012	0.0206	0.73	SUNC	0.0022	0.0200	0.84
COMM	0.0009	0.0221	0.63	CONS	0.0021	0.0155	0.08
EQUI	0.0012	0.0207	0.76	DRGE	0.0012	0.0147	0.11
FAMI	0.0016	0.0160	0.52	GUAR	0.0023	0.0178	0.65
FOCU	0.0013	0.0212	0.46	NORW	0.0024	0.0236	0.87
FRAM	0.0005	0.0346	0.51	LLOY	0.0035	0.0228	0.73
FPSI	0.0014	0.0108	0.37	HEND	0.0020	0.0172	0.66
FPSE	0.0020	0.0126	0.40	EHIT	0.0019	0.0171	0.65
HYPO	0.0008	0.0226	0.67	WALS	0.0034	0.0233	0.81
JUPE	0.0017	0.0183	0.58	SCLW	0.0006	0.0246	1.01
KBCE	0.0031	0.0195	0.77	CERA	-0.0022	0.0341	1.24
KDOE	0.0012	0.0226	0.65	NORD	0.0028	0.0255	0.88
LUXI	0.0008	0.0249	0.67	ADIG	-0.0019	0.0260	0.65
NPI	0.0021	0.0158	0.61	AESU	0.0025	0.0188	0.74
NPIP	0.0035	0.0158	0.61	BAIL	-0.0001	0.0144	0.40
OEKO	0.0005	0.0144	0.26	UBSE	0.0022	0.0221	1.00
ORBI	-0.0003	0.0293	0.82	UBSM	0.0023	0.0196	0.46
ROBU	0.0009	0.0248	0.14	HABO	0.0020	0.0295	1.02
SCOT	0.0017	0.0158	0.48	LAKE	0.0034	0.0183	0.73
SEBM	0.0008	0.0225	0.63	WASG	0.0019	0.0231	0.95
SOVE	0.0017	0.0178	0.45	SCEU	0.0020	0.0180	0.68
TSB	0.0034	0.0198	0.75	MCUG	0.0013	0.0190	0.71
VARL	0.0035	0.0278	0.95	SEBG	0.0017	0.0224	0.92
VGRN	-0.0007	0.0312	0.41	DNBR	-0.0005	0.0322	0.98
VMIL	0.0011	0.0247	0.62	VHOR	-0.0003	0.0316	0.91
WASA	0.0007	0.0206	0.59	BGLO	0.0017	0.0218	0.89
WASU	0.0021	0.0202	0.67	HASA	0.0022	0.0270	1.01
<i>AVERAGE</i>	0.0016	0.0212	0.62	<i>AVERAGE</i>	0.0018	0.0229	0.79
<i>MSCIWI</i>	0.0021	0.0218	1.00	<i>MSCIWI</i>	0.0021	0.0218	1.00

Descriptive statistics for the 80 funds and the Morgan Stanley World Index. The first four columns provide information on the ethical funds and the last four on the non-ethical funds. This table shows the average weekly rate of return for each fund (MEAN) calculated using equation [1], the standard deviation (SDEV), and the fund beta (BETA) estimated from equation [4]. The data for all funds is weekly Wednesday to Wednesday, dividends fully reinvested from 1996 to 1998, 156 observations are available for each fund, except for ROBU which has only 152 observations and WASS 150 observations. For one fund HYPO, Friday to Friday data is used, due to data-availability. Additional descriptive statistics for the ethical funds are reported in Chapter 6 and for the non-ethical funds in Appendix 7.1.

7.3 Results

This section analyses the results of calculating different performance measures and relates these results to the findings from previous studies of ethical funds. The risk adjusted performance measures were not significantly different for the two groups. In fact, they were surprisingly similar on average with a mean Sharpe measure of 0.100 for the ethical funds and 0.102 for their non-ethical counterparts and an average Treynor measure of 0.004 for both groups. The Sharpe, Treynor and Jensen measures for each fund are reported in Table 7.4.

Mallin *et al.* (1995) reported that for both the Sharpe and the Treynor measure 14 of the 29 ethical funds examined outperformed their non-ethical counterparts. In this investigation 18 ethical funds had a higher Sharpe ratio than their non-ethical pairs. The highest Sharpe ratio of 0.24 was recorded by the ethical fund NPIP, while the smallest ratio of -0.058 was achieved by the German non-ethical fund ADIG. In this study, 35 of the funds had a higher Sharpe ratio than the market, 15 of them ethical and 20 non-ethical. These findings are in line with Reyes and Grieb (1998), who found no significant difference between 15 ethical funds and peer indexes with the Sharpe measure. In a Scandinavian study, Naturvårdsverket (2001) found that the average Sharpe ratios for Swedish and Norwegian ethical funds were higher than those of their matched non-ethical counterparts.

In this study 21 of 40 ethical funds outperformed their non-ethical counterpart by the Treynor measure. Of the funds in this sample 52 outperformed the market with the Treynor measure; 25 of these were ethical and 27 were non-ethical funds. The findings therefore confirm that the performance of ethical and non-ethical funds was similar according to these two measures. The same conclusion for Swedish and Norwegian funds was reached by Naturvårdsverket (2001).

The average for the Jensen measure was again very similar for the two groups. The ethical funds had an average alpha of 0.0005 while the non-ethical funds had a mean Jensen alpha of 0.0003; this difference was not statistically significant. Some 18 ethical funds had a higher Jensen measure than their matched non-ethical pair. These results are similar to the findings documented

by Gregory *et al.* (1997) and Statman (2000) since there was no significant difference in the Jensen measures between ethical and non-ethical funds. The results also support the findings reported by Luther and Matatko (1994) in their two index model; there was neither significant over – nor under– performance compared to a market benchmark. An analysis of the Jensen measure reveals that 55 funds outperformed the market in this investigation, 27 ethical and 28 non-ethical funds. Two ethical funds (ASNA, NPIP) and three non-ethical funds (INGG, HSBC and POST) had significant positive Jensen measures at the 5% level. Interestingly all these funds were from the Netherlands and the UK. Only one non-ethical fund, CERA, had a significantly negative Jensen measure. The highest Jensen measure 0.0032 was recorded for the Dutch ethical fund ASNA.

This finding is slightly different from the results of Mallin *et al.* (1995). In their study the ethical funds performed better than the non-ethical funds when the Jensen measure was employed; specifically, 62% of the UK ethical funds in their investigation outperformed their non-ethical matched pairs. The Mallin *et al.* study also provided some evidence that funds in general outperformed the market as 8 of their 58 funds had a significantly positive Jensen alpha.²²⁴ It therefore seems as if the funds in general and the ethical funds in particular performed better in Mallin *et al.* (1995) than in this examination.

On the other hand, the fund performance in this investigation is slightly better than that documented in Gregory *et al.* (1997) where all funds tended to underperform the market and the ethical funds seemed to do worse than non-ethical funds although this difference was not statistically significant. In Statman (2000), the ethical funds outperformed the non-ethical funds while both groups underperformed the benchmarks employed. As in Gregory *et al.* (1997) the performance of the ethical funds improved with a two-factor benchmark, which incorporated a small company index. These results are reported in Appendix 7.2.²²⁵

²²⁴ According to French and Henderson (1985) a fund may have to record annual excess returns of 12% or more to record a significantly positive Jensen measure over a 5 year period.

²²⁵ With the two factor benchmark 9 of 18 UK ethical funds outperformed the non-ethical funds. The average size adjusted alpha was higher for the ethical funds, 0.00062 compared to 0.00037 for the non-ethical funds. Finally, 5 of the ethical funds had significantly positive size adjusted alphas compared to 2 of the non-ethical funds, full results are reported in Appendix 7.2.

Table 7.4 An Analysis of the Financial Performance of the Funds

Ethical Fund	Sharpe	Treynor	Jensen Alpha	Jensen T-value	Nonethical Fund	Sharpe	Treynor	Jensen Alpha	Jensen T-value
ABBE	0.088	0.0028	0.0002	0.12	SOVI	0.108	0.0025	0.0003	0.24
ABER	0.095	0.0025	0.0000	0.04	CAVE	0.046	0.0074	0.0006	0.32
ABFA	0.097	0.0112	0.0012	1.33	INGG	0.168	0.0042	0.0018	2.77
AKTA	0.101	0.0030	0.0007	0.46	HAUT	0.120	0.0032	0.0006	1.07
ALLC	0.141	0.0037	0.0007	0.67	CSGP	0.137	0.0033	0.0006	0.62
ASNA	0.097	0.0020	0.0032	2.37	POST	0.174	0.0045	0.0019	2.71
BHJA	0.126	0.0035	0.0012	0.78	SEBA	0.137	0.0039	0.0015	1.03
BHUM	0.110	0.0031	0.0008	0.51	WASS	0.082	0.0022	0.0002	0.12
BIDM	0.108	0.0030	0.0003	0.18	WAAA	0.093	0.0027	0.0003	0.19
BMIL	0.068	0.0022	-0.0001	-0.04	HARA	0.088	0.0025	0.0001	0.06
BSAM	0.110	0.0031	0.0008	0.52	SEBS	0.095	0.0030	0.0004	0.24
CISE	0.174	0.0047	0.0012	1.10	HSBC	0.201	0.0054	0.0027	2.30
CITY	0.071	0.0099	0.0011	0.54	CITI	0.020	0.0005	-0.0016	-1.86
CLEM	0.076	0.0021	-0.0002	-0.17	SUNC	0.128	0.0031	0.0005	0.92
COMM	0.057	0.0020	-0.0003	-0.14	CONS	0.156	0.0320	0.0022	1.51
EQUI	0.074	0.0020	-0.0003	-0.28	DRGE	0.108	0.0141	0.0013	1.38
FAMI	0.124	0.0038	0.0003	0.17	GUAR	0.149	0.0041	0.0011	1.14
FOCU	0.079	0.0036	0.0006	0.43	NORW	0.118	0.0032	0.0007	1.19
FRAM	0.025	0.0017	-0.0008	-0.28	LLOY	0.169	0.0053	0.0021	1.83
FPSI	0.158	0.0046	0.0005	0.43	HEND	0.139	0.0036	0.0008	0.85
FPSE	0.189	0.0060	0.0011	0.75	EHIT	0.130	0.0034	0.0007	0.63
HYP0	0.052	0.0017	-0.0008	-0.83	WALS	0.163	0.0047	0.0018	1.80
JUPE	0.112	0.0035	0.0006	0.39	SCLW	0.041	0.0010	-0.0014	-1.79
KBCE	0.176	0.0044	0.0015	1.91	CERA	-0.053	-0.0015	-0.0048	-2.48
KDOE	0.071	0.0024	0.0000	0.01	NORD	0.124	0.0036	0.0010	1.07
LUXI	0.045	0.0017	-0.0005	-0.36	ADIG	-0.058	-0.0020	-0.0031	-1.59
NPI	0.157	0.0041	0.0010	1.00	AESU	0.153	0.0039	0.0011	1.15
NPIP	0.243	0.0063	0.0024	2.36	BAIL	0.020	0.0007	-0.0007	-0.42
OEKO	0.062	0.0035	0.0003	0.34	UBSE	0.114	0.0046	0.0001	0.25
ORBI	0.001	0.0000	-0.0020	-1.16	UBSM	0.134	0.0026	0.0013	0.92
ROBU	0.049	0.0087	0.0009	0.35	HABO	0.080	0.0023	-0.0001	-0.07
SCOT	0.131	0.0043	0.0009	0.57	LAKE	0.206	0.0052	0.0020	1.86
SEBM	0.053	0.0019	-0.0002	-0.16	WASG	0.099	0.0024	0.0000	-0.05
SOVE	0.114	0.0045	0.0006	0.36	SCEU	0.133	0.0040	0.0008	0.76
TSB	0.191	0.0050	0.0020	1.80	MCUG	0.088	0.0023	-0.0001	-0.05
VARL	0.140	0.0041	0.0017	1.06	SEBG	0.093	0.0023	-0.0001	-0.28
VGRN	-0.010	-0.0008	-0.0012	-0.48	DNBR	-0.004	-0.0001	-0.0025	-1.17
VMIL	0.060	0.0024	0.0001	0.05	VHOR	0.001	0.0000	-0.0022	-0.96
WASA	0.051	0.0018	-0.0003	-0.17	BGLO	0.095	0.0023	-0.0001	-0.18
WASU	0.122	0.0037	0.0009	0.83	HASA	0.096	0.0026	0.0001	0.11
Average	0.100	0.0036	0.0005	0.44	Average	0.102	0.0039	0.0003	0.53
MSCIWI	0.111	0.0024	0.0000	NA	MSCIWI	0.111	0.0024	0.0000	NA

This table provides an analysis of the performance of the sample funds. The first five columns refer to the ethical funds and the last five to the non-ethical funds. The first column gives the code of the fund. The second and third columns report the Sharpe and the Treynor measures. The remaining columns report the results of the Jensen alpha and its t-value. The reported t-values are adjusted with the Newey-West procedure using 4-lags. Values in **Bold** are significant at the 5% level. The average adjusted R^2 for the ethical funds was 0.35 and for the non-ethical funds 0.51.

A ranking of the funds based on the traditional performance measures and fund returns is presented in Table 7.5. Three key findings emerge from this table. First, the overall performance of the ethical and non-ethical funds is similar since the proportion of ethical funds outperforming their matched pair is close to 50% with all the risk-adjusted measures.²²⁶ Second, the strong performance of the Dutch funds ASNA, ING and POST is worth noting. According to the Jensen measure, 3 of the 4 Dutch funds are in the top ten, while the Sharpe measure indicates that two of the Dutch funds are in the top ten. It is interesting to note the strong performance of UK funds according to the Sharpe and Treynor measures (15 and 14 of the top twenty funds were from the UK) and contrast this with the weaker performance of UK funds when raw returns are studied; only 6 of the top 20 funds are British.²²⁷

In particular the Swedish funds perform well as measured by raw returns, but this good performance vanishes once risk for British investors is accounted for.²²⁸ Finally, there is a high positive correlation between the rankings with all the traditional risk adjusted measures. The correlation values range from a low of 0.76 to a high of 0.85 according to the end of Table 7.5. Correlations for the value of the performance measures ranged from the low of 0.42 between the Sharpe and Treynor measures to the high of 0.87 between the Sharpe and the Jensen Measures.

²²⁶ Specifically, 45% of the ethical funds outperform their non-ethical counterpart for the Sharpe, 52.5% for the Treynor and 45% for the Jensen measure.

²²⁷ Rankings for the fund returns are provided in Appendix 7.3.

²²⁸ This may partly be caused by currency risk as the Swedish Krona depreciated on average by 10.8% per year against Pound Sterling in the time period studied.

Table 7.5 Ranking of Funds with Risk Adjusted Measures

Ethical				Non - Ethical			
Fund	Sharpe	Treynor	Jensen	Fund	Sharpe	Treynor	Jensen
ABBE	51	47	51	SOVI	38	52	48
ABER	46	53	56	CAVE	69	6	40
ABFA	43	3	18	INGG	10	21	10
AKTA	41	44	32	HAUT	31	40	38
ALLC	17	29	34	CSGP	20	38	36
ASNA	44	64	1	POST	7	18	8
BHJA	27	34	16	SEBA	21	26	13
BHUM	37	42	29	WASS	54	61	50
BIDM	40	45	49	WAAA	49	48	45
BMIL	61	62	60	HARA	53	51	53
BSAM	36	41	28	SEBS	48	46	44
CISE	8	13	17	HSBC	3	9	2
CITY	59	4	21	CITI	73	74	75
CLEM	57	63	64	SUNC	26	43	42
COMM	64	66	66	CONS	14	1	4
EQUI	58	65	68	DRGE	39	2	14
FAMI	28	28	47	GUAR	16	22	19
FOCU	56	31	41	NORW	32	39	33
FRAM	72	70	72	LLOY	9	10	5
FPSI	12	15	43	HEND	19	32	30
FPSE	5	8	22	EHIT	25	37	35
HYP0	66	69	71	WALS	11	14	9
JUPE	35	35	37	SCLW	71	72	74
KBCE	6	19	12	CERA	79	79	80
KDOE	60	54	57	NORD	29	33	23
LUXI	70	71	69	ADIG	80	80	79
NPI	13	24	24	AESU	15	27	20
NPIP	1	7	3	BAIL	74	73	70
OEKO	62	36	46	UBSE	34	16	55
ORBI	76	76	76	UBSM	22	49	15
ROBU	68	5	27	HABO	55	59	62
SCOT	24	20	26	LAKE	2	11	6
SEBM	65	67	65	WASG	42	55	58
SOVE	33	17	39	SCEU	23	25	31
TSB	4	12	7	MCUG	52	58	59
VARL	18	23	11	SEBG	50	60	63
VGRN	78	78	73	DNBR	77	77	78
VMIL	63	56	54	VHOR	75	75	77
WASA	67	68	67	BGLO	47	57	61
WASU	30	30	25	HASA	45	50	52

	<i>Sharpe</i>	<i>Treynor</i>	<i>Jensen</i>
Sharpe	1		
Treynor	0.7600	1	
Jensen	0.8455	0.8451	1

This table provides the rankings of the 80 funds with the traditional risk adjusted performance measures and the correlations between them. The first four columns reports the rankings for the ethical funds alphabetically and the latter four columns for the non-ethical matched pair funds.

7.4 Market Timing Results

Market timing ability was assessed using the Henriksson Merton (HM) model and the results of this assessment are shown in Table 7.6. The HM model evaluates whether fund managers vary the risk of their funds according to whether a bull or a bear market is present. Fund managers may increase bond and cash holdings at times when bonds provide higher returns than shares and vice versa. Specifically the timing coefficients are shown in this table. The results show that none of the funds had significant positive market timing ability. Instead, 13 ethical and 10 non-ethical funds had negative market timing coefficients which were significant at the 5% level. Instead of increasing fund betas when the market was expected to rise and decreasing the betas when the market was expected to fall, managers tended to alter risk in the wrong direction. However, a similar number of both ethical (38) and non-ethical (37) fund managers seemed to make this timing error. Funds from all countries except Belgium had significantly negative timing coefficients and the largest number of funds with a significantly negative timing coefficient came from Sweden. However, Germany had the worst relative performance of the sample with 4 of 8 funds having a significantly negative timing coefficient.²²⁹ The small sample of German funds prevents any conclusions to be drawn from this result. The results were worse for the ethical funds with the Treynor Mazuy model as 14 ethical and 8 non-ethical funds had a significantly negative timing coefficient, these results are reported in Appendix 7.4.

²²⁹ These German funds had statistically significantly negative timing coefficients: FOCU, KDOE, LUXI and WAL5.

Table 7.6 Measures of Timing Ability for the Sample Funds

TIMING ETHICAL FUNDS					TIMING NON-ETHICAL FUNDS				
Fund	Alpha	T-value	D	T-value	Fund	Alpha	T-value	D	T-value
ABBE	0.0026	1.70	-0.33	-1.81	SOVI	0.0007	0.48	-0.06	-0.47
ABER	0.0022	1.92	-0.29	-2.35	CAVE	0.0055	3.08	-0.68	-3.92
ABFA	0.0032	2.23	-0.27	-1.65	INGG	0.0026	2.15	-0.10	-0.82
AKTA	0.0040	1.45	-0.44	-1.55	HAUT	0.0054	2.92	-0.60	-3.09
ALLC	0.0017	1.31	-0.15	-1.31	CSGP	0.0018	1.33	-0.15	-1.12
ASNA	0.0083	4.77	-0.69	-4.11	POST	0.0027	1.62	-0.12	-0.63
BHJA	0.0032	1.23	-0.26	-1.05	SEBA	0.0063	2.43	-0.61	-2.26
BHUM	0.0025	0.94	-0.23	-0.91	WASS	0.0037	1.30	-0.51	-1.68
BIDM	0.0009	0.38	-0.09	-0.41	WAAA	0.0041	1.41	-0.47	-1.63
BMIL	0.0051	2.10	-0.70	-3.15	HARA	0.0037	1.19	-0.44	-1.33
BSAM	0.0024	0.90	-0.21	-0.85	SEBS	0.0061	2.19	-0.72	-2.66
CISE	0.0036	3.02	-0.32	-2.19	HSBC	0.0054	3.31	-0.37	-2.55
CITY	0.0036	1.93	-0.34	-1.16	CITI	-0.0014	-1.06	-0.03	-0.17
CLEM	0.0015	0.91	-0.22	-1.51	SUNC	0.0017	2.09	-0.15	-1.53
COMM	0.0019	1.04	-0.29	-1.28	CONS	0.0055	3.71	-0.45	-2.49
EQUI	0.0017	1.14	-0.27	-1.69	DRGE	0.0020	1.46	-0.09	-0.64
FAMI	0.0023	1.45	-0.22	-1.26	GUAR	0.0008	0.53	0.04	0.31
FOCU	0.0050	2.86	-0.60	-3.13	NORW	0.0017	1.45	-0.13	-1.00
FRAM	0.0064	2.16	-1.12	-3.78	LLOY	0.0041	2.34	-0.28	-1.68
FPSI	0.0027	1.87	-0.23	-1.67	HEND	0.0007	0.52	0.01	0.10
FPSE	0.0035	2.23	-0.28	-1.80	EHIT	0.0010	0.64	-0.05	-0.38
HYP0	-0.0023	-1.18	0.21	0.91	WALS	0.0037	2.41	-0.26	-1.98
JUPE	0.0049	3.18	-0.57	-3.60	SCLW	-0.0001	-0.10	-0.18	-1.31
KBCE	0.0033	2.67	-0.24	-1.53	CERA	-0.0047	-1.76	-0.02	-0.06
KDOE	0.0048	2.96	-0.64	-3.61	NORD	0.0030	1.74	-0.27	-1.40
LUXI	0.0048	2.76	-0.72	-3.26	ADIG	0.0005	0.20	-0.49	-1.46
NPI	0.0023	1.94	-0.18	-1.28	AESU	0.0014	0.98	-0.05	-0.32
NPIP	0.0037	3.04	-0.18	-1.53	BAIL	0.0020	1.20	-0.36	-1.90
OEKO	0.0022	1.96	-0.26	-1.85	UBSE	-0.0002	-0.36	0.04	0.49
ORBI	0.0063	2.42	-1.12	-5.36	UBSM	0.0040	2.12	-0.37	-1.88
ROBU	-0.0005	-0.17	1.16	0.18	HABO	0.0008	0.28	-0.06	-0.20
SCOT	0.0032	1.77	-0.31	-1.41	LAKE	0.0026	1.74	-0.08	-0.59
SEBM	0.0058	3.08	-0.82	-4.73	WASG	0.0041	2.10	-0.52	-2.45
SOVE	0.0027	1.54	-0.28	-1.44	SCEU	0.0014	0.96	-0.09	-0.64
TSB	0.0027	1.75	-0.10	-0.61	MCUG	0.0018	1.01	-0.25	-1.87
VARL	0.0037	1.46	-0.27	-1.07	SEBG	0.0032	2.09	-0.41	-2.80
VGRN	0.0037	1.08	-0.66	-1.71	DNBR	0.0012	0.37	-0.51	-1.54
VMIL	0.0061	2.91	-0.81	-3.92	VHOR	0.0011	0.40	-0.46	-1.80
WASA	0.0034	1.76	-0.49	-2.12	BGLO	0.0040	2.35	-0.51	-2.55
WASU	0.0041	2.03	-0.43	-1.83	HASA	0.0037	1.39	-0.43	-1.48
Average	0.0033	1.86	-0.36	-1.80	Average	0.0024	1.33	-0.28	-1.38

This table reports the results of the Henriksson-Merton market timing regressions according to equation [5]. The alpha coefficient gives a measure of the stock selection ability of the fund. The D coefficients are measures of the market timing ability of the fund. The t-values are all adjusted with the Newey-West procedure to mitigate problems with autocorrelation and heteroscedasticity. The average adjusted R² for ethical funds was 0.37 and for non-ethical funds 0.48.

7.5 Differences between Ethical and Non-ethical Funds

Formal tests were conducted to investigate whether there were any significant differences between the group of ethical funds and the matched group of non-ethical funds. The results of these tests are reported in Table 7.7. These tests show that in most cases there was no significant difference between the two groups at the 5% level. For example, ethical funds were smaller, younger and offered a lower mean return but these differences were not significantly different between the groups. All the performance measures for both groups were equally similar such that the p-values associated with the t-tests and the Friedman tests were all greater than 0.05. With one of the measures of risk – the natural logarithm of the standard deviations of the returns – the ethical funds were significantly less risky than the non-ethical funds (t-value of 2.23). In the case of risk it seemed justified to use a one-tailed test as one would expect ethical funds to be more risky because of their investment in small companies and their restricted investment universe (Rudd, 1981). However, the ethical funds surprisingly have significantly lower standard deviations and betas than the non-ethical funds (t-values of 1.92 and 1.69). This result is confirmed by the non-parametric Friedman tests with p-values of 0.002 and 0.027. The Min and Max average values also confirm this view as they indicate that the returns for ethical funds are less volatile than the returns for the non-ethical portfolios over the time period analysed.

These findings suggest that returns and risk adjusted performance measures are not significantly different for ethical and non-ethical funds in the sample. Surprisingly, the risk is significantly lower for ethical funds according to all the risk measures examined when a one tailed t-test and the Friedman non-parametric test were employed. The results from the timing models suggest that in those cases where ethical funds underperform their non-ethical counterparts this is due to market timing ability and not poor stock selection. These findings therefore support previous studies which have concluded that there does not seem to be a penalty for investing in ethical funds. Indeed, according to the risk adjusted performance measures, it seems just as likely that the ethical funds will outperform the non-ethical funds. Despite the restricted investment universe for

ethical funds it also seems as if they are less risky than similar non-ethical funds during the time period studied.

Table 7.7 Matched Pair t-tests and Friedman Non-parametric Tests

	Ethical	Nonethical	Matched pair t-value	Two tailed t-test P value	Friedman P value
SIZE	44.2	54.2	1.952	0.058	0.343
AGE	105.3	116.3	1.557	0.128	0.206
MEAN	0.0016	0.0018	0.915	0.366	0.058
SDEV	0.021	0.023	1.922	0.062	0.002
LNSDVN	-3.89	-3.80	2.268	0.029	0.002
BETA	0.62	0.74	1.691	0.099	0.027
MIN	-0.080	-0.083	-0.589	0.559	0.027
MAX	0.066	0.071	1.019	0.315	0.011
SHARPE	0.100	0.102	0.214	0.831	0.343
TREYNOR	0.0036	0.0039	0.305	0.762	0.752
JENSEN ALPHA	0.0005	0.0003	-0.710	0.482	0.527
D-HM	-0.36	-0.28	1.273	0.211	0.343
HM-ALPHA	0.0033	0.0024	-1.950	0.058	0.058

This table reports the results of the t-tests between the group of 40 non-ethical and 40 ethical funds. Values in **bold** are significant at the 5% level with a two tailed test; in some cases such as the risk measures in this study a one-tailed test is justified. The first column begins with SIZE referring to test of significance between size of the non-ethical and ethical funds. The first column reports the tested parameter, the second column reports the average value for the ethical funds for that parameter, the third column reports the average value for the non-ethical funds, fourth column reports the t-values and the fifth column reports the two tailed significance levels. In some cases this Chapter refers to one tailed significance levels which are half of the two tailed significance levels. The final column reports the p-values from the Friedman non-parametric test. The table begins with tests of fund characteristics such as fund size and age. It continues with tests of descriptive statistics of fund returns such as mean, standard deviation, Ln standard deviation, beta, min, max values of fund returns. Then the tests for differences in fund risk adjusted performance by Sharpe, Treynor and Jensen measures. Finally differences between the results in market timing for ethical and non-ethical funds are tested for by testing the parameters in the Henriksson-Merton (HM) model, some further tests are reported in Appendix 7.5.

Indeed, with the Treynor and Jensen measures there was weak evidence of both ethical and non-ethical funds performing slightly better than the benchmark. The results provided a negative answer to the question of whether there is a significant difference in the risk adjusted returns between the two groups; non-ethical funds did not perform better than their ethical counterparts as expected. This supports the results of previous studies, which found no significant difference in performance between a group of ethical and ordinary funds

(Hamilton *et al.*, 1993; Mallin *et al.*, 1995; Reyes and Grieb, 1998; Statman, 2000 and Naturvårdsverket 2001).

In this study there was evidence that ethical funds are a better choice for the risk averse investors than non-ethical funds, since the fund betas and the volatility were significantly lower for the ethical funds. Similar findings were reported by Mallin *et al.* (1995), Gregory *et al.* (1997) and Naturvårdsverket (2001).²³⁰ This was confirmed by the study of the market timing ability of the fund managers. When the Henriksson-Merton model was employed there was not a significant difference in performance and therefore the results did not conclusively support the hypothesis that non-ethical funds are better at timing the market, although non-ethical funds were significantly better at market timing according to the Treynor Mazuy model. These results are reported in Appendix 7.4 and 7.5.

7.6 Cross Sectional Analysis

Finally, an attempt was made to explain cross-sectional differences in performance measures such as the Jensen, Sharpe and Treynor measures, raw returns and the Henriksson Merton Alpha. Regressions were employed using variables such as; fund size at the 31.12.98, age of the fund in months and a dummy variable for the ethical status of the fund with a code of 1 for an ethical fund and a 0 for a non-ethical fund. These factors were used by Gregory *et al.* (1997), who found none of the variables to be significant. It is argued in Gregory *et al.* (1997) that economies of scale may lead to a better performance by large funds; if this was the case fund size might have explanatory power. Age is included as younger funds may face higher costs in the early stages. The findings are similar to those obtained by Gregory *et al.* (1997) and are reported in Table 7.8. The results in this study indicate that a greater fund size may be associated with better performance, but not significantly so.²³¹ This is similar to the findings of Liljeblom and Löflund (2000); fund size was significant and

²³⁰ For example, the average beta was 0.71 for ethical and 0.84 for non-ethical funds in Mallin *et al.* (1995). This difference is significant at the 1% level. The average beta was 0.79 for ethical funds and 0.87 for other funds in Gregory *et al.* (1997). This difference was not significant statistically, but it can be noted that this was because one non-ethical fund (Pearl UK Int.) had a low beta of 0.08. Without this fund the difference would have been significant (own calculations).

positive at the 10% level for the full time period, but insignificant in sub periods.

The age of the fund did not have explanatory power in the regression model. The ethical status of a fund was not significant in explaining Jensen alphas or Ln-returns. However when the Henriksson Merton alpha was the dependent variable ethical status was highly significant. Ethical funds had a higher Henriksson Merton alpha on average and this difference was significant at the 10% level. This may constitute some weak evidence that ethical research may improve financial performance (stock picking). The coefficients of determination, R^2 were low ranging from 4-5% for most of the models. However the model explaining the Henriksson Merton alphas had a higher R^2 of 27%. It thus seems as if this partial model is unable to fully explain the cross section of the fund performance. Other variables such as portfolio turnover and expense ratios might have greater explanatory power, but unfortunately such data were not available for many of the sample funds.²³²

Table 7.8 Cross-Sectional Regressions Explaining Performance Measures

(A) Jensen Measure explained

Jensen Alpha explained	Intercept	Size	Age	Ethical Status
Coefficient	0.0002540	0.0000033	-0.0000013	0.00021
t-value	0.79	1.73	-0.60	0.74

R^2 was 4%

(B) Sharpe Measure explained

Sharpe measures	Intercept	Size	Age	Ethical Status
Coefficient	0.0905500	0.0021910	-0.0000896	-0.0047950
t-value	6.37	2.57	-0.01	-0.04

R^2 was 8%

²³¹ Only in explaining the Sharpe measure was fund size significant at the 5% level, whereas it was significant at the 10% level for the Jensen measure, in most cases however size and other variables were not significant.

²³² The expenses were analysed for a number of funds. Generally many financial institutions had similar fees for all their funds (Banco, Ecclesiastical). For 23 matched pairs the initial charge and the management fees were available, there was no significant difference between the groups.

(C) Treynor Measure explained

Treynor measures	Intercept	Size	Age	Ethical Status
Coefficient	0.0038502	0.0000176	-0.0000049	-0.0027600
t-value	3.69	0.28	-0.07	-0.30

R² was 0.2%

(D) Fund Returns explained

Fund Ln returns explained	Intercept	Size	Age	Ethical Status
Coefficient	0.2231500	0.0004440	0.0000558	-0.0339930
t-value	5.24	1.51	0.17	-0.79

R² was 4%

(E) Henriksson-Merton Alpha explained

Henriksson Merton alphas	Intercept	Size	Age	Ethical Status
Coefficient	0.0010970	0.0000010	0.0000004	0.0005674
t-value	2.41	0.39	0.13	5.33

R² was 27%

These tables report the results of the cross-sectional regression explaining (A) the Jensen Alphas of all 80 funds, (B) the Sharpe measure, (C) the Treynor measure, (D) the returns for all funds and (E) the Henriksson-Merton alphas of the funds. **BOLD** font indicates a t-value significant at the 5% level. The Size variable is measured as size of funds in GBP as at 31.12.1998. The variable Age is measured as age of funds in months since month of inception until 31.12.1998. Ethical is a dummy variable with a value of 1 for ethical funds and 0 for non-ethical funds. Ω is a random disturbance term. Dummy variables relating to country of origin and investment universe have also been used in different versions of equation [5.7], most of them were significant, but the Netherlands was significant and positive, while Norway was significant and negative.

7.7 Conclusions

This Chapter has examined whether managers of investment funds can employ various ethical criteria in selecting their portfolio without sacrificing risk-adjusted returns to a significant extent, in order to assess whether ethical funds are a “good” investment financially. The financial performance of the 40 ethical funds from 7 countries discussed in Chapter 6 was compared against a matched group of 40 non-ethical funds. The results demonstrate that there has been no statistical difference in either returns or risk adjusted performance as measured by the Sharpe, Treynor and Jensen measures between ethical funds and their matched group of non-ethical funds. Despite the restricted investment universe of ethical funds, the results do not support the hypothesis that non-ethical funds perform better than ethical funds. Surprisingly, there is some evidence that

ethical funds were less risky than the non-ethical funds. These findings were similar to those reported in previous studies (Mallin *et al.*, 1995; Gregory *et al.*, 1997; Statman 2000 and Naturvårdsverket, 2001).

The vast majority of fund managers displayed negative market timing ability. The market timing ability seemed to be slightly worse for the ethical funds. This is to be expected as ethical fund managers may have to buy and sell securities for non-financial reasons and because they may have a longer time-horizon for investing than their non-ethical counterparts. This underperformance of ethical fund managers in market timing was not statistically significant with the Henriksson Merton model and may be compensated for by the significantly higher coefficients for stock selection.²³³ This supports the view that ethical and environmental research may add value to the stock selection process.

Finally, the cross-sectional analysis indicated that the size of the fund may have some power in explaining variations in fund performance for the Sharpe and Jensen measures, with larger funds performing somewhat better than smaller ones. The ethical status variable was insignificant in explaining returns and the Jensen measure, confirming the results from previous analysis which had indicated that there is not a statistically significant difference in financial performance between the two groups. The significant coefficient for ethical status in explaining the Henriksson Merton alpha and the significantly lower risk levels documented for ethical funds support the view that risk averse private and institutional investors may achieve higher risk adjusted returns by including ethical funds in their portfolios. The conclusion of the last four chapters is thus that the ethical funds in the sample were financially “good” investments in the time period studied, especially in comparison with other funds. This finding was supported by similar findings in other studies (Hamilton *et al.* 1993; Mallin *et al.* 1995; Naturvårdsverket, 2001; Statman, 2000). The next Chapter starts a new section where the investment processes of ethical funds are investigated by field study methods.

²³³ It was, however, significant with the Treynor Mazuy model, see Appendix 7.5.

Chapter 8 Assumptions and Methodology

8.1 Introduction

In the two previous Chapters, quantitative analysis of the financial performance of ethical funds was carried out to answer the research question: Are ethical funds a good investment, from a financial point of view? The question was addressed primarily from the viewpoint of an individual investor. However, as the names and classification of the ethical funds would suggest, there is more to these funds than financial risk and return. It was argued in Chapter 3 that theories other than those originating from finance or teleological/utilitarian ethics need to be employed to enable a more complete investigation of whether ethical funds are also good investments in an ethical sense.²³⁴ Following Kant and Reichmann it is argued that ethics is not only empirical, but exists independent of empirical reality and perception (Reichmann, 1994; Eskola, 1999). Therefore this Chapter considers some of the assumptions underlying these ethical theories and Chapter 11 will use these theories for an analysis of ethical investment.

In addition to the quantitative analysis, field research based mainly on interviews with ethical fund managers and researchers was conducted to answer the research question: Are ethical funds a good investment from an ethical point of view? Again the question is considered mainly from the viewpoint of an individual investor. The aim with these interviews was to get a tentative view on whether ethical funds are good investments in an ethical sense in comparison to non-ethical funds, through an investigation of the “ethical investment” processes adopted by these funds. The interview findings are reported in Chapter 10. Another aim of the interviews was to gain an understanding of the background of the ethical criteria of these funds, these findings being reported in Chapter 2.

This Chapter will argue that it can be beneficial to employ different methods to investigate a phenomenon. Indeed, it is argued that for an area such as ethical funds it can be beneficial to employ qualitative methods in addition to

quantitative analysis (Eisenhart, 1988; Leedy, 1997; Silverman 1997). Thus the rigour of the quantitative methods can be employed to investigate the financial performance whereas the richness of qualitative methods can facilitate study of the investment process of ethical funds and the manifestation of the ethical criteria and policies (Tomkins and Groves, 1983). Authors such as Harte *et al.* (1991) have argued for more qualitative research into ethical funds, while Lewis and Cullis (1990) argued for interviewing ethical fund managers.

The philosophical assumptions of the dissertation are outlined in the sections on ontology, epistemology and human nature. The theological assumptions underpinning an agape based ethic and Church doctrine are presented in section 8.7. This section takes a Christian perspective and serve as an introduction to Chapter 11. It is not expected that non-Christians or all Christians would agree with section 8.7 or indeed Chapter 11 itself. To some extent this Chapter and Chapter 11 represents the same type of mixture of “the religious and secular” which according to Kinder and Domini (1997) characterise the history and current practice in ethical funds.

It is argued here that the empirical sections in this dissertation can be of interest to someone who does not accept the validity of an ethic derived from the Judeo-Christian tradition such as agapism or the other assumptions made by the author. This is perhaps similar to Markowitz (1991) who argued that portfolio analysis can be conducted even if one does not accept the expected utility maxim. This Chapter thus differs from traditional mainstream accounting and finance literature by explicitly considering assumptions relating to ontology, epistemology and the nature of humans. However, ontological and epistemological assumptions have been discussed in finance in the context of an interview based methodology (Holland, 2001). In the accounting literature these discussions are more common (Hopper and Powell, 1985; Chua, 1986; Bebbington, 1999; O’Dwyer, 1999; Dick-Forde, 2000). There is also a longer

²³⁴ From an extreme laissez-faire point of view this would not be necessary, because all ethics required are already part of the system (Friedman, 1970). However, it is argued here that a more complete investigation demands that other ethical theories and theology is also considered.

tradition of outlining philosophical assumptions in accounting research dating back at least to Tomkins and Groves (1983).²³⁵

8.2 Ontology

A particular theory on what exists and the nature of being can be called an ontology (Lacey, 1996). It distinguishes between real existence and appearance. Ontology relates to the assumptions about existence underlying any conceptual scheme or any theory or system of ideas. Ontology is the study of the relationships of the researcher with the thing being researched. Ontology is about what is real. The distinction between ontology and epistemology is not always clear-cut. For example, some argue that understanding is connected with being (Oslington, 2000). Indeed, these categories are often intertwined such as in Kant (1907; 1997).²³⁶

A subjective or nominalist ontology assumes that there is no “real” structure. Names and labels are used to negotiate a shared understanding of the external world. The world, therefore, does not exist independent of observation, but is a product of individual consciousness. Social constructivism assumes a nominalist position (Hines, 1988). The extreme nominalist position views reality merely as a projection of human imagination (Morgan and Smircich, 1980).

By contrast, a realist ontology assumes that the external world is made up of hard, tangible and immutable structures and that the world exists independently of one’s perception of it. For example, Kant (1997) argued that the existence of objects in space is just as certain as the existence of self (p.162). It has been claimed that mainstream accountancy and modern science follow a realist ontology of discrete events, which privileges quantitative research (Hopper and Powell, 1985; Chua, 1986; Birkin, 2000). Instead of the determinism and reductionism which he claims are integral to modern science, Birkin (2000) suggests an ontology based on relationships rather than objects.²³⁷ However

²³⁵ Some of these issues were considered by the “Sheffield School” of the 1970s and in publications by Briloff. These assumptions are important as ethics is central for this dissertation.

²³⁶ It seems logical to me that one’s worldview affects what is accepted as knowledge, but the causality may flow in both directions: new knowledge may also change people’s worldview.

²³⁷ A brief outline of different perspectives in accounting research based on Chua (1986) are presented in Appendix 8.1. Birkin (2001) would seem to be closer to the critical perspective than

nominalism and realism are only two ontological positions on a continuum. Four ontological positions between these were described in Morgan and Smircich (1980) and Tomkins and Groves (1983). These positions are outlined in Table 8.1 below, with the more “subjective” positions on the left hand side.

Table 8.1 Ontological Assumptions

Reality as a Projection of Human imagination	Reality as a social construction	Reality as a realm of symbolic discourse	Reality as a Contextual field of information	Reality as a concrete Process	Reality as a Concrete structure
Subjectivist -	nominalist			Realist -	Objectivist

This table presents a continuum of ontological assumptions from Morgan and Smircich (1980).

It is the belief of the author that there is some validity in all these philosophical positions and that therefore they are all incomplete. For example, they do not recognise the distinctions between the real, the actual and the empirical (Outhwaite, 1983).²³⁸ In this dissertation Chapters 4-7 are based on an ontology of “reality as a concrete structure”. The interview research in Chapters 9 and 10 is based on an ontology of “reality as a concrete process”. This does not imply that the researcher thinks these positions are any better or more valid than other ontological positions. Rather these positions follow from adopting methods employed within accounting and finance which are relevant for the research question(s) (Tomkins and Groves, 1983).

In this dissertation a causal realist theory of perception is assumed to be valid for the external physical world, which means that a real world exists independently of people’s perceptions (Giere, 1997; Warburton, 1999).²³⁹ This assumption is not identical to positivistic scientific realism, but rather closer to the ontology of conservative Pragmatism leaning towards the position of moderate Pragmatists such as West (Dick-Forde, 2000). It is also acknowledged that different individuals may interpret external physical reality differently.

to mainstream accounting, or the interpretative perspective. The ontology of mainstream accounting and finance tends to lead to externalising problematic issues and taking the existing institutional framework for granted (Arrington 1990; Chua, 1986; Suranyi, 1999).

²³⁸ The empirical is made up of experiences obtained by observation. The actual includes events whether or not they are observed. The real comprises the processes that generates events.

²³⁹ There are other theories such as idealism and solipsism (Warburton, 1999). He concludes that “causal realism is the most satisfactory theory of perception up to date.” The Bible also makes it clear that the world and objects exist independent of perception (Hay, 1989).

However, Morgan and Smircich (1980) and Tomkins and Groves (1983) are primarily discussing not the physical world but the social world, the world of human beings and the constructs and organisations humans have created.²⁴⁰

Others have argued that for the social world and the inner world of human beings, social construction becomes more relevant and this is believed to be relevant for social sciences such as finance and accounting (Davis, Menon and Morgan, 1982; Hopper and Powell, 1985; Hines, 1988). For example, whilst a share price at a particular point is “real”, the processes generating it are not seen as only reflecting fundamental underlying economic factors, but also elements of fashion (Burton, Helliard and Power, 2000), a hyperreal economy (McGoun, 1997), overreaction (Power, 1992) and speculation (Kindleberger, 1996).

In this dissertation, an objectivist (causal realism) view is taken which acknowledges that external objects and phenomena exist independent of perception (Outhwaite, 1983; Reichmann, 1994; Laughlin, 1995; Kant, 1997), while recognising that social construction becomes relevant when human beings are an important part of the study.²⁴¹ A similar middle view ontology has been adopted by finance academics such as Holland (2001).²⁴² Thus an interviewer is likely to have some influence over an interview even when all possible measures are employed to ensure “objectivity” (Moser and Kalton, 1971). Completely objective empiricism in the social sciences may thus be an unattainable ideal, since the personal biases of researchers may affect the research questions and the interpretation of the results even in purely quantitative studies. For example, Cochrane (1999) gives an example where the same facts are interpreted in a completely different way by Fama and French (1993) who argue for a “risk factor”, and Lakonishok, Schleifer and Vishny (1994) who interpret the same

²⁴⁰ See the section on epistemology for a discussion of the difference between knowledge relating to the “physical world” and knowledge relating to human beings.

²⁴¹ Schumacher (1995) presents four areas of knowledge. First, the inner world of self. Second, the inner world of others. Third, how others perceive self. Fourth, the external world. Social construction arises as the inner world of others differ from the inner world of self, which may lead to different perceptions of the social world (Chua, 1986b). It has also been argued that “we do not form reality” but merely “formulate descriptions of reality”. There is “a fact of the matter” and realism can be applied to the social as well as the natural sciences (Outhwaite, 1983).

²⁴² Holland (2001) adopts different ontological positions at different stages of the research process.

facts as “investor irrationality”.²⁴³ The following quotation from Wolterstorff (1983) makes the point:

We all, in the practice of science, are guided by fundamental visions of life and reality. Theoretical reason is not autonomous. Thus two people who are guided by different visions may both practise science competently but wind up with differing results which science, by itself, is incapable of adjudicating (p.8).

It has also been claimed that there is no such thing as value free ethics and that it is “much more normative to present oneself as non-normative” (Arrington, 1990). The ontological position of the researcher has therefore been made explicit. A realist ontology is of relevance for the empirical studies in this dissertation (Morgan and Smircich, 1980; Outhwaite, 1983; Tomkins and Groves, 1983). It is recognised that there are other valid ontological positions and the positions adopted reflect the empirical research conducted in this dissertation rather than a claim that these would be the only valid ontological positions.

8.3 Epistemology

Epistemology is the theory of knowledge (Lacey, 1996). Epistemology is concerned with the nature, derivation, scope, and reliability of knowledge. There are different positions on what constitutes knowledge. Indeed, there is no agreed account on what counts as justification of knowledge, nor what has to be justified (Chua, 1986b; Lacey, 1996). Furthermore, even to define knowledge and understanding unambiguously is quite difficult (Plato, 1996).

Examples of epistemological positions include positivism which implies that knowledge can only be based on observation of what is (a development from empiricism formalised by the French philosopher Comte).²⁴⁴ In Comte’s version of positivism, critique, change and theology were seen as value driven and were hence not a part of his positivism (Laughlin, 1995; Lacey, 1996). Positivism defines the world as objects and truth is to be found in agreement by verification (Parker and Roffey, 1997). Authors such as Reichmann (1994) and Blanchard

²⁴³ This is an argument between “behavioural” and traditional finance.

²⁴⁴ Comte thought that the social sciences should use the methods physics to obtain “positive truth”; indeed he thought of social sciences as “social physics”. Comte disregarded philosophical and theological knowledge alike (Reichmann, 1994; Lacey, 1996; Blanchard, 2000).

(2000) have argued that positivism has largely been written off in philosophy.²⁴⁵ Indeed, Silverman (1997) claims that few quantitative researchers would accept the positivist label as most would differentiate between the natural and the social world. Many theologians would also reject the positivistic concept of knowledge and the distinction between facts and values which is commonly presupposed in classifying meta-ethical positions (Macquarrie and Childress, 1997).

An anti-positivist epistemology rejects the objectivity and independence of the researcher and seeks understanding of the basis and source of “social reality”. Anti-positivists tend to deny that science can produce objective knowledge (Burrell and Morgan, 1987).²⁴⁶ The frame of reference of the participant observed must be emphasised.²⁴⁷ An example of a finance academic explicitly adopting an anti-positivistic epistemology is Holland (2001). He seeks to understand the world through interviewing those “involved in its creation” and explicitly recognises a subjective element in this research.

An example of an epistemological position between positivism and anti-positivism would be the position adopted in grounded theory where truth is approximated by the researchers’ creative engagement with a systematic, iterative data collection, analysis and validation process (Parker and Roffey, 1997). The truth claims made by grounded theory researchers may thus be more modest than those of positivistic research. In the Morgan and Smircich (1980) continuum this would tend to lead to an epistemological position between positivism and anti-positivism. The implications of the six different epistemological positions outlined in Morgan and Smircich (1980) for accounting research was analysed in Tomkins and Groves (1983). They argued

²⁴⁵ In Blanchard (2000) Ronald Nash, a Professor of Philosophy, is quoted “Today it is quite difficult to find any philosopher who is willing to claim publicly the label of logical positivism. The movement is dead and quite properly so” (p.187).

²⁴⁶ It has been argued that “Relativism and positivism are, of course, purely metaphysical doctrines with the peculiar and ironical distinction that they deny the validity of all metaphysics, including themselves” (Schumacher, 1995, p.69).

²⁴⁷ An anti positivist epistemology might be based on theories of perception such as idealism, phenomenalism or solipsism, while a more objective epistemology might be based on causal or commonsense realism (Warburton, 1999). Warburton (1999) claims that idealism as a theory of perception is absurd and that solipsism is untenable as a philosophical position. He argues that both idealism and phenomenalism tend to lead to solipsism, in which all that exists is a person’s own mind, and everything else is imaginary. This is the extreme position outlined in Morgan and Smircich (1980) and Tomkins and Groves (1983).

like Hopper and Powell (1985) that valuable insights can be obtained from different perspectives and called for qualitative research using different methods to balance the dominance of the quantitative mainstream paradigm. The epistemological stance relevant to the empirical work in this dissertation is close to the “study of process, change and systems” in the Morgan and Smircich (1980) framework. The position is close to Lewis and Cullis (1990) who recognise the importance of knowledge originating from both statistical and various qualitative methods. This is particularly relevant for Chapters 2 and 10. In finance an externalist approach to what constitutes knowledge called reliabilism has often been adopted. Reliabilism insists that a belief is justified if it is produced by a method that normally produces true beliefs (Lacey, 1996). This has meant that the main source for knowledge in modern mainstream finance has been positivistic quantitative studies (Chua, 1986; Miller, 1999).²⁴⁸ This approach follows the empiricist tradition of Hume which was developed into positivism by Comte, who argued that experience is the primary source of knowledge. Empiricists argued that “we have no ideas at all other than those which come to us via our senses” (Brown, 1969 quoted in Laughlin, 1995). Some of the problems for accounting and finance with this type of epistemology have been discussed in Hines (1988b).

By contrast “Rationalist” philosophers such as Plato, Descartes and Leibniz have argued that ideas of reason, which are intrinsic to the mind are the primary source of knowledge. Indeed, the rationalists maintained that it was possible through reason to obtain an “absolute description of the world uncontaminated by the experiences of any observer” (Scruton, 1982 quoted in Laughlin, 1995).²⁴⁹ Immanuel Kant took a “middle” view of these issues, stressing that both experience and reason can generate knowledge (Kant, 1997). Furthermore, Kant demonstrated that there could be knowledge outside of empiricism and rationalism (Kant, 1997, p.165). It has been argued that positivism, tracing back to Comte and the empiricists, has dominated the “epistemological battle” in

²⁴⁸ Although case studies such as Baker and Wruck (1989); DeAngelo and DeAngelo (2000) and Gillan *et al.* (2000) have been published in the *Journal of Financial Economics*.

²⁴⁹ Rationalists such as Descartes and Leibniz believed in God and made great efforts to prove God’s existence rationally. Philosophers such as Kant also wrote about God, but from a Christian point of view they all overemphasised reason (Blanchard, 2000).

accounting research although other views such as those advocated by Kant are “far from destroyed” (Laughlin, 1995). Another “synthesis” between positivism and rationalism is realism which according to Outhwaite (1983) sees:

science as a human activity that aims at discovering, by a mixture of experimentation and theoretical reasoning, the entities, structures, and mechanisms that exist and operate in the world.

It has been argued by Reichmann (1994) that there are three levels of knowledge. The first level of knowledge is provided by natural sciences. This level is occupied mainly with the “external” world and lifeless phenomena. The second category relates to knowledge about human beings. The third category of knowledge relates to God and ethics (Reichmann, 1994).

The key difference between the categories is the power which the researcher has over the “object(s) of study”. For example, in the first category researchers have substantial power over chemicals in a laboratory or numbers in a spreadsheet. Most knowledge generated by mainstream finance would be in this first category. In the second category, which focuses on humans the researcher has less power. For example, an interviewee may decline to answer some questions, misunderstand questions or choose to lie during the interview. Therefore some degree of subjectivity would seem to be inevitable in this second category (Chua, 1986b). Furthermore, we can’t fully know ourselves – or at least know how others view us – without some comments and feedback from other people (Schumacher, 1995). The second level thus requires co-operation and interaction with other humans. The second category is relevant for field research.

In the third category the researcher has much less power than in the other two. No human has any power over God, although knowledge about God can be revealed to us and we can have a relationship with God (Reichmann, 1994). It is argued that ethics exist on this third level (Midgley, 1981; Reichmann, 1994). This third level is relevant for an ethical analysis of ethical funds. From a Judeo-Christian point of view the Bible contains general principles and specific instruction on what is and what is not ethical. From a Kantian (deontological) perspective the categorical imperative and some writings of Kant can be

employed to determine what is ethical, while from a teleological perspective utilitarian calculations can be employed to determine what is ethical.²⁵⁰

According to Reichmann (1994) this third level of knowledge in particular influences the behaviour of human beings. This is the reason why, from a Judeo-Christian point of view it is important that the knowledge of God is given primacy at this level. If this level is dominated by something else it means that something other than God has dominated us.²⁵¹ Many authors have argued that economics has tendencies to usurp the realms of ethics and theology (Hay, 1989; Oslington, 2000). Indeed, the field of ethical investing is one where these potential conflicts can be studied and Chapters 10 and 11 will present some analysis of this. It has been argued that “the subjectivity” related to knowledge in the second and third categories does not mean that this knowledge is less valuable than the knowledge of the lowest category (Schumacher, 1995).

Some of the confusion in this area of epistemology and methodology is perhaps a result of not distinguishing between the difference of knowledge in the first, second and the third levels.²⁵² There has been a tendency in accounting and finance to adopt methods and modes of thinking appropriate for the first level of knowledge and apply them to the behaviour of human beings and ethics (Tomkins and Groves, 1983). It is argued here that the normative aspect of finance theory is problematic from a Christian point of view as some theories in finance which are seen as normative are based on a form of ethical egoism and lack a charitable element (Jensen and Meckling, 1976; Markowitz, 1991). There may then be a risk that such theories (unintentionally) advocate ethical egoism as a norm. This dissertation focuses on the first two levels of knowledge. For

²⁵⁰ The categorical imperative states: “Act only on the maxim which you can at the same time will to be a universal law”.

²⁵¹ Examples of other things which can usurp some of this space would include addictions to drugs, money, power, sex, violence and work. An abnormal desire for any of these can affect behaviour adversely and is likely to lead away from theocentric ethics such as agapism. Agapism is based on an individual's love for God and other humans (Frankena, 1963; Calkins, 2000; Matthew 22:37-40). The belief that addictions partly usurp God's place is one reason why Christian investors have traditionally avoided sectors such as alcohol, gambling, pornography, tobacco and weapons. It is also why egoistic ethical theories are generally unacceptable to Christians at a normative level. This is because “self” is exalted to the level of God.

²⁵² Scientific enquiry has focused on how a researcher perceives the external world. There has perhaps been less emphasis on understanding the inner world of other human beings and how others perceive the external world and the researched phenomena (Schumacher, 1995).

example, Chapters 4-7 on financial performance represent this type of knowledge. There are elements of the second in addition to the first level in Chapters 2 and 10. Finally, Chapters 3, 8 and 11 contain glimpses of the third level in addition to the first and second levels of knowledge.

It is recognised that lessons can be learned from different perspectives on accounting such as mainstream, interpretative or critical (Hopper and Powell, 1985; Chua, 1986; Burrell and Morgan, 1987).²⁵³ Some authors such as Burrell and Morgan (1987) have claimed that the different paradigms are largely mutually exclusive. Others such as Bebbington (1999) have been informed by many perspectives, while Chua (1986b) and Elliott (1999) noted that paradigm shifting occurs. It is pointed out in Hopper and Powell (1985) that the different perspectives have different weaknesses, but that they can all yield valuable insights. This dissertation adopts a position which does not see the paradigms or different methods as mutually exclusive. As Silverman (1997) argues: “there are no principled grounds to be either qualitative or quantitative in approach...often one will want to combine both approaches” (p.14). The field research tradition of using both quantitative and qualitative data is followed in this dissertation (Glaser and Strauss, 1968; Ferreira and Merchant, 1992). Both empirical studies in this dissertation are in the mainstream paradigm, although the field study is close to the interpretative perspective (Hopper and Powell, 1985; Chua, 1986).

Finally, it is worth noting that epistemological diversity has also been a part of economics and finance. Finance academics such as Frankfurter (1994) and McGoun (1997) have adopted a rationalist epistemology, while Holland (2001) adopted an anti-positivist epistemology. It has been argued that different ways of thinking of probability lead to different views of efficient market models (James, 2001). Markowitz (1991) describes how Friedman wanted to fail his PhD because of epistemological differences. It is the aim of this dissertation to contribute to this plurality of views in finance by incorporating insight from ethics and theology.²⁵⁴ As Chapter 2 demonstrated this has been done for decades in practice in the context of ethical funds and Church investments. This

²⁵³ See Appendix 8.1 and 8.2 for a brief outline of different perspectives.

²⁵⁴ Work in this area of finance has been done by Dobson (1993) and Shefrin and Statman (1993). Insights from psychology has been incorporated in behavioral finance (Statman, 1999).

type of integration has been done in academic disciplines such as accounting, economics and finance (Hay, 1989; Gray, 1990; Dobson, 1993; Oslington, 2001). Table 8.2 summarises the positions on ontology, epistemology and human nature adopted in this dissertation.

Table 8.2 Positions of Relevance for this Dissertation

Ontology	Epistemology	Human Nature
Reality as a concrete process	To study process, systems, change	Humans as adaptors

Source: Morgan and Smircich (1980)

8.4 The Nature of Human Beings

Assumptions about the nature of humans are of importance since the research question primarily focuses on whether ethical funds are a good investment for an individual investor. The debate in both philosophy and theology on the role of the free will of humans in contrast to the influence of external forces is ancient and voluminous (Frankena, 1963; Lacey, 1996). To what extent are humans free to act and to what extent are we merely subject to deterministic forces? For example, Kant rejected the extremes of determinism (humans merely respond to the external world) and indeterminism (mere chance) (Frankena, 1963). Examples of researchers recognising both external influences and freedom and choice available to humans are provided in Burrell and Morgan (1987). In finance, both of these extremes are rejected by Frankfurter (1994), while he claims that many theories in finance treat human beings as animals “motivated only by economic concerns”.

In terms of structure and agency, the view adopted for this dissertation is that in the short term individual integrity can be maintained in most organisations. It is almost certain in the medium to long term that the organisation will influence the individual more than the individual will influence the organisation. This position is similar to that of Morgan and Smircich (1980) who label “humans as adaptive agents”.²⁵⁵ In Chapters 9-10 the observer assumption would be close to

²⁵⁵According to this view “Human beings exist in an interactive relationship with their world. They influence and are influenced by their context or environment”. This is close to the position of Hedman (2000). He argued that “human beings as complex and interactive”.

the “middle view” in Laughlin (1995) where the observer has an important role in the process of discovery.

Mainstream finance theory is criticised by Dobson (1993) for failing to recognise the capacity of humans to do some good. It was shown in Subotnik (1993) that the “tendency to lie for monetary gain” is different across individuals. In other words people have different ethical standards. The validity of models and theories which assume that everyone is the same is questioned in studies which are concerned with the knowledge of human beings. This applies to the field research in this dissertation where the ethics of the interviewees is considered.²⁵⁶

Indeed, if membership in Churches and Charities is a proxy of ethicality then the field study demonstrated substantial differences among the interviewees. It is argued that the view of what a human being is has consequences for ethics.²⁵⁷

For this dissertation a view similar to that proposed in Kant (1907) is adopted, where investors have the freedom – perhaps Kant would have argued the duty – to consider ethical matters as an integral part of their lives and investments. In addition to the view in some finance theory that man is selfish and mainly interested in money is added a Judeo-Christian insight that while humans are capable of being rational and moral, they may not act rationally or ethically. This is recognised in behavioural finance by authors such as Schleifer (2000).

8.5 Methodology

Methodology is the study of how we obtain knowledge, the study of research methods. A quantitative methodology implies testing with “scientific” rigour using large data sets and statistical analysis. A qualitative methodology suggests that understanding is achieved by obtaining first hand knowledge and getting inside situations. Examples of qualitative methods include action research, case studies and interviews. These quantitative and qualitative methods need not be mutually exclusive. For example, Markowitz (1952) argued that “statistical

²⁵⁶ The level of investment in ethical funds has been suggested as a proxy for the “ethicality” of an investor (Lewis and Mackenzie, 2000b: See also Inskeep, 1992 and Woodward, 2000).

²⁵⁷ For it has been argued that if animals are perceived as machines and human beings as animals they are soon treated accordingly (Schumacher, 1995).

techniques and the judgement of practical men” should be combined in the process of security selection for portfolios. Different methods ranging from action research and participant observation (Cowton, 1999; Cowton, 2000); case study (Mackenzie, 1997); interviews (Friedman and Miles, 2001); questionnaires (Perks *et al.* 1992; Harte *et al.* 1996) and statistical analysis (Mallin *et al.*, 1995; Gregory *et al.*, 1997) have been employed in the analysis of ethical funds.

This dissertation employs two main methods for the empirical analysis of ethical funds. First, quantitative measures for evaluating fund financial performance have been developed in Finance. Some of these measures were used in Chapters 6 and 7 to evaluate whether ethical funds have been “good” investments financially. These studies might be located in the mainstream paradigm (Chua, 1986; Hopper and Powell, 1985), because econometrics has its roots in positivist empiricism (Hay, 1989). Furthermore, there is a high level of prior theorisation and a high level of theoretical definition of the methods (Laughlin, 1995).

Second, it has been argued that for studying processes such as historical change, qualitative methods may be more appropriate (Morgan and Smircich, 1980). It is argued that Chapter 2 represents such a study of a historical change process; in this case the emergence and development of ethical funds was studied by means of face to face interviews. This draws upon an oral history approach in accounting (Collins and Bloom, 1991). It is argued here that the interview research in Chapter 10 has similarities to the “middle range” approach presented in Laughlin (1995). The aim is not to develop a grand theory of ethical investment, but rather to provide “a skeletal theory” and to address the research question(s). Theoretically the “middle approach” is connected both to Kantian and more positivistic thought (Laughlin, 1995). The qualitative research has some structure but is subject to refinement in actual situations. The conclusions can be reasonably conclusive in relation to a “skeletal” theory with empirical richness (Laughlin, 1995).

The qualitative research in this dissertation may be considered to be located in the mainstream paradigm. It is informed by the “interpretative perspective”, which draws on Kantian philosophy (Tomkins and Groves 1983; Hopper and Powell, 1985; Chua, 1986; Burrell and Morgan, 1987; Laughlin, 1995). The research in Chapters 9 and 10 is interview based field research (Ferreira and Merchant, 1992). This dissertation thus takes a rather pragmatic position regarding research methods. It is argued here that the use of the most appropriate method for a particular problem is desirable, rather than focusing on some specific method and ignoring questions which can’t be addressed by that method or paradigm (Tomkins and Groves, 1983). This position is similar to Melia (1997) as the following quotation demonstrates:

I propose a pragmatic approach to qualitative methods, which takes account of philosophical and epistemological debates but does not become so preoccupied with them that any form of research may be vetoed on some ground or other (p27).

Often two main paradigms – the qualitative and the quantitative – are discussed. These two paradigms are referred to by many names as Table 8.3 demonstrates. This is not a strict classification, since qualitative research can also be positivist and the terms listed in the columns are not necessarily synonyms.

Table 8.3 Terminology

Qualitative	Quantitative
Interpretative	Functionalist
Subjectivist	Objectivist
Humanistic	Empiricist
Ideographic	Nomothetic
Naturalistic	Scientific
Clinical	Positivist

This table presents some terminology used within certain paradigms. These terms are not necessarily synonymous. Source: Adapted from Elliott (1999).

These paradigms need not be mutually exclusive (Fontana and Frey, 1994). For example, Glaser and Strauss (1968) integrated both quantitative and qualitative methodological positions (Parker and Roffey, 1992). Examples of papers in finance which employ qualitative methods include; Holland (1998) and Holland and Doran (1998); Baker and Wruck (1989); DeAngelo and DeAngelo (2000); Gillan *et al.* (2000); Helliard *et al.* (2000). Others have employed interviews to support quantitative research (Christie and Marshall, 2001; Mallin, 1995).

It has been argued that it is beneficial to combine qualitative and quantitative methods to achieve the benefits of triangulation (Jick, 1979; Eisenhart, 1988; and Leedy, 1997). For example, Eisenhart (1988) notes that “the triangulation made possible by multiple data collection methods provides stronger substantiation of constructs and hypotheses” and that “combination of data types can be highly synergistic” (p.538). Others, such as Fontana and Frey (1994) and Yin (1994) have also argued that triangulation employing different methods is beneficial. Furthermore, Jick (1979) suggested that qualitative and quantitative methods are complementary and that “most textbooks underscore the desirability of mixing methods” (p.602). Table 8.4 highlights some differences between the approaches. In the context of this dissertation the previous four Chapters focused on and attempted to answer questions regarding the financial performance of ethical funds using quantitative methods. The next two Chapters will aim to describe and explain the process of investment employed by ethical funds using a qualitative method, in order to answer the research question of whether ethical funds are a good investment in an ethical sense. The previous Chapter statistically analysed 80 funds with 156 observations per fund. The next Chapters analyse around 20 ethical funds drawing on face to face semi structured interviews with experts in the area.

Table 8.4 Characteristics of Approaches

Question	Quantitative	Qualitative
<i>What is the purpose of the research?</i>	To explain and predict To confirm and validate To test theory Outcome-oriented	To describe and explain To explore and interpret To build theory Process oriented
<i>What is the nature of the research process?</i>	Focused Known variables Established guidelines Static design Context-free Detached view	Holistic Unknown variables Flexible guidelines Emergent design Context-bound Personal view
<i>What are the methods of data collection?</i>	Representative, large sample Standardized instruments	Informative, small sample Interviews, observations

This table outlines some characteristics of research. Source: Adapted from Leedy (1997), p.106.

Consistent with Mackenzie (1997) ethical theories, finance theory, and an agape based Christian perspective are considered in the analysis of ethical funds.

Others such as Lewis and Cullis (1990) have also argued for an “interdisciplinary investigation” into ethical funds. Indeed, employing an alternative perspective, such as an analysis from the point of view of a Christian ethic, can be seen as the theoretical perspective adopted in this dissertation. Finally, it is argued that, similar to accounting, finance research literature must provide space not only for quantitative research but also for qualitative methods (Parker and Roffey, 1997).²⁵⁸ It is argued that Chapters 2, 9 and 10 of this dissertation are consistent with this recommendation, which has been made by many in accounting (Tomkins and Groves, 1983; Wilmott, 1983; Ferreira and Merchant, 1992).

8.6 The Relationship between Theory and Data

For phenomenon about which little is known or current perspectives seem inadequate, Eisenhart (1988) argues for theory building from case study research. In such cases the theory emerges at the end, not the beginning of the study. This approach was indeed taken by Mackenzie (1997) in his analysis of an ethical fund. There are elements of this approach in the present study, such as theoretical sampling, multiple data collection methods and the combination of quantitative and qualitative data. In this type of approach, data and empirical research precedes theory. The method of grounded theory, which has been used in both accounting and finance, also adopts this approach (Glaser and Strauss, 1968). This “empiricist” approach has in fact been common in finance. For example, Fama (1970) notes that for capital market research, “empirical work in this area preceded the development of theory”. This type of approach where theory is built on empirical work was also advocated by Haugen (1995). More generally, Leedy (1997) argued for a qualitative approach when the available literature is limited. Indeed, the only systematic attempts to theorise the field of ethical investments the author is aware of are Bruyn (1987), Moore (1988) and Owen (1990).²⁵⁹

²⁵⁸ Some authors have argued that “the price of mathematical model building is the loss of the qualitative factor, the very thing that matters most” (Schumacher, 1993).

²⁵⁹ Issues relating to ethical funds have been addressed in Kinder and Domini (1997); Mackenzie (1997); Mackenzie (1997b); Sparkes (2001). There is also a substantial popular literature on ethical funds (Simpson, 1991; Melton and Keenan, 1994; Sparkes, 1995; Hancock, 1999).

It is claimed by Chua (1986) that mainstream accounting seeks to provide useful information for decision makers. This “neutral” position often serves the powerful and may sometimes be contrary to the public interest (Arrington, 1990). The qualitative paradigm by contrast aims to explain action (Chua, 1986). The interpretative paradigm claims that whilst numbers may be inadequate representations of events, they may actually shape reality and the research conducted may influence the researcher (Chua, 1986; Subotnik, 1993).²⁶⁰ It has also been claimed by Parker and Roffey (1997) that qualitative researchers may influence an interviewee.

Finally, it is argued here that the conclusions of Chua (1986b) and Laughlin (1995), that accounting theories and empirical research tend to be partial, often distanced from the experiences in the practical realm and influenced by prior assumptions, are also valid in finance, as James (2001) indicates for efficient market models. Since the call from Tomkins and Groves (1983) for more field research generally and Lewis and Cullis (1990) and Harte *et al.* (1991) for field research into ethical funds specifically would also seem to be relevant, the next two Chapters will address these recommendations.

8.7 Assumptions Underpinning an Agape Based Ethic

The literature and Chapter 2 demonstrated that a number of Church investors had a role in establishing many of the early ethical funds in Europe (Sparkes, 1995). This was confirmed by the field study which demonstrated that at least 15 of the ethical funds studied in the previous Chapters had a link to Churches.²⁶¹ Agapism is an element in the doctrine of these Churches (Macquerrie and Childress, 1987). This section therefore considers some of the assumptions underpinning the agape based ethics introduced in Chapter 3. These assumptions are important as it has been argued that an individual's worldview influences their ethics (Mäkela, 1998). So far this Chapter has focused mainly on the philosophical view, while this section will concentrate on a Judeo-

²⁶⁰ The major paradigms in accounting research are presented in appendix 8.1.

²⁶¹ Typically these Church investors were significant customers and/or individuals from these Churches were involved in starting the funds and on their ethical committees. It has also been argued that religion is an important variable (Stultz and Williamson, 2001). All the countries studied were “Christian” in a nominal sense and so were most of the interviewees.

Christian view. Table 8.5 Outlines some differences between a secular and a Judeo-Christian worldview.

Table 8.5 Differences Between Humanist and Christian Worldview

Secular humanist view	Judeo-Christian view
No Creator Humans not created No God given values Man determines right	A Creator Humans created God given values Man discovers right

Source: Geisler (1994)

This section presents the theological assumptions of the dissertation as they relate to ontology. The theological assumptions underlying the research are more basic than the philosophical assumptions (Lacey, 1996; Warburton, 1999).²⁶² Theology in this dissertation refers to truth which is revealed in the Bible; this view of theology has been taken by Augustine, Newman and others (Oslington, 2000). The theological assumptions reflect the values of the researcher and are thus part of the ontology. The views of ontology, epistemology, human nature and ethics are likely to differ depending on the theological position adopted.²⁶³ God permeates the reality of any one believing in God (Bonhoeffer, 1978). As Frankena (1963) puts it:

Anyone, for instance, who has experienced God must put this experience first (p.75).

This means that the primary element of the ontology of a believing Christian is God. In the context of economics, Oslington (2000) has argued for “the primacy of theology without having to reject secular learning”; more specifically he suggested that “the primacy of theology does not do away with the need for economic enquiry”. Similarly, it has been argued in accounting that “accountants and theologians have common interests and should share the common features of their varied research for the insights each gives to the other”

²⁶² It is argued that “all these enquiries about the overall nature of the universe lead to the question whether a necessary being, or God, must be postulated to explain the universe” (Lacey, 1996). It has been argued that “...all thought and all knowledge, including knowledge of one’s own mind presupposes beliefs” (McKernan and O’Donnell, 2002).

²⁶³ Indeed, it has been argued that Christianity emphasises a personal God and the limitations of finite things whereas Greek philosophy considers universal concepts (Lacey, 1996, p.207. Calkins, 2000). The Cambridge University theologian Brian Heblethwaite argued for a theistic worldview and mentioned that non-theistic ethics is a relatively recent phenomenon.

(Molyneux, 2001). Finally, Adam Smith wrote about economics, ethics and God (Smith, 1853). His economic theory was premised on his earlier ethical theory which was based on God (Smith, 1853; Gray, 1990b).²⁶⁴ Oslington (2000) argued that:

From an ethical point of view, it is the philosophical account of economics which excludes theological discussion which should be viewed with suspicion.

The desire to integrate Christian ethical values into all aspects of one's life including investments played an important part in the establishment of ethical funds in many countries such as Germany, Finland, Sweden, the UK and the USA (Deml and Baumgarten, 1998; Leonia, 2000; Melton and Keenan, 1994; Sparkes, 1995).²⁶⁵ Furthermore, Church investors continue to be major players in the ethical fund sector (Melton and Keenan, 1994).²⁶⁶ In terms of ethics theology is important as it has been claimed by authors such as Dostoyevsky that "if God does not exist, then anything is permitted" (Warburton, 1999). Other ethical traditions such as Kantian ethics also advocate beneficence towards other human beings (Kant, 1907). Nevertheless, it may be difficult to consistently adopt the ethic of agapism if one does not believe in the existence of a benevolent God (Warburton, 1999).

Specifically, it has been suggested that Church doctrine would be relevant for an analysis of ethical funds (Mackenzie, 1997). Therefore the theological assumptions underpinning agapism and the Church perspectives presented in Chapter 11 are made explicit. The following theological positions are taken as axioms in this dissertation. The God of the Bible exists and Jesus Christ is God the Son. Together God the Father, God the Son and the Holy Spirit form the one God.²⁶⁷ The Bible is the true revelation of God.²⁶⁸ The consequence of these assumptions is that a Christian and the world are imbedded in the reality of God

²⁶⁴ Adam Smith wrote that "the rules of morality are the commands and laws of the Deity" (Smith, 1853; p.229-242). Smith's book *The Theory of Moral Sentiments* was published 18 years before his better known book, *Wealth of Nations* (Gray, 1990b).

²⁶⁵ Indeed 70% of the interviewees in Chapter 9 and 10 were members of Christian Churches.

²⁶⁶ The field study found that several Churches had substantial investments in the ethical funds.

²⁶⁷ This position is the doctrine of Christian Churches, see for example Church of Finland (2000).

²⁶⁸ There are different views on this. The Church of Finland's view is that the Bible is the "Word of God" and the holy book for the Christians (Church of Finland, 2000).

(Acts 17:28; Bonhoeffer, 1978).²⁶⁹ These assumptions are important because ethics is not value free and generally ethics is based on the individuals' view of reality (Mäkela, 1998). For a Christian these axioms are vital because without Jesus Christ there can't be any Christian ethics and agapism was formulated by Jesus, based on God and the Bible (Frankena, 1963; Mäkela, 1998). These assumptions will not be acceptable to non-Christians, which may therefore not agree with some sections of Chapter 11. However, Chapter 11 can still be of interest to adherents of other faiths and philosophies who can compare and contrast the agape based ethic with their own. The other Chapters of the dissertation and the empirical work in particular should be accessible to anyone regardless of philosophical or religious allegiance.

Epistemology from a Judeo-Christian Perspective

From an agape based perspective in which God is seen as the source of all knowledge the anti-positivist, positivist and rationalist views of knowledge are incomplete (Bonhoeffer, 1978). Such a perspective might be closer to a Pragmatist's view with its belief in both subjective and objective knowledge (Laughlin, 1995). Furthermore, similar to Pragmatism a Christian perspective might be distrustful of grand humanistic theory; rather, theories are seen as instruments or tools to cope with our world (Dick-Forde, 2000). A Christian perspective recognises the importance of empirical enquiry and reasoning, but also insists on the value of *a priori* knowledge and divine revelation (Oslington, 2000).²⁷⁰ Finally, an agape based approach would share the concerns of prophetic pragmatism regarding ills in society and particularly a concern for the disadvantaged (Calkins, 2000; Dick-Forde, 2000).

Epistemology in the New Testament sense emphasises personal involvement and doing, as opposed to intellectual knowledge with no application (Bonhoeffer, 1978; Hay, 1989).²⁷¹ There is thus an element of action in this

²⁶⁹ Bonhoeffer (1978) argued that to focus on how I can be good and how I can do good presupposes that self and the world are regarded as the ultimate reality. Instead he suggested that "it is from... Jesus Christ that all factual reality derives its ultimate foundation" (p.198).

²⁷⁰ It is of course recognised that valuable insights can be attained through reasoning and important discoveries can be made through empirical research. Indeed, many scientists from Francis Bacon (1561-1626) to the present have been Christian theists (Laughlin, 1995).

²⁷¹ 'My mother and brothers are those who hear God's word and put it into practice' (Luke 8:21). The activities of organisations advancing fair trade such as Shared Interest and Traidcraft and

particular Christian perspective. Indeed, the word for knowledge in the New Testament is not normally the Greek word from which the term epistemology is derived (Hay, 1989). Instead a word is used which implies personal involvement. Action is more important than words in biblical ethics (Bonhoeffer, 1978). Knowledge should thus influence standards and behaviour, and implies responsibility. Wisdom is found in the knowledge of God and His ways (Hay, 1989).

Human Nature from A Judeo-Christian Perspective

The biblical view of human beings is that humans were made with free will to be stewards of God's world (Hay, 1989).²⁷² Furthermore, stewardship is different from ownership; we are here only as caretakers for a limited time (Hay, 1989; Mirvish, 1993). God the creator remains the sole owner (Enderle, 1997).²⁷³ Humans were created in the likeness of God, but used their freedom to ignore and turn their back on God. This is the doctrine of the fall of the human race as a consequence of disobeying God (Hay, 1989). At the fall ethics and economics came into being. Before the fall evil and scarcity had been unknown to humans (Bonhoeffer, 1989; Richardson, 1988). Human beings are thus capable of both good and evil, but have an inclination to break rules (Hay, 1989). Indeed, all humans have a tendency to act sometimes in an unethical manner (Ecclesiastes 7:20; Plato, 1993). Therefore, it is argued that whilst a degree of selfishness is part of human nature, there is also an element of voluntarism in human nature (Church of Scotland. 1988).²⁷⁴

The assumption relating to human nature in this dissertation is that humans are created by God with a free will and are therefore accountable to God. Man is not just a naked ape and humans and animals are not merely complex machines. Indeed, prominent authors in finance have used the terms "rational man" and "perfect computational machine" as if they were synonyms; perhaps this usage

the recent Jubilee 2000 campaign to forgive some third world debt can be seen as examples of this Christian approach to care for others and thus perhaps achieve some positive change.

²⁷² Genesis 1:26-28; 2:15-17; 3:6.

²⁷³ God: "the world is mine, and all that is in it" Psalm 50:12. See also Job 40:1; Exodus 19:5.

²⁷⁴ It is claimed that at least to some extent individuals in the UK are free to act and create their own reality. It was argued by the Cambridge theologian Brian Hebblethwaite (4.9.2001) that (some) moral philosophy and the judicial system of the UK presuppose a free will.

is mitigated by the acknowledgement that neither exist (Markowitz, 1991). Others have argued that finance theory presupposes “that humans are nothing more than economic creatures” (Frankfurter, 1994; Proddham, 1994). It is argued that the view of what a human being is has consequences for ethics.²⁷⁵

Assumptions about humans also have consequences for one’s view of the firm and its objectives. From an ethical perspective the view adopted in mainstream finance theory, which assumes that a firm is simply an abstract engine that uses money today to make money tomorrow, is insufficient (Dobson, 1993). From a Christian point of view, it has been argued that the objective of enterprise is provision of service in a manner which satisfies a number of stakeholders (Moore, 1988). In Kantian terms an individual in any firm ought not to be treated as a means only, but also as an end (Thielemann, 2000). Additionally, a Christian perspective recognises that while some investors prioritise money above other considerations, this is not necessary for private investors, and indeed “the love of money” is strongly condemned by many theologians and the Bible (Luther, 1524; Sider, 1987).²⁷⁶ Judeo-Christian and Kantian ethics would agree that money ought never be an end in itself, but should always be thought of as a means only.

Some parts of Chapter 11 are based on the assumptions in this section. Even those who do not accept these can verify that the results are consistent given the axioms. In theology an argument does not have to be rational as an atheist understands rational, but it must be reasonable theologically. As Frankena (1963) puts it:

The claim that we cannot prove judgements of intrinsic value does not mean that we cannot justify them or reasonably claim them to be justified (p.94).

²⁷⁵ For it has been argued that if animals are perceived as machines and human beings as animals they are soon treated accordingly (Schumacher, 1995).

²⁷⁶ “For the love of money is a root of all kinds of evil.” (1 Timothy 6:10)

8.8 Conclusions

This Chapter argued for an ontology where living beings and objects exist independent of observation in a physical reality (Hay, 1989). Therefore a causal realist theory of perception was adopted for the physical world (Warburton, 1999). For the social world, which includes parts of accounting and finance, elements of social construction seemed to apply as partly abstract man made constructs such as annual reports and stock markets are involved (Hines, 1988; Hines, 1998b). Particularly, when human beings and historical change processes are studied qualitative methods and an interpretative perspective may be relevant (Collins and Bloom, 1991; Leedy, 1997). The ontology is similar to the position of “reality as a concrete process” (Morgan and Smircich, 1980).

Such an ontology leads to an epistemology which assumes that knowledge can be obtained through a number of different methods, both quantitative and qualitative. It is what one tries to do which determines which methods are appropriate (Morgan, 1983; Silverman, 1997). This reflected the first and second levels of knowledge outlined in Reichmann (1994). Thus Chapters 4-7 which evaluated financial performance are based on an objectivist ontology. Chapters 9-10 which investigate investment processes move towards the subjective and are informed by the qualitative/interpretative paradigm. These Chapters can still be located in the mainstream perspective with an epistemology of studying process, change and systems (Burrell and Morgan, 1987; Chua, 1996; Hopper and Powell, 1995; Morgan and Smircich, 1980).

It has been argued that the mainstream accounting paradigm draws on the utilitarian framework about which reservations were raised in Chapter 3 (Chua, 1996). The researcher does not subscribe to utilitarianism, although it is recognised that many studies in the mainstream paradigm, including Chapters 6 and 7 in this dissertation, are influenced by it. Indeed, Chapter 3 argued that some other ethical framework than utilitarianism may be more beneficial for evaluating the fourth research question of whether “ethical funds are a good

investment from an ethical point of view”.²⁷⁷ From a Christian point of view the state of affairs when money is more important than people and God is wrong: “You cannot serve both God and Money” (Matthew 6.24).²⁷⁸ This is the case when a financial objective dominates the third level of knowledge (Reichmann, 1994). Therefore ethical funds will be evaluated in Chapter 11 by the ethical theories presented in Chapter 3. Insights from Agapism, deontological and teleological ethics will be considered in this evaluation. To enable such an evaluation more knowledge of the processes and strategies employed by ethical funds to deal with ethical issues is needed. The methodological implication of this is that the next two Chapters will employ qualitative methods to investigate processes and strategies employed by ethical funds.

It was argued that there are different levels of knowledge. Falsificationism and positivistic research would seem to be of relevance mainly for the first level of knowledge, such as the natural sciences and quantitative finance, but even here there are problems with the notion (Roll, 1977; Hines, 1988b). Thus it was suggested that in addition to the valuable insights which can be obtained through empirical research, an agape based ethic may yield additional insights in an ethical analysis of ethical investment (Mackenzie, 1997; Calkins, 2000).²⁷⁹

Human beings were seen as free agents. Therefore notions of humans as “computational machines” were seen to be problematic. Indeed, it was argued that adopting a view of a human as a machine, a chemical accident or merely a factor in production may lead to unethical behaviour because the intrinsic value of human life is not recognised (Schumacher, 1993). In terms of the framework of Morgan and Smircich (1980) humans were considered to be “adaptors”.

It was argued that quantitative and qualitative methods may complement each other and lead to more valid results (Jicks, 1979; Yin, 1994; Silverman, 1997).²⁸⁰ Researchers such as Harte *et al.* (1991) have also specifically argued

²⁷⁷ Indeed, Markowitz (1991) noted that there is no need to adopt the expected utility maxim even if one employs mean and variance analysis for portfolio analysis. He also noted many contradictions to the expected utility maxim, including the fact that many investors do not behave according to it (Markowitz, 1991).

²⁷⁸ Greed is put in the same category as sexual immorality, slander and fraud in 1 Cor 5:11.

²⁷⁹ It was assumed for this dissertation that the Bible is the basis for such an evaluation.

²⁸⁰ Advocates of qualitative methods also use quantitative data. (Glaser and Strauss, 1968)

for more qualitative research into ethical funds. Triangulation has been advocated by many authors (Eisenhart, 1989; Ferreira and Merchant, 1992). The different theoretical perspectives and methods employed in this dissertation represent an attempt to improve the understanding of ethical funds by triangulation. In the next Chapter the qualitative interview method is presented in detail. Chapter 10 presents findings from this interview study of ethical investment funds.

Chapter 11 also provides an agape based ethical evaluation of ethical investment, which considers some Church perspectives on ethical investment. The theological assumptions underpinning an agape based ethic and the Church perspectives includes belief in the God of the Bible and the Lord Jesus Christ. According to this view human beings are created by God with a free will and therefore humans are accountable to God for their actions. Human beings were seen as capable of doing good, but with an inclination to be selfish (Church of Scotland, 1988). The conclusions of the dissertation are presented in Chapter 12.

Chapter 9 Qualitative Method and Ethical Fund Strategies

9.1 Introduction

The previous Chapter presented some of the assumptions relating to the research and the theories. This Chapter will present the qualitative method employed. The aim of the field research in this dissertation is to examine whether: “ethical funds are a good investment” compared with other stock market investments from an ethical point of view. Chapter 10 explores the activities, policies and processes of the sample ethical funds in order to identify the extent to which ethical considerations were incorporated into the investment process. It employs field-based research to do so.

Several researchers have argued for qualitative methods when studying “new” phenomena such as ethical funds (Borg and Gall, 1989; Gillham, 2000).²⁸¹ Others have specifically argued for more field research into ethical funds (Lewis and Cullis, 1990; Harte *et al.*, 1991). This field research is a response to those arguments. In addition Friedman and Miles (2001) suggested an interview based study into ethical funds with a large sample of interviewees. This field study responds to this call by interviewing staff from many financial institutions.

Initially the researcher had considered developing quantitative measures for evaluating environmental and ethical performance of the funds, but due to both a lack of data and the difficulty in quantifying some ethical issues a qualitative approach was chosen. Ethical and spiritual returns are neither readily observable nor easily proxied. It was decided to explore this topic through interviews. In addition, field work – including interviews represent a relatively “new” method of studying ethical funds; indeed funds at all in accounting and finance (Holland and Doran, 1998).²⁸² This Chapter presents the interview method employed and outlines some background details about the interviewees and funds evaluated in Chapter 10. The next section discusses the qualitative method and interviews, in

²⁸¹ Ethical funds existed in only three European countries prior to 1987 (NPI, 1995), even in the UK 26 of the 60 ethical funds were launched after June 1998 (EIRiS, June 1998; Autumn 2001).

²⁸² The author was aware of only one interview based study of ethical funds published in accounting or finance by July 2001 (SustainAbility, 2000). Studies of ethical fund financial performance, case studies based on a single ethical fund and surveys of ethical criteria had been done, these were discussed in Chapters 2 and 4.

general while section 9.3 examines the qualitative method used in the current study. Section 9.4 outlines how the interviews were analysed. Section 9.5 gives an overview of the sample funds' ethical strategies. The ethical screening strategy is presented in section 9.6. Section 9.7 outlines the engagement strategy employed by some funds and some conclusions are offered in Section 9.8.

9.2 Qualitative Method

According to Borg and Gall (1986) the first type of research question especially appropriate for qualitative methods is "What's happening in this field setting?" This type of question is analysed in this dissertation in the context of ethical funds. Field research in particular seemed appropriate for exploring the question generally. More specifically, there was a focus on how ethical values are integrated into the investment process and whether sufficient processes were in place to ensure that the funds investigated were "good" investments in an ethical sense.²⁸³ Furthermore, Borg and Gall (1986) argue that qualitative methods are relevant for studying new phenomena, generating hypotheses and theory development. To some extent all these points are applicable to this current study.²⁸⁴

The research in Chapter 10 and to an extent, the analysis in Chapter 2, is based on in-depth interviews with 21 experts in the ethical investment area (see Appendix 9.1 for a list of organisations where individuals were interviewed).²⁸⁵ It builds on interview based field research in accounting and finance (Baker and Wruck, 1989; Holland, 1995 and 1998; Holland and Doran, 1998; Cowton, 1999; Burton, *et al.* 2000; Gillan *et al.* 2000;). A semistructured interview approach was followed in this investigation whereby some predetermined questions were asked of each interviewee, whilst still providing the interviewee time and freedom to discuss the issues they believed to be important (Moser and Kalton, 1971). The broad themes were outlined at the start of each interview and the interviewee was asked to talk freely about the issues.²⁸⁶ This process helped

²⁸³ The interviews aim to provide insights into the complex question of how the funds themselves determined "goodness".

²⁸⁴ Although only "skeletal" theory development is attempted (Laughlin, 1995).

²⁸⁵ In addition 15 experts from other organisations were interviewed informally and four other experts were interviewed briefly as part of the formal process, see Appendix 9.1 and Table 9.1.

²⁸⁶ These themes had been mentioned to the interviewees when the interview was agreed upon.

establish a more relaxed atmosphere and to build trust (Borg and Gall, 1986). Semi structured interviews were seen to be an appropriate method because some of the questions in the interview protocol were sensitive and open ended questions were asked (Gillham, 2000). According to Borg and Gall (1986):

The semistructured interview therefore has the advantage of being reasonably objective while still permitting a more thorough understanding of the respondents opinions and the reasons behind them than would be possible using a mailed questionnaire (p.452).

This method gives the interviewer the freedom to choose when to pose certain questions and to explore specific issues in greater depth. It also allows the researcher to probe the answers given thereby clarifying any uncertainties (Moser and Kalton, 1971). If many questions were unanswered towards the end of the interview they could then be specifically addressed. Following interview guidelines in Borg and Gall (1986), open ended questions were used to elicit rich responses, while complex or controversial questions such as those relating to possible conflicts between ethical and financial criteria and sustainable development issues were saved for the latter part of the interview. The interview protocol employed is presented in Appendix 9.2.

There are three main sections in the interview protocol. The first section consists of 9 questions about the basis of the fund's ethics and its approach to stock selection. The second section comprises 8 questions relating to the implications of the fund's ethics and its relationships with companies. There are 9 questions on possible conflicts between ethical and financial criteria in section 3. In addition the protocol asks for background facts such as fund size, age and number of companies in the portfolio. This background data was in most cases obtained from other sources prior to the interview. Finally at the end of the interviews the interviewees were asked the general and wide ranging question of whether the fund considers sustainability issues in its investment process.

It is argued that "qualitative methods, in particular, can play an especially prominent role by eliciting data and suggesting conclusions to which other methods would be blind" (Jick, 1979). Specifically, these semistructured interviews have the advantage of supplying depth and yielding a rich

understanding of complex issues (Moser and Kalton, 1971). This is particularly helpful for examining how ethical values are manifested in the investment process and whether there are conflicts between ethics and finance. The interview method facilitates probing into the heart of the interviewees' attitudes regarding these issues (Moser and Kalton, 1971). An example of the need for further probing was one ethical fund which stated that they follow the Association of British Insurers (ABI) guidelines in voting their shares. The initial impression was that this fund votes its shares on ethical issues, after further probing it emerged that whilst this fund could vote its shares on ethical issues it had actually never done so. The importance of effective probing for getting more complete information was emphasised in Borg and Gall (1986).

Chapter 2 was influenced by an oral history approach which “by providing a first-hand account from someone who witnessed and experienced specific events...can make the written record come alive” (Collins and Bloom, 1991). This approach can provide a record of an area where no written account exists. It can also complement and clarify existing written records. The oral history approach involves interviewing principal participants who were “eyewitnesses” to history.²⁸⁷ For this reason, individuals with a particularly long experience of the ethical fund sector such as Charles Jacob and Tessa Tennant were interviewed.²⁸⁸ In addition, one individual with 15 years of experience with ethical funds and three other individuals with more than 10 years of experience were included among the interviewees. These interviews were important as a basis for the discussion in Chapter 2 as well as providing the central input to Chapter 10.

9.3 Method

The in depth formal interviews conducted for this dissertation can be broadly categorised into two groups. First, internal experts such as ethical fund managers, ethical researchers and other staff currently working with ethical funds were interviewed. Eight fund managers, five ethical researchers, two

²⁸⁷ An “eyewitness account” approach has been used in finance by Miller (1999).

²⁸⁸ Charles Jacob was co-author of the first UK ethical fund proposal in 1973 and member of the Friends Provident Stewardship ethical committee 1984-1999. Tessa Tennant was co-founder of the Merlin Ecology fund in 1988 (Jupiter Ecology). The oldest existing environmental fund in Europe. In addition to these, many others involved in launching ethical funds were interviewed.

managing directors and two other staff members participated in this process. Second, external experts not currently working for any particular ethical fund, but with significant expertise in the field such as Charles Jacob, Tessa Tennant as well as representatives from EIRiS and UKSIF were consulted. Table 9.1 lists the formal interviews which provide “data” for Chapter 10.

Table 9.1 The Interviewees

Interviewee	Organisation	Position	Location
A	A	Managing Director	Netherlands
B	B	Ethical Researcher	Netherlands
C	C	Fund Manager	Sweden
D	D	Fund Manager	Sweden
E	E	Ethical Researcher	UK
F	F	Ethical Researcher	UK
G	G	Fund Manager	Finland
H	H	Ethical Researcher	UK
I	I	Fund Manager	Belgium
J	J	Managing Director	Finland
J2	J	Fund Manager	Finland
K	K	Director of SRI	UK
L	L	Marketing Manager	UK
M	M	Ethical Researcher	UK
M2	M2	Fund Manager	UK
N	N	Fund Manager	UK
O	O	Fund Manager	UK
P	P	Ethical Researcher	UK
Q	Q	Fund Manager	UK
R	R	Ethical Researcher	UK
S	S	Managing Director	UK
SHORTER	INTERVIEWS		
G2	G	Managing Director	Finland
G3	G	Fund Manager	Finland
G4	G	Fund Manager	Finland
H2	H	Ethical Researcher	UK

This table describes the interviewees. The shorter interviews were part of the formal setup, but were less structured and shorter in duration than the 21 main interviews. The short interviews were with different individuals, but with the same organisations as those in the main interviews.

An effort was made in this investigation to study documents relating to the ethical fund/ institution interviewed prior to each interview. For most of the funds information from several of the following sources were studied; the fund annual report, other fund material such as newsletter or website, EIRiS (1998) and EIRiS (1999), books, conference presentations made by staff of the fund, newspaper articles, academic publications and other publications on ethical

funds.²⁸⁹ These sources were studied prior to the interview as well as checked after the interview date. Data relating to the ethical portfolios, the ethical criteria, the investment process and other background information was obtained from these sources.

These face to face interviews were conducted in five European countries: Belgium, Finland, Holland, Sweden and the UK. All the formal interviews were conducted in the year 2000. The formal data included around 23 hours of interviews. Notes were taken at all interviews and an initial write up was done. In most cases the interviews lasted for around one hour. For 14 of the 21 experts the interview was tape recorded. The reason why some interviews were not recorded was that at the initial interviews, sensitive information was only revealed after the tape recorder was stopped at the request of the interviewees and one interviewee seemed uncomfortable with the tape recorder. It was thus believed that more information in these exceptional cases would be revealed when a tape recorder was not disturbing the interview process.²⁹⁰ Indeed, Yin (1994) specifically argues that a tape recorder should not be used if the interviewee appears to be uncomfortable in its presence. Furthermore, the interviews which were not recorded were carried out in “neutral”, but noisy environments at the request of the interviewees. The noisy background would have interfered with the recording process which was another reason why the tape recorder was not used.

All the tapes were then listened to several times and a summary of each interview was written up. Discussions before and after the interviews which were not covered by the tape, but which were recorded in the notes were also added to the write up. Complete word for word transcripts were made for ten of the interviews covering eleven of the experts. Regrettably the audio quality of some recordings was not good enough to permit a full word for word

²⁸⁹ For example, the researcher has subscribed to and studied the EIRiS newsletter *Ethical Investor* and the UKSIF newsletter since the summer of 1997. Since 1999 the researcher has subscribed to the *Environmental Finance* magazine, The *Ethical Performance* newsletter and *Tomorrow* magazine has also been studied. These publications regularly contain information about ethical funds.

²⁹⁰ A researcher using triangulation sometimes relies on the “feel” of the situation (Jick, 1979).

transcript.²⁹¹ These transcripts which often were more than 15 pages each were read at least three times.²⁹²

A second researcher was present at three of the initial interviews. Notes from these interviews were compared and discussed to check for reliability. It has been argued that multiple investigators add to the study as team members may have complimentary insights, which add to the richness of the data (Eisenhart, 1988). As the interviews were conducted in five different countries with many interviews outside of Scotland it was not possible to have multiple investigators in most cases. Follow up discussions with interviewees over the phone were undertaken to clarify unclear issues.

The choice of interviewees was firstly, based on the need to cover the “key players”, especially the pioneers such as Friends Provident and Jupiter in the UK and ABF and ASN in the Netherlands. Second, more recent entrants such as Murray Johnstone and Standard Life in the UK and Gyllenberg and Leonia in Finland were also interviewed to ensure that the views of new entrants were included in the analysis.²⁹³ Third, it was thought desirable that a spread of European countries be covered to get a picture of any differences in approaches or ethical criteria. It was thought that conducting interviews in many countries would help to control for variation in how values are integrated into the investment process and how ethical policies manifest themselves in practice (Eisenhart, 1988).²⁹⁴ The aim of this strategy was to reduce the possibility of the results being specific to any one country, particularly the UK. Conducting interviews in many countries and including funds in different stages of development was done to “achieve a balanced view” (Collins and Bloom, 1991). There was also a desire to include many of the ethical funds analysed in Chapters 6 and 7 in order to provide a further check on the external validity of the quantitative study by methodological triangulation (Jick, 1979; Yin,

²⁹¹ Those few tapes from which a complete transcript could not be done were still useful as parts of the interviews were audible. They thus complemented the notes and facilitated the write up.

²⁹² The length ranged from 10 to 27 pages for the full word for word transcripts, totalling 143 pages.

²⁹³ Although recent entrants, Gyllenberg and Leonia launched the first Finnish ethical funds. Murray Johnstone is now part of Aberdeen Asset Management and the Leonia Bank has merged with the insurance company Sampo.

1994).²⁹⁵ Some 17 of the funds analysed in Chapter 6 were covered by the formal interviews and a further 3 were covered by informal interviews.²⁹⁶ Nevertheless, the sample ethical funds are not claimed to be representative of the population of European ethical funds. Despite the inclusion of some recent entrants, there is a bias towards the larger and older ethical funds in the sample. Population validity thus remains a problem, which may limit the generalisability of any findings (Borg and Gall, 1986).

Finally, access was a criterion.²⁹⁷ The final sample for the formal interviews includes individuals from Belgium, Finland, Holland, Sweden and the UK. Central, Eastern and Southern Europe are covered in less detail, partly because of the language barrier but also because some countries in these regions still did not have ethical investment funds at the time of writing.²⁹⁸ The sample selection was influenced by the strategy adopted of covering the most experienced and the biggest players and to cover different types of ethical funds. The sample was not random but aimed to cover a broad range of ethical funds. This approach was advocated in Eisenhart (1988) where she argued that in case study research “random selection is neither necessary, nor even preferable” (p.537). Collins and Bloom (1991) also argued for including “a mix of relevant people”(p.28) on the grounds that many different but relevant voices are then heard. Indeed, a similar approach to sample selection as that adopted for this present investigation has been taken in other field studies of ethical funds (Harte and Owen, 1996; SustainAbility, 2000 and Friedman and Miles, 2001).²⁹⁹

In addition to the focused interviews, unstructured face to face interviews with more than 10 other experts on ethical investment funds have contributed to the

²⁹⁴ For example Stulz and Williamson (2001) document how a country’s main religion predicts the creditors rights and correlates with shareholder rights.

²⁹⁵ Interviewees were for example asked about the matched pair fund in Chapter 7.

²⁹⁶ In addition six of the remaining ethical funds in the sample in Chapter 6 were asked some questions over the phone. Some discussions were held with a further ten experts working for other ethical funds, but these were not classified as interviews, rather they provided a basis for the more formal interviews. These discussions often took place at conferences on ethical investment and UKSIF seminars.

²⁹⁷ Only one financial institution denied access, referring to time constraints.

²⁹⁸ Informal discussions were held with the ethical researcher of the first Spanish ethical fund; with a researcher studying French ethical funds and with individuals involved with funds in Germany.

²⁹⁹ Although only SustainAbility (2000) is an international study, the others focus on UK funds.

research. The unstructured face to face interviews took place in Finland, Norway, Sweden, Switzerland and the UK. They were carried out between 1998 and 2001 (see Appendix 9.1 for a list of the interviewees' organisations).³⁰⁰ For example, the head office of one financial institution in London was visited three times; each time discussions which lasted around one hour were held about their ethical funds. Three different individuals from the institution participated in the discussions. Only the last one of these visits was counted as an in depth interview as this interview was recorded and followed the interview protocol in Appendix 9.2.³⁰¹ Due to the limited number of interviews particularly in continental Europe it is not claimed that the results are generalisable to all European ethical funds. Taken together however, the interviews should give an overview of the attitudes and experiences of ethical fund managers and researchers particularly in Finland, Sweden and the UK; findings relating to other countries may not be as complete.

Of course it must be acknowledged that interviews are only verbal reports. As such, they are subject to the common problems of response bias, poor recall, and poor or inaccurate articulation (Yin, 1994). A subjective element in the interview analysis is recognised as it is difficult to eliminate the problem that the same question may have a different meaning to different interviewees. Indeed, it has been noted that there is not always a clear relationship between what people believe, what they do and what they know (Gillham, 2000).³⁰²

A potential problem which is impossible to eliminate completely is interviewer bias. This refers to biases and expectations held by the researcher leading to distorted interview data (Borg and Gall, 1986). The procedure adopted during the face to face interviews was to generally avoid disclosing the interviewer's opinions on ethical, financial or theological issues. The aim was that the interviewees would do the talking in a manner which would cover a large

³⁰⁰ The unstructured interviews conducted prior to the "formal" semi-structured interviews helped to develop and improve questions and served as a pilot test (Borg and Gall, 1986).

³⁰¹ Similarly the head office of another financial institution in London was visited twice. This counted as one in depth and one unstructured interview. Discussions have been held with four individuals from a Finnish institution, this counted as one in depth interview and three short ones.

³⁰² "People are never more mistaken about themselves than when they are speaking sincerely and from the heart" (Gillham, 2000).

number of the items on the interview protocol in appendix 9.2. Due to time constraints, lack of information or unwillingness not all interviewees answered all the questions. These limitations mean that the results of the interview study are not assumed to be free from bias or to be generalisable to all European ethical funds.

To mitigate the response bias problem the interview findings were cross checked with a number of sources including academic publications on ethical investment funds.³⁰³ Books, newspaper articles and reports on ethical investment were also studied.³⁰⁴ Material and publications from EIRIS, SustainAbility, UKSIF and the WM Company were scrutinised as well as annual reports and publications from ethical funds. This procedure enabled the researcher to check and improve the internal validity of the empirical investigations by using multiple sources of evidence (Jick, 1979; Yin, 1994). For example fund material obtained by the researcher from Banco, CIS, Jupiter, NPI, Friends Provident, Scottish Equitable, Standard Life other financial institutions and EIRiS provide detailed information on the criteria and operations of the ethical funds. An attempt was made to investigate if this information was consistent with the interview data or not.³⁰⁵ It was also hoped that the use of multiple data sources might improve the quality of the analysis. Cross checking the interview data with these documents provided data triangulation (Yin, 1994). Such triangulation helps to address, but does not fully mitigate, the response bias problem. It is still possible that in some case the researcher has made errors in the notes or that the interviewee has for some reason provided incorrect information (Moser and Kalton, 1971). As the interviews and the documental evidence seemed to be in agreement it is hoped that few material errors remained after this triangulation process. An additional audit on the initial interview findings was provided by sending Kreander (2001) to all of the interviewees. Most interviewees were also given Kreander, Gray, Power and Sinclair (2000a or b) at the start of the interview.

³⁰³ For example: Rockness and Williams (1988); Harte, Lewis and Owen (1991); Perks *et al.*, (1992), Kinder and Domini (1997); Mackenzie (1997); Cowton (2000); Stone (2000).

³⁰⁴ For example: Simpson (1991), Kinder *et al.* (1993), Merlin (1993), NPI (1995), Sparkes (1995), Deml and Baumgarten (1998), EIRiS (1998), Hancock (1999) and Kuisma (2001).

³⁰⁵ Some interviewees claimed the marketing material by one Scandinavian ethical fund was dishonest, while one interviewee claimed that the material from a UK fund was claiming too much. UKSIF has advocated honesty in marketing claims made by ethical funds.

The interviewees were later contacted and asked to provide any comments on these documents.

A more serious problem than response bias may be non-response. It has been argued that some individuals may be unwilling to discuss certain issues or tell the truth about specific events (Collins and Bloom, 1991). Indeed, some interviewees for this investigation seemed unwilling (or unable) to discuss certain issues such as conflicts between ethics and finance. Another challenge is “maturation” or changes in subject(s) during the study (Borg and Gall, 1986). In this context the “maturation” problem is the extent to which the ethical investment scene has changed since 1998. A large number of ethical funds and indexes have been launched since the start of this work and the engagement strategy described later in this Chapter has become increasingly popular. Some funds such as SEB Miljöfond have changed concept to embrace wider ethical concerns. A further issue is “experimental mortality” or loss of subjects during the study (Borg and Gall, 1986).³⁰⁶ For example, there have been a number of mergers and takeovers between 1999-2001 affecting the financial institutions providing the ethical funds in this study. These issues will be further examined in the next Chapter. The most significant event was perhaps the announcement of the pension law review in July 1999, which came into effect in July 2000. This amendment to the pension act of 1995 requires trustees to disclose their policy on “socially responsible investment” in their stated investment policy (UKSIF, 2000). This could lead to substantial growth for funds managed ethically as the value of occupational pension funds in the UK exceeds £800 billion (UKSIF, 2000).

9.4 Analysis

For the analysis of the interviews a matrix was constructed with answers provided by ethical funds to questions in the interview protocol. When the tapes were listened to and the transcripts were read, coding on separate sheets was also performed. The coding process was informed by Bouwman (1985) and Bouwman *et al.* (1987) who employed protocol analysis to model financial

³⁰⁶ The Commercial Union Ethical Fund was closed down in 1999. The fund manager blamed it on lack of shareholder interest, but the fund had performed poorly with all measures (Chapter 6).

analyst decision making. In (this form of) protocol analysis, interviewees usually think out aloud about solving some task such as approving a stock for investment. Protocol analysis is commonly used in medicine and psychology and has occasionally been used in accounting (Bouwman, 1985). Protocol analysis can be employed to study ill-structured poorly defined tasks. Protocol analysis techniques are classified into four categories in Bouwman (1985):

- (1) Scanning: Examining the protocol for (frequently) anecdotal information;
- (2) Scoring: Tabulating the frequencies of certain key items of interest;
- (3) Global modelling: Flowcharts and algorithms that capture the decision making;
- (4) Computer Simulation: Simulating decision making behaviour by computers.

Bouwman (1985) develops a computer model for financial analysis, while Bouwman *et al.* (1987) model the investment screening decisions of financial analysts using flowcharts. For example Bouwman (1985) notes that scanning is helpful for supporting other analysis techniques such as regression. Interviews have also been employed to support other methods in finance (Mallin, 1995; Gillan *et al.*, 2000; Marshall and Christie, 2001). The investigation in this dissertation is mainly focused on the scanning and scoring. In Bouwman's studies subjects were asked to think aloud about the financial analysis process, while fund managers in this study were asked to "outline the story of their latest ethical investment". They were also asked to provide examples and motivations of companies that had been divested for ethical reasons. "Scoring" was employed to investigate issues ranging from how many shares are approved for investment and included in the portfolio to how many times Christianity was referred to.

Although informed by Bouwman (1985) and Bouwman *et al.* (1987), this field study differs from protocol analysis in a number of ways. For example, protocol analysis often aims to understand the decision making process of an individual (or a certain type of individual). This study was more interested in understanding good practice among ethical funds "what good ethical performance is" and the ethical investment process of a fund than modelling the decision making process of an individual fund manager. Protocol analysis,

especially at the more advanced stages, requires full transcripts. In this study however much interview data was obtained that was not tape recorded in addition to the recorded interviews. Indeed, even at the interviews where a tape recorder was used some interesting data was obtained after the tape recorder had been turned off. The coding and analysis in this study was thus informed by Bouwman (1985) and Bouwman *et al.* (1987), but did not go to the same detail. The analysis in this investigation was more interpretative than that employed in protocol analysis.

Finally, the interview method presents some challenges for the analysis as the items of information obtained at different interviews were not identical and some answers may not be fully comparable. It is therefore recognised that there is a subjective element which means that although the interview investigation is in the mainstream paradigm, it is close to and informed by the interpretative/qualitative paradigm (Burrell and Morgan, 1987; Chua 1986). Because of some inevitable subjectivity the findings in this Chapter and Chapter 10 must be treated with some caution. The next section describes the ethical criteria adopted by the sample funds.

9.5 A Description of Ethical Fund Strategies

Based on the interviews it appears that the sample ethical funds tend to follow one or both of two strategies for implementing their ethical policy: (1). **Ethical screening** (by negative and/or positive ethical criteria); and/or (2). **Engagement** with companies (or as interviewee L put it “turning the bad firms into good”).

Through these strategies, the ethical funds tried to incorporate ethical values into the investment process. The first of these two strategies can be negative in that the funds identify the “bad” companies and then avoid investing in them. Many funds also had a positive approach in that firms which met certain positive ethical criteria were the target for investment. Finally, this positive screening was taken a step further when the fund actively encouraged firms to improve their ethical performance by engaging with company management on these issues. These two strategies are not mutually exclusive and some ethical funds

pursued both strategies simultaneously.³⁰⁷ Indeed, all sample funds employed the first strategy of screening while 13 funds had some kind of engagement strategy in place. This section describes the part of the stock selection process of the ethical funds which arises from the fund's ethical criteria. The ethical criteria adopted by the sample funds are discussed (Table 9.2 and 9.3), while the engagement strategy is presented in section 9.7. The investment processes of ethical funds are analysed in Chapter 10.

9.6 Ethical Screening

This section describes the traditional “ethical screening” strategy of avoiding the ‘bad’ companies and investing in the ‘good’ companies. The first strategy of ethical screening, based on negative and/or positive criteria was put into practice in this way. This is how ethical funds dealt with the ‘investment ethic problem’ (Mackenzie, 1997).³⁰⁸ The ethical funds attempted to align the ethical values of the investors with the investments by avoiding certain harmful sectors and prioritising certain beneficial industries/products. Investors in ethical funds often value strict ethical criteria. For example, some 80% of the respondents in a survey by Friends Provident claimed that strict ethical criteria was a reason for investing in the fund (UKSIF, 2001). The information about ethical criteria mentioned in this section come from three main sources; material published by the funds themselves, EIRiS publications and the interviews. It must be emphasised here that many ethical fund managers said that they invested in ‘ethically neutral’ companies also, few if any ethical fund managers claimed that all companies in their portfolios are ethical. Indeed, one of the interviewees argued that: “There is no such thing as an ethical company, only companies which meet certain ethical criteria”. The interviewees also recognised that there are limits to what ethical funds can do as the following quote demonstrates “if one wants to be really green then don’t invest in the stock market, full stop”. This interviewee proceeded to suggest investment through the “Triodos ethical bank” as an alternative to ethical funds.

³⁰⁷ Some ethical funds identify “best in class” companies by a combination of environmental and social criteria, this can be seen as a development of positive ethical criteria.

³⁰⁸ The investment ethic problem refers to the fact that many companies have activities or products which some investors do not want to be part of or support (Mackenzie, 1997).

Many of the early ethical funds claimed to be ethical by adopting a few exclusionary criteria. For example, Jacob (1991) argues that the majority of the early American funds called themselves ethical by virtue of only one criterion, avoiding companies with an involvement in South Africa.³⁰⁹ Similarly, the first European ethical fund avoided investments only in the alcohol and weapons industries. The old concerns of addictions such as alcohol and tobacco in addition to weapons manufacturing are still the most common exclusion criteria in Europe in Table 9.2 (see also Avanzi, 1999).

Often ethical funds do not employ “criteria of absolute avoidance”, but rather choose a cut off point such as 10% of turnover generated from a product such as alcohol or tobacco (Banco, 2000b). For example, Friends Provident Stewardship accepts no turnover from production of alcohol or tobacco, but up to 10% is allowed from sales, thus enabling investment in the supermarkets (Friends Provident, 2001).³¹⁰ Many ethical funds with tobacco and alcohol criteria would invest in supermarkets and hotels which sell alcohol and tobacco provided that the cut off point is not exceeded. There is thus a concern that some criteria may be too lax or vague to have much practical significance. There are also funds with more strict definitions of the criteria. For example Clerical Medical Evergreen, Equitable Ethical and Framlington Health funds which were analysed in Chapters 6 and 7 avoid all companies with any turnover from production or sale of alcohol, tobacco or gambling (EIRiS, 1998).³¹¹ Thus the strictness of the definition of a criterion may be more important for the size of the investment universe than the actual number of exclusionary criteria. Indeed, it is a widespread perception that the strictness of the criteria may directly affect the investment universe and the therefore the risk of the fund (Holden and Meehan, 1998). However the results of Chapters 6 and 7 and Guerard (1997) do not support the assertion that funds with strict environmental criteria would necessarily be the most high risk funds.

³⁰⁹ By the mid 1990’s this criterion had been dropped by all sample ethical funds.

³¹⁰ Stewardship allows up to 33% of turnover from alcohol for the hotels and leisure sector, claiming that this turnover originates mainly from alcohol with meals, rather than “drinking”.

³¹¹ They also have other ethical criteria.

In addition to traditional exclusion criteria such as tobacco and weapons a number of environmental concerns seemed to be common among the ethical funds where the interviewees worked. The most recent environmental concern which has been added as an exclusion criterion by some ethical funds was genetically manipulated (GM) crops. In recent years a “best in class/best in sector” approach has become increasingly common. This approach aims to invest in the best companies in a sector according to environmental, financial and social criteria rather than necessarily excluding sectors, although ethical funds with “a best in class” approach also tend to have exclusionary criteria. The president of fund management company A expressed concern over the “best in class” strategy on its own. He argued that the “best in sector is not good enough, (since) minimum (ethical) criteria must be satisfied”.

Table 9.2 lists some of the exclusion criteria used by the sample funds. Some of the funds had many additional criteria to those listed such as; avoiding companies with misleading advertising or avoiding firms involved in the fur trade or meat production. In addition the exact definitions for the same criteria varied substantially from fund to fund. These tables only give a brief introduction to ethical issues considered by the funds. An extensive scrutiny of the various criteria is beyond the scope of this Chapter as the stated criteria are only one part of the ethical investment process.³¹²

³¹² Detailed information about ethical criteria for UK funds is provided in EIRiS (1998; 2002). The decision on what is ethical and what is not is not an easy one, as one of the fund managers pointed out: “It is hard to draw the line on what is ethical”.

Table 9.2 Negative Ethical Criteria used by Funds

Ethical Funds	Alcohol	Animal Testing	Gamb-ling	Human Rights	Nuclear Power	Ozone Deplet.	Genetic Manip.	Environ-ment	Porno-Graphy	Tobacco	Weapons
ABF Andere Beleggingsfond	X	X	X	X	X		X	X		X	X
ASN Aandelenfonds	X	X	X	X	X		X	X		X	X
Banco Hjälpfond	X									X	X
Banco Humanfond	X									X	X
Banco Samaritfond	X									X	X
Carlson Världsnaturfonden	X					X		X		X	X
CIS Environ	X	X		X	X					X	X
FP Stewardship Income	X	X	X	X	X	X		X	X	X	X
FP Stewardship Unit	X	X	X	X	X	X		X	X	X	X
Gyllenberg Forum				X				X			
Jupiter Ecology	X	X	X	X	X		X	X	X	X	X
Jupiter International Green	X	X	X		X		X	X	X	X	X
KBC Eco	X	X	X	X	X	X	X	X	X	X	X
Murray Johnstone Ethical World	X	X	X	X	X		X	X	X	X	X
NPI/Henderson Global Care Income	X	X	X	X	X	X	X	X	X	X	X
NPI/Henderson Global Care Unit	X	X	X	X	X	X	X	X	X	X	X
Sampo Arvo	X		X					X	X	X	X
Scottish Equitable Ethical	X	X	X		X	X		X	X	X	X
Sovereign Ethical	X	X	X	X	X	X			X	X	X
Standard Life UK Ethical	X	X	X	X	X	X		X	X	X	X

Table 9.2 presents common criteria. Some of the listed ethical funds have additional ethical criteria to those mentioned in this table. For example, *Scottish Equitable Ethical* excludes the banking sector and meat producers and has other criteria in addition to those in this table. The definitions for the same criteria listed can be very different for different funds. For example one fund excluding tobacco companies can invest in a company where 9% of the revenues come from tobacco sales (10% cut off limit), but for another fund 1% or any turnover may be the cut off limit. Especially the environment criterion in this table differs between the funds. This table is thus a simplification of the ethical criteria and **intended to give an overview only**. The table was checked with the interviewees. *Source: Interviews with funds, fund annual reports and marketing material and EIRiS (1998).*

Table 9.2 shows that a broad range of ethical concerns were considered by the typical fund examined. This table was checked with interviewees and one fund manager added some criteria for his fund at a later stage. Interestingly, UK ethical funds considered a larger number of ethical issues than their counterparts in continental Europe. One possible reason for this difference is that EIRiS and other organisations provided information for ethical funds in the UK to enable them to implement the ethical screens (Perks *et al.*, 1992). In most other European countries less information was available on company environmental performance and ethical matters. Also, one ethical researcher argued that

“inherently within the British psyche is an element of avoidance”. The most common exclusionary ethical criteria among the sample funds were the old concerns relating to alcohol, tobacco and weapons, which reflects concerns of groups such as Mennonites, Methodists and Quakers (Kinder *et al.*, 1993).³¹³ These findings are similar to Perks *et al.* (1992) who found tobacco, weapons and alcohol to be the most common exclusionary criteria for 14 UK ethical funds. These results also seem consistent with Holden & Meehan (1998) who found Jupiter Ecology and NPI Global Care to have the most extensive ethical criteria of 34 UK ethical funds. However, The findings differ slightly from Harte *et al.* (1991) who also found alcohol, tobacco and weapons to be top concerns for 11 UK ethical funds, but not quite as common as criteria relating to the environmental track record of the firm and employee welfare. There are also some differences if the criteria in Table 9.2 are compared to the importance which UK ethical investors placed upon ethical criteria according to Woodward (2000). In her study weapons were the top “product criteria”, but tobacco was fourth and alcohol ninth. Similar to Harte *et al.* (1991) environmental criteria seemed more important in Woodward (2000). This phenomenon was described by interviewee H as a “changed emphasis much more towards environmental matters and away from the output criteria”. A possible explanation of this is increased media coverage of environmental issues and public concern relating to climate change and food safety (SustainAbility, 2001). An earlier example was the concern about apartheid in South Africa. Ethical funds would thus seem to reflect “popular public concerns” and changes in ethical criteria may reflect cultural changes in society. Indeed, Interviewee R mentioned that her financial institution conducted substantial market surveys prior to the launch of the fund partly to determine the ethical criteria. These issues are explored in Chapter 11.

There are some country differences in the ethical criteria for the funds in this investigation. For example, criteria relating to animal testing were most

³¹³ The Church of Scotland Trust has avoided alcohol, gambling and tobacco since 1932 (Church of Scotland, 1988). The Church of England avoids alcohol, gambling, newspaper companies, pornography, tobacco and weapons (Church of England, 1999/2000). In a survey of “non-ethical” fund presidents Butzby and Falk (1978) noted that 11 of them avoided alcohol or tobacco stocks and 49% considered environmental pollution to be important, although financial considerations dominated. However EIRiS (1998), Avanzi (1999) and the interviews indicated that at present the most common screen adopted by European ethical funds is tobacco.

common in the UK. The strongest concern about genetic engineering appeared to be in the Netherlands and the UK. In the UK and Finland it was more common that ethical funds integrate various ethical and environmental criteria, while there was a clearer split between environmental and ethical funds in Norway and Sweden.

Sometimes there seemed to be a difference between published criteria and actual practice. This has also been noted in previous studies such as Cowton (2000). Thus one of the sample funds avoided the chemical industry although this criterion was not mentioned in the fund material. Another fund avoided the alcohol and tobacco industries although they were not initially among the formal/stated criteria of the fund, later this fund publicised these criteria. A third case related to Stagecoach plc which had been divested although it did not breach any fund criteria, but rather some unit holders had expressed their unease about this holding and the interviewee described it as a “customer unfriendly stock” because of the ruthless business practices Stagecoach had employed.

One interviewee was critical of the screening strategy if employed without any in house ethical research expertise. The interviewee argued that it is subjective and that “what is left after exclusion is crap” and “fails to meet customer expectations”. This interviewee did not only mean that what is left after screening was financially unsatisfactory, but that it could also be ethically problematical.³¹⁴ Some interviewees also mentioned that their institutions have model portfolios for national and other funds. These model portfolios are then tailored for different funds. If the resulting holdings are similar between the ethical and non-ethical funds of the same institution it may partly explain the result of Chapter 7 of no significant difference between ethical and non-ethical funds.

An example of similar portfolios for ethical and non-ethical funds within the same institution is Banco, Sweden’s largest provider of ethical funds. The researcher examined the holdings of the five Banco ethical funds analysed in

³¹⁴ The interviewee provided examples of firms approved for investment by some ethical funds such as Flying Flowers and Provident Financial. It was claimed that the business of flower

Chapters 6 and 7 and the non-ethical Banco Sweden fund. It was found that 54 of the 55 securities in Banco Sweden were included in one or more of the ethical funds, this included all the companies held by Banco Sweden. In fact 3 of the Banco ethical funds and the Banco Sweden fund were almost identical in terms of the composition of the portfolios. Another point to note was that 4 of the Banco ethical funds and the Banco Sweden fund all had the same fund manager. This raises a concern about whether the ethics of some ethical funds is genuine or whether the ethical criteria are mainly marketing slogans. Alternatively, well managed companies may also be progressive in ethical matters. The “ethical performance” of firm could thus be a proxy for good management. To check this further the portfolios of some other institutions were examined, but for these other institutions there was almost no resemblance of the holdings of the ethical funds and the other funds managed by the same institution.³¹⁵ Indeed, the fund manager of another continental ethical fund mentioned that due to the small investment universe the global investment approach of the institution is not really applicable to the ethical fund. The effects of ethical criteria and strategies would seem very different for different funds. For example two of the sample ethical funds had approved less than 90 companies for investment worldwide, a third fund had approved 200 companies, while another fund had 503 companies on its approved list. A few continental funds investing mainly in their home countries had only excluded around ten companies from their universe. There is no clear evidence how the differences in the ethical screens among ethical funds impact performance. For example the Friends Provident Stewardship fund which has extensive ethical criteria had good financial performance in Chapters 6 and 7, Mallin *et al.* (1995) and in WM Company (1996). Equally Carlson Världsnaturfonden with very few ethical criteria had excellent financial performance. Indeed, Guerard (1997) argued that most (negative) ethical screens in the 1987-1996 period actually resulted in better financial performance. The only ethical screen of the 15 he examined which seem to have entailed a

transport by air was unsustainable and that the high interest rates charged by Provident Financial were unethical.

³¹⁵ For BfG Invest, Hypobank, SEB, Vesta and Wasa Länsförsäkringar there was little if any resemblance between the ethical and their non-ethical funds. For KBC it seemed as if the fact that the ethical funds manager also managed North American funds may have influenced the ethical portfolio as 14 of 37 stocks in KBC Eco Fond were US companies compared to a maximum of 3 stocks from any other country.

financial cost was the military screen. Appendix 9.4 provides examples of companies often found in ethical funds. It shows that telecommunications was a popular sector for ethical funds in the late 1990's.

Table 9.3 reports some of the areas which ethical funds supported. Specifically, it highlights whether a fund sought to invest in a firm because it worked with communities, had taken measures to limit its impact on the environment and a number of other areas which might facilitate the approval for investment. In the UK, positive ethical criteria date back to 1973 and the stated objective of supporting "companies fulfilling a useful purpose" (Stewardship proposal, 1973).

Table 9.3 Positive Ethical Criteria used by Funds

Ethical Funds	Community Involvement	Environ. Initiatives	Env/soc Reporting	Equal opp Human rights	Positive Products
Aberdeen ethical world (1)	X	X	X	X	
ABF Andere Beleggingsfonds	X	X	X	X	
ASN Aandelenfonds	X	X	X	X	
Banco Hjälpfond					
Banco Humanfond					
Banco Samaritfond					
Carlson Världsnaturfonden					
CIS Environ	X	X	X	X	X
FP Stewardship Income	X	X	X	X	
FP Stewardship Unit Trust	X	X	X	X	
Gyllenberg Forum	X	X		X	
Jupiter Ecology	X	X	X	X	X
Jupiter International Green	X	X		X	X
KBC Eco Fund		X	X		X
NPI/Henderson Global Care Income Trust	X	X	X	X	X
NPI/Henderson Global Care Unit	X	X	X	X	X
Sampo Arvo	X	X		X	
Scottish Equitable Ethical					
Sovereign Ethical	X	X		X	
Standard Life UK Ethical	X	X	X	X	X

The exact definitions of these criteria varies from fund to fund. Some of the funds have additional positive criteria to those in the table. For greater detail see EIRiS (1998). *Source: Interviews, fund annual reports and marketing material, EIRiS (1998).* (1) Aberdeen ethical World was previously Murray Johnstone ethical world.

The table shows that there were fewer positive than negative criteria and that most sample funds employed many positive criteria. The positive criteria were

most common among the UK, the Dutch and Finnish sample funds whereas they seemed to be less common in Sweden.³¹⁶ The number one positive criterion among the sample funds was environmental initiatives. This finding is consistent with the result of Harte *et al.* (1991) who found “environmental awareness” to be the number one positive criterion for UK funds. Community involvement was also a concern for most funds in Harte *et al.* (1991) and this investigation, while positive products/sectors was a less common criterion. Positive ethical criteria are not explicitly listed in Perks *et al.* (1992), but 8 of 17 UK funds expressed “positive commitment to the environment” and a few funds mentioned a concern for various environmental issues. Some interviewees voiced their support for increased disclosure on environmental and social issues. One fund manager argued that: “An environmental report is a criterion, it is very difficult to invest in a company which does not even have an environmental report”. There was a demand by sample ethical funds for environmental information.

The opinions of UK ethical investors on ethical criteria was slightly different from the criteria actually employed by UK ethical funds according to Woodward (2000). The main difference between positive criteria mentioned in Table 9.3 and those outlined in Woodward (2000) was that community relations ranked only tenth in her table of ethical criteria. In common with the sample funds in this study environmental initiatives, human rights and equal opportunities were ranked high in Woodward (2000). In Chapter 10 where approaches to stock selection are considered in more detail it will be argued that one of the characteristics of the more advanced ethical funds is that they consider positive factors in addition to the negative criteria. The next section will consider the second strategy of engaging with company management to achieve positive change in ethical matters.

9.7 Engagement

In addition to ethical screening, engaging with company management on ethical issues is the other major strategy for implementing an ethical policy. It is not incompatible with the ethical screening criteria in the previous section. Indeed,

³¹⁶ There are other Swedish ethical funds which do consider positive criteria (Kuisma, 2001).

all the funds in this investigation with an engagement approach also employed ethical screening in a similar way to which some financial analysts employ financial screens (Bouwman *et al.*, 1987). A view advocated in Mackenzie (1997) is that investment should encourage companies to improve their ethical as well as financial performance. For example, Dr Michael Northcott, who served on an ethical committee for a fund pointed out that: “I would like my money to actively work for good, in addition to avoiding certain sectors”.

Engagement with company management on ethical issues may achieve this aim. It is a strategy which generally requires at least one ethical researcher and/or an active ethical committee. There are a number of ways to pursue this strategy. The most basic element underpinning the approach is that the ethical funds contact companies for information on ethical issues through questionnaires, phone calls and company visits. Mere data gathering does not constitute engagement however. Engagement involves actively encouraging good practices such as adopting ethical policies, increasing environmental reporting and generally operating the business in an ethical way. In the present study, many interviewees emphasised the need to work with companies on these issues rather than just “shaming” them or telling the management how to run their firms. An important part of engagement is informing companies that are sold because of ethical reasons about why their shares are being disposed of or ensuring through dialogue with management that a situation where the ethical criteria is breached will not arise. Nevertheless, at least 14 of the funds in Tables 9.2 and 9.3 had sold shares for ethical reasons. Engagement has become increasingly popular; for example interviewee H argued that “engagement is the way forward”. This was supported by a recent study which found that 39% of large UK pension funds mentioned engagement in their investment policy (UKSIF, 2000). A recent report claims that 10% of the UK stock market has adopted some sort of engagement approach regarding environmental, ethical and social issues (ABI, 2001). Miles and Friedman (2001) document how some pension funds such as Sainsbury and USS engage with company management on some ethical issues. They argue that the new pension regulations have stimulated the engagement approach. A recent report by the Association of British Insurers claimed that £45 billion worth of local authority pension funds pursue an engagement strategy in

addition to many ethical funds (ABI, 2001). On the other hand Guptara (2001) argues that the wording of these investment policies mentioning engagement is often so vague that it is impossible to know whether it has any real meaning. This view was supported by interviewee P who argued that “engagement is not a term I like...because it’s undefined...and pretty ambiguous” and “what I don’t like is the ethical fund which just has engagement as its remit, but without any recourse to tweezering out or excluding”.³¹⁷

Engagement is sometimes thought of as a new strategy. This is not the case, exclusionary criteria or other action has in some cases been adopted only after engagement has failed. An example was apartheid in the exclusion of South Africa. The negative investment criterion was adopted only after many years of engagement which did not cause the government in South Africa to alter its policies. Another example is the court case in 1991 by the Bishop of Oxford against the Church Commissioners. This was only brought forward after many years of “engagement” had failed to persuade the Church Commissioners to adopt a more strict ethical investment policy (Sparkes, 1995).

Voting the fund shares on ethical issues is also part of the engagement process, but according to the interviewees and a study by EIRiS (1999a) voting was still not common among ethical funds. The interviews demonstrated that voting was more common among UK financial institutions, but rare in other European countries. For example interviewee B from a continental institution said “it is always good to get into contact with the company but it is not our main priority to go to the shareholders meeting”. Indeed, all the interviewees at UK ethical funds claimed they could vote the funds’ shares on ethical issues and some gave specific examples where they had done so.³¹⁸ By contrast none of the Belgian, Finnish or Swedish ethical funds interviewed had voted shares on ethical issues. One continental fund manager argued that the reason for not voting often is that “you have to do the thing that is best for your shareholders” and therefore if it is

³¹⁷ By “tweezering out” the interviewee refers to divesting firms breaching criteria.

³¹⁸ The interviews revealed that the ethical funds do not necessarily represent “a block” when voting on ethical or environmental issues. For example, in a recent BP/Amoco resolution on arctic exploration and solar power some of the sample funds abstained, some voted for and some against the resolution.

not absolutely clear what is best for the shareholders the fund should not vote (against management). Many of the UK ethical funds were managed by large insurance companies, while the European funds were managed by smaller financial institutions.

This is consistent with the finding that many large UK institutions and insurance companies in particular tend to vote their shares, while voting was less common among smaller institutions (Mallin, 1995). Nevertheless the approach taken by many of the sample funds is summarised by interviewee P “we don’t have any engagement overlay of trying to change them all for the better good, we don’t feel that is our place at all”. This raises a concern mentioned by one of the interviewees. The concern is that there is no one to check the power of company management if even the ethical funds abstain from voting on ethical issues and never raise these issues at company annual general meetings. It may create an imbalance in the system when limited liability companies are monitored by absentee shareholders. The interviews indicated that many ethical funds are no different from their non-ethical counterparts in terms of their voting behaviour. The interviews supported the finding in Friedman and Miles (2001) that ethical funds have not voted as a bloc and that some ethical funds have voted against environmental initiatives. As a group it would therefore seem as the sample ethical funds fail to achieve the aim of “democratising shareholder power” since 50% of the sample funds did not vote on ethical issues.³¹⁹

One interviewee claimed that engagement only became more common at the end of 1999 and was encouraged by the new legislation which requires pension funds to disclose whether they consider ethical matters in their investments or not. As an example of engagement, Jupiter (2000) reported that its environmental research unit held 60 meetings with company management for environmental and social purposes, 161 completed questionnaires were received from firms and Jupiter wrote 116 letters to companies on specific environmental and social issues in 1999. It appeared from the interviews that in some cases

³¹⁹ This is different from the USA, where shareholder activism has been part of the concept of ethical funds from the start. Legal and cultural reasons have been suggested as explanatory factors (Purcell, 1980; Bruyn, 1987; Sparkes, 1995).

engagement may offer a partial solution to the corporate harm problem by addressing some environmental and ethical issues. The corporate harm problem refers to the fact that “corporate practice is frequently harmful to people, animals and the environment” (Mackenzie, 1997). Engagement and voting are further explored in Appendix 9.3.³²⁰

9.8 Conclusions

This Chapter has presented the qualitative method employed in the dissertation. The main method in this field research was face to face semi-structured interviews. The interview guide presented in Appendix 9.2 was guiding the “formal” interviews, although the aim was not to get an answer to every question but rather to let the interviewees describe the stock selection process of the fund, the manifestation of ethics and possible conflicts between ethical and financial aims. As part of the formal investigation 25 individuals from 5 countries were interviewed. In addition informal unstructured interviews were conducted with some other experts from a number of financial institutions and organisations in several countries in the early stage of the study to provide background information about ethical investment funds and to help develop the interview guide. The aim with this field research employing mainly interviews and literature on specific ethical funds was to provide a tentative assessment of which sample funds were ethically good investments in comparison to the other sample ethical funds and non ethical stock market investments.

This Chapter started to consider these issues by presenting some ethical criteria of the sample funds. Some of these criteria were exclusionary such as alcohol, tobacco and weapons production. Companies involved in certain activities and/or producing certain products are excluded from investment by these negative screens. Almost all European ethical funds seemed to have some negative screens. Most avoid tobacco and weapons producers (Table 9.2). Some

³²⁰ Friends Provident Stewardship, Jupiter Ecology, NPI/Henderson Global Care, Scottish Equitable Ethical and Standard Life are particularly active in “engagement” in the UK (EIRiS, 1999a). The interviews confirmed this and CIS Environ and Murray Johnstone Ethical World Fund (now part of Aberdeen Asset Management) in the UK, and ASN/SNS and VBDO in the Netherlands can be added to the list of the organisations engaging with company management.

background to these ethical criteria was presented in Chapter 2, while some further analysis is conducted in Chapter 11.

Positive criteria relating to beneficial products, community involvement and environmental initiatives are becoming more common (Table 9.3). Many ethical funds aim to focus investment to companies meeting positive criteria. For example the Standard Life Ethical Fund has a target of having 75% of the companies in the portfolio positively screened. Typical positive criteria included community involvement and environmental initiatives by the firms. These negative and positive ethical criteria are a key element in the “screening” strategy of ethical funds of incorporating ethical values into the investment process. Many fund managers recognised that their funds in addition to some “more ethical” firms also included some “ethically neutral” companies. A problem for comparison of ethical criteria is that the exact definitions of the same criterion often vary between ethical funds (EIRiS, 1998; SustainAbility, 2000).

An increasingly popular approach to ethical investment is engagement. This approach entails active dialogue between the fund and company management on ethical issues. In the UK voting on company annual general meetings was often a part of the engagement process, while continental European ethical funds rarely vote their shares. A potential concern was the imbalance in the system because even ethical funds often did not vote on ethical issues. As the interviewees argued that most financial institutions normally vote with management, this could lead to a situation where no shareholders hold company management accountable on ethical issues.

The next Chapter will consider different approaches to stock selection among ethical funds in greater detail. Different issues relating to ethical policies and possible conflicts between these and financial aims are explored based on interview findings in order to tentatively answer the question of whether ethical funds are a good investment compared to non ethical funds in terms of their investment processes.

Chapter 10 Interview Findings

10.1 Introduction

The previous Chapter considered the qualitative method to be employed in the field work and introduced the two broad ethical fund strategies for dealing with ethical issues; screening and engagement. This Chapter reports the findings from the interviews which were conducted by the researcher. The focus is on the formal interviews that were conducted in 5 countries (Table 9.1 and Appendix 9.1) although in some cases findings from unstructured interviews are also included to help inform the overall results. This Chapter begins by analysing the ethical fund approaches to stock selection. Section 10.3 then considers other related findings. Issues about the ethical policies are presented in Section 10.4, while section 10.5 investigates areas where ethical and financial aims may conflict with each other. Section 10.6 considers some of the limitations of ethical funds. The importance of Christianity for some of these funds is presented in Section 10.7. Finally, conclusions regarding the findings and whether these funds are a “good” investment from an ethical point of view compared to other stock market investments are presented in Section 10.8.

10.2 Approaches to Stock Selection

The two strategies of ethical screening and engagement discussed in the previous Chapter have consequences in terms of the stock selection process which an ethical fund might follow. It is possible to pursue the first strategy – screening – without in-house experts on ethical issues, but the second one (engagement) can only be followed effectively if the financial institution has some staff member(s) with a remit to engage with companies on ethical issues. This is often done by “ethical researchers” employed by the financial institution. These two broad strategies were discussed in greater depth in Chapter 9. In the next section three approaches to stock selection based on these two strategies which were identified from the interviews, will be examined in detail.

These approaches to security selection are:

1. The twin track approach³²¹ (usually some ethical screening and engagement);
2. The commercial ethic approach³²² (generally only negative screening);
3. The integrated approach³²³ (negative and positive criteria and engagement).

Table 10.1 is developed from the interviews and reports the approaches to security selection that the sample funds followed and gives details on the operation of the different funds. The table reflects the situation in the year 2000. It is clear from the table that the majority of these funds followed a Twin Track approach whilst the Commercial Ethic and the Integrated Approach seemed to be less common³²⁴. In addition, the majority of these funds actively engaged with company management on ethical issues. Indeed, 9 of these funds had voted their shares on ethical issues at company annual general meetings and 80% had an ethical committee. The majority of the funds had in-house ethical researchers, but in many cases this was only one person in addition to the fund manager(s). Most funds had sold company shares for ethical reasons. Examples of 'ethical divesting' included selling the shares of companies which had been prosecuted by the Environment Agency, firms which did not provide sufficient information to enable the funds to be certain that they did not breach ethical criteria and previously approved companies which after mergers and acquisitions were involved in unacceptable activities. At least 7 of the sample funds informed companies of these ethical reasons for the divestment as a matter of policy, while 5 funds just sold their shares without contacting the companies about it. Media was not informed about divestment. In the following sections the three approaches: Twin Track, Commercial Ethic and the Integrated Approach are explained in greater detail. To some extent these categories overlap. For example all these approaches use some ethical criteria.

³²¹ Jupiter Ecology refer to their approach as a "twin track approach" (Jupiter, 1999).

³²² This "market driven, merchant" approach was identified in SustainAbility (2000).

³²³ The interviewee from NPI/Henderson Global Care referred to their "integrated" approach.

³²⁴ Among European ethical funds the commercial ethic is generally more common than for the sample funds. This difference reflects the sample, which included many of the more advanced ethical funds, which have improved their processes over many years.

Table 10.1 Ethical Fund Approach to Ethics

	Approach	Engagement	Screening (+) (-)	Fund Voting	Ethical Committee	In-house Research	Ethical Divesting
Ethical Funds							
ABF Andere Beleggingsfonds	TT/IA	Yes	(+) (-)	No	Yes	(6)	Yes
ASN Aandelensfonds	TT/IA	Yes	(+) (-)	No	Yes	Yes	Yes
Banco Hjälpfond	CE/TT	No	(-)	No	Yes	Yes	No
Banco Humanfond	CE/TT	No	(-)	No	Yes	Yes	No
Banco Samaritfond	CE/TT	No	(-)	No	Yes	Yes	No
Carlson Världsnaturfonden	CE	No	(-)	No	No	No	No
CIS Environ	TT	Yes	(+) (-)	Yes	Yes	Yes	Yes
FP Stewardship Income	TT/IA	Yes	(+) (-)	Yes	Yes	Yes	Yes
FP Stewardship Unit Trust	TT/IA	Yes	(+) (-)	Yes	Yes	Yes	Yes
Gyllenberg Forum	CE	No	(+) (-)	No	Yes	No	No
Jupiter Ecology	TT	Yes	(+) (-)	Yes (2)	Yes	Yes	Yes
Jupiter International Green	TT	Yes	(+) (-)	Yes	Yes	Yes	Yes
KBC Eco	CE/TT	No	(+) (-)	No	Yes	Yes	Yes
Murray Johnstone Ethical World (1)	TT/IA	Yes	(+) (-)	Yes	No	Yes	No
NPI/Henderson Global Care Income Trust	IA	Yes	(+) (-)	Yes	Yes	Yes	Yes
NPI/Henderson Global Care Unit Trust	IA	Yes	(+) (-)	Yes	Yes	Yes	Yes
Sampo Arvo	CE	No	(+) (-)	No	No	No	Yes
Scottish Equitable Ethical	TT	Yes	(-)	No (3)	(5)	Yes	Yes
Sovereign Ethical	TT	Yes	(+) (-)	Yes	Yes	Yes	Yes
Standard Life UK Ethical	TT	Yes	(+) (-)	Yes (4)	Yes	(7)	Yes

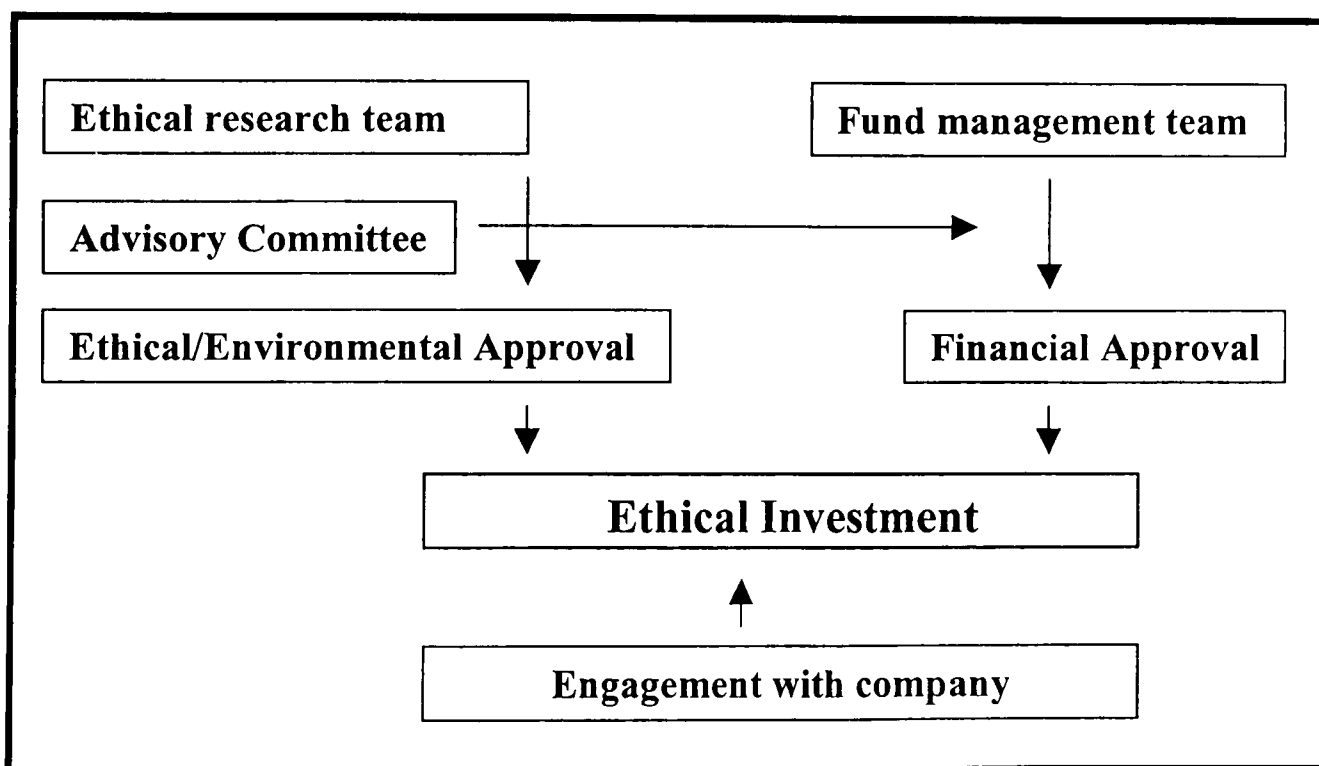
The table reflects the situation in the year 2000. The **Approach** column discloses whether the Twin Track (TT), Commercial Ethic (CE) or Integrated Approach (IA) is adopted by the fund. **Engagement** refers to whether the fund actively contacts companies on ethical issues. The **Screening** column reports whether the fund employs positive (+) and/or negative (-) ethical criteria. These criteria are presented in detail in Tables 9.2 and 9.3 in Chapter 9. The **Fund voting** column refers to whether or not the fund has actually voted its shares on ethical issues. The **Ethical Committee** column refers to whether the fund has an ethical advisory committee with external members. **In house research** refers to whether the fund had ethical researchers in addition to the fund manager. All ethical funds can sell firms for ethical reasons, the **Ethical divesting** column reports whether the fund had actually done so. The following numbers refer to the Table and further explain some details. (1) Murray Johnstone is now part of Aberdeen Asset Management. (2) Jupiter prefers dialogue but voted for example in a Rio Tinto resolution (3) Scottish Equitable ethical funds can vote their shares on ethical issues, but prior to the interview they had not voted. (4) The Standard Life ethical funds generally do not vote on their own, although they can do, but the corporate governance team of Standard Life may vote on ethical issues with their shares. (5) Scottish Equitable (part of Aegon) has an internal ethical committee, but its main role is with the Ethical Care Funds. An external committee was formed in November 2001. (6) ABF relies on a team of 6 ethical researchers working for SNS/ASN. (7) Standard Life corporate governance team and ethical fund manager do some research relating to ethical issues, but the fund does not have an environmental team like Jupiter.³²⁵

³²⁵ Financial companies specialising in asset management managed 9 of the funds in this table, 8 were managed by insurance companies, one by a bank. It is notable that large banks tend not to provide ethical funds in Europe. The interviewees suggested an explanation for this. The companies typically excluded by ethical funds may be large customers to the bank. They may thus be reluctant to upset key clients for the sake of a small “niche fund”. Indeed, all the “ethical” funds managed by banks in Chapter 6 were environmental funds with a limited coverage of ethical criteria.

10.2.1 Twin Track Approaches

The Twin Track Approach is a term coined by Jupiter Ecology.³²⁶ Twin track approaches are followed by a number of funds such as Jupiter Ecology and CIS Environ (see Figure 10.1). The key characteristic of this approach is that there is in-house ethical and financial expertise. Twin track funds research companies through two separate research processes; one ethical and one financial. The research into company ethical performance is mainly conducted by the fund's "ethical researchers" although external research is also used. Based on this research and other information, a pool of approved companies is generated from which the investment manager can choose. Both Jupiter and CIS have in-house specialist researchers who are responsible for the ethical/environmental approval of a company (such approval may be on positive, negative and/or best in class criteria).³²⁷ These choices are scrutinised by an advisory committee, which will make the decision in difficult cases. The majority of the advisory committee members are usually external experts.³²⁸ Figure 10.1 describes the approach adopted by Jupiter Ecology and CIS Environ.

Figure 10.1 One Specification of a Twin Track Approach



Source: adapted from Jupiter (1999)

³²⁶ See for example, Jupiter (1997) and Jupiter (1999).

³²⁷ Funds adopting a twin track approach would typically send out questionnaires to companies asking about environmental and ethical issues. Some funds such as CIS Environ requires a reply to the questionnaire as a condition for a company to be in the fund and some companies have been removed from the investable universe due to poor responses.

³²⁸ For example, environmental scientists and experts from Charities and Churches.

Another example of a fund adopting this approach would be Scottish Equitable Ethical. The interviewees at Scottish Equitable mentioned that the investment universe is “created” by the ethical researchers and the fund managers have no influence on this. Within the universe, the fund managers choose stocks on financial grounds and the ethical researchers have no influence over that activity. As one interviewee stated “there is a strict split between the two”. Over the years these funds have built up their own “case law”, based on advisory committee meetings, position papers on ethical issues and previous research.

There are a number of variations to this model throughout the industry. For example, Scottish Equitable Ethical has in-house ethical experts, but lacked an external advisory committee.³²⁹ In contrast, KBC Eco Fund in Belgium has a powerful external advisory committee which has to approve every stock, but apart from the fund manager there is no in-house ethical expertise. Such an approach can lead to a small number of approved stocks, less than 100 in KBC’s case. The Standard Life UK Ethical fund has a similar approach to KBC Eco Fund in that both have an ethical committee, but in addition Standard Life has an influential corporate governance team, which engages with company management and may vote the fund’s shares at a company AGM.

Some funds with a twin track approach undertake an internal ethical rating of companies. For example one continental fund had a 7 point rating from A to C. In this system A and B+ companies formed the investment universe. The fund manager often wrote to B and B- companies to suggest to them that publication of an environmental report or adoption of environmental auditing procedures could result in upgrading of the company to B+ status and thus inclusion in the investment universe. One UK ethical fund had 4 ethical categories; excluded, refer to the ethical researchers, approved and preferred. The first two categories were not (directly) available for investment, while the fund manager could freely invest in the approved and preferred stocks. These ratings made by the ethical researchers were available for the fund manager on the computer system.

³²⁹ Scottish Equitable formed an external ethical committee in November 2001.

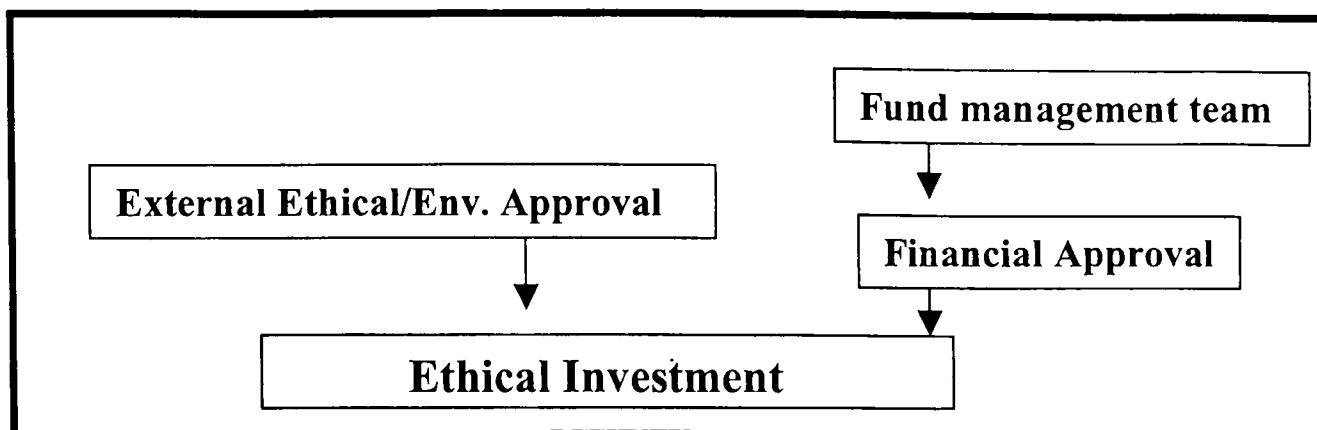
The analysis of the interviews and the fund material indicated that funds with a twin track approach generally had some understanding of the concept of sustainable development although it did not necessarily influence the investment process beyond avoidance of certain sectors and consideration of the eco-efficiency of companies.³³⁰ The ethical process for “twin track” funds such as Jupiter Ecology was based more on what Mackenzie (1997b) called systematic reasoning than solely mechanistic exclusionary criteria. Through this approach, ethical values seemed to be integrated into the investment process to some extent, although there was a degree of separation between ethics and finance.

10.2.2 The Commercial Ethic Approach

A number of funds have neither an ethical advisory committee nor conduct their own in-house ethical research. These funds adopt the “commercial ethic” approach and have, in some cases, followed their competitors into the market because they spot a profitable niche or because their clients have requested them to do so. Many of these funds might be described as “opportunistic” (SustainAbility, 2000). For this second group of funds, ethical information on companies is often obtained solely from external sources. This information usually includes a list of companies that the fund can invest in. The majority of these funds operate exclusionary ethical criteria in a mechanistic way and there is no engagement with companies on ethical matters. One fund manager from such a fund claimed that their “ethical” fund was purely a sector fund and said he had nothing to do with ethical issues. Another interviewee claimed that 60% of the UK ethical funds just buy the ethical research from external sources and operate mechanistic criteria. Many of these funds do not have positive criteria. The ethical criteria adopted by such funds are often determined by market surveys of independent financial advisors (IFA) and a review of the competition rather than ethical reasoning by the fund management team (Mackenzie, 1997b). Figure 10.2 describes the commercial ethic approach which is the same as for a non-ethical fund except that some sectors and/or companies have been excluded for ethical reasons by some external organisation such as EIRiS in the UK.

³³⁰ One fund mentioned they had had training on sustainable development (SD). Avoiding the automobile sector and investing in public transport instead was mentioned in the context of SD.

Figure 10.2 The Commercial Ethic Approach



Some of these funds differ from ethical funds which follow other approaches. For example, a UK interviewee called the ethical fund of his financial institution a “conscience fund”. This particular interviewee, considered “his own ethical fund” as only partly ethical because it did not have an ethical committee; it had no in-house ethical expertise and the financial institution had only entered the market recently motivated by the fact that many competitors had successfully launched ethical funds.³³¹ For these funds, the institutions managing them do not generally think that environmental or ethical research would contribute to financial performance. Rather, the objective is to cover a new market segment in a cost effective way. Generally these funds would neither engage with companies nor vote their shares on ethical issues at company annual general meetings. One interviewee thought that 75% of UK ethical funds follow the commercial ethic approach. He argued that it was common particularly among the more recent funds. As the ethics seemed to be largely ‘external’ for funds adopting this approach, it seemed as if this approach was less concerned about ethical motives and issues than the twin track approach when integrating ethical values into the investment process. This approach does not perform well if one agrees with Domini (2001) or Lydenberg (2002) who argue that there is more to ethical investment than screening.

10.2.3 The Integrated Approach

A more integrated and more advanced approach to stock selection and portfolio construction was identified among some funds. Indeed, for some funds,

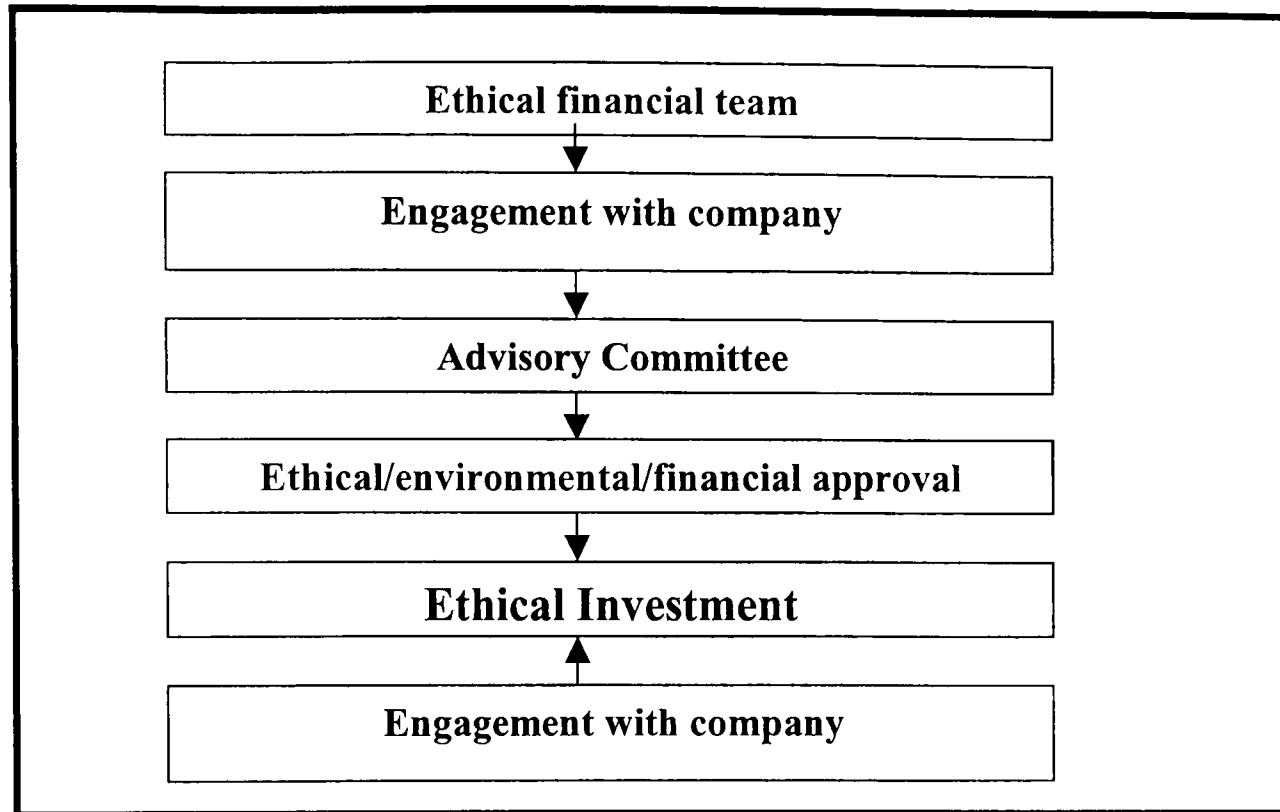
³³¹ These funds were described by Patrick Meehan of independent financial adviser Holden & Meehan as “me too funds” from financial institutions, which want an ethical fund in their range, without putting in satisfactory resources to manage them (Pridham, 2001, p.24).

environmental or ethical considerations appeared to drive the investment process. With these funds, the fund manager was typically one individual in the ethical team and had a personal interest in socially responsible investment. The approach taken by these fund managers was that “environment and ethics are a natural part of the financial analysis”. Fund managers and ethical researchers from these funds would regularly meet with companies and ethical matters would also be discussed. For example, ABF Andere Beleggingsfonds aimed to visit all the companies approved for investment over a minimum of every 3 years. The difference to the twin track approach is that there is not a “big separation from the normal investment process” but rather the ethical values are more closely integrated into the security selection process. A possibility that environmental and ethical research might have relevance for financial performance was acknowledged by these funds.³³² In addition, the team usually included expert researchers in ethical and environmental issues and an experienced external advisory committee. Typically, funds following this approach would, in addition to in-house research, also use a number of external organisations. For example, Murray Johnstone Ethical World Fund employed EIRiS for research on UK companies and Calvert for research on American companies in addition to research conducted by their in-house team.

Figure 10.3 describes the Integrated Approach. The main difference to the other approaches is that there is only one stream in this approach rather than the two in the other ones. The fund manager is thus “integrated” into the ethical team. Active engagement is always a part of this approach, which is not always the case with the twin track approaches.

³³² For example, climate change and its effect on the oil and renewable energy companies and their share prices was mentioned as an example and the interviewee claimed that “SRI can drive the investment process”. Individual companies such as Sony were also mentioned.

Figure 10.3 The Integrated Approach



Some funds such as the Dutch ethical funds ABF Andere Beleggingsfonds and ASN Aandelenfonds also had a tradition of lively annual general meetings for their ethical funds where unit holders would raise various ethical issues and concerns. Thus funds with an integrated approach would tend to have active contact with unit holders.³³³ Typically funds with a more integrated approach required companies to have good performance in many areas. For example, ASN Aandelenfonds required companies to score well on environmental, human rights and social criteria in addition to the financial yardsticks.

In practice, the distinction between the twin track approach and the integrated approach is not always clear. An example of a fund which appeared to be in between the approaches is Friends Provident Stewardship Unit Trust, which, prior to the launch of the “responsible engagement overlay” (*reo*TM) initiative and the strengthening of the ethical team, was closer to the twin track approach than to the integrated approach. This was because the in-house research capacity and the extent to which the fund(s) engaged with companies on ethical issues was much weaker prior 1998. With their new strengthened ethical team and the *reo*TM initiative however Stewardship may be closer to the integrated than the twin track approach. Ethical funds such as the NPI/Henderson Global Care

³³³ For example, Friends Provident, NPI and Murray Johnstone have newsletters for unit holders.

funds have a more integrated approach than most ethical funds. The main issue in the integrated approach is that the fund manager and some other key person involved with the fund have a strong personal interest in ethical issues in addition to a commitment to rigorous in-house research which is complemented by external analysis and an advisory committee.³³⁴ For example, at NPI the Global Care fund managers and the ethical researchers sit in the same room. The other major difference is that environmental and ethical concerns and values are integrated into the stock selection process rather than kept separate from it as in the commercial ethic approach. For example, Murray Johnstone Ethical World Fund has regional fund management teams and each of these includes an “ethical investment” specialist. Funds with an integrated approach often seemed most aware of the concept of sustainable development based on their answer to question 4 in the interview protocol (see Appendix 9.2) and the issues covered in material published by these funds. For example, it was claimed that the NPI/Henderson Global Care funds tried to interpret the concept of sustainable development through a scenario analysis of those sectors which would be necessary and successful in a more sustainable world. This analysis was one component in the sector allocation.

Voting on ethical issues was most common among funds with an integrated approach. The NPI Global Care funds were examples of funds which actively voted on ethical issues. Other ethical funds such as the Murray Johnstone Ethical World Fund also voted. In some cases such as the Rio Tinto resolution, their non-ethical funds also voted on ethical issues. It seemed that ethical values were most strongly integrated into the investment process by the integrated approach. Since the funds following an integrated approach had a larger staff researching ethical matters, had more active communication with unit holders and were more actively engaging with companies and voting on ethical issues than funds adopting a commercial or twin track approach.³³⁵ The ethical funds following the integrated approach also had more extensive ethical criteria and more active engagement than the commercial ethic funds (EIRiS, 1998; Holden

³³⁴ A tentative view of this was formed during the interviews depending on the answers to questions about ethics and sustainable development.

& Meehan, 1998; EIRiS, 1999). Integrated funds also had some ethical policy for the entire organisation and often there were additional initiatives such as the NPI and the carbon dioxide indicator, co-operation with WWF and a social index. Therefore they generally seemed to be better investments for investors with an active interest in ethical issues than non-ethical funds or ethical funds following a commercial approach in terms of their processes and strategy.

10.3 Financial Considerations Mentioned by Interviewees

One British interviewee argued that markets are inefficient and typically do not understand the financial implications of environmental and social issues. He argued that this provided an opportunity for ethical funds to earn superior returns by utilising information which was largely ignored by the market. Some fund managers mentioned that the consideration of environmental issues was a part of the financial analysis. A Belgian fund manager pointed out that some of the assets of firms which ignored environmental issues might end up as liabilities. One example given in this context was contaminated land and clean up costs. Another fund manager noted that he did not believe that firms which ignored environmental considerations could deliver value for shareholders in the long run. It was also claimed by a fund manager that investing in companies which met environmental and social criteria was “a good strategy because they have a clean image”. This in turn was seen as a “powerful marketing tool” in selling the ethical fund. Others too mentioned that clear ethical criteria was good for marketing the funds.³³⁶ Another interviewee mentioned that ethical issues could represent serious reputational risks. These findings are similar to Friedman and Miles (2001) who argued that many interviewees believed that “good environmental, ethical or social performance enhance shareholder value”. Some interviewees argued that despite some financial benefits from environmental management there was no clear evidence about whether good environmental performance lead to good financial performance or not. All interviewees seemed to agree that ethical funds ought to perform well

³³⁵ For example newsletters for unit holders and active fund Annual General Meetings were most common among integrated funds. Non-ethical fund voting on ethical matters also seemed most common among institutions with integrated funds.

³³⁶ Many UK ethical funds rely primarily on independent financial advisors (ifa) to sell the funds. Therefore it is an advantage to have clear criteria which the independent financial advisors can explain to customers.

financially as well as meeting ethical criteria. This performance requirement may explain the result in Chapter 7 of no significant difference in performance between ethical and non-ethical funds. However, a few interviewees recognised that due to sector and size biases there could be times when ethical funds would perform differently from non-ethical funds.³³⁷ A Belgian and a British fund manager pointed out that it was important to diversify not just internationally, but also by different sectors. Indeed, a Finnish fund manager claimed that 90% of the fund performance (for a mixed fund) comes from the asset allocation decision(s), between bonds and stocks and only 10% from stock picking.

Two Swedish interviewees mentioned that the period after launching the fund had been difficult in terms of attracting capital. It took more than a year to effectively launch the fund. If funds had a worse performance than normal in their first year then this could bias the results against the ethical funds studied in Chapter 6. Four of the ethical funds in the sample were launched less than 6 months before the time period studied.³³⁸ The young age of many of the ethical funds was perhaps another reason why many of the funds were small in size. One fund manager mentioned that the size of the (recent) ethical fund was 20 million Euro, and this was sufficient for the fund to break even, but not for being profitable for the institution. If ethical funds needed to have a portfolio of £15 million to be profitable, 12 of the funds studied in Chapter 6 would have been too small to be profitable for their institutions.³³⁹

The interview results supported the finding in Luther *et al.* (1992) that ethical funds tend to have a small company bias. Several interviewees indicated that their ethical funds had a small company bias. Sometimes this bias was partly a consequence of exclusionary ethical criteria. For example, Sovereign Ethical excluded 75% of the FTSE 100 stocks from investment, while another ethical fund had 65% of its portfolio in small companies. The largest ethical fund Friends Provident Stewardship also had a small company bias. One Scottish interviewee claimed that there was a tendency among financial institutions to

³³⁷ Sectors such as alcohol, chemicals, tobacco and weapons would often be underweighted.

³³⁸ This problem should not affect the study in Chapter 7, where funds were matched by age.

³³⁹ It seems unlikely that this would be the case as many sample funds established before 1993 had portfolios with less than £10 million of securities.

“follow the leader”. If this assertion is true a small company bias would be common among UK ethical funds, because FP Stewardship, the first and largest UK ethical fund had such a small company bias for 17 years (Luther *et al.*, 1992; WM Company, 1996; WM Company, 1999). A consequence of the small company bias was that some ethical funds held a large number of shares. For example, FP Stewardship held 190 different shares April 2001,³⁴⁰ while CIS Environ had 106 shares in May 2001. By contrast some ethical funds had a small number of firms in their portfolios. The smallest number of companies in an ethical portfolio was Carlson Världsnaturfonden with 29 companies.³⁴¹ The average number of securities in the sample ethical funds was around 70.

The maximum limit for one share differed substantially among the funds. For example, The 5 Banco ethical funds analysed in Chapters 6 and 7 often invested up to 10% in one stock, while another ethical fund had a maximum limit of 2% of the portfolio in any one stock.³⁴² A more common limit was the one employed by ABF Andere Beleggingsfonds and ASN Aandelensfonds of a maximum of 5% invested in any one share. Table 10.2 summarises some of the differences between ethical and non-ethical funds which could impact performance.

Table 10.2 Differences between Ethical and Non-ethical Funds

Ethical Funds	Financial impact
Ethical advisory committee	Wider information set used
Ethical researchers	Wider information set used
Ethical criteria	Smaller investment universe
Selling shares for non-financial reasons	Problems with market timing

This table outlines some differences between ethical and non-ethical funds. Some (but not all) ethical funds have advisory committees and/or employ specialist ethical researchers. This wider set of information could be a source of superior performance if some risks can be identified earlier. Ethical criteria may reduce the investment universe. In some cases only a few firms are excluded, but in other cases most of the listed shares may be unavailable for investment. In the first case no significant financial impact is expected, but extensive exclusions could harm financial performance. Selling shares for non-financial reasons could be a reason for the poor market timing of ethical funds documented in Chapters 6 and 7.

³⁴⁰ All of these were UK listed companies of which 23 were in the FTSE 100.

³⁴¹ In addition Carlson Världsnaturfonden had 4% of the fund invested in two other funds. Gyllenberg Forum had 27 companies, but the majority of assets were in EU government bonds. ABF Andere Beleggingsfonds had 36 companies plus 29 interest bearing securities.

³⁴² Indeed, all the 5 Banco ethical funds analysed in Chapters 6 and 7 had more than 24% of the fund in 3 stocks including more than 9,5% in one company, Ericsson.

10.4 Ethical Considerations Raised by Interviewees

A general observation from many interviewees was that the funds had to be reasonable towards companies, or “a little bit nice to them” as one interviewee said as companies might not “work with” them in the future otherwise. For example, a Dutch interviewee argued that companies could not be “100% perfect, that is not possible”, while another mentioned that almost all manufacturing firms are at some stage fined for environmental reasons. The difficulty of drawing the boundaries of “ethical investment” both in terms of criteria and definitions was reflected in some interviews. For example, one sample fund did not have clear published criteria; ethical issues were considered in detail by the ethical committee.

Another point raised concerned the origin of the ethical funds and the source of their ethical criteria. Chapter 2 argued that Churches and later the environmental movement had a significant role in many of the early ethical funds. These organisations held certain views which were operationalised as ethical criteria. Some of the more recent funds were less clear on where their ethics come from. For example, a Swedish fund manager mentioned that “ethical criteria are based on discussion” with different stakeholders. Some UK interviewees stated that their institutions had followed a “market based approach” including surveys of independent financial advisors, a study of existing funds and sometimes a survey of investors to determine the ethical criteria which they should adopt. Indeed, this market based approach was a characteristic of many recent funds following the commercial ethical approach. Some ethical funds have worked with organisations such as the Worldwide Fund for Nature (WWF) or various Churches. These funds mentioned that the aims of the partner organisation influences the ethics. In the UK and Finland, in particular, there seemed to have been a convergence of views regarding ethical criteria. Many environmental funds have expanded their criteria from environmental to various ethical issues such as human rights, while traditional ethical funds have embraced a range of environmental screens such as pollution and nuclear power in addition to traditional ethical concerns. This convergence may have been due to competition and the influence of research organisations such as EIRiS and Ethibel.

A Dutch interviewee argued that the ethical approach taken by an ethical fund depended on the character of the client. Another interviewee mentioned that trade union clients were less interested in avoiding companies and/or sectors and more keen to engage with management on the issues which interested their members. Church investors on the other hand had areas which were deemed unacceptable for investment. A UK interviewee argued that many financial institutions were merely responding to customer demand rather than providing something very ethical. The personal ethics of the interviewees is discussed in Appendix 9.5. At least one interviewee mentioned that this might influence the composition of the portfolio. Another British interviewee mentioned that in the absence of an institutional ethical policy the personal ethic of (key) employees is important. Around 70% of the interviewees were a member of some Church and almost 60% were members of at least one NGO.

10.5 Conflicts between Ethics and Finance

One of the areas explored through the interviews was whether the interviewees perceived there to be a conflict between ethical and financial issues.³⁴³ These conflicts between ethics and finance may be important for the question of whether funds are a good investment in an ethical sense. A British interviewee put the problem in terms of two extremes. The first extreme is a fund with ethical criteria (if any) that are so lax that they invest in anything. The other extreme would be a fund whose criteria were so strict that no company would qualify for investment. The ethical funds occupied positions somewhere along this continuum, but the multiple aims of these funds might generate conflicts. These conflicts date back to the early days of ethical investment funds in Europe as mentioned in Chapter 2.³⁴⁴

Some tension between ethical and financial aims would seem natural for ethical funds. Indeed, some level of “conflict” might even be a characteristic of an

³⁴³ Harte *et al.*, (1991) specifically requested research into this area. Page 3 of the interview protocol presented in Appendix 9.2 outlines the questions asked to explore this area.

³⁴⁴ According to Charles Jacob, the applications to launch the Stewardship ethical fund were rejected twice by the Department of Trade in the 1970's. The main reason given was a conflict between “capital and conscience”. Another early conflict between ethics and finance was within Friends Provident. It had, as a Quaker company, avoided investments in alcohol, gambling, tobacco and weapons. In 1980, the board which by then was “secular” decided to remove these “restrictions” (Mackenzie, 1997).

ethical fund. The lack of tension would perhaps indicate a complete domination by financial considerations.³⁴⁵ These issues are explored in detail in this section.

Many interviewees seemed uncomfortable with the notion that there was a possible conflict between ethical and financial performance. One UK interviewee admitted that “ethical funds are a compromise”. Another view was that “there is no conflict between ethics and high returns” or that “we do not recognise such a trade off”.³⁴⁶ It was argued by a British interviewee that a compromise between ethics and finance is due to the customers’ compromise; one fund manager mentioned the issue of “cheap clothes vs. labour standards”. One fund manager mentioned that conflict between ethics and finance “happens all the time”. This UK fund manager then mentioned how she sometimes wanted to invest in a company, but the ethical researchers said “absolutely not” for ethical reasons. On the other hand, she mentioned how the ethical researchers might recommend a company based on ethical credentials and she would say “absolutely not” on financial grounds. A Belgian fund manager made the same point by noting that some companies are very attractive financially but do not meet the environmental criteria.

Another interviewee was asked what an optimal environmental fund might look like. She replied that “if you want to be really green then don’t invest in the stock market, full stop.” This view was reinforced by a British interviewee who argued that “if you have a big problem with the profit motive, don’t invest in the stock market”. One ethical researcher mentioned that in an optimum ethical portfolio, all companies should score well on environmental, social and financial performance. The manager of a Swedish fund was unable to answer the question as his organisation did not have such a product (eg an optimum ethical fund), while a UK interviewee said that their “portfolio is the optimum portfolio”.

One fund manager had held on to the shares of some companies such as the Body Shop and Northern Rock – which he considered to be ethical although their financial performance was weak – in order to have a more ethical portfolio.

³⁴⁵ One fund manager mentioned that most funds give a 100% weighting to the financial side.

³⁴⁶ Another interviewee argued that there was not a problem because they had a clear ethical policy and they had also achieved good financial performance.

However, he suggested that a part of this holding was sold because of the financial considerations. This fund manager argued that “a balanced portfolio with a reasonable level of ethicality and financial performance can be constructed. There does not have to be a trade off”. He was also concerned that a very ethical portfolio would mean high financial risks because many sectors would be excluded and there would be a bias towards small companies from a few sectors.

The interviewees indicated that there might in some cases be pressure on ethical researchers to approve companies for financial reasons although this might not necessarily be desirable from an ethical point of view. An example of this involved fund managers who wanted to invest in some large companies which were excluded because they did not meet certain ethical criteria. Eventually a large UK oil company which one of these fund managers wanted to invest in was approved and included in an ethical fund. A Dutch interviewee mentioned that ethically progressive companies might not be considered even for research if their financial performance was not good enough. The dominance of financial considerations was reinforced by another expert. She argued that there are no ethical funds (in the UK) marketing themselves on high ethics and low financial returns and no (UK) funds giving part of the returns to charity because the market does not see the demand for such products.³⁴⁷ A key factor here she argued was that unit trusts were sold on past performance.

A further trade off concerned the divestment of a company from an ethical portfolio when the company breached the ethical criteria of the fund due to a merger, an acquisition or for some other reason. Three ethical funds gave examples where they had instantly sold companies when this happened, whereas three other ethical funds said the fund manager had up to six months to divest the shares. A longer period may enable the fund to get a better price at the cost of actually breaching its own ethical criteria for a short time. One interviewee justified this by stating that it enabled the fund to fulfil “its fiduciary duties towards unit holders”, while another argued that selling immediately may “harm unit holder interests”. A Swedish ethical fund manager mentioned that: “It

³⁴⁷ In Sweden many ethical funds give 1-2% of returns to some Church or Charity.

would be unethical to divest a company just because a newspaper writes a critical article”. This interviewee indicated that he might sue a fund manager if he was a unit holder in such a fund. An ethical problem was that companies that were not approved for investment had entered some portfolios through mergers. One example was AstraZeneca. Astra was in the portfolio but Zeneca was not approved for investment, yet AstraZeneca was kept in the portfolio. Most of the interviewees indicated that they always contact the company to get their explanation of what happened – when some criteria was breached – before the shares would be sold.³⁴⁸

An issue often related to mergers and acquisitions is downsizing. This was a difficult issue for the interviewees. One expert mentioned that “it is difficult, everyone is doing it” and that downsizing is not a criterion for them. Another interviewee said that “lay offs are very, very tricky” and mentioned that they looked at the whole process of a merger or shifting production to other countries over a period of time. For example, the fund considered whether anything was done for the staff left unemployed. If production was moved to other countries, were the same environmental standards adhered to in that location as in the home country. A British interviewee argued that social issues such as lay offs were difficult because they tended to get political and his financial institution wanted to be “politically neutral”. Another UK fund manager also mentioned that his institution was “apolitical”.³⁴⁹ A continental fund manager mentioned that lay offs were not a big problem for his fund because most of the investments in the ethical fund were in service sectors rather than manufacturing where most of the shifting of production to other countries occurred.

A further issue that was raised concerned the ethic of the financial institution managing the funds. For example, one British interviewee moved to another institution because she thought the Chief Executive of the previous institution had a negative attitude towards the environment. Another interviewee mentioned that her institution had “no written ethical policy, it is just personal

³⁴⁸ An example was a company that was fined for an environmental breach but the breach was caused by sabotage from a third party. This company was therefore kept in the portfolio.

³⁴⁹ Perhaps this is why ethical funds at large have avoided issues such as genetic engineering, the multilateral agreement on investment and third world debt (Mayo and Doane, 2002).

ethics”. This may be a challenge if the majority of staff at the financial institution think that “ethics is nonsense” as a Swedish fund manager put it. Some UK interviewees mentioned that for some fund managers “Microsoft is more important than Hong Kong” or that “ethics will not be considered by institutional investors if it leads to a 0,5% annual reduction of portfolio return”. It was clear from the interviews that there was an internal conflict in some financial institutions regarding the role of ethics in investment. Some individuals held the financial-utilitarian view that high returns was the only ethical aim, while ethical fund staff were, in some cases, willing to let ethical considerations override purely financial objectives. External members of ethical committees also often put a higher priority on ethics. It is pointed out in Mayo and Doane (2002) that many fund management companies don’t practice themselves what they require from the firms they invest in.

In most cases the ethical fund(s) represented only a small proportion of the assets of that financial institution. Indeed, only 3 of the sample institutions employed ethical criteria for more than 20% of their assets.³⁵⁰ Because of the relatively modest proportion of assets in the ethical funds Friedman and Miles (2001) argue that they have lacked “power and influence”. Often, the ethical funds had extensive ethical criteria – Friends Provident Stewardship – for example, but the other funds managed by these institutions did not adhere to these criteria. A possible ethical conflict may arise if the financial institution as a whole is a big investor in pornography, tobacco and weapons (Friends Provident, 2001).

Mergers and acquisitions among financial institutions themselves was seen as another related challenge. For example, investors in the small independent Spanish firm managing the ethical fund Fondo Etico – with close NGO links – found themselves to be clients of Morgan Stanley Dean Witter, which acquired

³⁵⁰ These were ABF (100%), ASN (100%), Banco (30%). A majority of funds managed by CIS and Friends Ivory & Sime are part of their engagement initiatives, but no strict ethical criteria are applied for these funds. For many financial institutions the funds managed ethically would be less than 3% of the assets.

this firm.³⁵¹ In Sweden, a leading ethical fund provider – Banco – was acquired by a larger Swedish institution, which in turn was bought by the Dutch bank ABN Amro. Similarly Merlin in the UK was acquired by Jupiter which in turn was acquired by Commerzbank of Germany.³⁵² Thus, investors who invested in a small institution which was perhaps committed to the ethical aspects – or as one interviewee put it, investing in a fund “started for the right reasons” – soon found themselves investing in very large international institutions for which ethical funds were a small niche market at best. A Finnish interviewee argued that the “institutional investors” determined what happens in the market, while another mentioned that financial utilitarianism was the norm among institutional investors.³⁵³ A Dutch interviewee thought of this in positive terms and argued that the ethical team was doing their best to influence the “non-ethical” funds. Some other interviewees also discussed the financial implications of ethical issues with analysts and managers of the non-ethical funds. Non-ethical funds may therefore occasionally avoid investment in a company (for apparently) ethical reasons.

Another perceived trade off concerned the number of companies that were excluded on ethical grounds. One interviewee mentioned that if all the EIRiS criteria were adopted by a fund in the strictest way, only 2% of companies listed in the UK would be eligible for investment. Therefore funds had to balance ethical and financial considerations in arriving at a decision about what was and what was not acceptable. A striking example is Murray Johnstone Ethical World and Standard Life Ethical which prior to their launch, envisaged more strict ethical criteria, but due to the large number of excluded companies the criteria were modified to become “more inclusive”. Challenges for diversification both in terms of sectors and geographic areas often occurred. For example, Scottish Equitable Ethical was marketed as a vegan fund, since 2001. This means that all food companies are excluded from investment. Therefore the interviewee

³⁵¹ One interviewee thought it a problem that executives from financial institutions such as Morgan Stanley Dean Witter were treated as gods by company management. She further argued that this firm deliberately had caused havoc in Asia to profit from it

³⁵² Fondo Etico was the only fund managed by the company, thus “100% ethical”. Merlin had one ethical and one non ethical fund “50% ethical”. After the acquisitions only a fraction was managed “ethically”. There has also been many other mergers affecting the sample funds.

³⁵³ Another interviewee argued that they had many small clients because ethical investors often do not have much money. He claimed that large investors often don’t care about ethics.

mentioned that pension funds were not interested in this fund as it had “too many exclusions”. One sample fund had a list of 60 countries which it saw as problematic on human rights grounds. The approach taken of approving or excluding companies for/from investment varied from Carlson Världsnaturfonden and Gyllenberg Forum, which excluded less than 15% of the companies on the Stockholm and Helsinki Stock Exchanges to some Dutch and Belgian funds with less than 90 companies approved for investment globally. As these restricted Belgian and Dutch funds had a strong financial performance, the real conflict may be less important than the perceived conflict, (Kreander, Gray, Power and Sinclair, 2000).

One of the main findings from the interviews was that financial consideration generally seemed to dominate the ethical for the sample funds. Ethical unit trusts are perceived to have a duty to maintain a reasonable financial performance. Several interviewees made statements such as: “No company is invested in for solely ethical reasons” and that “environmental and ethical have to perform as well as other funds” and “financial aspects come first, we do not take an idealist approach”. It became very clear during the interviews that the financial performance dominated any ethical concerns for the fund managers. One of them said: “One can never forget the demands for financial returns”. A Belgian fund manager thought of the question of an optimum ethical portfolio without financial constraints as “a very bizarre question”. Indeed, one expert argued that the dominance of the financial criteria is due to the fact that unit trusts are sold on past performance. It may also reflect the concerns of the charity and pension fund market where there is a stricter legal fiduciary duty. Many of the ethical researchers also emphasised the importance of financial performance. This domination of the financial considerations within financial institutions indicates that ethical funds would not be suitable channels for investment for individuals with deep concerns about the profit motive.³⁵⁴ By contrast, some interviewees pointed out that some members of the ethical committees gave a high priority to environmental or ethical considerations.

³⁵⁴ For example Murray Johnstone (Aberdeen Asset Management) had the following statement on their website “Our sole aim is to help investors maximise return on their investments”.

A different conflict between ethics and finance concerns the marketing material of some ethical funds. Unrealistic marketing claims for ethical funds were documented in Harte *et al.* (1991). Indeed, honesty in marketing claims was one recommendation made in UKSIF (2000) for good practice among ethical funds. Yet two interviewees mentioned that some ethical funds were less than honest and even misleading in their marketing material. Essentially these interviewees pointed out that claims such as “no harm done” by a leading UK ethical fund provider or promises of substantial “environmental dividends” by a Norwegian ethical fund were nonsensical at best.

Several interviewees mentioned that financial products provided by small ethical banks were an alternative to ethical funds. Because ethical funds are generally limited to stock markets they will always be more ethically constrained than ethical banks/institutions such as ASN, Shared Interest and the Triodos Bank.³⁵⁵ Indeed, two interviewees mentioned that those investors with serious reservations about the profit motive and/or environmental issues could, through investing in the Triodos Bank, support sectors such as renewable energy more effectively than by investing in quoted companies. This is in line with the claim of another expert that “there are no ethical companies, only companies which meet certain ethical criteria, and the companies quoted on stock exchanges tend to be the least ethical companies”.

Finally, the issue discussed in the previous Chapter relating to the role of ethical funds and voting at company annual general meetings was raised by some interviewees. Several interviewees argued that it was not their role to tell management how to run their companies; many ethical funds, particularly the continental European funds extended this argument to abstaining from voting on ethical issues. The interviewees thus indicated that some of the funds who claim to “engage” with companies do not actually actively encourage good environmental or ethical practice among companies in the portfolio. Their engagement was mainly limited to information gathering. One author who expressed concern about the vague ethical policies of pension funds was

³⁵⁵ For example a Dutch interviewee mentioned the ethical bank Triodos positively 9 times.

Guptara (2001). He claimed the many of these statements which refer to engagement with companies are so general that they mean nothing in practice. A concern which was raised by two UK interviewees was that many pension funds in the wake of recent regulations “want to become ethical without changing anything”. Some interviewees seemed to think that the only practical change for some pension funds was a sentence on “engagement” in the investment policy in order to make it “ethical”.³⁵⁶

This ambiguity regarding engagement and voting raises questions of how accountable the ethical fund managers are to their unit holders and whether the ethical objectives of the unit holders are being met by ethical funds which either do not vote their shares or always vote with management. Thus it would seem as “ethical funds are a compromise”, but as an English interviewee pointed out it may be “the customers compromise”.³⁵⁷ This imperfection was recognised by some interviewees, one of whom argued that “the world is not perfect but we must try our best”.

10.6 The Limits of Ethical Funds

Another important aim in this field study of ethical funds was to get some understanding of what they can achieve and what their limits are. In the previous section, many interviewees argued that laying off personnel and moving production is one issue which ethical funds cannot address. One ethical researcher mentioned issues such as housing and unemployment, but these concerns generally fell outside of the scope of ethical funds. It was mentioned that “savings in a community should stay in the community”. Such concerns cannot be addressed through ethical funds, where even the funds focusing on the home country typically invest in many multinational corporations. Indeed, most sample funds invest only in companies quoted on stock exchanges. On the other hand some interviewees had a pragmatic stance and wanted to ensure that all

³⁵⁶ Indeed, this view was perhaps supported by the interviewee at EIRiS who in December 2001 mentioned that pension fund clients had not significantly increased in 2001 for EIRiS.

³⁵⁷ Some ethical researchers expressed hesitation of making judgements of what is ethical. Especially in difficult cases they preferred to leave this choice to someone else such as an ethical committee or the investor in terms of choosing a fund which matches the ethical preferences.

investors would have the option to integrate at least some ethical considerations into the investment process.

Another challenge was to effectively monitor working conditions in other countries. For example a Dutch interviewee noted that “voluntary codes of conduct are a joke in a place like the Maquiladoras in Mexico”. Another interviewee on the other hand gave an example of how Sony had been successfully challenged over the issue of dismissing pregnant women in their South American operations. One interviewee argued that “multinational corporations have diverse operations” and that individuals who have a major problem with that perhaps ought to avoid stock market investments. Because of the difficulty of controlling large corporations one UK interviewee argued that “legislation and regulation are important in driving company behaviour”.

The main limitations of ethical funds seemed to be linked to the stock markets and the financial system itself. One interviewee specifically mentioned problems with accountability and “the politics of fund management”. He argued that governments are powerless to regulate global companies. He argued that shareholders/investors were the most powerful group in terms of influence over companies. He did not think that ethical investing could change the system, but argued that the balance could be altered towards more accountability.³⁵⁸ This is in line with Mayo and Doane (2002) who argue that ethical funds have a vested interest in keeping quiet on larger issues such as third world debt.

It was recognised by at least five interviewees that there are not that many ethical companies on the stock exchanges. Therefore some interviewees recognised that their ethical funds included some “ethically neutral companies”.³⁵⁹ An English interviewee mentioned that Church funds which employed ethical criteria for longer than ethical unit trusts were not fully ethical

³⁵⁸ Secondly, he claimed that to a large extent even financial stakeholders such as fund managers were unable to check company management. Thus he argued that the interests of business were winning at the expense of other groups. This was similar to the view in Greider (1997) according to which no-one effectively has control over the global market system. Another interviewee mentioned the importance of legislation and regulation as a driver of company behaviour.

³⁵⁹ One interviewee argued that “no company is so wonderfully good there is nothing bad about it and no company is so bad there is nothing positive about it”.

either. Particularly in its early stage this interviewee called the approach of one Church fund “semi-ethical”.³⁶⁰ It was also difficult for ethical funds to support many positive sectors such as renewable energy, because ethical funds tended to limit themselves to companies quoted on a stock exchange and many companies in sectors such as renewable energy are not quoted (Friends Provident, 2001). One interviewee mentioned that ethical funds therefore could not be as effective as the Triodos Bank which financed and supported renewable energy directly. Indeed, another interviewee said that “ethical investing is about achieving incremental change in the margin. It cannot change the system since it is part of it, but the balance can be altered towards more accountability”. Similarly a Dutch interviewee argued that because ethical funds comprise less than 2% of the assets managed by Dutch financial institutions there were limits to what they could do. He claimed that the ethical funds have made a contribution towards a more positive business climate where sustainability issues were considered by businesses. This point was also recognised by Guptara (2001). Indeed, in the countries studied ethical funds represented only a fraction of the market capitalisation of the respective stock exchanges. It might therefore be likely that even in companies frequently found in ethical portfolios, the interests of non-ethical investors would dominate.

Related to this was the issue discussed in the previous section that funds “managed ethically” typically comprised only a (small) minority of the assets of a financial institution.³⁶¹ In these institutions many ethical fund managers also managed non-ethical funds and were part of various in-house teams. One UK interviewee described their approach which is based on an international macro economic model. The model started with regions and then proceeded to countries and industry sectors based on the house view of developments. Thus a country and sector allocation was determined on economic grounds and was then given to fund managers to choose the appropriate companies to invest in. For the ethical funds this meant that the first two steps in the stock selection process were determined by financial considerations before ethics entered the

³⁶⁰ This fund avoided the alcohol, gambling, pornography, tobacco and weapons sectors.

³⁶¹ Friedman and Miles (2001) quote an interviewee at Friends Provident “Large fund managers don’t like to be seen to be too radical because they have lots of other clients”.

equation.³⁶² Similarly another interviewee mentioned that the institution has model portfolios which were tailored to different funds. A third fund manager mentioned that together with the ethical researcher they had meetings with other fund managers every morning. Therefore some ethical and non-ethical funds managed by the same institution might have many common holdings, as was the case with Banco. There was thus a possibility for ethical fund managers and researchers to influence the mainstream investment process and bring ethical issues into it. Particularly fund managers who managed both ethical and non-ethical funds had an opportunity to bring ethics into mainstream investment.³⁶³ On the other hand there was a risk that purely financial considerations would dominate.³⁶⁴

A further limitation to ethical funds as a group identified in the previous sections was that the majority of ethical funds which followed the commercial ethic approach did not raise ethical issues with company management. Even some funds with a twin track approach did not vote their shares on ethical issues. This problem was even worse for ethical funds which merely tracked indexes such as the Dow Jones Sustainability Indexes or the FTSE4Good indexes. These “ethical” index funds also excluded many of the small companies found in other ethical funds from investment.³⁶⁵ Some interviewees were very sceptical about the rigour of the research which the Dow Jones Sustainability index was based on.³⁶⁶ Some funds such as SEB Miljö which previously specialised in environmental technology stocks had in order to reduce risk shifted emphasis towards larger companies such as those in the Dow Jones Sustainability index.

³⁶² Although, the country and sector allocations might differ for the ethical funds as certain countries and sectors are excluded.

³⁶³ One ethical fund manager mentioned that his non-ethical fund had no tobacco stocks and that it included stocks from the ethical fund although he argued that the two portfolios were different.

³⁶⁴ For example two ethical researchers mentioned that they went to the relevant fund manager or analyst to discuss ethical issues which might affect the risk or returns of the company.

³⁶⁵ For example, Kuisma (2001) argued that many of the largest Finnish corporations such as Kesko and Rautaruukki which were in the initial Dow Jones Sustainability Index were removed in the revision in year 2000 for no other reason than “being too small”.

³⁶⁶ For example, one fund manager mentioned that a company in the Dow Jones Index which is supposed to be free of weapons manufacturers generated substantial revenue from making parts for American attack helicopters. He claimed this business was obvious even on the company website. Another interviewee said that SAM researched many companies very, very quickly.

A positive aspect was that some interviewees claimed that ethical funds held their shares longer than the average portfolio managed by the institution. This was partly related to the “small company effect”. One Scottish fund manager mentioned that because selling (a large quantity) of a small company could more easily result in a fall of the share price, the trading with these small company shares was less frequent than the large company shares. Another UK fund manager mentioned that he knew several small company CEOs by first name and met them regularly, while the contact with large companies was much more impersonal. Holding (small company) shares a longer time provided better opportunities for engagement with the companies. Similarly, many interviewees mentioned that the “ethical” investors also kept their holdings in the ethical funds longer than average investors held non-ethical funds managed by the same institution.³⁶⁷

10.7 Interviewee Discussions Relating to Christianity

Chapter 2 outlined how some financial institutions prominent in the “ethical investment” area such as Friends Provident and NPI were started by the Quakers. It was also noted how Methodists such as Charles Jacob had a key part in the development of the ethical fund sector in the UK through the Stewardship fund.³⁶⁸ Other Churches had key roles with early ethical funds in Finland, Germany, Sweden and The Netherlands. This section mentions some additional points to those mentioned in Chapter 2. Of the institutions in the sample for the formal interviews 80% mentioned some link to Christianity when asked. For more than a third of the interviewees there were links to Christianity related to the history of the funds and the current customer base. Typically Church investors or Christianity in some other context was referred to a few times in an interview.³⁶⁹ One interviewee mentioned that an active member of the Church of England played an important role when the Ecology team from Jupiter moved to NPI in 1994. This move resulted in the launch of many ethical funds including the NPI Global Care Income Fund analysed in Chapters 6 and 7. The

³⁶⁷ The Finnish ethical fund Sampo Arvo recommended investment for a minimum of 4 years.

³⁶⁸ Charles Jacob argued that a key factor in the early success of Friends Provident Stewardship was the support it got from The Church of England, Methodists, Quakers and other Churches.

³⁶⁹ For example interviewee A referred to Christianity 3 times, while interviewee Q mentioned various Church groups 55 times. At least 17 of the interviewees for the formal interviews made some reference to Church investors or Christianity, excluding their own background.

interviewee argued that the “NPI Global Care Funds reflect the broad religious and cultural values of society”. In this context the “Judeo-Christian tradition” was mentioned as one of these influences, while environmental concerns were mentioned as another influence.

Interviewees from at least two funds mentioned that their ethical funds had adopted a risk averse approach because a Church was a key customer. Indeed, some of the continental ethical funds with Church links invested part of the assets in bonds to reduce the risk of the fund. If a risk averse investment policy was an implicit part of the policy of ethical funds more generally it might perhaps explain the surprising result from Chapter 7 that ethical funds seemed to be less risky than the non-ethical match pair funds.

Many of the sample institutions had gained experience in managing Church funds ethically prior to the launch of their own ethical retail fund. One example was Murray Johnstone, which had managed funds ethically for Church clients since 1988 and launched their first ethical retail fund in 1999. Only 5% of the funds Murray Johnstone managed ethically was in their ethical retail fund in the year 2000, while the majority of the ethical portfolios were managed for institutional Church clients. The interviewee also mentioned that “religious organisations continue to be the mainstream investors” in the Aberdeen (previously Murray Johnstone) Ethical World Fund. A Dutch interviewee mentioned that they managed several portfolios ethically for religious organisations in addition to the ethical funds and that “monasteries are very progressive in sustainable asset management”. Interviewees from Finland, Sweden, The Netherlands and the UK mentioned that Church investors were still key clients for the ethical funds. Similarly the interviewee at EIRiS mentioned that Churches were an important client group, although now declining in relative importance. One interviewee mentioned that the hope of attracting Charity and Church clients could have been a reason for some financial institutions to launch ethical funds.

10.8 Conclusions

The field study conducted for this dissertation found substantial differences in approaches to stock selection and ethical criteria among the sample funds. This Chapter considered three approaches to stock selection adopted by ethical funds; the twin track, the commercial and the integrated approach. Some effort to contribute to positive change was a feature of funds with an integrated or twin track approach. This change dimension was missing in the commercial ethical funds. It was argued that funds with an integrated approach seemed to have more processes and strategies in place for considering ethical issues than other ethical funds, particularly in comparison to the funds following “a commercial ethic” approach. Integrated funds such as the NPI Global Care funds also had more substantial ethical criteria and an ethical policy for their own financial institution (EIRiS, 1998, Holden & Meehan, 1998). Ethical funds with a twin track approach also had procedures and structures in place to ensure that ethical values were incorporated into the investment process. Those funds adopting a commercial approach seemed to be least successful in actively considering ethical issues. Compared to non-ethical funds commercial ethic funds still ensured that certain sectors or companies were excluded for ethical reasons. These 3 categories identified; commercial, twin track and integrated were not always entirely discrete or precise, rather they represent a first step towards theory building or “skeletal theory” (Eisenhart, 1988; Laughlin, 1995).

Some interviewees thought that ethical funds had contributed to a climate where ethical and environmental issues were considered by (some) companies. Examples were given where positive change in companies was achieved by ethical funds. These examples included increased reporting on environmental and social issues, adopting environmental management systems, stricter monitoring of suppliers, ethical policies and avoidance of some acquisitions for ethical reasons. On the other hand issues relating to the economic system such as lay offs, moving production and substantial change of the financial system itself were seen to be outside the remit of ethical funds.

Ethical fund influence was limited by a number of factors such as their small size relative to the market and to the non-ethical funds managed by the

institution. Although the exact emphasis varied from fund to fund, the financial considerations generally seemed to dominate the ethical ones for the sample funds.³⁷⁰ Thus ethical funds seemed to be a good investment primarily for those investors who recognised some environmental and ethical problems associated with corporate activity and were willing to consider these issues in their investments. Investors in these funds thought the ethical criteria were important (Lewis and Mackenzie, 2000; Woodward 2000). Examples of such investors included Church, Charity and pension funds in addition to individual investors. Indeed, it would seem that the ethical investment strategies outlined in Chapter 9 and this Chapter might enable pension funds and Charities to integrate values into their investments to a certain degree. For example the Environment Agency (2001) identified their pension fund as one of their key environmental impacts.

Ethical funds were found to employ various means such as internal and external research on ethical issues, ethical advisory committees, divestment on ethical grounds, company visits and written dialogue with management on ethical issues to implement engagement and screening strategies. The investment processes of ethical funds in general and for integrated and twin track funds in particular seemed to integrate ethical values into the investment processes to a greater extent than non-ethical funds. Thus the interview study agreed with Mills (2001) who argued that “ethical funds offer a definite improvement over ordinary funds, but they are not a panacea”. In terms of their investment processes ethical funds seemed to be “good” investments “ethically” in comparison to other funds. The field study demonstrated that the variance in ethical fund processes was as great as the divergence in financial performance.

For investors with deep green views or serious reservations about the profit motive, ethical funds might not be able to meet their expectations. Alternatives such as the Triodos bank and Shared Interest were suggested by interviewees for investors wanting to address ethical issues directly. The next Chapter provides an agape based Christian perspective on ethical investment, whilst also considering insights from the ethical theories presented in Chapter 3.

³⁷⁰ Some interviewees thought that there would not be demand for investment products which would give financial returns secondary importance.

Chapter 11 Agape Based Ethical Reflection

11.1 Introduction

The previous two Chapters have described the field study and presented the interview findings. The field study indicated that ethical funds had processes and strategies in place to implement ethical policies. Although there were problems, they seemed to be good investments “ethically” compared to their non-ethical counterparts in this sense.³⁷¹

This Chapter seeks to consider briefly the question of “what is ethical” in the context of ethical funds in order to formulate a tentative answer to the question of whether ethical funds are a “good” investment both from a philosophical point of view and from a Christian perspective. Chapter 3 demonstrated that there are many problems with teleological ethics such as utilitarianism and egoism. Indeed, investors who do not subscribe to such consequentialist ethics will have to add ethics into the investment process (Statman, 2000).³⁷² It was demonstrated in Chapters 1 and 2 that Christian Churches have integrated some ethical values into the investment process. For example the Church of Scotland and the Church of England have employed ethical criteria for stock market investments since 1932 and 1948 respectively. This links to the interview finding in Chapter 10 that institutions such as Friends Provident, Gyllenberg, KBC and Murray Johnstone, had managed funds for Church investors with ethical criteria many years before launching ethical funds. It was also mentioned by interviewees that one motivation for institutions to launch ethical retail funds was to be able to compete for management of Church and Charity funds.

Mackenzie (1997) argued that Church doctrine can be employed in an analysis of ethical funds. This Chapter will respond to this call by adopting a general Christian perspective since the literature outlined in Chapter 2 and interview findings in Chapters 2 and 10 demonstrated that many denominations have had a key role in establishing ethical funds and Church doctrine has strongly

³⁷¹ Chapter 10 demonstrated that many ethical issues were ignored by ethical funds and financial considerations tended to dominate the ethical ones for most ethical funds.

influenced the various criteria adopted (Melton and Keenan, 1994; NPI, 1995; Gray *et al.*, 1996; Kinder and Domini, 1997; Mackenzie, 1997).³⁷³ This Christian perspective draws on the Agape based ethic which was outlined in Chapter 3 and its manifestation in terms of investments in different Churches (Wesley, 1760; Church of Scotland, 1988; CEIG, 1992; Sparkes, 1995; Calkins, 2000). This Agape based perspective is chosen because it is recognised in philosophy (Frankena, 1963; Warburton, 1999) and because it is relevant for the Christian Churches which have pioneered ethical funds (Church of Scotland, 1988; Macquerrie and Childress, 1997; Church of Finland, 1999; Calkins, 2000). Therefore a general Christian ethic such as Agapism was favoured rather than a denominational ethic such as Lutheran or Wesleyan ethics.³⁷⁴ This Chapter also builds on Oslington (2000) who argued for theology as a framework for ethics in economics, and Calkins (2000) who argued for utilising an agape based religious ethics in business ethics.

Some additional attention is devoted to Methodist or Wesleyan ethics and Quaker ethics as both the interviews and the literature indicated that these groups have been active in “ethical investment” in particular and in the “social gospel” in general (Wogaman, 1994; Gray *et al.*, 1996; Hancock, 1999).

The next section will briefly consider the significance of religion as an influence of the culture of a country. Section 11.3 evaluates some issues in terms of assessing the ethicality of the ethical funds. Section 11.4 applies the ethical theories presented in Chapter 3 to ethical funds, while section 11.5 reflects on ethical investment from a Christian Church point of view. Section 11.6 considers ethical investments from an agape based ethical perspective. Finally some conclusions are offered in section 11.7.

³⁷² He argues that “investors care about social responsibility and value expressive features”.

³⁷³ Anglicans, Lutherans, Methodists and Quakers have pioneered some sample ethical funds.

³⁷⁴ Agapism is an important element of Lutheran and Methodist ethics; it is also relevant for other Churches such as the Catholic and Presbyterian Churches (Calkins, 2000). This ties in with the majority of the interviewees who were Anglicans, Lutherans, Methodists or Presbyterians.

11.2 Cultural Background

Religion is used in many studies as a proxy variable for culture (La Porta, Lopez-de-Silanes, Schleifer, and Vishny, 1999; Stulz and Williamson, 2001). In these investigations, it has dominated other variables such as language and legal system. Particularly relevant variables for explaining creditor rights and the enforcement of these rights was whether a country's population supports predominantly the Catholic or Protestant Churches. In terms of ethical fund criteria, differences also seem to exist between the various Churches. In general terms Protestant Churches have concentrated more on issues such as alcohol and gambling (Wesley, 1760; Jones, 1984; Kinder and Domini, 1997), while the Catholic Church seems to have focused more on criteria relating to abortion and contraception (Jones, 1984; Catholic Bishops, 1992). All Christian Churches seem to have found common ground in criteria relating to South Africa in the 1970's and 1980's and the manufacturing of weapons (Catholic Bishops, 1992; Church of England, 1999/2000; Church of Scotland, 1988; Aktie-Ansvar, 1999).

Table 11.1 presents the main religions in the countries in which ethical funds were studied. This table demonstrates that all countries were predominantly Christian in a nominal sense.³⁷⁵ Most countries were predominantly Protestant, while the Catholic Church was the largest religious group in Belgium, Netherlands and Switzerland. In terms of the funds studied in Chapter 6 and 7, 88% of them were based in "Protestant" countries. Of the formal interviewees, 70% were members of a Christian Church and one of these was Catholic.³⁷⁶

The other main conclusion to be drawn from Table 11.1 is a decline in Christianity. Chapter 2 demonstrated a decline in the proportion of shares owned by Charities and individuals. These trends may be of concern if the Centre for Theology and Public Issues (1992) is correct in its claim that:

...there is a widespread feeling that certain sectors of the financial community have broken loose from the constraints of the past and from the values of a society which did not have the making of money out of money as its number one priority.

³⁷⁵ This does not mean all are practicing their faith. Luther wrote "...the world and the masses are and always will be unChristian, although they are...nominally Christian" (Wogaman, 1994).

³⁷⁶ Most of the ethical funds studied were based in countries in which Protestantism was the main religion and most interviewees belonged to a church which followed the Protestant tradition. It is unknown what percentage of these were active practising Christians.

Table 11.1 Main Religions in Countries Studied

	Belgium	Germany	Finland	Nether-lands	Norway	Sweden	Switzer-land	UK
1985								1985
Catholic	86%	33%	0.1%	39%	0.4%	1.9%	47%	9%
Protestant	1%	41%	92%	29%	95%	66%	45%	55%
Christian	89%	85%	93%	69%	96%	70%	95%	69%
<i>Muslim</i>	2.9%	3%	0%**	2.1%	0.4%	0.4%	0.9%	2.7%
2000								2000
Catholic	58%	33%	0.1%	33%	0.9%	1.8%	44%	9.7%
Protestant	9%	36%	88%*	23%	91%	60%*	42%	58%
Christian	68%	70%	87%	56%	94%	55%	87%	68%
<i>Muslim</i>	3.6%	3.7%	0.2%	5.4%	1%	3.1%	3.1%	2%

Sources: Figures from 1985 from Johnstone (1986) and figures for 2000 from Johnstone and Mandryck (2001). The **Christian** row refers to the percentage of population belonging to some Christian Church. The second and third rows detail the percentage of the population as member of the Catholic or Protestant Churches. These figures do not always add up because many groups such as the Orthodox Church and the Quakers are not included in them. The star * for Finland and Sweden indicates that Protestants have a higher figure than Christians in total. This is partly due to some individuals being active members in two denominations. The two star ** indicate that in 1985 Judaism was actually the largest non-Christian religion with 1800 followers, by year 2000 the number of Muslims had surpassed the number of Jews in Finland. Finally, the *Muslim* row discloses the adherents of the largest non-Christian religion in the sample countries.

11.3 Issues

One issue which has been touched upon in the interviews is whether ethical funds are beneficial for society.³⁷⁷ For example, Lydenberg (2002) argues that the fundamental goal of ethical investing in the stock market is “to positively impact corporate behaviour in the direction of a more sustainable and humane economy”. This question is indirectly explored by considering the practical manifestation of the ethical fund policies and possible conflicts between ethical and financial objectives. The previous Chapter indicated that although some ethical funds maintained an active dialogue with company management there were a number of structural issues which the ethical funds were unable to address. One example was corporate restructuring involving mergers and takeovers with the resulting unemployment and difficulties for communities

³⁷⁷ Two theologians interviewed for this dissertation, Dr Eskola and Dr Northcott thought this was a key question. They pondered the extent to which the ethical funds could change companies.

affected. In Judeo-Christian teaching there is generally a concern for the unprivileged such as the fatherless, the poor and the strangers.³⁷⁸ These broad questions about ethical investment are considered further in Section 11.6.

The foregoing may suggest that if Gray *et al.* (1996) are right in their argument that there is no conclusive proof of individual wealth spreading to the disadvantaged groups in society, then more than 90% of the sample ethical funds do little if anything for these disadvantaged groups. Indeed, some interviewees argued along similar lines that “there are no ethical companies” and that “if you want to be really green then don’t invest in the stock market”. The literature notes that “socially beneficial and socially undesirable activities are often inextricably linked...by corporations” (Catholic Bishops, 1992). However, the difficulty of finding morally perfect companies does not imply that there are no companies one can legitimately invest in, neither does it remove the ethical problems with investing in certain companies (CEIG, 1992). Business ethicists and Churches agree that some companies are acceptable investments while other companies which may be financially attractive, nevertheless are unethical ventures (Irvine, 1987; Church of Scotland, 1988; Larmer, 1997; Church of England, 1998).

The theologian Dr Eskola from the Finnish Institute of Theology claimed that if ethical funds do not address issues such as product pricing and safety, employee rights and the plight of the disadvantaged, then one must ask whether these funds actually are ethical from a Christian point of view? Alternatively, if some “ethical” funds are deceiving investors by misleading marketing claims, are such funds a hoax? For example, the Sustainable Performance Group claim to invest in companies “whose products and services generate economic, ecological and social benefits” (Sustainable Performance Group, 2000). Their portfolio included companies such as Shell, Intel and GlaxoWellcome which have all been challenged on various environmental and ethical criteria.³⁷⁹ Dr Eskola suggested that ethical funds will use the arguments which make them look as

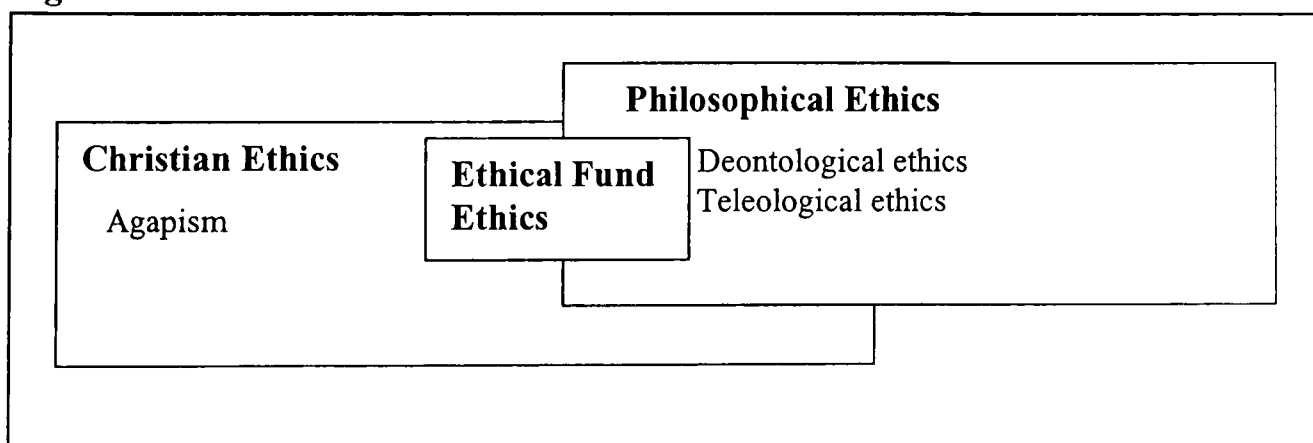
³⁷⁸ For example the words “fatherless”, “poor” and “strangers” are mentioned 40, 174 and 75 times respectively in the Bible (King James Version); often in terms which encourage material assistance to these groups (Psalm 10:14, Proverbs 21:13, Isaiah 1:17, James 1:27).

³⁷⁹ These issues included indigenous peoples’ rights, toxic waste and animal testing.

good as possible. Indeed, the material from some ethical funds indicated that this could be the case. The Norwegian Storebrand Environmental Value Fund, claimed environmental dividends through a “best in sector” approach while investing in; airlines, alcohol companies, the chemical industry, companies with defence contracts and pharmaceuticals. From a marketing point of view this is not surprising, but it may indicate that some ethical funds would not perform well if honest marketing is a criterion. This suggests that few if any ethical funds perform well against all ethical criteria.

Therefore, when an evaluation is performed from an ethical point of view, ethical funds should not be allowed to define what is ethical. Instead they should be evaluated from some independent ethical perspective, one example being a Christian ethical framework. Figure 11.1 illustrates Christian ethics and philosophical ethics as subsets of ethics which partly overlaps. It also shows the more limited subset of ethics considered by ethical funds. Examples of overlapping issues may be ethical issues associated with alcohol, pornography, tobacco, weapons and the aim to encourage good practice in a number of areas. Section 11.4 will analyse ethical funds based on philosophical ethics, while section 11.5 will consider ethical funds from a Christian Church perspective, while section 11.6 considers alternative investments.

Figure 11.1 Subsets of Ethics



11.4 An Application of Ethical Theories to Ethical Funds

It was noted in Chapter 2 that the early ethical criteria relating to avoidance of areas such as alcohol, tobacco and weapons had roots in the doctrine of various Churches, especially the Methodists and the Quakers (Sparkes, 1995; Kinder and Domini, 1997). This was confirmed by interview findings in Chapter 9 and

10. More recently, a number of environmental criteria have emerged. Many authors have argued that investments are subject to ethical considerations in the same manner as other human activities (Sparkes, 1998; Boatright, 1999; Cowton, 2002). This section will consider the ethical funds in light of the ethical theories presented in Chapter 3. These ethical theories link to three models of the moral obligation of the firm. A stakeholder model of the firm based on Kantian deontological ethics was proposed by Evans and Freeman (1988). A utilitarian model was suggested by Friedman (1970) and an Agape based social responsibility model was adopted by the Church of Finland (1999).

Before addressing the main issues of this section, it is worth highlighting a number of problems associated with the application of ethical theories. First, it is important to note that the ethical screens of a fund in themselves are not a philosophical system, they are tools for implementing religious concerns or some other underlying philosophy (Kinder and Domini, 1997). Second, interpretations will differ depending on which ethical theory is adopted. No single theory of ethics has achieved acceptance among philosophers as authoritative (Warburton, 1999). Third, to some extent employing ethical criteria and engaging with companies on ethical matters can be seen as compatible with many ethical theories – deontological, teleological and Christian ethics – albeit in different ways.³⁸⁰ Despite these limitations, the section proceeds to address how ethical theories might be applied to ethical funds.

A deontological argument for considering ethical issues in investment decisions is that it fulfils a duty to avoid harmful and promote positive activities.³⁸¹ For example, Irvine (1987) argues that it is sometimes morally wrong to invest in certain companies, particularly if this enables others to do what is wrong. This argument may support traditional ethical criteria such as avoidance of weapon manufacturers and companies co-operating with oppressive regimes. Business

³⁸⁰ For example Mäkela (1998) argues that when a Christian perspective is employed to evaluate whether some act is ethical one must consider motivist, consequential, deontological ethics and the situation. The same point has been made from a philosophical perspective (Frankena, 1963).

ethicist have claimed that ethical funds may partly enable investors to solve the investment ethic problem associated with the “evil company principle” by enabling individuals to avoid ethically dubious investments (Larmer, 1997; Mackenzie, 1997). The field study indicated that the majority of ethical funds in the 1980’s were primarily relying on a screening strategy they could therefore be seen as implementing one type of deontological ethic. All sample funds in the field study in Chapters 9 and 10 had elements of this deontological approach, but from the late 1990’s engagement with no exclusion is becoming more common. This is a shift towards a financial utilitarian approach.

A utilitarian argument for ethical investment funds might be that such vehicles are more consistent with promoting the greatest good for the greatest number; it is better therefore to consider ethical issues in investment decisions than to ignore them. This promotion of the greatest good might arise through engagement with company management and promotion of good environmental and social practices. From a utilitarian point of view, it would also seem that a wider sharing of fund returns would better fulfil the utilitarian maxim of the greatest good for the greatest number, rather than the investor and the financial institution being the only beneficiaries. Thus utilitarian arguments could support charitable giving as part of the ethical fund concept. Another view is that the greatest good results from maximising profits (Friedman, 1970). This latter view is challenged as flawed by Stiglitz (1981) and Gray *et al.*, (1996).

There are some utilitarian features in the process by which some of the more recent ethical funds have chosen their ethical criteria. For example, the interviews carried out for this dissertation revealed that institutions such as Murray Johnstone and Standard Life carried out extensive consultations among independent financial advisors prior to launching their ethical funds. The aim of these consultations was to help establish ethical criteria which would be accepted by most people. This consultation can be seen as an attempt to establish the ethics which are in demand by “the market”. Indeed, as Kinder and

³⁸¹ From a Kantian perspective one might consider whether a proposition such as: “When pension money is invested ethical issues ought to be considered in addition to risk and return” would be consistent with the categorical imperative.

Domini (1997) put it: “With mutual funds the challenge to their managers lies in capturing the views of a sufficiently broad segment of the population, so that...the fund attracts enough capital to justify its existence”. This approach of selecting ethical criteria echoes a financial utilitarian approach of the greatest utility for the largest number of investors as opposed to all people. To analyse the criteria of ethical funds from this sort of utilitarian point of view one approach would be to survey a large sample of investors in ethical funds to determine which criteria and what type of an approach would bring the greatest utility to the greatest number of these “ethical” investors and then compare the ethical funds against this standard.³⁸²

Utilitarian arguments have been used to argue against some ethical criteria. For example Anderson *et al.* (1996) used utilitarian arguments for the “benevolence” of alcohol and pornography. This points to a difficulty in employing utilitarianism for analysing ethical funds. The problem is that one might use utilitarianism to argue for or against almost any ethical criteria or method which the ethical funds employ. So, whilst analysis based on utilitarianism may generate some insights, utilitarianism has not been employed as the sole theory this dissertation. The utilitarian approach is limited in that ascertaining individual utility functions is difficult, while interpersonal comparisons are impossible and “group utility functions have no meaning” (Copeland and Weston, 1992). Therefore operationalising the notion of “the greatest good for the greatest number” seems to be problematic. Nevertheless, ethical funds would seem to be good investments from a financial utilitarian moral point of view, because Chapter 7 demonstrated that they provided returns no different from other funds. Other research has demonstrated that investors in ethical funds are highly supportive of the ethical criteria that these funds employ (Lewis and Mackenzie, 2000) and Chapter 10 demonstrated that ethical funds unlike their non-ethical counterparts had processes for dealing with ethical issues.

³⁸² Surveys of ethical investors have been done by researchers such as Lewis and Mackenzie (2000) and Woodward (2000). They found that there was a resemblance between the most common ethical criteria employed by funds and investor preferences. Most investors invested only a minority of their assets “ethically”. The most important criteria for the investors related to third world concerns, fair employment, weapons, environment, pornography and tobacco (Woodward, 2000). A reason for a minority of assets in ethical funds was a perception of low returns and/or high risk (Lewis and Mackenzie, 2000).

Ethical criteria related to alcohol, gambling, oppressive regimes and weapons can be seen as manifestations of deontological ethics with Judeo-Christian origins (Church of Finland, 1999).³⁸³ One might see the services of EIRiS, Ethibel and similar research organisations as an attempt to enable the implementation of deontological ethics. These organisations have focused on research enabling funds to implement exclusionary criteria to meet the duty of avoiding harmful activities. EIRiS researches all UK listed companies in terms of nearly 300 ethical criteria. A similar service for ethical funds in Belgium is provided by Ethibel.

Some ethical criteria such as not investing in tobacco firms, in companies with poor human rights records and in organisations which exploit third world workers, and practices such as voting shares on ethical issues might also be supported by Kantian deontological ethics.³⁸⁴ Kantian ethics would seem to be

The categorical imperative states: Act only on the maxim which you can at the same time will to be a universal law
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of some value in analysing ethical criteria and various

practices employed by ethical funds. Because Kantian ethics apply to all aspects of life it would seem that all investments should need to meet some minimum ethical standards. Kantian ethics might therefore generally support the integration of ethical values into the investment process. The categorical imperative can approve of investors investing a limited proportion of surplus assets in ethical funds. This in itself does not necessarily mean that ethical funds are a morally good investment from a Kantian point of view. Authors such as Thielemann (2000) have argued that a market exchange system may be incompatible with Kantian ethics, because people are treated as means, not ends. It may be the case that this problem is less severe for ethical than for non-ethical funds, but this comparative advantage does not eliminate the problem.

Kantian ethics are perhaps less useful in comparing ethical funds with similar criteria and practices. For example, the categorical imperative may be useful in

³⁸³ For example the Stewardship proposal from 1973 detailed the exclusion of these sectors. These sectors were also avoided by the Methodist Church and other Churches (Sparkes, 1995).

³⁸⁴ These questions can be analysed with the categorical and the practical imperatives. For example, should it be universal law that all people harm their health by smoking? The practical imperative of never treating people as means only can be used in relation to human rights.

evaluating whether an issue ought to be addressed by an ethical criterion, but the categorical imperative may be less useful in evaluating small differences in the definition of the same criterion. Whereas the literature review indicated that Christian ethics has been important in establishing ethical investment funds in most European countries, it is far from clear whether there is any link between the establishment and operations of these funds and Kantian ethics. For these reasons, Kantian ethics – which advocates incorporation of ethics into all areas of life and can therefore support the idea of “ethical investment” – has not been employed on its own to analyse ethical funds in order to answer the research questions in this dissertation.³⁸⁵ Instead an agape based Christian ethic linked to the doctrines of various Churches is presented in the next sections.

11.5 Christian Reflections

The Judeo-Christian ethic of agapism was put forward as one alternative to the ethical theory of utilitarianism. This Chapter demonstrated that the majority of individuals in all the countries studied were members of a Christian Church. For practising members of such Churches in particular agapism may be a more appropriate ethical theory than utilitarianism which according to some theologians is not compatible with Christian ethics (Geisler, 1994; Eskola, 2001). Furthermore, utilitarianism is not a sufficient theory for ethical investment according to Church investors (Church of Scotland, 1988; Church of Finland, 1999). A substantial literature on accounting in Churches already exists (Laughlin, 1988; Booth, 1993; Parker, 2001). Much less is known about Church investments. This section will contribute to the understanding of investments made by Churches by exploring the topic in the context of ethical investments.

A general Christian perspective is adopted because the literature outlined in Chapter 2 and interview findings in Chapter 9 and 10 demonstrated that many denominations have had a role in establishing ethical funds and Church doctrine has strongly influenced the ethical criteria adopted. The field study also demonstrated that some financial institutions had managed Church funds with ethical criteria prior to launching their first retail ethical fund. In some cases

³⁸⁵ The Kantian notion of treating other people as an end in themselves rather than means only provides philosophical support to human rights and other criteria employed by the sample funds.

these Church funds were far greater in size than the retail ethical funds. Chapter 3 introduced Agapism which is a Theocentric Christian ethic. Calkins (2000) argues that such a religious ethic has two key components, the love and worship of God and the service of disadvantaged others.³⁸⁶ Elements of Agapism can be found in the theology of Christian Churches, for example, the Anglican, Catholic, Lutheran, Methodist and Presbyterian Churches (Church of Scotland, 1988; CEIG, 1992; Macquerrie and Childress, 1997; Calkins, 2002). Agapism is also an element in Church doctrine on ethical investment (Wesley, 1760; Church of Scotland, 1988; Church of Finland, 1999).

One consideration from an agape based point of view is the extent to which financial considerations dominate ethical ones. The interviews conducted for the field study in Chapters 9 and 10 indicated that external members of ethical committees were less dominated by financial considerations than fund staff. Many of these advisory committees, such as those of Friends Provident Stewardship, Gyllenberg Forum and the Banco ethical funds, included representatives who had been chosen because of their membership and position within some Church. The ethical researchers employed by ethical funds seemed to represent a middle category, while fund managers seemed to be focused on the financial returns. This is perhaps to be expected given performance appraisal, peer pressure and, for pension funds in particular, legal obligations for the fund managers.³⁸⁷

Another important consideration from an agape based perspective is whether ethical funds help the disadvantaged. The field study provided evidence that there were areas outside of the remit of ethical funds, because they were “part of the system”. For example, areas perceived to be outside of the remit of the ethical funds included reductions in personnel. Other areas often overlooked by ethical funds included dubious business practices such as not paying suppliers, dumping or the misuse of monopoly power. The interviewees provided only three specific examples of how ethical funds had actually directly addressed

³⁸⁶ The apostles John and Paul elaborate on love in 1 John 4 and 1 Corinthians 13.

³⁸⁷ One interviewee claimed that unit trusts, including ethical ones are sold on past performance.

dubious business practices or helped the most disadvantaged groups.³⁸⁸ From a Christian perspective such issues may be of importance when making investment decisions although they are not considered by many ethical funds (Church of Scotland, 1988). The next section considers different Church perspectives on stock market investments.

11.5.1 Church Perspectives

The ethical values of investors are formed by various factors. One such factor which shapes the ethic of an individual is religion. Indeed, Church investors have pioneered ethical funds in both Europe and the USA (NPI, 1995; Sparkes, 1995; Gray *et al.*, 1996). This section outlines some theory and practice of ethical investment of some Church investors. Christian investors have argued that ethical investment helps in achieving a oneness with the Lord in all areas of life (Provost of a Quaker college quoted in Hamilton *et al.*, 1993).³⁸⁹ In a manner similar to other areas such as biology (bioethics) or medicine (medical ethics) ethical values are also applicable to investments (Catholic Bishops, 1992; Sparkes, 1998; Boatright, 1999; Cowton, 2002).

This section will first consider the Quakers and Methodists. The role of these two groups in pioneering ethical investments in the UK is well established (Sparkes, 1995; Hancock, 1999). The field study also demonstrated that the Lutheran Church had been pioneering ethical funds in Finland and Sweden. The contributions of the Lutheran Church will therefore be briefly considered.³⁹⁰ Some policies of the Church of Scotland are also considered because the Church of Scotland Trust established in 1932 – although not available outside of the Church – is the oldest European ethical fund encountered in the field study.³⁹¹

³⁸⁸ One example was how a large company which had dismissed women in Mexico when they became pregnant had successfully been challenged and changed this practice. Another example was an ethical researcher visiting textile factories in India. Stagecoach had been sold by an ethical fund because of aggressive business practices.

³⁸⁹ Christian investors would also recognise that ethical investment funds are only one form of ethical investment (Catholic Bishops, 1992), not necessarily the most ethical one (Moore, 1988) and no substitute for charity (Moore, 1988; Mills, 2000).

³⁹⁰ Lutherans & Presbyterians are active in ethical investment in USA (Melton and Keenan, 1994).

³⁹¹ Some interviews were in Scotland and several interviewees were members of this Church.

Quaker Contributions

The field study made clear that Quaker ethics has influenced the field of ethical investment in the UK. The Society of Friends, or Quakers was founded by George Fox in 17th century England (Jones, 1984). Two of the leading ethical fund providers (Friends Provident and NPI) were established by Quakers. In addition individual Quakers had a key role in the establishment of the Ethical Investment Research Service (EIRiS) in 1983 and the Friends Provident Stewardship ethical fund in 1984. Early Quaker norms included opposing dishonesty and war (Macquarrie and Childress, 1986). Indeed, the Methodists and the Quakers were often credited as originators of the criterion to avoid investing in armament firms (Gray *et al.*, 1996; Kinder and Domini, 1997).³⁹² The Quakers continue to influence the ethical investment fund sector.³⁹³ The Quakers have also been represented in the advisory committee of the largest and oldest UK ethical fund, Friends Provident Stewardship since its inception in 1984 (Sparkes, 1995; Friends Provident, 1998). Indeed, the Society of Friends is one of the clients of Friends Ivory & Sime which manage their funds employing ethical criteria. Recent Quaker authors have argued that the “conditions under which the income is produced” and the plight of the poor, particularly in the third world ought to be considered when Friends are investing (Donnelly, 2002; Marrs, 2002). Most sample funds enabled Quaker investors to address one of their key concerns, avoidance of weapon manufacturers. However, ethical funds which do not consider issues such as child labour and human rights would not be good investments in an ethical sense for Quakers agreeing with Donnelly (2002) and Marrs (2002). At least 7 of the ethical funds in the field study would not be morally good investments according to these criteria.

³⁹² Generally there has been some consensus between Churches on many ethical criteria. An example was apartheid in South Africa; the World Council of Churches pioneered the criterion by divesting shares of companies operating in South Africa in 1972 (Harrington, 1992). The Church of Scotland, the Methodists and the Catholics also employed a South Africa criterion. Most Churches have avoided investments in alcohol, gambling, tobacco and weapons companies (Church of Scotland, 1988).

³⁹³ For example, a recent survey of UK “ethical investors” by Lewis and Mackenzie (2000) found that 10.3% of 1146 respondents were Quakers. This Quaker influence is remarkable given that the Society of Friends is a very small religious group with only 17000 adult members in the UK in 2001 (UK National Statistics, 2002).

Methodist Ethics and Ethical Investment

As Chapter 2 mentioned, the Methodist Church bodies and their individual members played a key part in establishing ethical funds in the UK and the USA (Kinder *et al.*, 1993; Sparkes, 1995). Such a link is perhaps not surprising since John Wesley, the founder of Methodism, believed that “one must devote the whole of one’s life to love of God and neighbour” (Macquarrie and Childress, 1997). Agapism was thus Wesley’s personal ethic. Wesleyan agapism would seem to have played some part in establishing ethical funds in the UK, through key individuals such as Charles Jacob who co-authored the Stewardship proposal and Elliott Kendall who helped to establish EIRiS (Sparkes, 1995).

An early document advocating ethical criteria and integration of ethical concerns into commercial activity and investment was Wesley (1760). Wesley (1760) argued that we should “gain all we can” subject to ethical criteria such as “not at the expense of our neighbour’s health, not at the expense of our neighbour’s wealth and not at the expense of our conscience”. After having gained “all we can” we then ought to “save all we can”, so that we may “give all we can”. It is important to note that this message was largely aimed at “the lower classes” as an encouragement to improve their standard of life and that the aim was charitable giving once a basic standard of living was achieved rather than the hoarding of wealth (Macquarrie and Childress, 1997).

Wesley (1760) also emphasised that “we ought not to gain money at the expense of life, nor at the expense of our health”. Financial considerations have been balanced by ethical ones in Methodist ethics. This approach may support exclusion of (the environmentally worst performing) firms which are repeatedly fined for environmental, health and safety reasons.³⁹⁴ Avoiding “spirituous liquors” was another ethical criteria especially mentioned in Wesley (1760). Indeed, Kinder and Domini (1997) attributed the alcohol criterion employed by ethical funds to Methodists and Baptists.

High interest rates, dumping and other activities which might hurt our neighbour were also condemned by Wesley (1760). Wesley’s emphasis on stewardship

accords well with a rigorous investment process for ethical funds, as he emphasised that all things should be done as well as possible.³⁹⁵ This may support the argument that funds following a twin track or integrated approach, may be preferable to those following a commercial ethic approach. Giving as much as one can was also advocated in Wesley (1760) and would seem to be consistent with agapism.³⁹⁶ This raises the question of how the returns generated by ethical funds should be used. Wesley (1760) argued that whilst it can be acceptable to earn high returns – if it has been done in an ethical manner – it is not acceptable to spend all this income on consumption or to keep it for one self. Ethical funds would seem to be compatible with Wesleyan ethics since Methodism had “an acute social conscience”, but also supported the King (Jones, 1984). Wesley opposed slavery and gave “sharp warnings to rich men, but none about the economic order itself” (Jones, 1984).³⁹⁷

The Methodist Church in the UK set up a fund in 1960 which avoided investments in sectors such as: armaments, alcohol, gambling and tobacco. Later Apartheid in South Africa was added as a criterion. The same criteria have been employed by the Church Commissioners of the Church of England (CEIG, 1992; Church of England, 1999/2000). According to Charles Jacob the Methodist Church had a group discussing ethical issues in Methodist Church investments since the early 1970’s.³⁹⁸ This ethical advisory group may have served as a model for subsequent ethical committees for ethical funds. Indeed, the Stewardship proposal from 1973 and subsequent Stewardship proposals suggested exactly the same ethical criteria as those employed by the Methodist Church and the formation of a similar ethical advisory committee. These criteria are still very common. Chapter 9 demonstrated that all but one of the funds in

³⁹⁴ Involvement with toxic chemicals (arsenic and lead) were to be avoided (Wesley, 1760).

³⁹⁵ For ethical funds this may include use of internal and external ethical research, an ethical committee to monitor investments and an AGM and a newsletter for unit holders (EIRiS, 1998).

³⁹⁶ Indeed, Wesley practised what he preached by giving away a substantial part of his income (Sider, 1987). Ethical funds may struggle to live up to Wesley’s ethics, for he was “passionately generous, passionately devoted to social welfare and the care of the poor” (Jones, 1984). Some Swedish ethical funds give 1-2% of annual returns to a Church or a Charity, but in the rest of Europe this procedure does not seem to be a part of the ethical fund concepts. Some UK ethical funds interviewed argued that this decision belongs to the investor.

³⁹⁷ The Methodist Church is small but influential in the ethical investment field. In the UK the Methodists had 370 000 members and 1.1 million affiliates (Johnstone and Mandryck, 2001).

³⁹⁸ However, the ethics of investment advisory committee was formally established in 1983 to monitor investments from an ethical viewpoint (Sparkes, 1995).

the field study excluded alcohol, tobacco and weapon companies from investment. Methodist investment policy thus influenced the criteria of the early UK ethical funds. Some sample funds would seem to be suitable investment vehicles for Methodist investors, because they employ similar criteria and processes as the Church. However, environmental funds investing in breweries/distilleries would thus not seem to be good investments for adherents of Wesleyan ethics. Ethical funds investing in media companies involved with pornography would not be suitable either.³⁹⁹ In terms of process those investors who want to invest in ethical funds with similar processes to their Church would exclude funds which don't have an ethical committee and those which do not vote. This means that at least 50% of the sample ethical funds would not be good investments in moral sense from a Methodist point of view.

Lutheran Views on Ethical Investment

The majority of people in three sample countries, Finland, Norway and Sweden are affiliated with the Lutheran Church, which is also a major denomination in Germany. The Lutheran Church in these countries has been active in ethical investment. For example, an ethical fund available to private investors was established by the Church in Sweden in 1980; The Church of Finland was involved in launching the first two ethical funds in Finland. It has been argued that Luther was against ethical quietism and that Lutheran Christians should seek social justice through love (Macquarrie and Childress, 1997).⁴⁰⁰ Lutheran agapism lends support for engagement with company management on ethical issues. Such engagement is consistent with the example of Jesus who actively helped those in need (CEIG, 1992).⁴⁰¹ The Lutheran theologian Dr Eskola has argued that “the stock market driven capital democracy” leads to inevitable conflicts with Christian ethics because moderation and wealth distribution are normative biblical criteria which cannot always be reconciled with financial profit maximisation (Eskola, 2000). Dr Vikström, Lutheran Archbishop of

³⁹⁹ Sparkes (1999) documents how the Methodist Church divested a media company which through an acquisition became involved in pornography. Another firm was divested because it became involved in gambling, a third firm was divested because it became involved in weapons (Methodist Church, 2001).

⁴⁰⁰ It is recognised that “agapists” have often failed to walk the talk. It is argued in Gill (1999) that Luther have contributed to anti-semitism and racism (p.499). The majority of the Lutheran Church staff members surveyed in Inskip (1992) chose not to invest their pensions ethically.

Finland has argued that corporations which exploit people and the environment in a region and then relocate act in an immoral way. Ethical performance, – how certain outcomes were achieved – should always be considered, not only financial performance (Lindqvist, 2002).

An interesting account of Lutheran ethics in relation to pension investment is provided by Inskip (1992). He analysed ethical investment of pensions for staff members of the Evangelical Lutheran Church in America.⁴⁰² The results were similar to what has been established by Lewis and Mackenzie (2000) in Europe, namely, that most “ethical” investors do not invest all their funds ethically. There was substantial support from all the staff for ethical screens (especially; pornography, weapons, gambling and tobacco), shareholder activism and divestment. The Finnish evangelical Lutheran Church avoids investment in alcohol, gambling, pornography, tobacco and weapons firms. In addition positive criteria such as environment, human rights and social responsibility are employed (Church of Finland, 1999). The Lutheran Church in Sweden recommends environmental and social criteria in addition to the traditional exclusionary screens (Church of Sweden, 1996). If Lutheran investors wanted to address these concerns through ethical funds, they would need to invest in twin track or integrated ethical funds, because commercial funds typically did not vote their shares (Luther was against ethical quietism). In terms of the criteria employed by the Lutheran Church in their investments many sample ethical funds would be acceptable investments. However, at least 7 of the sample funds did not employ all the negative screens which the Church does. If corporations which behave in an unethical way according to Archbishop Vikström were to be excluded many other firms and therefore also many ethical funds would become unacceptable investments for Lutherans from an ethical point of view. Nevertheless, the Church of Finland (1999) recommends ethical funds as one way of investing ethically and pledges to take an active role in the development of such funds.

⁴⁰¹ The Lutheran Church in America has engaged in shareholder activism (Kinder *et al.*, 1993).

⁴⁰² Kinder *et al.* (1993) mentioned that the Methodist and the Lutheran pension funds have played a leading role in socially responsible investing in the USA.

Ethical Investment and the Church of Scotland

The Church of Scotland of whom many interviewees were members has produced some of the most comprehensive reports on ethical investment among the European Churches (Church of Scotland, 1988; Centre for Theology and Public Issues, 1992). This section will consider some of the insights from Church of Scotland (1988). This report argues that “responsible share ownership” entails:

- (i) Long term investment
- (ii) Concern for stakeholders such as employees and the community
- (iii) A serious interest in the policies and practices of the company

The report argues that the “concern for stakeholders” is especially relevant in “merger and takeover situations”. The field study demonstrated that layoffs were not employed as an exclusionary ethical criterion and no case was put forward where shareholder resolutions had been employed to address layoffs or mergers. In this respect the sample funds did not consider employee interests.

Church of Scotland (1988) specifies that “serious interest” includes studying corporate publications, “exercising voting powers...and being prepared to oppose actions of the directors”. In terms of voting, 10 ethical funds studied in Chapter 10 had voted their shares on ethical issues. The majority of ethical funds did not perform well if voting on ethical issues was a criterion for their performance.⁴⁰³ The low levels of voting among ethical funds are disappointing given that Mallin (1995) argued that voting was one contribution that institutional investors could make in the corporate governance process. Both practitioners in the field of ethical investment funds and Churches have argued that voting is an important part of “responsible ownership” (Church of Scotland, 1988; Domini, 2000).⁴⁰⁴ Finally, the aim of taking a serious interest in the companies invested in, seems difficult for those funds that were identified in the

⁴⁰³ For 5 sample funds evidence was obtained that they had at times voted against management on ethical issues. Four of these funds followed an “integrated” and one a “twin track approach”.

⁴⁰⁴ Domini (2000) argues that “shareholder activism, publishing the votes, focusing on dialogue, transparency and community economic development” are important for ethical funds. Others have argued that shareholder activism can, but need not be part of ethical funds (Sparkes, 2001).

previous Chapter as following a “commercial ethic”. This is because there is not necessarily anyone in the financial institution managing these funds with a professional interest in ethical or environmental issues relating to the investee companies. This may also be the reason why none of the sample “commercial ethic” funds had voted on an ethical issue. These three criteria could be used for evaluating the ethical funds from a Christian perspective. Preliminary anecdotal evidence from the interviewees suggests that the ethical funds with a twin track and integrated approach may fare better than non-ethical funds when measured against the three Church of Scotland (1988) criteria of long term investments, concern for stakeholder and serious interest in the companies invested in.⁴⁰⁵

Church of Scotland (1988) recommends investment in ethical funds and the use of EIRiS for individual investors. Yet it would seem that ethical funds which do not vote their shares on ethical issues would not meet the criteria for “responsible share ownership” set forth in Church of Scotland (1988). Only a minority of the sample funds would both vote on ethical issues and have criteria relating to how employees and local communities are treated. It would therefore seem that only a minority of the ethical funds would be good investments morally for members of the Church of Scotland who agree with their Church’s guidelines on ethical investment.⁴⁰⁶

Finally, investments for helping the poor through agencies such as the Ecumenical Development Co-operative Society are also recommended (Church of Scotland, 1988). In the next section such alternative investments are further examined and it is argued that they are consistent with an agape based ethic.

11.6 Agapism and Alternative Ethical Investments

Alternative investments include investing in organisations working in benevolent areas ranging from low income housing, low interest credit for the poor, fair trade and organic farming to renewable energy. Such alternative

⁴⁰⁵ Ethical principles for economic life derived from the Bible and criteria of Christian environmental stewardship which could be used for evaluating ethical fund portfolios have been presented by Hay (1989) and Enderle (1997). Their criteria are presented in Appendix 11.1.

⁴⁰⁶ For Church funds the report recommends the use of the Church of Scotland Trust which is managed with ethical criteria. The Church of Scotland Trust has avoided alcohol, gambling and tobacco firms and South Africa.

investments often generate lower returns than stock market investment. Some financial return is thus deliberately sacrificed for social and/or environmental returns. In America, community economic development is sometimes one part of ethical investment funds (Lydenberg, 2002).⁴⁰⁷ Indeed, Domini (2001) argued that ethical investing has three components: Screening; shareholder activism; and community development investing. Although this dissertation focuses on European ethical investment funds, and therefore stock market investments, these alternative investments were recognised by at least six of the interviewees. Research has also demonstrated that many individual investors have invested in both ethical funds and alternative investments (Lewis and Mackenzie, 2000). Among the sample institutions the Dutch ASN provides such alternative investments (Negenman, 2001). Many interviewees also mentioned ethical banks such as the Triodos Bank as an alternative to investing in ethical funds. The Triodos bank provides both ethical funds and alternative investments (Louche, 2001).⁴⁰⁸ Some of the sample funds deposited some of their cash to ethical banks such as the Triodos Bank. Another example mentioned by interviewees was investing in bonds financing community development. These broader issues relate to the definition of “ethical investment” in Chapter 1, which also includes alternative ethical investments (Church of Scotland, 1988; Melton and Keenan, 1994; Cowton, 1999; Domini, 2000). This section thus provides a broader context of investment and ethical investment. This addresses the concerns by authors such as Moore (1988) and Mayo and Doane (2002) that ethical investment will be narrowed down to refer merely to ethical funds, which is only one form of ethical investment.

The ethic of Agapism which was outlined in Chapter 3 is especially relevant for the ethical investment strategy of actively pursuing “good” through “alternative investments” (Catholic Bishops, 1992). These alternative investments aim to support the poor or to produce some truly significant social good. They are

⁴⁰⁷ For example, Domini Social Investments offer funds focusing on community development. One is a social bond fund and another is a fund in partnership with an “ethical” bank.

⁴⁰⁸ The Triodos bank lends directly to projects in areas such as organic farming and renewable energy. Other ethical banks such as Ökobank also provide both ethical funds and alternative investments. Another institution mentioned as an example of ethical investment is ‘Shared Interest’. This UK based lending co-operative focuses on financing fair trade and on micro credit in developing countries.

sometimes referred to as “community investing” or “mission related investing”. These alternative investments aim to support benevolent areas such as low cost housing or renewable energy through direct investment. These investments are not charity as some return on investment is usually sought.⁴⁰⁹

Alternative investments are important from a Christian perspective as they would broadly seem to be in harmony with the example and teaching of Jesus (Church of Scotland, 1988). Indeed, the major Churches have been involved in such alternative investments (Melton and Keenan, 1994). Many sayings recorded in the Christian gospels would seem to be supportive of alternative investments and charity. For example, Jesus said: “For where your investments are there will your heart be also” (Luke 12:34).⁴¹⁰ Theologians such as Bonhoeffer (1959) have argued that being a Christian is costly. Bonhoeffer’s ethics were based on following Christ in doing God’s will regardless of the cost (Bonhoeffer, 1978). The importance of doing what was right for its own sake, even if it involved a financial cost has been advocated in a business ethics context by Chandler (2002) and in theology by Mäkela (1998). Ultimately such an ethic is manifested in Jesus Christ (Church of Scotland, 1988). It therefore seems that Christians need also to consider investments which directly benefit the disadvantaged rather than limiting ethical investments to the ethical investment funds only (Haan, 1988). In this context it must be noted that low profits do not always mean “high ethics” and that some “ethical” projects may not be viable for economic reasons (CEIG, 1992; Melton and Keenan, 1994).

The UK Social Investment Forum of which most UK ethical funds are members also devotes substantial resources to Community/social investment. In the USA, Churches have a long tradition of alternative investments to help the disadvantaged. For example, the Methodist Church has allocated \$100 million of its pension funds to low and moderate income housing development. The Lutheran Church pension fund has also made alternative investments including investment in a Community Reinvestment Fund in addition to screened stock

⁴⁰⁹ An example of such investment would be Microcredit bonds issued by Shared Interest and other organisations. Community or mission related investment also fall under this category.

⁴¹⁰ This verse is quoted here from The Catholic Pastoral Edition Bible translation. Jesus also said “Do not store up a treasure for yourself here on earth where moth and rust destroy it, and where thieves can steal it. Store up a treasure for yourself with God” (Matt 6:19).

market investments (Melton and Keenan, 1994). Arguments for investing in low income housing are also made in CEIG (1992) and Church of Finland (1999). Perhaps one reason why alternative and community investment seems to be more unusual in Europe is that the state traditionally has had a substantial role in this field. Nevertheless, members of these Churches who want to invest their funds in a similar manner to their Church would need to allocate some part of their investments to alternative investments (Church of Scotland, 1988).

These alternative investments point to the issue of justice. It has been argued that all Christians have at least “a billion hungry neighbours” (Sider, 1987). Others have argued that the poor in Latin America are ensnared in international economic structures which generate dependency and these structures are referred to as “structural sin” (Northcott, 1999). If some economic structures are “sinful” as some theologians claim, then this prompts the question; to what extent are ethical investment funds a part of unethical structures? (Sider, 1987; Northcott, 1999; Eskola, 2000). Some interviewees clearly stated that ethical funds are part of the current economic system. The field study also demonstrated that most sample ethical funds did not invest in Latin America or Africa. It is argued by Gorringer (2000) that active stock market investment is often similar to gambling and that there is “a vast chasm” between profit maximisation and “meeting human needs”. A radical Christian perspective may not approve of stock market investments. Yet others, whilst recognising the problems of corruption and manipulation, have argued that “it is possible to be a Christian on the stock exchange” and that it is better for Christians to control their own investments than to delegate them to financial institutions (Jacob, 1979; Haan, 1988).

Ultimately Jacob (1979) Moore (1988), Eskola (2000) and Gorringer (2000), all make the same point. The values underlying financial utilitarianism, which tend to give money primacy can be challenged as fundamentally flawed (Centre for Theology and Public Issues, 1992). It is recognised in Moore (1988), Harte *et al.*, (1991), Mills (2000), and Sparkes (2001) that ethical funds do make a contribution towards reducing the primacy of financial utilitarianism by introducing some ethical issues into the investment process. Perhaps two of the

more important ethical issues are the following: First, some investments should not be made at all, regardless of the financial returns (CEIG, 1992). The ethical fund strategy of screening is helpful in this respect. Second, when an investment is made there should be serious long term interest (Church of Scotland, 1988). The strategy of engagement can be helpful in this regard.

Authors such as Moore (1988) have argued that because the aim of unit trusts is primarily to maximise financial returns, unit trusts cannot be considered an “ethical investment” according to his definition.⁴¹¹ Others such as Cooper and Schlegelmilch (1993) have argued that the profit motive underlying ethical funds is not a problem. Indeed, if it was a problem all stock market investments would be “unethical”. Instead they argue that altruism is not the only motive for ethical investors; risk and return are also relevant. The problems associated with a strong desire for money and wealth is why Mills (2000b) argues that from a Christian perspective wealth can be “a bad investment”. Indeed, this is a challenge for Churches as Jones (1984) argues that recent theology is pressing the Church of England to regain a sense of “God’s bias towards the poor” while Sider (1987) argues that “Christians of all theological labels have bowed the knee to mammon”. A distinction is made in Angus (1992) between the positive activity of wealth creation and the negative activity of “amassing riches”. A positive view towards wealth creation (but not towards amassing wealth) with some reservations is also taken in Church of Scotland (1988).

Because of the manifestations of the screening and engagement strategies it seems that ethical funds – particularly those with a twin track or integrated approach – are an improvement on non-ethical funds in areas such as engaging with company management on ethical issues and avoiding certain activities (Moore, 1988; Mills, 2000). Mills (2000) and Moore (1988) were also in agreement that there were more ethical investments available than the ethical funds. One such example suggested by the interviewees was deposits in “ethical financial institutions” such as the Triodos Bank and Shared Interest.

⁴¹¹ Chryssides and Kaler (1993) have argued that business can be socially responsible, but this requires that profit is not the sole or predominant motive.

Some interviewees believed that investment in these organisations was more ethical than investment in ethical funds, because direct support and financing were provided to areas such as low cost housing or renewable energy. However, these institutions do not provide pensions and may be unsuitable for some investors because of restrictions other than low returns.⁴¹² Mills (2000) argues that whilst there “are no easy answers”, owner occupied housing and employee share ownership may be ethically preferable to investments in ethical funds, while ethical funds fare better than non-ethical funds, government bonds and bank accounts in his analysis. The main criteria employed for this assessment are: “Personal stewardship, knowledge of how invested funds are used, equity vs interest, hoarding of wealth and speculation.

Some sayings of Jesus within the Christian Gospels appear to pose a challenge to ethical funds. For example, Jesus said: “You cannot serve both God and Money” (Mathew 6:24).⁴¹³ In the context of this verse it is argued by Gorringer (2000) that although individuals within financial institutions need not be greedy at all, “the system is greedy on their behalf”. The issue here is that at least 9 interviewees argued that the financial return was of primary importance and seemed to dominate ethical considerations.⁴¹⁴ The field study demonstrated that the demands for financial returns influenced both choice of ethical criteria and how these criteria were operationalised towards a “less restrictive” direction (often a 10% of turnover cut off point, rather than 0%, 1%, or 5%). As one commentator argued the literature seems to agree, that:

I know of no example of such a fund making an investment purchase in expectation of below average returns. Nor do I know of any example of a retail ethical/SRI fund publicly stating that it was doing something likely to be unpopular among its clients on the grounds that it was the ethically correct thing to do (Sparkes, 2001).

⁴¹² For example, the Shared Interest 2007 Microcredit bond with zero return has a minimum investment of £2000 and the assets are unavailable until 2007.

⁴¹³ The context is the Sermon of the Mount where Jesus also disapproves of divorce and tells people to turn the other cheek rather than to strike back. This verse is also quoted in Luke 16:13 in the context of the parable of the shrewd manager.

⁴¹⁴ At least 5 interviewees argued for a high priority on ethics and some argued for high priority on both ethics and financial performance.

The extreme form of these less restrictive funds are some “best in class eco efficiency” funds which can invest in any sector including nuclear power, pornography, tobacco and weapons as long as the companies would be “progressive within the sector”. Such funds, although referred to as “ethical”, would not fall within the definition of an ethical fund in this dissertation.

It would seem as if Haan (1988), Greider (1997) and Northcott (1999) are right in their claim that the system dominates wealthy and poor alike. If this is so, then investment into small financial institutions or institutions not listed on a stock exchange may be preferable to some of the large listed ones, because smaller unquoted companies may not be as dominated by financial utilitarianism. This suggests that the type of organisation and the ethics of the institution might be of relevance in addition to the ethical fund itself.

The findings would also suggest that ethical funds alone are not sufficient for addressing the Biblical concern for the disadvantaged (Centre for Theology and Public Issues, 1992). Alternative investment and charity would seem to have an important role to play in relieving the plight of the poor (Catholic Bishops, 1992; Haan, 1988). It is argued by Haan (1988) that money should be used “to establish friendly relations so that those poor whom you have befriended will welcome you into heaven...The poor are the representatives of Jesus”.⁴¹⁵ These issues are not addressed through investment in ethical funds.⁴¹⁶ One interviewee argued that it is the individual investor who brings together the various forms of ethical investment. The literature made it clear that there were both individual and institutional investors who invested in ordinary funds, ethical funds, community projects and gave to charity simultaneously (Melton and Keenan, 1994; Lewis and Mackenzie, 2000).⁴¹⁷ It has been suggested by Lewis and Mackenzie (2000) that the proportions allocated to different categories may serve as a proxy for “the ethicality of the investor”. Concern has been expressed that some investors might actually ignore alternative ethical investment because

⁴¹⁵ This is an interpretation of Luke 16:9 where Jesus says: “I tell you, use worldly wealth to gain friends for yourselves, so that when it is gone you will be welcomed into eternal dwellings” (NIV), worldly wealth is translated “mammon of unrighteousness” in the King James Bible.

⁴¹⁶ Marrs (2002) argues for ethical investing on the grounds that “Jesus’ gospel was good news to the poor”, whilst current trends in the economic order are not.

of a focus on ethical funds (Moore, 1988; Centre for Theology and Public Issues, 1992). It was argued in Haan (1988) that whilst money is a tool with no intrinsic value, wealth often has a negative spiritual aspect attached to it. For example the Brazilian Bishop Camara has argued that:

“I know how very hard it is to be rich and still keep the milk of human kindness. Money has a dangerous way of putting scales on one’s eyes, a dangerous way of freezing people’s hands, eyes, lips and hearts” (quoted in Sparkes 1998).⁴¹⁸

There can of course be legitimate reasons to invest in ethical funds from an agape based perspective such as to provide for pensions and maintenance of property. Ethical funds did seem to have certain benefits in comparison to non-ethical funds such as specialist ethical researchers and ethical committees which implement screening and engagement strategies. Despite these and other benefits, it does not automatically follow that ethical funds are a good investment from an agape based Christian perspective. A conclusive answer would require assessment of many factors such as the motivations for making the investment, how the proceedings will be used and what alternative uses of the resources were available. A general answer to the question of whether ethical funds are a good investment from an agape based Christian point of view would seem to be difficult to provide within this dissertation. This inconclusive answer points to a need to go beyond financial considerations when major investment decisions are made and to consider the ethical dimension however difficult it may be. Chapter 3 suggested that ethical theories in themselves may help to gain some insights such as considering duties involved (deontological ethics), possible consequences (teleological ethics), and whether love has anything to do with the investment and the motives (agapism).

This section has identified a problem in terms of ethical funds being a good investment from an agape based point of view. This challenge is the promotion of good for the disadvantaged. Most ethical funds make no investments in poor countries. Furthermore, this investigation has provided little evidence that

⁴¹⁷ Institutions included the Catholic Church and Protestant Churches (Catholic Bishops, 1992).

investment in ethical funds benefit the disadvantaged within the countries they invest in. The field study also provided evidence that many sample funds were dominated by financial motivations. This is not surprising, but means that such funds are not intrinsically good in a moral sense from an agape based perspective. Instead, they provide investors with an opportunity to utilise the stock market with less conflict between their values than non-ethical funds.

The investor must therefore ensure that the ethical fund considered has rigorous criteria and processes for dealing with ethical issues to minimise the conflict with personal ethical values. Furthermore, an agape based ethic would require that ethical funds are used as a means for a legitimate end if it is to be a morally good investment. The motive for the investment and the use of the returns would need to be in harmony with a love of God and other people.

11.7 Conclusions

This Chapter points to a need to extend the appraisal of investments beyond the traditional risk and return framework. This argument has been put forward by others such as Purcell (1980) and Boatright (1999).⁴¹⁹ Others have argued that society grants companies the privilege of limited liability and that this privilege entails an obligation to consider ethical issues (Sparkes, 2001). Indeed, ethical funds have been mentioned as one example when ethical values are considered in making investment decision in addition to financial considerations (Lewis and Mackenzie, 2000; Statman, 2000). For ethical funds in particular ethics should be incorporated as a third dimension in addition to risk and return.

A number of ethical theories and Church doctrines may be relevant for this ethical dimension. This dissertation considered ethical theories such as deontological, teleological and the ethic of agapism. Agapism is a common element influencing investments by many Church investors. Examples provided in this Chapter included Lutheran, Methodist, Quaker and Presbyterian investment ethics (Wesley, 1760; Church of Scotland, 1988; Church of Finland,

⁴¹⁸ Card (2000) argued that “Judas betrayed Jesus for money”, see also Ez 16:49 and 1 Tim. 6:10. Yet some esteemed men in the Bible such as Abraham were wealthy men (Haan, 1988).

1999; Marrs, 2002). In terms of Church doctrine the interviews and the literature agreed that Methodist and Quaker ethics have had a substantial influence on how ethical funds developed in the UK. These groups have historically been active in social causes such as opposing slavery and prison reform (Wogaman, 1994). Lutheran ethics was considered as it was the main religion in 4 of the countries studied and this Church is involved in ethical funds in Finland and Sweden. For investors in these denominations who want to invest in the same way as their Churches, criteria addressing issues such as alcohol, child labour, human rights, pornography and weapons would be required to make an ethical fund a morally good investment. Furthermore, processes such as use of ethical research and an ethical committee would be desirable for such Methodist and Quaker investors (Methodist Church, 2001).

This ethical dimension is subjective because various ethical theories may lead to different views on the same ethical issue (Geisler, 1997). The field study demonstrated that there was substantial variation in approach and criteria adopted by different ethical funds. The literature also demonstrated some differences among institutional investors such as Churches and Charities in terms of which ethical criteria were adopted (Jones, 1984; Church of Scotland, 1988; Domini and Kinder, 1997; EIRiS, 2001). Despite these differences the field study demonstrated a similarity between ethical criteria employed by ethical unit trusts and Church funds, particularly in the 1980's.

The interviewees and many authors agreed that investment options which are more ethical than the ethical funds are available, although at a lower return. Examples included "ethical banks and financial institutions" such as the Triodos Bank and Shared Interest and "ethical companies" such as Traidcraft, but none of these organisations provide pensions. For Christians who consider the Bible as authoritative and adherents of Kantian ethics the interviews and literature pointed to the possibility of more fundamental tensions. Because the financial returns were the main concern for most ethical funds, they are not necessarily a good investment in an ethical sense for adherents of such ethics.

⁴¹⁹ Statman (1999; 2000) argued that value expressive features such as social responsibility should be considered in behavioural asset pricing models.

Many theologians have argued that accumulation and concentration of financial wealth can have negative spiritual consequences (Haan, 1988; Sider, 1987). In the Proverbs of Solomon this is expressed many times; for example, “better a little with righteousness than much gain with injustice” (16:8). If the financial needs of an investor including a reasonable pension have been provided, then alternative investments and charity would seem as better investments morally than ethical funds for an individual investor from the viewpoint of an agape based ethic. The motivation for this is that the primary function of alternative investment is to help “people in need”, while the primary function of unit trusts is to provide financial returns.

There is an important distinction in how the proceedings will be used between retail funds and pension funds. For example, the main aim of stock market investments by Churches is to provide pay and pensions for their staff and funds for maintenance of the buildings (Laughlin, 1988; Church of Finland, 1999). There are thus differences in the motives and the use of the proceedings in which providing pensions and funds to maintain buildings are more ethical objectives than an aim to get rich in an ethical manner. The area of “ethical” pension funds is perhaps where the greatest opportunities for implementing screening and engagement strategies lies, especially after the UK regulation introduced in July 2000 on disclosure of whether ethical issues are considered in investments (ABI, 2001). Indeed, the UK ethical funds analysed in the field study contribute to this development by offering ethical pension funds (Holden and Meehan, 2001).

It seemed difficult to provide a conclusive answer to the question of whether ethical funds are a good investment morally from a philosophical or a Christian point of view. In both cases it seemed that the answer could be positive or negative depending on circumstances and assumptions made. It seemed as if most if not all ethical funds had room for improvement in areas such as philanthropy, voting, and in direct support for positive activities and disadvantaged groups. Therefore the conclusion is that no amount of investment in ethical funds can remove the need for alternative investments and charity.

Nevertheless ethical funds did seem to represent an improvement over non-ethical funds in terms of some of the areas outlined in Church of Scotland (1988) and Wesley (1760) and therefore would seem to be a useful investment tool in some cases. Indeed, the field study demonstrated that some ethical funds had as extensive criteria and processes as Church investors. Yet it was clear that many ethical funds did not employ the same criteria and processes as various Church investors. For members of such Churches who want to invest in a similar manner to their Church it was clear that some ethical funds would not be morally good investments. Other ethical funds closer aligned to Church doctrine can still be good investments ethically and are endorsed as such by Church of Scotland (1988) and Mills (2000).

Chapter 12 Conclusions

12.1 Introduction

The previous Chapter considered ethical funds from an agape based Christian perspective. This Chapter aims to analyse the issues raised in the previous Chapter(s) further. In addition, this Chapter will bring together the previous conclusions and address the research question: Are ethical funds a good investment? This question was partitioned to two major empirical research areas. First, the question of whether ethical funds were good investments financially was examined in Chapters 4 to 7. Second, the processes underpinning ethical fund operations rather than the outcomes of the funds' decisions was analysed in Chapters 9 and 10 in order to consider whether such funds were good investments "ethically" when compared with other stock market investments. Historical information about the development of ethical funds in Europe was provided as background and context to the empirical investigations in Chapter 2. Finally, a number of ethical theories were presented in Chapter 3; the assumptions underpinning these theories were outlined in Chapter 8 and the ethical theories were employed in Chapter 11 to analyse whether ethical funds were a "good" investment in terms of various ethical approaches and Church doctrine. This was done because the question of whether ethical funds are a good investment is not only an empirical question; it is also a philosophical and a theological question.

This Chapter is structured as follows. The next section will consider the financial performance of ethical funds. Section 12.3 will evaluate the strategies and processes of ethical funds, while section 12.4 will provide an agape based perspective on the topic of this thesis. Section 12.5 will consider the contribution of the dissertation to the literature in this area, while section 12.6 will address limitations and unresolved issues and present some topics for future research. Policy implications are highlighted in section 12.7. Finally the dissertation is concluded in section 12.8.

12.2 Financial Performance of Ethical Funds

Chapter 2 demonstrated that the question of the financial performance of ethical unit trusts in the UK dates back to 1973 when the first proposal for the ethical unit trust with the name Stewardship was turned down because of a possible conflict between “capital and conscience”. Some individual(s) in the Department of Trade at that time gave a negative answer to the question of whether ethical funds were a good investment financially. Indeed, non-financial papers on ethical funds have argued that the financial performance is an important consideration and that many investors in ethical funds expect returns that are similar to non-ethical funds (Cooper and Schlegelmilch, 1993).⁴²⁰

The standard approach in the fund performance literature which permeates finance is adopted in this thesis. A number of benchmarks and risk adjusted performance measures were employed in Chapter 6 in order to address the question of whether ethical funds were good investments financially. The financial performance of 40 ethical funds in 7 European countries were analysed between 1996 and 1998. Because of concerns with benchmark sensitivity, 3 main benchmarks were employed; The Financial Times All Shares Index, The Morgan Stanley Capital International World Index and the major domestic index for each individual country.⁴²¹ Specifically, following earlier studies of ethical fund performance the Sharpe, Treynor and Jensen performance measures were employed (Luther, Matatko and Corner, 1992; Mallin, Saadouni, and Briston, 1995; Statman, 2000).

The market timing models developed by Treynor and Mazuy (1966) and Henriksson and Merton (1981) were also used to study whether ethical fund managers have any market timing ability. No positive timing ability was found; indeed, many funds had significantly negative market timing coefficients. The results indicated that any under-performance of ethical funds was more likely to arise through poor market timing than poor stock selection decisions. Preliminary regressions to explain some of the performance measures found

⁴²⁰ Many studies have identified sub-groups of ethical investors where typically a minority are willing to “invest ethically” regardless of cost, while the majority expect good financial performance (Inskeep, 1992; Cooper and Schlegelmilch, 1993; Lewis and Mackenzie, 2000b).

⁴²¹ A two factor model with the FTSA index and a small company index was also employed.

weak evidence of a positive relationship between ethical fund size and fund performance.⁴²²

Substantial differences between the performances of different ethical funds were documented in the analysis but as a group their risk adjusted returns were similar to those earned by the Morgan Stanley Index. The results were broadly similar with the FTSA Index; as a group, ethical fund performance was similar to that of the index. Analysis using national indices, also yielded similar findings. Indeed, six ethical funds actually had significantly positive Jensen measures when the national benchmarks were used. Therefore the conclusion of Chapter 6 was that the sample funds were “good” investments financially as the risk adjusted returns they offered were not significantly different to those available to funds which simply track an index. However only 156 observations per fund (or three years of data) was analysed in Chapter 6. The main reason for this short time period was that some of the sample funds were launched in 1995 and the first month of 1996. Extending the time period back would thus have cut the sample size. In order to control for whether the findings were sample or time period specific the findings were compared to other studies of ethical fund performance. These studies have documented that the performance for ethical funds is similar to market benchmarks (Luther, Matatko and Corner, 1992; Hamilton *et al.*, 1993; WM Company, 1996; Reyes and Grieb, 1998; and Cummings, 2000). Although Luther and Matatko (1994) noted that ethical funds underperformed a market benchmark, the under-performance disappeared when a small company index was incorporated into the performance evaluation.

Other recent investigations such as Guerard (1997), EIRiS (1999), WM Company (1999) and Antonio *et al.* (2000) have documented similar performance for ethical indexes and market indexes. The results from Chapter 6 do not imply that investors should expect that the returns from ethical funds will be identical or higher than those from a market index. The findings of this study and other previous investigations simply demonstrate that, on average, investors in ethical funds have not incurred a significant cost in terms of risk adjusted

⁴²² Large ethical funds seemed to have better financial performance than the small ones.

returns because of less diversification through a focus on a restricted universe of securities. The overall conclusion from Chapters 4-6 is therefore that ethical funds are good investments financially in comparison with market benchmarks.

12.2.1 A Comparison of the Performance of Ethical and Non-Ethical Funds

The benchmark problem is well documented in the fund performance literature (Roll, 1978; Grinblatt and Titman, 1994; Luther and Matatko, 1994); the returns achieved are sensitive to the index used. One approach to overcome this problem was developed by Mallin *et al.* (1995). Instead of focusing on a comparison of the performance of a group of funds and a market benchmark, they compared the performance of ethical funds with “matched pair” non-ethical funds.⁴²³ This approach was later followed by Gregory *et al.* (1997), Statman (2000) and Naturvårdsverket (2001). The matched pair approach was also adopted for Chapter 7 and extended to a European context. Following Mallin *et al.* (1995) and Gregory *et al.* (1997), the size and age of the funds were employed as criteria in the matching process. Other criteria considered in the matching were country in which the fund was located and investment universe in terms of geography and asset allocation. Because of data gathering difficulties, the “matches” were less exact for a few of the continental European pairs than for the UK funds. Nevertheless, the findings of this study demonstrated that the performance of ethical and non-ethical funds was similar according to the Sharpe, Jensen and Treynor measures. The matched pair study of Chapter 7 therefore confirmed the earlier results from Chapter 6. These findings are also in line with the results reported in Mallin *et al.* (1995), Gregory *et al.* (1997), Statman (2000) and Naturvårdsverket (2001). The findings of Chapter 7 therefore confirmed the conclusion from Chapter 6 that ethical funds as a group were “good” investments in a financial sense.

In all of these studies there were some non-ethical funds which outperformed their ethical counterparts, but *a priori* there did not seem to be evidence that investors in ethical funds would achieve significantly lower risk adjusted returns than investors in the matched pair funds. In fact Chapter 7, provided some

⁴²³ Others have also argued for comparing “performance to other active portfolios” (Travers, 1997).

further evidence that ethical funds were less risky than the matched pair funds, particularly when risk was measured by fund beta. A possible explanation was suggested by a few fund managers who said that their funds had adopted a low risk strategy. The results from market timing regressions again indicated that any under-performance by ethical funds was likely to be due to poor market timing rather than stock selection. This was because the stock selection coefficients were higher for ethical than for the non-ethical funds, while non-ethical funds seemed to have less negative timing coefficients than the ethical funds. This would suggest that the ethical policies did not harm the stock picking ability of the ethical funds.

The overall conclusion of Chapters 4-7 was therefore that, on a risk-adjusted, basis ethical funds were good investments in comparison with both market benchmarks and matched non-ethical funds. Ethical funds thus seem to have been able to integrate some ethical considerations into the investment processes, without a significant cost for investors in terms of risk adjusted returns.⁴²⁴ The next section will consider the processes and strategies employed by ethical funds to address ethical considerations.

12.3 Strategies and Processes of Ethical Funds

The funds analysed in Chapters 6 and 7 were classified as ethical by various organisations such as EIRiS and Standard & Poor; in addition, the funds generally marketed themselves as ethical. Therefore the researcher considered the investment processes of ethical funds and investigated how they differ from those of other funds. Indeed, ethical funds claim that they consider ethical issues relating to how the financial returns are generated by their investee firms. These processes were studied using a field study approach in Chapters 9 and 10. The field study also informed the historical analysis of the development of ethical funds described in Chapter 2. Such field research into ethical funds has been advocated by Lewis and Cullis (1990) and Harte *et al.* (1991).

⁴²⁴ Furthermore, ethical funds with extensive screens and active engagement such as Friends Provident Stewardship achieved good financial performance (Chapter 6, Mallin *et al.*, 1995). This was also the case for NPI Global Care (Chapter 6, Gregory *et al.*, 1997).

Two main strategies for integrating ethical values into the investment process were identified in Chapter 9. These strategies were (i) ethical screening and (ii) engagement with company management on ethical issues. Ethical screening was operationalised by using both negative and positive ethical criteria. Typical negative criteria included avoidance of companies substantially involved in sectors such as alcohol, nuclear power, tobacco and weapons.⁴²⁵ Chapter 2 demonstrated that exclusionary screens are the oldest and most commonly used method of integrating ethical concerns into the investment policy of ethical funds. In the 1990's it became common to employ positive criteria with the aim of investing in companies and sectors which benefited the community and/or the environment such as public transport and renewable energy or in firms with progressive ethical policies and practices. Positive and negative criteria are complementary and many sample funds employed both types of criteria. Exclusionary ethical criteria in particular may lead to a situation where companies – for example due to mergers and takeovers – have to be divested for ethical reasons. The field study revealed that most sample funds had sold shares for such ethical reasons. This could be one reason for the poor market timing ability exhibited by ethical funds in Chapters 6 and 7. Strict use of positive criteria can limit the investment universe more than negative criteria. The field study demonstrated that this was the case for some continental funds which had approved less than 100 firms for investment.⁴²⁶

In the UK the second strategy, that of engagement with company management on ethical issues, was pioneered by Merlin Ecology which was launched in 1988. This approach remained relatively rare until the mid 1990's when some of the pioneering individuals from Merlin Ecology moved to NPI and Friends Provident employed new staff. These individuals encouraged their institutions to become more active in engaging with companies on ethical issues. In the

⁴²⁵ Generally, only firms manufacturing such products are excluded. The exact definitions varies, but typically only firms deriving 10% or more of their turnover from such activity are avoided.

⁴²⁶ An interesting point made in Cowton (1999) and reinforced by this field study was that some ethical funds had additional ethical criteria to the published ones. Cowton (1999) mentioned a fund which did not employ nuclear power as a criterion, but no investments in this sector had ever been made. This field study revealed other examples such as a fund which did not have the chemical industry as a criterion but in practice avoided this industry. This suggests that published material may not provide sufficient information about the ethical policies of some funds as Mackenzie (1997b) argued.

Netherlands the team of ethical researchers at ASN/SNS have engaged company management on ethical matters particularly since the late 1990's. An effective engagement strategy seemed to require some in house ethical expertise and the field study revealed that those funds with an engagement strategy had such a research capability. However, a recent study of ethical fund engagement with companies indicated that only 4 institutions of the UK sample had voted on ethical issues and were able to provide examples of successful engagement (EIRiS, 1999). Despite the challenges with this approach and the risk that it is being employed as an excuse for lax ethics (Guptara, 2001), some interviewees thought it had great potential and that it was a major trend in ethical investment. Friedman and Miles (2001) argued that new pension regulations further increased interest in the engagement approach as some pension funds found this strategy more attractive than screening, primarily for legal reasons. The engagement approach has therefore recently become more common (Miles and Friedman, 2001). This supports the argument of an interviewee who claimed that "engagement is the way forward".

The engagement approach of European ethical funds differs from that of their American counterparts which tend to vote more often on ethical issues (Bruyn, 1987). The field study indicated that voting on ethical issues seemed to be restricted to a few UK ethical funds. Voting on ethical issues is, however, becoming more common, although it is still rare outside the UK.⁴²⁷ A concern was expressed in Chapter 9 that because most ethical funds did not vote on ethical issues there was a risk that very few shareholders seriously raised ethical issues with management. This lack of interest from shareholders could in turn discourage company managers from treating ethical issues seriously.

The two strategies of screening and engagement are not mutually exclusive. Indeed, all the sample funds with an engagement strategy also employed some ethical screens. Most sample funds also had an ethical advisory committee consisting mainly of external members who monitored the implementation of the ethical strategies. Some of these committees also monitored correspondence

⁴²⁷ An example was shareholder resolutions on environmental issues at the BP Annual General Meeting in 2000, some ethical funds voted on these. Other examples include Rio Tinto and Shell.

and complaints from unit holders. Other mechanisms employed by some ethical funds to increase the transparency of their own investment processes included newsletters to unit holders and annual general meetings attended by unit holders of the ethical fund(s).

Chapter 10 identified 3 approaches to stock selection among the sample funds; commercial, twin track and integrated. These categories were not always entirely discrete or precise, rather they represent a first step towards theory building or “skeletal theory” (Eisenhart, 1988; Laughlin, 1995). The typical commercial fund was a recently established fund, employed only a few exclusionary screens and did not engage with companies on ethical issues. Often funds following this market led approach relied solely on an external source for the information necessary to implement the screens. By contrast twin track funds generally had some in-house ethical expertise, including specialist ethical researcher(s).⁴²⁸ Twin track funds also tended to engage in one or more of the following; engage with companies on ethical issues, vote on ethical issues, have an ethical committee and/or sell companies for ethical reasons. In the twin track funds two very separate processes generally existed; one financial and one ethical. In the third approach, the integrated approach the fund manager played more of a part in the ethical process. In addition, the financial institution themselves had an ethical policy, often gave high level support for the ethical funds and allowed these funds to engage in various related initiatives.⁴²⁹

Some interviewees argued that ethical funds could not change the economic system substantially, but rather achieve “incremental change at the margin”. This incremental approach meant that areas such as plant closures, moving production to countries with cheap labour and mergers and acquisitions generally were thought to be outside the scope of the ethical funds. Issues such as product pricing and aggressive business practices and some negative effects of global markets such as the distress of local and domestic businesses which

⁴²⁸ For example Jupiter which describe their approach as “twin track” states that the institution has 8 staff members dedicated to ethical investment (Jupiter, 1999; 2001).

⁴²⁹ The only fund(s) identified as integrated funds were the NPI Global Care Funds. In addition to everything mentioned above the parent company has a sustainability policy. The funds have worked with WWF on various initiatives, they launched a CO2 indicator with UNEP and they launched the NPI Social index. The fund manager sat in the same room as the ethical team.

fail in competition with international corporations were rarely directly addressed by ethical fund criteria. On the other hand, at least six interviewees gave examples where the funds had helped to achieve positive change in areas such as environmental reporting, environmental management systems, ethical policies and avoidance of some acquisitions which would have resulted in a breach of the ethical funds' criteria. A number of examples were also given where firms had been divested for ethical reasons, while a few examples were given where border line companies were kept in the portfolio, but on the condition that the firm(s) improve performance in certain non-financial areas.

A number of other areas were identified where there was room for improvement for ethical funds. These included investing in emerging markets, co-operation with non-governmental organisations and philanthropy. The problem of low environmental and human rights standards in some countries were often addressed by avoiding investments in these countries.⁴³⁰ Yet it seemed perplexing that none of the sample ethical funds seemed to have significant investments in Africa or South America. Increased investment in emerging markets would therefore seem to be an opportunity for ethical funds. A few ethical funds co-operated with NGOs and some others had links to Church groups. Most sample funds however had no formal links to neither NGOs nor Church groups. Co-operation with such organisations could help the funds in gathering information on companies and various ethical issues.

The field study did reveal substantial variations in the approaches employed and the criteria adopted by ethical funds indicating that any investor would need to study the specific ethical policies with great care. However, as a result of the processes and strategies in place it was argued in Chapter 10 that ethical funds did represent an improvement over non-ethical funds for ethically concerned investors. This was especially true where ethical funds devoted some resources to ethical issues. These funds tended to follow a twin track or integrated approach and seemed more successful in addressing ethical concerns than non-ethical or ethical funds following a commercial ethical approach. Therefore

⁴³⁰ For example, the CIS Environ fund avoided around 60 countries.

Chapter 10 argued that although ethical funds “were not a panacea” they seemed to be “good” investments in an ethical sense when compared to other funds. This conclusion is consistent with the findings of Cowton (1999) who argued that the ethical fund he studied “kept its ethical promises”. Some interviewees made the point that alternative investments outside the stock market in organisations such as Shared Interest and Traidcraft were perhaps “more ethical” than investments in ethical funds. These alternative investments will be considered further in the next section which will present an agape-based Christian perspective on the topic of ethical funds.

12.4 An Agape Based Christian Perspective

A significant minority of the interviewees mentioned that Christian groups had been instrumental in starting the fund and/or that religious investors were a major customer group for the ethical fund(s).⁴³¹ These facts are also well established in the literature (Sparkes, 1995; Gray *et al.*, 1996; Hancock, 1999). A Judeo-Christian ethic such as agapism may be preferable to utilitarianism for some Church members, since utilitarianism according to many theologians is incompatible with Christianity (Geisler, 1994; Eskola, 2001).⁴³² Others have argued that a reason for the environmental problems is the spiritual failing of Western society and that spiritual re-awakening and restraint is necessary to address the problems (Daly and Cobb, 1990; Harte *et al.*, 1991; Schumacher, 1993). The theocentric ethic of agapism presented in Chapter 3 is one ethic which advocates such restraint. Agapism emphasises the importance of God and concern for the well being of others. This ethic has been normative for many Christian Churches (Frankena, 1963; Macquarrie and Childress, 1997; Calkins, 2000).⁴³³ Specifically, agapism is mentioned as an element in the ethical investment strategy of Lutherans, Methodists, Quakers and Presbyterians (Wesley, 1760; Church of Scotland, 1988; Church of Finland, 1999; Marrs, 2002). These Churches had devoted some assets to alternative investments such as affordable housing for disadvantaged groups (Melton and Keenan, 1994).

⁴³¹ Chapter 2 provided examples of 12 European ethical funds with such Church links.

⁴³² Other Church members may support certain forms of utilitarianism and mainstream economic theory (Frankena, 1963; Richardson, 1988).

Chapter 11 suggested that Churches have been an important cultural influence in the countries studied. In the investment arena different Churches have manifested this agape based ethic in different ways (Melton and Keenan, 1994). Church perspectives were used as a basis of a reflection on ethical investment in general and ethical funds in particular. All Churches screened investments; indeed, Chapter 2 demonstrated that the origin of many screens such as alcohol, gambling, tobacco and weapons originated from Church doctrine (Catholic Bishops, 1992; Kinder and Domini, 1997). This approach of early ethical funds and Church investments could be seen as a manifestation of a pragmatic deontological ethic (CEIG, 1992; Church of Finland, 1999).

There are however accounts in the Bible which indicate that a deontological approach of avoiding “sin stocks” alone is insufficient from a Christian perspective.⁴³⁴ Indeed, Churches have engaged with company management on ethical issues, but according to critics within these Churches this engagement has been neither systematic nor transparent (Sparkes, 1995). Among ethical funds, engagement with companies on ethical issues became more common in the latter half of the 1990’s. Working with companies on ethical issues in order to promote best practice seemed to be an approach which to some was in harmony with teleological and Christian ethics (Purcell, 1979; CEIG, 1992).⁴³⁵

Chapter 11 demonstrated that many religious investors employed exclusionary criteria such as alcohol, gambling, pornography, tobacco and weapons for their investments (Church of Scotland, 1988; Church of Finland, 1999).⁴³⁶ In addition Church investors have started to consider environmental issues in their investments (Church of Sweden, 1996; Church of England, 1999). It was argued that ethical funds which ignored most of the concerns of such Church investors

⁴³³ For example, it has been argued that the ethics of the Lutheran and Methodist Churches draws on agapism, while Calkins (2000) has written about agapism from a Catholic perspective (Macquarrie and Childress, 1997).

⁴³⁴ Examples of engagement are provided in the story of Jesus and Zaccheus the tax collector (Luke 19:1-10), Jesus and the sinful woman (Luke 7:36) and the good Samaritan (Luke 10:25).

⁴³⁵ The view of Simon *et al.* (1972) was that “the basing of portfolio purchases on maximum return principles can be compatible with an ethical approach to investment, but only if the individual shareholder actively seeks to bring about corrective action on discovering corporate wrong” (quoted in Gray *et al.*, 1996).

⁴³⁶ The Methodist Church had sold a number of firms for ethical reasons and voted their shares on ethical issues. An ethical committee regularly monitored investments (Sparkes, 2001).

were not good investments from a moral point of view for investors who wanted to align their investments with the doctrine and practice advocated by their Church. This meant that for the denominations considered there were some ethical funds which were not good investments from a moral point of view.

From an agape based ethical viewpoint, compassion for the disadvantaged and the concerns raised about some of the consequences associated with global markets are relevant (Church of Scotland, 1988; Church of Sweden, 1996). Some interviewees indicated that if positive change for these groups was an investment objective then socially directed investment through institutions such as ASN or Triodos, (sometimes referred to as “ethical banking”) might be more effective than ethical funds.⁴³⁷ Other options included investment in social enterprises such as Shared Interest, Traidcraft or direct contribution to charity. Indeed, for Christians adhering to an agapist ethic who had arranged their pension investment and met their reasonable consumption needs it was possible to consider circumstances where ethical funds would not be good investments from an ethical point of view. Such a case could arise if the needs of others were ignored in favour of hoarding wealth (Mills, 2000b).

It is difficult to provide a conclusive answer to the question of whether ethical funds are a good investment morally from a philosophical or a theological point of view. It seems that the answer could be positive or negative depending on circumstances and assumptions made (Bonhoeffer, 1978). Most if not all ethical funds have room for improvement in areas such as philanthropy, voting and in direct support for positive activities and disadvantaged groups.⁴³⁸ Therefore, the conclusion is that no amount of investment in ethical funds will remove the need for alternative investments and charity. Nevertheless, ethical funds did seem to represent an improvement over non-ethical funds in some of the areas outlined in Wesley (1760), Church of Scotland (1988) and Church of Sweden (1996).

The concern of Wesley (1760) of not earning returns at the expense of “our neighbours health” was partly addressed through screening out certain industries

⁴³⁷ It is noteworthy that “ethical banks” such as ASN, Triodos and Ökobank have all launched ethical funds, signalling their approval of this form of ethical investment.

⁴³⁸ Of the sample funds in the field study 25% provided funds to charity and 50% had voted on an ethical issue. It was not clear if any of the funds had helped disadvantaged groups.

and products and encouraging best practice in the areas of health, safety and environment through engagement with companies. Other areas included taking an “interest in the policies and practices of the company” through an engagement strategy and by employing ethical criteria relating to the community and stakeholders such as employees (Church of Scotland, 1988). The concern for the environment expressed in Church of Sweden (1996) was addressed through a number of environmental criteria and engaging company management on environmental issues. Ethical funds would therefore seem to be a useful investment tool in some cases, especially for providing pensions and means for education and housing.

From a Christian ethical perspective, the answer to the question of whether ethical funds are a good investment is context bound (Bonhoeffer, 1978). For providing a pension, ethical funds seemed to be a good investment. Indeed, the empirical study suggested that some level of screening and engagement could be employed by funds without a significant economic cost. In America, pension funds have for many years employed both screening and engagement on ethical issues (Melton and Keenan, 1994). However, if an adherent of an agape based ethic invested in ethical funds with wealth accumulation as the only motivation and in so doing neglect to show concern for others in need then this would not be a good investment in a moral sense. Furthermore, this would mean that in such a case even an ethical fund with outstanding financial performance and comprehensive ethical criteria and processes would not be a good investment for an adherent of an agapist ethic. This indicates that an ethical framework such as agapism can help to put financial considerations in the right perspective as Calkins (2000) and Oslington (2000) argued. From an agape based perspective maximum return must be put aside as the primary aim of fund management if ethical criteria are violated. A reasonable profit rather than maximum profit is the line taken in agapism (Luther, 1524; Moore, 1988; Church of Finland, 1999). From an agape based perspective compassion for others is a motive which leads to introducing ethical criteria into the investment process. The investment is not an end in itself but only a means to some other end (CEIG, 1992; Church of Finland, 1999).

12.5 The Contribution of the Dissertation

This dissertation sought to contribute to the existing literature on ethical funds in a number of ways. In terms of analysing the financial performance of ethical funds, the analysis in Luther *et al.* (1992) and the matched pair analysis developed by Mallin *et al.* (1995) was extended to 7 European countries. The number of ethical funds studied was also increased when compared to previous investigations (Luther and Mataka, 1994; Gregory *et al.*, 1997). For the first time (as far as I'm aware) the well known market timing models developed by Treynor and Mazuy (1966) and Henriksson and Merton (1981) were employed in a study of ethical fund performance. The study also contributes to the European fund performance literature in that, rather than examining funds from a single country only, this study investigates funds from 7 countries. In previous studies of funds, only funds from one country have typically been studied.

This dissertation also contributes with a field study of ethical funds. Various authors have requested qualitative research into ethical funds, yet such research is scarce (Lewis and Cullis, 1990; Harte *et al.*, 1991). Chapters 9 and 10 extend the number of interviews conducted and institutions examined in comparison to previous research as Friedman and Miles (2001) recommended. In addition, this field investigation extends previous research which typically has been limited to one country into 5 European countries. This field research may facilitate the building of "skeletal theory" in an area which is new in most European countries and still not well understood (Laughlin, 1995; Cummings, 2000). The study of ethical fund investment processes represents an attempt to increase our understanding of such processes. This field based investigation builds on the qualitative work of Mackenzie (1997) and Cowton (1999).

The historical development of ethical funds was studied through interviews of key individuals involved in the launch of early and pioneering ethical funds. Some historical documents such as the Stewardship proposal from 1973 and material from the Merlin Ecology fund at the time of its launch in 1988 were also scrutinised. In this regard Chapter 2 extends the descriptive literature on

ethical funds in Europe (Simpson, 1991; Merlin Research Unit, 1993; Sparkes, 1995; Deml and Baumgarten, 1998; Hancock, 1999; Naturvårdsverket, 1999).

Early investigations addressed both ethical issues and the financial performance of ethical funds, but they did not seek out empirical evidence of their own (Lewis and Cullis, 1990; Cooper and Schlegelmilch, 1993). This dissertation builds on their work and extends it by offering research results on both aspects. Indeed, as far as the author know this is the first document in Europe to employ ethical theory and to conduct both quantitative and qualitative research in a study of ethical investment funds. Many authors have advocated the approach in this dissertation of using both quantitative and qualitative research (Jick, 1979; Morgan, 1983; Eisenhart, 1988; Yin, 1994; Silverman, 1997).

There is a literature on accounting in Churches (Laughlin, 1988; Booth, 1993; Duncan, Flesher and Stocks, 1999; Parker, 2001). For example, Booth (1993) advocates comparative studies of accounting practices in different Churches both within and across countries. This dissertation follows this recommendation by briefly examining “ethical investments” of Church investors. A first attempt is then made to consider the implications for investors who want to invest in a similar manner as their Church. An ethic utilised by such religious investors, Agapism was used to reflect on ethical investment. Such an ethic provides one alternative for investors who do not fully agree with financial utilitarianism.

12.6 Limitations, Unresolved Issues and Future Research

This study of the financial performance of ethical funds suffered from the fact that only a short time-period of data were analysed. Another difficulty was finding appropriate benchmarks. These problems were somewhat mitigated by use of different benchmarks, and the adoption of the matched pair approach. However this work could be expanded by extending the time period and employing other benchmarks. For example, the FTSE4GOOD and the Dow Jones Sustainability indexes could be employed in future studies of ethical fund performance (Cooper, 2001). These indexes were not used in this dissertation as they were only launched in 2001 and 1999. Building on Elton *et al.* (1993) and Gregory *et al.* (1997) multi-index models could be employed to evaluate the

performance of ethical funds.⁴³⁹ Other research has suggested that factors such as book to market and momentum may add power to single index models (Fama and French, 1993; 1996; Carhart, 1997). These factors could be used in future studies of ethical fund performance.

For the field study in particular there is an issue of generalisability. It is not claimed that the findings of this work are generalisable outside of the sample funds, although it would seem likely that other ethical funds employ similar strategies and processes. Indeed, several interviewees representing more recent ethical funds indicated that existing ethical funds had been studied and used as models when their ethical funds were created. The sample included many of the pioneering early funds which are likely to have served as models for others.

Another limitation of the dissertation is that some of the assumptions, axioms and analysis in Chapters 8 and 11 may not be acceptable to some readers.⁴⁴⁰ Yet similar conclusions could, for different reasons, be drawn from other perspectives. For example, various authors have drawn the conclusion that there is some value for ethically concerned investors in the processes employed by ethical funds, while they nevertheless may not be optimal investments ethically from certain viewpoints such as a deep ecology or some philosophical perspectives (Bruyn, 1987; Harte *et al.*, 1991; Anderson *et al.*, 1996). The view taken in this dissertation is that ethical funds can be, but are not necessarily a good investment from an agape based perspective. Different insights could be gained by analysing ethical funds from other philosophical and theological perspectives.

A major difficulty has been the integration and synthesis of different literatures. Literature relevant for ethical investing can be found in many disciplines including business ethics, philosophy and theology in addition to accounting and

⁴³⁹ A preliminary attempt is presented in Appendix 6.5 where a two index model was employed.

⁴⁴⁰ Others might not accept the assumptions underpinning financial theory such as the agency theory, asset pricing models such as the CAPM or utility theory.

finance. Some of the tensions between these literatures have neither been solved nor reconciled in this dissertation.⁴⁴¹

Several other avenues for further research can be suggested based on work done for this dissertation. The field study indicated that pension funds and Church and Charity funds represent other areas where both the performance and rationale of investments could be investigated. A different test of how ethical policies affect financial performance would be to compare the performance of Church funds which employ screening to “unconstrained” pension funds. The advantage of this approach is that much longer time series could be employed than with the more recently established retail ethical funds.

The field study pointed to alternative investments and ethical banking as interesting options for ethically concerned investors. The research into such alternative investments is limited in accounting and finance. Such research might provide insight into how financial solutions could be provided for individuals and firms whose needs are not met by the capital market(s).

12.7 Policy implications

The empirical research in this dissertation indicates that the ethical funds have successfully integrated some ethical issues into their investment processes. Despite the claims of some authors (Rudd, 1981; Kahn *et al.*, 1997) this did not lead to significantly lower risk adjusted returns. This dissertation therefore supports arguments by Midgley (1981) and Cowton (2002) that individuals can extend ethical values – at least to a degree – to their investments. Such arguments are in line with Kantian deontological ethics and an agape based ethic. Therefore, risk and return are seen as necessary, but not sufficient for an analysis of ethical investment funds (Dobson, 1993; Sparkes, 2001).⁴⁴² Ethical theory is relevant because the ethical funds claim that “ethics” is a

⁴⁴¹ For example, alternative investments may not be fully compatible with conventional finance theory. On the other hand if the non-financial utility an investor receives from such investments compensates for the financial loss, they may be compatible to some extent.

⁴⁴² Many investment funds are managed by trustees who have a fiduciary duty. They cannot therefore make investment decisions on purely ethical grounds (Church of Scotland, 1988). Research has shown that many investors in ethical funds expect similar financial performance from ethical funds as from other funds (Gregory and Lewis, 2000; Woodward, 2000).

distinguishing feature of the funds and research has demonstrated that ethical concerns are important to the unit holders (Lewis and Mackenzie, 2000; Woodward, 2000).

There is also a case for extending the ethical strategies employed by the ethical funds to pension fund and charity investments. Some Dutch and Swedish pension funds have done this (Bayon, 2001b; Matthias, 2002). Alternatively pension funds could invest some of their funds in existing ethical funds. Indeed, this has already been done by some charities and pension funds (UKSIF, 2000; EIRiS, 2001b). In America there is a long history of large pension funds employing ethical investment strategies (Kinder *et al.* 1993; Melton and Keenan, 1994).⁴⁴³ A policy issue related to this is whether legislation would need to be amended to provide European investors the option of an “ethical pension” which has been available to many investors in America for a long time (Melton and Keenan, 1994). In addition to the evidence of reasonable financial performance achieved by both European and American ethical funds, anecdotal evidence was gathered in the field study and examples were provided in the literature indicating that some institutional funds employing ethical criteria had also performed well (Catholic Bishops, 1992; Sparkes, 1995).

In America ethical funds, some pension funds and Church funds have in contrast to their European counterparts actively voted on ethical and corporate governance issues. Some of these funds such as the New York Pension funds have also pursued alternative investments, particularly to provide low cost housing for disadvantaged groups (Melton and Keenan, 1994). This would point to the possibility of another type of ethical fund. An ethical fund which would invest the majority of funds in the stock market and a minority proportion of the funds in low risk alternative investments such as “ethical” bonds.⁴⁴⁴

Two interviewees argued for the importance of regulation if ethical concerns were to be integrated into capital market decisions. Indeed, the new regulation

⁴⁴³ For example, California State Employees’ Retirement System (Calpers), Teachers Insurance and Annuity Association-College Retirement Equity Fund (TIA-CREF) and the New York City Pension Funds.

on disclosure has stimulated many UK pension funds to adopt ethical policies (UKSIF, 2000). Examples include the BT pension fund and the University Superannuation Scheme (USS). Yet a recent EIRiS survey indicated that many UK charities had no ethical policies for their investments (EIRiS, 2002). This may point to a need for legislative change to make incorporation of such ethical policies easier for Charities and Churches in particular.⁴⁴⁵

12.8 Final Remarks

This dissertation set out to answer the question of whether ethical funds are good investments for individual investors. The financial performance of ethical funds was reasonable in comparison to market benchmarks and other funds. The ethical funds had strategies and processes in place which provided some assurance that they would be able to keep some of their ethical promises. The empirical analysis therefore concluded that the answer to this question was positive for ethical funds as a group.

Nevertheless when ethical funds were analysed with ethical theory it seemed clear that although they may be ethically preferable to non-ethical funds this did not translate to ethical funds always being good investments from a moral point of view. Ethical funds are not always “ethical” from an agape based perspective, but they may provide an ethical opportunity to investors in comparison to other funds. Key issues for individuals to consider in this respect is their view on the profit motive and the role of stock markets and corporations in global markets.⁴⁴⁶

It was argued that depending on the view taken on these issues the answer to the research question could be no. From an agape based perspective ethical concerns can override financial objectives (Wesley, 1760; CEIG, 1992; Church of Finland, 1999).

⁴⁴⁴ For example micro credit bonds issued by Shared Interest or bonds issued to regenerate cities such as Glasgow and Sheffield.

⁴⁴⁵ One interviewee commented that it was straightforward for charities to adopt ethical criteria related to their mission. Thus a cancer charity could avoid tobacco firms, however adopting other ethical criteria such as pornography or weapons was very difficult for such a charity.

⁴⁴⁶ A trend worth noting in this respect was mentioned in Chapter 2, which demonstrated that direct shareholdings of charities, Churches and individuals have been declining substantially while institutional investors and foreign institutional investors in particular have increased their shareholdings. This could have an adverse impact on the influence of “ethical” investors.

The other key issue is the individuals personal ethics and situation. Are alternative ethical investments available which would correspond more closely to the values of the investor? An early account of the implications an agape based ethic has for investments was detailed in Wesley (1760). Such an ethic manifests itself in avoidance of some economic activity perceived as ethically problematic although it can have financial consequences. It may also lead to an emphasis on charity and alternative investments. Indeed, John Wesley gave away a substantial part of his income to charitable causes (Sider, 1987). Another early manifestation of an agape based ethic was the abolishment of slavery among Quakers in America and a refusal to profit from (the civil) war (Kinder *et al.*, 1993).⁴⁴⁷ Perhaps it was therefore not surprising that Methodists and Quakers had a key role in establishing “ethical investment” in the UK and the USA (Sparkes, 1995; Boyle, 1999; Hancock, 1999; EIRiS 2001).

It is important to remember that despite the trend of increase in ethical investment funds which was detailed in Chapter 1, an investor must not expect too much in terms of results of corresponding ethical issues. Ethical investors should not expect that even a substantial growth of ethical funds would significantly alter the policies, share price nor production of (most of) the avoided companies (Angel and Rivoli, 1997). Similarly, investors should not expect too much from an engagement strategy. The field study provided some examples of successful engagement but for example Kinder *et al.*, (1993) document how the avoidance of South Africa criterion was employed after many years of engagement had produced no change for the better. Positive changes in South African policy came only after many years of strict exclusions and sustained pressure from many organisations and nations. Ethical funds may help to achieve some change on the margin, but certain ethical issues are addressed more effectively through alternative investment or charity (Moore, 1988).

Finally, this dissertation has sought to argue that at least for ethical funds, risk and return are necessary but not sufficient for an evaluation of the investment (CEIG, 1992). Ethical considerations are also relevant (Irvine, 1987; Church of

⁴⁴⁷ This was not only costly financially for individual Quaker land owners, but also personally as other land owners fiercely opposed this “new ethics”.

Scotland, 1988; Lewis, and Cullis, 1990; Boatright, 1999; Lewis, and Mackenzie 2000; Statman, 2000; Woodward, 2000). As Prodhon (1994) put it:

“An understanding of ethics is relevant in finance” (p.21).

For investors who do not subscribe to financial utilitarianism insights from some other ethical theory such as agapism or Kantian ethics may be necessary for formulating ethical criteria which can be integrated into the investment process (Wesley, 1760; Kant, 1907; Frankena, 1963; Dobson, 1993; Dobson 1997; Boatright, 1999; Church of Finland, 1999). I conclude the dissertation with a quote which provides the rationale for why I think that the topic of “ethical investment” is important.

“For where your investment is there your heart will be also” (Luke 12:34).

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Appendix 1.1 Different Types of Ethical Funds

Environmental technology funds

Funds which seek to invest primarily in companies that provide environmental technologies and services. The companies typically are involved in recycling, renewable energy and waste management. Funds in this category include the Swedish, Wasa Miljöteknikfonden and previously SEB Miljöfonden, the Swiss Orbitex Health and Environmental fund and the UK Commercial Union Environmental Trust. These funds focus on certain sectors. Many of the funds in this category have in recent years changed the fund policy and would nowadays invest in most sectors although they might aim to invest in those “best in class” environmentally within a sector.

Ethical funds

An ethical fund uses non-financial criteria in its security selection process. These criteria range from eco-efficiency to exclusion of companies producing alcohol, pornography, tobacco or weapons. Certain companies and or sectors are therefore excluded for ethical reasons. In addition there is often a positive bias towards certain sectors such as renewable energy and a focus on companies with progressive environmental and ethical policies. Examples of ethical funds include: Aberdeen Ethical World fund, Friends Provident Stewardship, NPI/Henderson Global Care, Scottish Equitable Ethical, Sovereign Ethical, ABF Andere Beleggingfonds (Holland), ASN Aandelensfonds (Holland), Bacob Defensive Stimulus (Belgium), Banco Samarit (Sweden) and Gyllenberg Forum (Finland). Some ethical funds have an environmental focus, although many other ethical issues are considered. Examples include; CIS Environ, Jupiter Ecology, KBC Eco fund (Belgium), KD Fonds Ökoinvest (Germany), Ökoverision (Germany), Robur Miljöfonden (Sweden). This latter group of funds has sometimes been referred to as environmental or green funds.

Socially responsible funds

The UK Social Investment Forum defines socially responsible investing as “investment that combines investors financial objectives with their

commitment to social concerns such as social justice, economic development, peace or a healthy environment”. This term is therefore very similar to the notion underpinning ethical investing and for the purpose of this dissertation the two are treated as synonymous. The established term in Europe has been ethical fund, whereas socially responsible investment fund has been the established term in North America.

Sustainable funds

All economic activity has an environmental impact, which in most cases is negative. It is therefore difficult to see how even the most ethical fund could be fully sustainable environmentally and socially. Some funds by virtue of addressing environmental, ethical and social issues call themselves sustainability funds. For the purposes of this dissertation these funds are categorised as ethical funds. Examples include; Sustainable Performance Group, Oekosar Sustainable Development in Switzerland and Storebrand/Scudder Principle World Fund in Norway. There are also funds based on the Dow/Jones Sustainability Index such as Leonia Arvo in Finland. None of these are fully compatible with sustainable development.

Appendix 2.1 Changes in Share Ownership in the UK

Institution	<u>1963 (%)</u>	<u>1975 (%)</u>	<u>1981 (%)</u>	<u>1989 (%)</u>	<u>1997 (%)</u>	<u>1998 (%)</u>	<u>1999 (%)</u>
Banks	1.3	0.7	0.3	0.7	0.1	0.6	1.0
Insurance	10.0	15.9	20.5	18.6	23.5	21.6	21.6
Pension funds	6.4	16.8	26.7	30.6	22.1	21.7	19.6
Investment trusts	9.0	10.1	7.1	4.1	3.6	Combined with ut	Combined with ut
Unit trusts	1.2	4.1	3.6	5.8	7.0	9.0	9.7
Total Institutions	27.9	46.6	58.2	59.8	55.3	52.9	51.9
Individuals	58.7	37.5	28.2	20.6	16.5	16.7	15.3
Charities	2.7	2.3	2.2	2.3	1.9	1.4	1.3
Government	1.6	3.6	3.0	2.0	0.1	0.1	0.1
Industrial	4.8	4.1	5.1	3.8	1.2	1.4	2.2
Overseas	4.4	5.6	3.6	12.8	24.0	27.6	29.3
Total Institutions + Overseas	32.3	52.2	61.8	72.6	79.3	80.5	81.2

Sources: Sparkes (1995, p.167), Office of National Statistics (ONS) (2000, p.8) Quoted in Institutional Investment in the UK (2001, p.27). For the purposes of this table investment trusts and unit trusts have been combined for 1998 and 1999. Institution and overseas (institutional) investors have increased their share from about 30% in 1963 to about 80% in 1999. Simultaneously direct share ownership by individuals has declined from nearly 60% in 1963 to around 15% in 1999.

A
24/9/73

Proposal relating to the formation of the
Stewardship Unit Trust

Objective

1. To provide a unit trust suitable for corporate and individual investors, who for social or religious reasons are concerned that their investment should be confined to companies whose operations are of benefit to the community. As a result, industries such as tobacco, breweries, gambling and armaments, would be among those to be excluded as would investment in companies whose income was largely derived from countries which adopt a policy of apartheid.
2. Through the formation of the trust, to create an increased awareness of the responsibility of ownership at national level and to provide a suitable avenue through which those members of the public already conscious of their social responsibility, are enabled to invest in equity (in some cases for the first time) without disturbing conscience and with the diversification advisable for their requirements.
3. By using votes and influence to support and provide encouragement to companies fulfilling a useful purpose, in the maintenance of their standards.
4. To obtain growth of capital values and reasonable yield by investment in a selected portfolio on the lines of that shown in Appendix 'A' to this proposal.

Method

To create two types of unit trusts, both of which would be authorised by the Department of Trade and Industry and would be suitable for the investment of Trustee Funds under the Trustee Investment Act 1961.

1. An ordinary unit trust to appeal to members of the general public and trusts liable to taxation.
2. A tax exempt trust to appeal to charitable and church organisations.

Name

It is suggested that the names of the trusts should be "THE STEWARDSHIP UNIT TRUST", and "THE STEWARDSHIP EXEMPT UNIT TRUST".

Council of Reference

It is proposed that a Council of Reference should be appointed which should meet to discuss matters of general policy and regularly review the trust investments in the light of changing social and international conditions. The Council would be widely representative and selected with a view to meriting the confidence of a wide range of social and religious opinion.

Managers

Management would be provided by a separate unit trust management company called Stewardship Unit Managers Limited. This company would be a subsidiary within the J.H. Vavasour Group of Companies, currently managing funds approaching £100m.

Trustee

The Midland Bank Trust Company has kindly consented to act as Trustee to both trusts.

Charges

The intention is to restrict charges to a level sufficient to cover management, administrative and marketing costs. These charges will be kept to a level which will take into account the need to provide an allowance for selected advertising in order to make the general public aware of the existence of the trust.

Distribution of Income

The first distribution will be payable on 20th August, 1974 and the second on 20th February 1975, and thereafter on these dates annually. Facilities will be available for re-investment of income.

Marketing

It is intended that marketing to selected charitable bodies and church organisations would be carried out largely on a personal basis but in order to attract members of the general public, advertising in selected press media is intended.

Timing

It is proposed that the launch date for the trust should be 1st December, 1973.

24.9.1973: JJCE/CWJ/ap

THE FIRST FORTY COMPANIES BEING RESEARCHED WITH A VIEW TO
INCLUSION IN THE STEWARDSHIP UNIT TRUST PORTFOLIO

<u>COMPANY</u>	<u>ACTIVITIES</u>
A.D. INTERNATIONAL	Dental Products, Dental Equipment, Products for Medical Profession
ASSOCIATED BISCUIT	Biscuits, packaging and light engineering products
BODYCOTE	Protective industrial clothing, personal safety helmets and goggles
BRITISH ROPES	Wire and rope manufacturers including cargo slings, safety ropes, traffic barriers
BRITISH RELAY, WIRELESS & TELEVISION	Radio relay, TV Rental
CUSSONS	Soap, talc, hygiene
CREST NICHOLSON	Housing development, tennis courts, swimming pools
DANISH BACON	Distributers of bacon, Lurpak butter, canned meats etc.
GLAXO	Vaccines, anti-biotics, vitamins, surgical and hospital equipment
GOMME HOLDINGS	Furniture
K SHOES	Manufacturer and sale footwear
LONDON BRICK	Production and sale of bricks field drain pipes etc.
MADAME TUSSAUD'S	Wax portraits, London Planetarium, Wookey Hole Caves Hand paper Mill. Reforming and managing existing natural and historical locations
D. MACPHERSON	Manufacturers protective paints varnishes and lacquers

<u>COMPANY</u>	<u>ACTIVITIES</u>
MARKS & SPENCER	Leading chainstore. Emphasis on food and clothing.
METTOY	"Sunshine" Toys, Wembley footballs etc.
MOTHERCARE	Mother and baby requirements
MENTMORE MANUFACTURING	Pens (Platignum) and pencils
NU-SWIFT INDUSTRIES	Leading manufacturers portable fire extinguishers.
NOTTINGHAM MANUFACTURING	Hosiery, Knitwear, and carpets
M. F. NORTH	Residential hotels (Unlicensed)
NATIONAL CARBONISING	Producer smokeless fuels
PEARSON LONGMAN	Financial, provincial newspapers, Penguin books etc.
PILKINGTON	Manufacturers flat and toughened glass, glass fibre and optical equipment
PORTALS	Bank notes, security paper, water purification, anti-pollution
PRESTIGE GROUP	Leading British houseware manufacturer (Prestige, Ewbank, Skyline)
RENTOKIL	Timber preservation. Hygiene services, pest control
RANK HOVIS	Largest British flour miller, trade names include Mothers Pride, Mr. Kipling, Bisto, Saxa, Hovis, Energen and Nimble.
RICHARDS OF SHEFFIELD	Household cutlery, scissors etc.
ROTARY HOES	Farm equipment, agricultural horticultural and harvesting
ROBERTSONS FOODS	Jam, marmalade, and other well known preserves and pudding mixes

COMPANY

ACTIVITIES

SMITH & NEPHEW

Medical, optical and pharmaceutical products

W.H. SMITH

Booksellers, newsagents and stationery etc.

SAINSBURY'S

Supermarkets

TELEPHONE RENTALS

Communications equipment, fire alarms, refrigeration counters

TRANMER

Domestic heating, plumbing, light engineering

UK OPTICAL

Manufacturers and distributors of ophthalmic lenses, spectacle frames, sunglasses, safety frames and optical elements

UNIGATE

Milk and food production and distribution, engineering etc.

WESTERN BOARD MILLS

Board from waste paper

WOLSELEY HUGHES

Agricultural implements, baby carriage wheels, trucks and hospital equipment and heating equipment

Appendix 2.3 UK Environmental Investment Code (PIRC, 1990)

UK ENVIRONMENTAL INVESTMENT CODE

As investors, we recognise that corporate performance and the value of our investments are increasingly affected by environmental factors. In pursuance of a prudent and environmentally responsible policy, we will encourage and support companies that demonstrate a positive response to environmental concerns. The fund calls on companies:

- to make a commitment to achieving environmental excellence;
- to institute regular monitoring of their environmental impact;
- to establish procedures which will lead to incremental improvements in environmental performance;
- to comply with all current environmental legislation and seek to anticipate future legislative changes
- to make available to shareholders regular and detailed reports of progress

Source: Pirc Intelligence, November 1990.

The significance of this code in addition to the £16 billion signed up to it by 1995 is that PIRC has been active in shareholder resolutions on ethical issues (Sparkes, 1995).

Appendix 2.4 Ethical Criteria

Company Ethos	Product or Service	Social Factors	Environment
Accounting	Alcohol	Charitable giving	Animal testing
Community involvement	Automobile	Child labour	Energy use
Corporate governance	Armaments	Equal opportunities	Environmental reporting
Pay of directors	Banks	Fair wages	Environmental prosecutions
Political ties	Fur trade	Health and Safety	Genetic manipulation
	Gambling	Misleading advertising	Greenhouse gases
	Military contracts	Oppressive regimes	Intensive farming
	Pornography	Third world concerns	Nuclear power
	Tobacco	Trade union recognition	Ozone depletion
			Pesticides
			Pollution
			Recycling
			Tropical hardwood
			Waste disposal

Positive Criteria	Positive Criteria	Positive Criteria	Positive Criteria	Positive Criteria
Companies involved in safety and protection	Companies involved in training and education	Health services	Public transport	Renewable energy

Sources: EIRiS (1998); Hancock (1999); Sparkes, (1995). This is not an exhaustive list of ethical criteria, such a listing is provided in EIRiS (1998) and EIRiS (2002). Many of these criteria are used both as negative and positive criteria. For example all ethical funds encourage environmental reporting, but only a few would exclude companies which do not report on the environment from investment. Those criteria in the second part of the table are used only as positive criteria.

Appendix 3.1 Some Ethical Theories

Descriptive ethical theories				Examples	Time
Normative Ethical Theories	Deontological	Act-deontological	Existentialism	Sartre	1905-1980
		Rule deontological	Kantian ethics	Kant	1724-1804
	Telological	Utilitarianism	Act-utilitarianism	Bentham	1748-1832
			Rule-utilitarianism	J.S.Mill	1806-1873
		Negative utilitarianism			
		Ethical Egoism	Hedonism	Epicurus	342-271 BC
	Judeo-Christian	Biblical ethics	Agapism	Joseph	~1300 BC
	Other	Virtue ethics	Aristotlenianism	Aristotle	384-322 BC
Meta ethical theories				Examples	Time

This table presents some ethical theories. It does not attempt to present all theories, only those mentioned in Chapter 3.

Appendix 6.1 Fund Performance with UK Benchmark

Fund	Sharpe	Treydor	Jensen			
			Alpha	T-value	Beta	Adj. R2
ABBE	-0.023	-0.0006	-0.00100	-1.011	0.548	0.49
ABER	-0.012	-0.0005	-0.00113	-1.214	0.350	0.41
ABFA	-0.005	-0.0003	-0.00038	-0.405	0.253	0.08
AKTA	0.050	0.0014	0.00022	0.142	1.101	0.42
ALLC	0.023	0.0005	-0.00046	-0.820	0.629	0.74
ASNA	0.127	0.0036	0.00216	1.673	0.898	0.42
BHJA	0.071	0.0018	0.00065	0.435	1.117	0.52
BHUM	0.055	0.0014	0.00021	0.143	1.108	0.51
BIDM	0.052	0.0013	0.00012	0.083	1.116	0.51
BMIL	0.005	0.0001	-0.00097	-0.566	0.880	0.41
BSAM	0.055	0.0014	0.00021	0.141	1.106	0.51
CISE	0.063	0.0015	0.00015	0.191	0.625	0.64
CITY	-0.009	-0.0013	-0.00036	-0.204	0.144	0.01
CLEM	-0.002	0.0000	-0.00110	-1.012	0.855	0.59
COMM	-0.016	-0.0005	-0.00115	-0.683	0.651	0.30
EQUI	-0.003	-0.0001	-0.00110	-0.980	0.833	0.56
FAMI	0.024	0.0011	-0.00044	-0.463	0.666	0.59
FOCU	0.004	0.0001	-0.00065	-0.505	0.588	0.26
FRAM	-0.022	-0.0006	-0.00218	-0.959	1.162	0.39
FPSI	0.010	0.0003	-0.00032	-0.375	0.344	0.34
FPSE	0.062	0.0018	0.00025	0.245	0.435	0.40
HYPO	-0.034	-0.0012	0.00042	0.423	0.660	0.34
JUPE	0.024	0.0006	-0.00041	-0.309	0.687	0.48
KBCE	0.093	0.0026	0.00095	0.943	0.711	0.45
KDOE	0.000	0.0000	-0.00088	-0.820	0.711	0.34
LUXI	-0.020	-0.0006	-0.00143	-0.999	0.766	0.32
NPI	0.055	0.0013	0.00001	0.019	0.701	0.68
NPIP	0.141	0.0032	0.00137	2.000	0.701	0.68
OEKO	-0.049	-0.0019	-0.00116	-1.330	0.372	0.23
ORBI	-0.054	-0.0018	-0.00265	-1.460	0.868	0.30
ROBU	-0.016	-0.0054	-0.00046	-0.209	0.073	0.00
SCOT	0.030	0.0008	-0.00022	-0.186	0.558	0.42
SEBM	-0.018	-0.0006	-0.00132	-0.972	0.742	0.37
SOVE	0.005	0.0001	-0.00058	-0.466	0.527	0.41
TSB	0.110	0.0024	0.00105	1.786	0.913	0.73
VARL	0.082	0.0021	0.00097	0.666	1.065	0.50
WASA	-0.027	-0.0008	-0.00146	-1.120	0.732	0.43
WASU	0.042	0.0012	-0.00006	-0.497	0.734	0.45
VGRN	-0.061	-0.0032	-0.00265	-1.230	0.593	0.12
VMIL	-0.005	-0.0002	-0.00110	-0.700	0.792	0.35
Average	0.021	0.0003	-0.00042	-0.265	0.708	0.42

Financial Times All Share Index and UK one month T-bill used as benchmark for all funds. Time period 3.1.1996-31.12.1998, dividends fully reinvested. T-values adjusted according to Newey-West (1987).

Appendix 6.2 Fund Performance with National Benchmarks

Fund	Sharpe	Treynor	Jensen			
			Alpha	T-value	Beta	Adj. R2
ABBE	-0.023	-0.0006	-0.001004	-1.011	0.548	0.490
ABER	-0.012	-0.0005	-0.00113	-1.214	0.350	0.408
ABFA	0.137	0.0106	0.00125	1.603	0.192	0.108
AKTA	0.118	0.0038	0.000738	0.693	0.976	0.722
ALLC	0.023	0.0005	-0.000464	-0.820	0.629	0.739
ASNA	0.205	0.0086	0.00291	2.219	0.649	0.386
BHJA	0.159	0.0045	0.001437	2.635	0.980	0.937
BHUM	0.143	0.0040	0.000968	1.980	0.992	0.946
BIDM	0.140	0.0040	0.000898	1.839	0.990	0.946
BMIL	0.106	0.0034	0.000214	0.249	0.735	0.762
BSAM	0.143	0.0040	0.000974	1.986	0.989	0.946
CISE	0.063	0.0015	0.00015	0.191	0.625	0.638
CITY	-0.009	-0.0013	-0.00036	-0.204	0.144	0.012
CLEM	-0.002	0.0000	-0.001095	-1.012	0.855	0.593
COMM	-0.016	-0.0005	-0.00115	-0.683	0.651	0.295
EQUI	-0.003	-0.0001	-0.00110	-0.980	0.833	0.556
FAMI	0.024	0.0011	-0.000437	-0.463	0.666	0.594
FOCU	0.095	0.0040	0.00012	0.089	0.491	0.383
FRAM	-0.022	-0.0006	-0.002184	-0.959	1.162	0.385
FPSI	0.010	0.0003	-0.0003189	-0.375	0.344	0.344
FPSE	0.062	0.0018	0.0002482	0.245	0.435	0.404
HYP0	0.072	0.0006	-0.00067	-0.562	0.398	0.233
JUPE	0.024	0.0006	-0.0004046	-0.309	0.687	0.483
KBCE	0.168	0.0057	0.00097	0.682	0.645	0.351
KDOE	0.081	0.0029	-0.00057	-0.574	0.650	0.540
LUXI	0.055	0.0021	-0.00109	-0.741	0.661	0.459
NPI	0.055	0.0013	0.0000132	0.019	0.701	0.676
NPIP	0.141	0.0032	0.0013684	2.000	0.701	0.675
OEKO	0.129	0.0065	0.00055	0.547	0.270	0.270
ORBI	-0.071	-0.0075	-0.00352	-1.437	0.294	0.056
ROBU	0.087	0.0030	-0.000169	-0.188	0.625	0.636
SCOT	0.030	0.0008	-0.00022	-0.186	0.558	0.423
SEBM	0.080	0.0037	0.000301	0.208	0.494	0.360
SOVE	0.005	0.0001	-0.00058	-0.466	0.527	0.409
TSB	0.110	0.0024	0.00105	1.786	0.913	0.729
VARL	0.175	0.0050	0.001832	3.132	0.934	0.919
WASA	0.084	0.0036	0.000251	0.199	0.472	0.412
WASU	0.153	0.0055	0.001322	1.478	0.547	0.586
VGRN	0.001	0.0001	-0.00020	-0.127	0.565	0.280
VMIL	0.085	0.0032	0.00159	1.291	0.577	0.512
Average	0.070	0.0023	-0.00010	0.319	0.636	0.515

Market Indices: UK-FTSA; Sweden Affärsvärlden General; Germany FAZ; Netherlands CBS; Belgium Brussels All share; Norway Oslo Stock Exchange General Index; Switzerland Swiss Market Index. RF- National 1 month rates, UK and Sweden 1 month T-Bills, other countries 1 month interbank rate.

Appendix 6.3 Domestic Sharpe and Treynor measures

Country	Index	Sharpe	Treynor
Belgium	Brussels	0.207	0.0042
Germany	FAZ	0.144	0.0037
Holland	CBS	0.157	0.0041
Norway	Oslo	0.009	0.0004
Sweden	Affvall	0.111	0.0031
Switzerland	Swiss	0.169	0.0045
UK	FTALL	0.007	0.0012

This table provides the Sharpe and Treynor ratios for the national benchmarks: UK-FTSA; Sweden Affärsvärlden General; Germany FAZ; Netherlands CBS; Belgium Brussels All share; Norway Oslo Stock Exchange General Index; Switzerland Swiss Market Index.

Appendix 6.4 Fund Rankings with a UK Benchmark

Fund	Sharpe	Jensen	Treynor
ABBE	35	28	31
ABER	29	32	28
ABFA	26	19	27
AKTA	13	9	9
ALLC	18	23	18
ASNA	2	1	1
BHJA	6	6	6
BHUM	10	10	10
BIDM	12	13	12
BMIL	21	27	21
BSAM	11	11	11
CISE	7	12	8
CITY	28	18	36
CLEM	24	31	24
COMM	30	33	29
EQUI	25	29	25
FAMI	17	21	15
FOCU	22	25	22
FRAM	34	38	33
FPSI	19	17	19
FPSE	8	8	7
HYP0	37	7	35
JUPE	16	20	17
KBCE	4	5	3
KDOE	23	26	23
LUXI	33	36	32
NPI	9	14	13
NPIP	1	2	2
OEKO	38	34	38
ORBI	39	40	37
ROBU	31	22	40
SCOT	15	16	16
SEBM	32	35	30
SOVE	20	24	20
TSB	3	3	4
VARL	5	4	5
WASA	36	37	34
WASU	14	15	14
VGRN	40	39	39
VMIL	27	30	26

	<i>Sharpe</i>	<i>Jensen</i>	<i>Treynor</i>
Sharpe	1		
Jensen	0.8567	1	
Treynor	0.9786	0.8229	1

Appendix 6.5 Two-index Model Results`

A modified alpha measure was estimated according to equation [8] for the UK funds. This two index model, incorporates the FTSE Small Cap index in addition to the All Share Index.

$$r_{jt} - r_{ft} = \alpha_{4j} + \beta_{4j}(r_{mt} - r_{ftr}) + \gamma_j(r_{st} - r_{mt}) + \tau_{jt} \quad [8]$$

where, r_{st} is the return of a small company index and τ is a random error term. This equation was used by Gregory *et al.* (1997). The results for this model are reported in the table on the next page for the UK funds.

The performance with this model seems much better for the funds as five UK funds had significantly positive “size adjusted” alphas, whereas only one UK fund had a significantly positive Jensen measure with the international and the UK benchmarks. Other differences include the high Beta coefficients and the high values for the adjusted coefficients of determination. These findings are very similar to Gregory *et al.* (1997), they also reported more positive fund performance with the size adjusted benchmark and higher coefficients of determination.⁴⁴⁸

⁴⁴⁸ Indeed 4 ethical funds which in Gregory *et al.* (1997) had negative Jensen measures had positive size adjusted alphas. In 16 of the 18 cases the adjusted R^2 rose in the two-index model and in all but one case the two-index beta was higher (Gregory *et al.* 1997). These results differ from (Liljeblom and Löflund, 2000) who concluded that; “no major changes occurred after the introduction of additional benchmarks, namely a small firm index and a bond index”.

Appendix 6.5 Two Index Model Results for UK funds

Fund	Alpha	t-value	Beta	Gamma	t-value	Adj.r2
ABBE	0.00001	0.02	0.82	0.63	12.88	0.73
ABER	-0.00015	-0.35	0.87	0.51	8.94	0.78
ALLC	0.00006	0.15	0.77	0.33	6.04	0.81
CIS	0.00109	2.63	0.88	0.59	9.63	0.84
CITY	0.00095	0.71	0.55	0.92	7.60	0.27
CLER	-0.00031	-0.34	1.07	0.49	7.50	0.66
COMM	-0.00013	-0.09	0.92	0.63	4.95	0.39
EQUI	-0.00013	-0.14	1.09	0.60	5.30	0.66
FAMI	0.00054	0.89	0.93	0.61	9.12	0.77
FRAM	-0.00030	-0.14	1.67	1.17	5.83	0.53
FPSI	0.00060	1.18	0.59	0.57	9.64	0.69
FPSE	0.00144	3.92	0.76	0.74	16.53	0.83
JUPE	0.00095	1.53	1.05	0.84	13.01	0.75
NPIP	0.00222	4.84	0.93	0.53	9.12	0.82
NPI	0.00086	1.88	0.93	0.53	9.07	0.81
SCOT	0.00129	3.16	0.96	0.94	18.85	0.86
SOVE	0.00070	1.13	0.87	0.79	14.78	0.74
TSB	0.00155	2.68	1.05	0.31	2.61	0.76
AVERAGE	0.00062	1.32	0.93	0.65	9.52	0.71

This Table reports the results of the two-index model estimated with equation [8].

Appendix 6.6 Henriksson-Merton Estimates with National Benchmarks

Fund	Alpha	T-value	Beta	D	T-value	Adj R2
ABBE	0.00269	2.29	0.269	-0.52	-3.29	0.53
ABER	0.00271	2.63	0.368	-0.52	-4.79	0.68
ABFA	0.00378	2.50	0.059	-0.25	-1.81	0.12
AKTA	-0.00030	-0.02	0.499	0.96	0.39	0.72
ALLC	0.00117	-1.52	0.506	-0.23	-2.40	0.75
ASNA	0.00973	3.77	0.290	-0.67	-2.85	0.43
BHJA	0.01400	2.24	0.980	0.04	0.12	0.94
BHUM	0.00640	1.19	0.997	0.41	1.43	0.95
BIDM	0.00550	1.02	0.995	0.43	1.23	0.96
BMIL	0.00290	3.76	0.693	-3.48	-9.82	0.81
BSAM	0.00620	1.15	0.994	0.44	1.58	0.95
CISE	0.00311	2.88	0.402	-0.42	-2.69	0.67
CITY	0.00328	1.38	-0.130	-0.51	-1.24	0.03
CLEM	0.00181	1.23	0.636	-0.41	-2.27	0.60
COMM	0.00286	1.34	0.349	-0.56	-1.63	0.31
EQUI	0.00109	0.59	0.669	-0.31	-1.40	0.56
FAMI	0.00321	2.68	0.392	-0.51	-2.93	0.63
FOCU	0.00514	2.87	0.206	-0.49	-3.33	0.42
FRAM	0.00478	1.23	0.637	-0.98	-2.27	0.41
FPSI	0.00194	1.63	0.174	-0.32	-2.45	0.37
FPSE	0.00365	2.69	0.179	-0.48	-2.95	0.45
HYPO	-0.00128	-0.84	0.414	0.69	0.82	0.23
JUPE	0.00531	3.55	0.257	-0.80	-4.16	0.55
KBCE	0.00799	4.48	0.227	1.95	-4.27	0.41
KDOE	0.00415	2.43	0.383	-0.46	-3.25	0.57
LUXI	0.00325	1.51	0.415	-0.43	-2.18	0.48
NPI	0.00253	2.24	0.512	-0.35	-2.35	0.69
NPIP	0.00396	3.49	0.505	-0.36	-2.39	0.69
OEKO	0.00358	3.06	0.116	-0.29	-2.43	0.31
ORBI	-0.00330	-0.91	0.283	-0.02	-0.08	0.05
ROBU	0.02020	1.59	0.593	-2.73	-2.44	0.67
SCOT	0.00371	2.23	0.262	-0.55	-2.21	0.46
SEBM	0.00320	1.98	0.450	-3.69	-3.23	0.41
SOVE	0.00204	1.25	0.330	-0.37	-1.78	0.43
TSB	0.00267	1.75	0.700	-0.10	-0.61	0.47
VARL	0.00170	2.64	0.936	0.16	0.34	0.92
WASA	0.00210	1.53	0.443	-2.34	-1.81	0.44
WASU	0.00170	1.73	0.541	-0.50	-0.43	0.58
VGRN	0.00267	1.00	0.397	1.99	-1.33	0.28
VMIL	0.00395	2.23	0.439	0.44	-1.88	0.52
Average	0.00389	1.86	0.459	-0.40	-1.98	0.54

This Table provides estimates of Equation [5] with the 7 national benchmarks.

Appendix 6.7 The Treynor-Mazuy Measure of Timing Ability

Fund	Alpha	T-value	Beta	C	T-value	Adj R2
ABBE	0.00155	1.23	0.423	-0.149	-2.42	0.30
ABER	0.00113	1.16	0.543	-2.478	-2.77	0.48
ABFA	0.00246	2.33	0.106	-2.871	-1.97	0.05
AKTA	0.00168	0.81	1.027	-2.152	-0.88	0.41
ALLC	0.00104	0.96	0.506	-0.856	-1.14	0.42
ASNA	0.00580	4.76	0.697	-5.892	-4.90	0.41
BHJA	0.00149	0.77	1.018	-0.547	-0.32	0.43
BHUM	0.00089	0.45	1.017	-0.172	-0.10	0.42
BIDM	-0.00012	-0.07	1.039	0.856	0.57	0.52
BMIL	0.00182	0.90	0.734	-4.304	-2.44	0.31
BSAM	0.00084	0.42	1.013	-0.047	-0.03	0.42
CISE	0.00233	2.30	0.506	-2.515	-2.01	0.46
CITY	0.00265	1.75	0.105	-3.600	-1.22	0.03
CLEM	0.00037	0.29	0.715	-1.319	-1.41	0.55
COMM	0.00102	0.63	0.596	-2.933	-1.52	0.29
EQUI	0.00030	0.26	0.746	-1.408	-1.00	0.59
FAMI	0.00163	1.98	0.537	-2.283	-1.48	0.36
FOCU	0.00261	1.94	0.412	-4.667	-3.38	0.26
FRAM	0.00222	0.89	1.029	-9.373	-3.45	0.51
FPSI	0.00174	1.43	0.292	-1.787	-1.69	0.21
FPSE	0.00246	1.79	0.359	-2.275	-1.82	0.25
HYP0	-0.00170	-1.29	0.690	2.105	1.17	0.35
JUPE	0.00267	1.87	0.533	-4.638	-3.26	0.40
KBCE	0.00212	2.52	0.761	-1.310	-1.00	0.66
KDOE	0.00245	2.29	0.594	-5.568	-4.50	0.42
LUXI	0.00212	1.56	0.604	-5.999	-2.90	0.37
NPI	0.00157	1.65	0.597	-1.294	-1.12	0.58
NPIP	0.00295	3.12	0.596	-1.354	-1.16	0.58
OEKO	0.00142	1.84	0.230	-2.617	-2.48	0.17
ORBI	0.00248	1.20	0.716	-10.160	-5.86	0.46
ROBU	0.00038	0.15	0.155	1.127	0.59	0.00
SCOT	0.00204	1.37	0.455	-2.586	-1.36	0.29
SEBM	0.00235	1.51	0.570	-5.920	-4.14	0.28
SOVE	0.00162	1.08	0.427	-2.375	-1.34	0.27
TSB	0.00232	2.09	0.746	-0.830	-0.71	0.47
VARL	0.00192	1.01	0.946	-0.573	-0.31	0.39
WASA	0.00131	0.88	0.547	-3.598	-1.81	0.25
WASU	0.00222	1.69	0.634	-2.925	-1.68	0.37
VGRN	0.00237	1.31	0.364	-4.154	-1.27	0.06
VMIL	0.00237	1.31	0.562	-5.199	-3.26	0.22
Average	0.00177	1.35	0.604	-2.716	-1.79	0.36

This table reports the results of the Treynor-Mazuy market timing regression according to equation [6] with the **International** benchmark. The alpha gives a measure of stock selection ability. The C coefficient is a measure of the market timing ability of the fund. The t-values are all adjusted with the Newey-West procedure to mitigate problems with autocorrelation and heteroscedasticity. The Adj R2 gives the adjusted coefficient of determination.

Appendix 6.8 The Treynor-Mazuy Estimates with National Benchmarks

Fund	Alpha	T-value	Beta	C	T-value*	Adj R2
ABBE	0.00057	0.67	0.03	-0.01	-0.10	-0.01
ABER	0.00100	1.32	0.62	-5.64	-5.84	0.63
ABFA	0.00267	2.84	0.18	-1.97	-2.18	0.13
AKTA	-0.00030	-0.02	0.50	0.96	0.39	0.72
ALLC	0.00029	0.47	0.62	-2.16	-2.30	0.75
ASNA	0.00670	4.14	0.61	-5.23	-3.06	0.43
BHJA	0.01400	2.24	0.98	0.04	0.12	0.94
BHUM	0.00640	1.19	1.00	0.41	1.43	0.95
BIDM	0.00550	1.02	0.99	0.43	1.23	0.96
BMIL	0.00290	3.76	0.69	-3.48	-9.82	0.81
BSAM	0.00620	1.15	0.99	0.44	1.58	0.95
CISE	0.00158	2.00	0.61	-4.10	-2.27	0.66
CITY	0.00163	1.08	0.12	-5.68	-1.17	0.03
CLEM	0.00022	0.19	0.84	-3.76	-2.07	0.60
COMM	0.00097	0.64	0.62	-6.05	-1.53	0.32
EQUI	-0.00088	-0.07	0.82	-2.88	-1.25	0.56
FAMI	0.00134	1.52	0.64	-5.09	-2.54	0.63
FOCU	0.00280	2.13	0.43	-3.57	-3.70	0.42
FRAM	0.00237	0.79	1.10	-13.00	-2.47	0.43
FPSI	0.00081	0.86	0.33	-3.23	-2.25	0.37
FPSE	0.00185	1.77	0.41	-4.58	-2.57	0.45
HYPO	-0.00128	-0.84	0.41	0.69	0.82	0.23
JUPE	0.00250	2.07	0.65	-8.29	-3.71	0.55
KBCE	0.00436	2.91	0.65	-7.90	-3.18	0.40
KDOE	0.00195	1.70	0.59	-3.34	-3.25	0.57
LUXI	0.00100	0.61	0.61	-2.76	-1.75	0.47
NPI	0.00125	1.69	0.68	-3.54	-2.24	0.69
NPIP	0.00264	3.55	0.68	-3.64	-2.24	0.69
OEKO	0.00197	1.79	0.25	-1.87	-1.58	0.29
ORBI	-0.00334	-1.17	0.29	-0.24	-0.14	0.05
ROBU	0.02020	1.59	0.59	-2.73	-2.44	0.67
SCOT	0.00161	1.34	0.53	-5.21	-1.75	0.46
SEBM	0.00320	1.98	0.45	-3.69	-3.23	0.41
SOVE	0.00075	0.58	0.51	-3.79	-1.52	0.43
TSB	0.00174	2.67	0.90	-1.96	-1.35	0.73
VARL	0.00170	2.64	0.94	0.16	0.34	0.92
WASA	0.00210	1.53	0.44	-2.34	1.81	0.44
WASU	0.00170	1.73	0.54	-0.50	-0.43	0.58
VGRN	0.00096	0.55	0.55	-1.16	-1.43	0.28
VMIL	0.00298	2.27	0.55	-1.94	-3.60	0.53
Average	0.00267	1.47	0.60	-3.06	-1.78	0.53

This Table provides estimates of Equation [6] with the 7 national benchmarks.

Appendix 6.9 Treynor Mazuy Alpha Explained

Treynor Mazuy Alpha	Intercept	Size	Age	I.Universe
Coefficient	0.001219	0.00000264	0.00000108	0.000616
t-value	4.61	2.55	0.77	1.74

R² was 9%

This table reports the result of the cross-sectional regression explaining the Treynor Mazuy alpha. All reported t-values are adjusted for heteroscedasticity according to White (1980). **BOLD** font indicate a t-value significant at the 5% level. The Size variable is measured as size of funds in GBP as at the 31.12.1998. The t-value for Size is significant at the 10% level and in the simplest model with only Size and Age also at the 5% level. The variable Age is measured as age of funds in months since month of inception until the 31.12.1998. Universe is a dummy variable with a value of 0 for funds investing in the home country (or for two funds investing in Scandinavia, but these funds invest predominantly in their home country) and 1 for funds investing globally. Dummy variables relating to country of origin have also been used in different versions of equation [7], none of them were significant.

Appendix 7.1 Descriptive Statistics for Non-ethical Funds

FUND	MEAN	SDEV	MIN	MAX	KURT	SKEW
SOVI	0.00136	0.0158	-0.0525	0.0570	1.5526	-0.4545
CAVE	0.00050	0.0186	-0.0714	0.0516	1.8577	-0.6530
INGG	0.00390	0.0254	-0.0765	0.0799	1.0456	-0.5326
HAUT	0.00230	0.0222	-0.0817	0.0538	1.4940	-0.7281
CSGP	0.00203	0.0175	-0.0591	0.0536	2.3399	-0.7065
POST	0.00377	0.0237	-0.0847	0.0753	1.4126	-0.5864
SEBA	0.00359	0.0288	-0.0941	0.0805	1.0522	-0.5618
WASS	0.00204	0.0305	-0.0818	0.0886	0.8354	-0.3141
WAAA	0.00242	0.0297	-0.1064	0.0864	1.4450	-0.4610
HARA	0.00224	0.0296	-0.0892	0.0893	1.2333	-0.4120
SEBS	0.00211	0.0261	-0.1062	0.0802	2.8786	-0.8586
HSBC	0.00452	0.0242	-0.0787	0.0671	1.6984	-0.8274
CITI	0.00011	0.0227	-0.0913	0.0767	3.0327	-0.5865
SUNC	0.00221	0.0200	-0.0862	0.0539	2.6596	-0.9174
CONS	0.00206	0.0155	-0.0427	0.0351	0.4133	-0.3784
DRGE	0.00123	0.0147	-0.0681	0.0432	3.4299	-0.6516
GUAR	0.00230	0.0178	-0.0605	0.0538	1.2079	-0.3808
NORW	0.00243	0.0236	-0.0844	0.0635	1.2913	-0.6590
LLOY	0.00348	0.0228	-0.0751	0.0673	1.0694	-0.4981
HEND	0.00205	0.0172	-0.0521	0.0543	1.3661	-0.4558
EHIT	0.00187	0.0171	-0.0527	0.0524	0.9432	-0.5044
WALS	0.00344	0.0233	-0.0759	0.0718	1.3616	-0.5880
SCLW	0.00064	0.0246	-0.1102	0.0732	3.3808	-0.9132
CERA	-0.00217	0.0341	-0.1594	0.0937	4.1630	-1.1252
NORD	0.00280	0.0255	-0.1146	0.0705	3.0820	-0.9500
ADIG	-0.00186	0.0260	-0.1334	0.0872	4.3305	-0.8293
AESU	0.00252	0.0188	-0.0688	0.0607	2.3753	-0.3525
BAIL	-0.00007	0.0144	-0.0735	0.0489	5.2691	-0.9768
UBSE	0.00216	0.0221	-0.0760	0.0593	1.2445	-0.5356
UBSM	0.00228	0.0196	-0.0640	0.0770	2.8712	-0.2061
HABO	0.00202	0.0295	-0.0873	0.0892	1.2172	-0.4120
LAKE	0.00341	0.0183	-0.0618	0.0607	1.5529	-0.5276
WASG	0.00192	0.0231	-0.0896	0.0792	2.8758	-0.7978
SCEU	0.00204	0.0180	-0.0619	0.0502	1.2901	-0.5185
MCUG	0.00131	0.0190	-0.0691	0.0678	2.6167	-0.6596
SEBG	0.00173	0.0224	-0.0662	0.0598	0.5747	-0.4237
BGLO	0.00171	0.0218	-0.0881	0.0684	1.8514	-0.5725
HASA	0.00222	0.0270	-0.0856	0.0798	1.1713	-0.4938
DNBR	-0.00048	0.0322	-0.1269	0.1325	2.8969	-0.3821
VHOR	-0.00032	0.0316	-0.1152	0.1333	2.3877	-0.2036
AVERAGE	0.00185	0.0229	-0.0831	0.0707	2.0193	-0.5899
MSCIWI	0.00207	0.0218	-0.0798	0.0626	1.9301	-0.6719

Descriptive statistics for the 40 non-ethical fund returns and the Morgan Stanley World Index. This table shows the average weekly rate for each fund (MEAN), the standard deviation (SDEV), minimum (MIN) and maximum (MAX) returns. A measure of skewness (SKEW) and kurtosis (KURT) is provided in the final columns. The data for all funds is weekly Wednesday to Wednesday, dividends fully reinvested from 1996 to 1998, 156 observations are available for each fund.

Appendix 7.2 Ethical and Non-ethical Funds with 2 Factor Benchmark

UK ETHICAL FUNDS

Fund	Alpha	t-value	Beta	Gamma	t-value	adj.r2
ABBE	0.00001	0.02	0.82	0.63	12.88	0.73
ABER	-0.00015	-0.35	0.87	0.51	8.94	0.78
ALLC	0.00006	0.15	0.77	0.33	6.04	0.81
CIS	0.00109	2.63	0.88	0.59	9.63	0.84
CITY	0.00095	0.71	0.55	0.92	7.60	0.27
CLER	-0.00031	-0.34	1.07	0.49	7.50	0.66
COMM	-0.00013	-0.09	0.92	0.63	4.95	0.39
EQUI	-0.00013	-0.14	1.09	0.60	5.30	0.66
FAMI	0.00054	0.89	0.93	0.61	9.12	0.77
FRAM	-0.00030	-0.14	1.67	1.17	5.83	0.53
FPSI	0.00060	1.18	0.59	0.57	9.64	0.69
FPSE	0.00144	3.92	0.76	0.74	16.53	0.83
JUPE	0.00095	1.53	1.05	0.84	13.01	0.75
NPPI	0.00222	4.84	0.93	0.53	9.12	0.82
NPI	0.00086	1.88	0.93	0.53	9.07	0.81
SCOT	0.00129	3.16	0.96	0.94	18.85	0.86
SOVE	0.00070	1.13	0.87	0.79	14.78	0.74
TSB	0.00155	2.68	1.05	0.31	2.61	0.76
Average	0.00062	1.32	0.93	0.65	9.52	0.71

UK NON-ETHICAL FUNDS

Fund	Alpha	t-value	Beta	Gamma	t-value	adj.r2
SOVI	0.00070	1.13	0.87	0.79	14.78	0.75
CAVE	0.00022	0.15	0.37	0.66	6.49	0.15
CSGP	-0.00029	0.82	1.02	0.35	6.41	0.91
HSBC	0.00288	2.55	1.19	0.50	5.22	0.60
CITI	-0.00149	-1.17	1.12	0.48	4.66	0.60
SUNC	0.00041	0.46	1.03	0.33	3.92	0.70
CONS	0.00208	1.94	0.33	0.78	7.73	0.31
DRGE	-0.00012	-0.11	0.23	0.09	0.91	0.05
GUAR	0.00035	0.58	0.91	0.20	2.66	0.76
LLOY	0.00198	1.96	1.05	0.49	4.69	0.52
EHIT	-0.00013	-0.14	1.09	0.60	5.30	0.66
HEND	0.00017	0.48	0.96	0.26	4.53	0.86
SCLW	-0.00129	-0.98	1.18	0.36	3.06	0.61
BAIL	-0.00044	-0.67	0.80	0.87	15.15	0.75
AESU	0.00056	1.29	1.03	0.26	3.88	0.84
LAKE	0.00148	2.60	0.98	0.24	3.76	0.81
SCEU	-0.00023	-0.48	0.88	0.03	0.33	0.80
MCUG	-0.00022	-0.40	1.09	0.49	7.72	0.81
Average	0.00037	0.56	0.90	0.43	5.62	0.64

These tables reports the results of estimating equation [6.8], see Appendix 6.5. The first column gives the code for the fund, the second and third columns reports a size adjusted alpha with its t-value. The fourth column reports the beta, while the fifth and sixth columns report the gamma coefficient with its value. Finally, the last column reports the adj. coefficient of determination.

Appendix 7.3 Return Rankings

Ethical		Non - Ethical	
Fund	Return	Fund	Return
ABBE	62	SOVI	49
ABER	61	CAVE	71
ABFA	57	INGG	2
AKTA	14	HAUT	22
ALLC	47	CSGP	36
ASNA	58	POST	3
BHJA	11	SEBA	4
BHUM	13	WASS	35
BIDM	17	WAAA	20
BMIL	48	HARA	24
BSAM	15	SEBS	30
CISE	27	HSBC	1
CITY	60	CITI	73
CLEM	55	SUNC	26
COMM	63	CONS	32
EQUI	56	DRGE	54
FAMI	46	GUAR	21
FOCU	51	NORW	19
FRAM	72	LLOY	7
FPSI	50	HEND	33
FPSE	37	EHIT	40
HYPO	66	WALS	8
JUPE	44	SCLW	69
KBCE	12	CERA	80
KDOE	53	NORD	16
LUXI	67	ADIG	79
NPI	29	AESU	18
NPIP	6	BAIL	74
OEKO	70	UBSE	28
ORBI	76	UBSM	23
ROBU	64	HABO	38
SCOT	42	LAKE	10
SEBM	65	WASG	39
SOVE	45	SCEU	34
TSB	9	MCUG	52
VARL	5	SEBG	41
VGRN	78	DNBR	77
VMIL	59	VHOR	75
WASA	68	BGLO	43
WASU	31	HASA	25

Appendix 7.4 The Treynor Mazuy Measure of Timing Ability

TIMING ETHICAL FUNDS					TIMING NON-ETHICAL FUNDS				
Fund	Alpha	T-value	C-TM	T-value	Fund	Alpha	T-value	C-TM	T-value
ABBE	0.00155	1.23	-0.15	-2.42	SOVI	0.00033	0.28	-0.17	-0.16
ABER	0.00113	1.16	-2.48	-2.77	CAVE	0.00292	1.90	-5.35	-3.54
ABFA	0.00246	2.33	-2.87	-1.97	INGG	0.00210	2.54	-0.64	-0.68
AKTA	0.00168	0.81	-2.15	-0.88	HAUT	0.00312	2.56	-4.86	-3.06
ALLC	0.00104	0.96	-0.86	-1.14	CSGP	0.00104	0.97	-0.90	-0.89
ASNA	0.00580	4.76	-5.89	-4.90	POST	0.00189	1.63	0.02	0.01
BHJA	0.00149	0.77	-0.55	-0.32	SEBA	0.00350	1.87	-3.72	-1.81
BHUM	0.00089	0.45	-0.17	-0.10	WASS	0.00080	0.41	-1.54	-0.69
BIDM	-0.00012	-0.07	0.86	0.57	WAAA	0.00150	0.70	-1.88	-0.84
BMIL	0.00182	0.90	-4.30	-2.44	HARA	0.00134	0.61	-1.97	-0.72
BSAM	0.00084	0.42	-0.05	-0.03	SEBS	0.00288	1.32	-4.69	-2.02
CISE	0.00233	2.30	-2.51	-2.01	HSBC	0.00354	2.76	-1.91	-1.83
CITY	0.00265	1.75	-3.60	-1.22	CITI	-0.00114	-1.35	-1.00	-0.60
CLEM	0.00037	0.29	-1.32	-1.41	SUNC	0.00121	2.20	-1.54	-1.74
COMM	0.00102	0.63	-2.93	-1.52	CONS	0.00389	3.01	-3.76	-2.72
EQUI	0.00030	0.26	-1.41	-1.00	DRGE	0.00159	1.42	-0.62	-0.54
FAMI	0.00163	1.98	-2.28	-1.48	GUAR	0.00094	0.79	0.34	0.35
FOCU	0.00261	1.94	-4.67	-3.38	NORW	0.00150	2.17	-1.86	-2.10
FRAM	0.00222	0.89	-9.37	-3.45	LLOY	0.00272	2.13	-1.49	-1.33
FPSI	0.00174	1.43	-1.79	-1.69	HEND	0.00054	0.51	0.56	0.58
FPSE	0.00246	1.79	-2.27	-1.82	EHIT	0.00063	0.51	0.06	0.06
HYP0	-0.00170	-1.29	2.11	1.17	WALS	0.00249	2.14	-1.48	-1.86
JUPE	0.00267	1.87	-4.64	-3.26	SCLW	-0.00074	-0.90	-1.61	-1.28
KBCE	0.00212	2.52	-1.31	-1.00	CERA	-0.00457	-2.34	-0.58	-0.19
KDOE	0.00245	2.29	-5.57	-4.50	NORD	0.00219	1.90	-2.65	-1.72
LUXI	0.00212	1.56	-6.00	-2.90	ADIG	-0.00069	-0.39	-5.45	-2.05
NPI	0.00157	1.65	-1.29	-1.12	AESU	0.00137	1.26	-0.65	-0.58
NPIP	0.00295	3.12	-1.35	-1.16	BAIL	0.00084	0.57	-3.47	-1.96
OEKO	0.00142	1.84	-2.62	-2.48	UBSE	-0.00015	-0.43	0.54	0.70
ORBI	0.00248	1.20	-10.16	-5.86	UBSM	0.00226	1.54	-2.17	-1.36
ROBU	0.00038	0.15	1.13	0.59	HABO	-0.00016	-0.08	1.16	0.61
SCOT	0.00204	1.37	-2.59	-1.36	LAKE	0.00210	1.76	-0.23	-0.22
SEBM	0.00235	1.51	-5.92	-4.14	WASG	0.00219	1.68	-4.21	-2.24
SOVE	0.00162	1.08	-2.38	-1.34	SCEU	0.00077	0.65	-0.02	-0.02
TSB	0.00232	2.09	-0.83	-0.71	MCUG	0.00080	0.59	-1.96	-1.95
VARL	0.00192	1.01	-0.57	-0.31	SEBG	0.00126	1.19	-2.34	-2.13
WASA	0.00131	0.88	-3.60	-1.81	BGLO	0.00186	1.62	-3.58	-1.95
WASU	0.00222	1.69	-2.93	-1.68	HASA	0.00148	0.83	-2.22	-0.94
VGRN	0.00237	1.31	-4.15	-1.27	DNBR	-0.00112	-0.43	-3.14	-1.08
VMIL	0.00237	1.31	-5.20	-3.26	VHOR	-0.00099	-0.41	-2.72	-1.50
Average	0.00177	1.353	-2.72	-1.79	Average	0.00120	0.99	-1.84	-1.15

This table reports the results of the Treynor Mazuy market timing regressions according to equation [5.6]. The alpha coefficient gives a measure of the stock selection ability of the fund. The C coefficients are measures of the market timing ability of the fund. The t-values are all adjusted with the Newey-West procedure to mitigate problems with autocorrelation and heteroscedasticity. The average adjusted R^2 for ethical funds was 0.36 and for non-ethical funds 0.48.

Appendix 7.5 Further Matched Pair Tests

	Ethical	Nonethical	Matched pair t-value	2 tailed t-test P value
KURT	2.442	2.019	-1.343	0.187
SKEW	-0.629	-0.590	0.671	0.506
ALPHATM	0.0018	0.0148	0.961	0.342
BETATM	0.604	0.765	2.813	0.008
C-TM	-2.716	-1.812	2.080	0.044

This table reports the results of the t-tests between the group of 40 non-ethical and 40 ethical funds. Values in **bold** are significant at the 5% level with a two tailed test. The first column begins with KURT and SKEW referring to test of significance between kurtosis and skewness. The first column reports the tested parameter, the second column reports the average value for the ethical funds for that parameter, the third column reports the average value for the non-ethical funds, fourth column reports the t-values and the fifth column reports the two tailed significance levels. The table begins with tests of descriptive statistics such as kurtosis and skewness. Finally, differences between the results in market timing for ethical and non-ethical funds are tested for by testing the parameters in the Treynor Mazuy (TM) model.

Size Adjusted	Ethical	Nonethical	Matched pair t-value	2 tailed t-test P value
ALPHA	0.00066	0.00035	0.850	0.408
BETA	0.9293	0.8959	0.366	0.719
GAMMA	0.6513	0.4311	2.671	0.016

This table reports the results of the t-tests between the group of 18 non-ethical and 18 ethical UK funds. Values in **bold** are significant at the 5% level with a two tailed test. The first column reports the ALPHA, BETA and GAMMA parameters referring to test of significance between the two benchmark alpha, beta and gamma parameters.

	Ethical	Nonethical	Matched pair t-value	2 tailed t-test P value
Charges	3.85	3.60	1.41	0.173
Annual fee	1.446	1.326	1.49	0.123

This table reports the results of t-tests for the 23 matched pair funds for which both annual management fee and charges (initial charge and exit fee) were available. The reported values are the average percentages for the 23 funds.

Appendix 8.1 The Main Paradigms in Accounting Research

Dominant Assumptions of Mainstream Accounting

Beliefs about Physical and Social Reality (Ontology)
Empirical reality is objective and external to the subject. Human beings are also characterised as passive objects; not seen as makers of social reality. Single goal of utility-maximisation assumed for individuals and firms. Means end rationality assumed. Societies and organizations are essentially stable; “dysfunctional conflict may be managed through the design of appropriate accounting control.
Beliefs about Knowledge (Epistemology)
Theory is separate from observations that may be used to verify or falsify a theory. Hypothetico-deductive account of scientific explanation accepted. Quantitative methods of data analysis and collection which allow generalisation favored.
Relationship between Theory and Practice
Accounting specifies means, not ends. Acceptance of extant institutional structures. Source: Chua (1986). It is argued that similar assumptions dominate mainstream finance.

Dominant Assumptions of the Interpretative Perspective

Beliefs about Physical and Social Reality (Ontology)
Social reality is emergent, subjectively created, and objectified through human interaction. All actions have meaning and intention and are retrospectively endowed and that are grounded in social and historical practices. Social order assumed. Conflict mediated through common schemes of social meanings.
Beliefs about Knowledge (Epistemology)
Scientific explanations of human intentions sought. Their adequacy assessed via the criteria of logical consistency, subjective interpretation, and agreement with actors’ common-sense interpretation.
Relationship between Theory and Practice
Theory seeks only to explain action and to understand how social order is produced and reproduced Source: Chua (1986).

Dominant Assumptions of the Critical Perspective

Beliefs about Physical and Social Reality (Ontology)
Human beings have inner potentialities which are alienated (prevented from full emergence) through restrictive mechanisms. Objects can only be understood through a study of their historical development and change within the totality of relations. Empirical reality is characterised by objective, real relations which are transformed and reproduced through subjective interpretation. Human intention, rationality, and agency are accepted, but this is critically analyzed given a belief in false consciousness and ideology. Fundamental conflict is endemic to society. Conflict arises because of injustice and ideology in the social, economic, and political domains which obscure the creative dimension in people.
Beliefs about Knowledge (Epistemology)
Criteria for judging theories are temporal and context-bound. Historical, ethnographic research and case studies more commonly used.
Relationship between Theory and Practice
Theory has a critical imperative; the identification and removal of domination and ideological practices.

Appendix 8.2 The Burrell and Morgan Paradigms

The sociology of radical change		
Subjective	Radical humanist Paradigm Nominalist ontology Anti-positivist epistemology Voluntarist human nature Ideographic methodology High on change <div style="text-align: right; border: 1px solid black; padding: 2px;">Critical theory</div>	Radical structuralist Paradigm Realist ontology Positivist epistemology Deterministic human nature Nomothetic methodology High on change <div style="text-align: right; border: 1px solid black; padding: 2px;">Marxist Theory</div>
	Interpretive Paradigm Nominalist ontology Anti-positivist epistemology Voluntarist human nature Ideographic methodology Low on change <div style="text-align: right; border: 1px solid black; padding: 2px;">German idealism</div>	Functionalist Paradigm Realist ontology Positivist epistemology Deterministic human nature Nomothetic methodology Low on change <div style="text-align: right; border: 1px solid black; padding: 2px;">Objectivism and system theory</div>
	The sociology of regulation	
	Objective	

The Functionalist paradigm in social sciences traces its roots to Comte (1798-1857). Other significant positivist thinkers developing this paradigm included Pareto (1848-1923). Mill, Weber and others also made important contributions. The functionalist paradigm emphasises the scientific method and is close to the natural sciences. The functionalist paradigm tries to explain the status quo and tends to be low on the change dimension. Its approach tends to be realist, positivist, determinist and nomothetic. Most mainstream accounting and finance research are in this paradigm.

The **Interpretive paradigm** is based on Kant and has been influenced by Hegel, Goethe and others related to German idealism. The interpretive paradigm tries to investigate the world by being involved with the actors directly. Common methods used thus include case studies and ethnomethodology. The paradigm generally follows a nominalist ontology, an anti-positivist epistemology, a voluntary assumption about human nature and an ideographic methodology. It tends to be low on the change dimension.

The **radical humanist paradigm** draws on early work by Marx and later contributions by authors such as Habermas, Castaneda, Marcuse and Sartre. The paradigm emphasises radical change from a subjectivist viewpoint.

The **radical structuralist paradigm** is influenced mainly by later works of Marx, and work by Engels and Lenin. It has many similarities with the functionalist paradigm, but advocates radical change.

Appendix 9.1 Organisations Interviewed

Aberdeen Asset Management, formerly Murray Johnstone (UK)
ABF (The Netherlands)
ASN / SNS Asset Management (The Netherlands)
Banco (Sweden)
Carlson Asset Management (Sweden)
CIS (UK)
EIRiS (UK)
Friends Ivory & Sime (UK)
Gyllenberg (Finland)
Jupiter (UK)
KBC (Belgium)
Leonia, now Sampo-Leonia (Finland)
NPI/Henderson (UK)
Scottish Equitable (UK)
Sovereign (UK)
Standard Life (UK)
UK Social Investment Forum (UK)

Other experts who were interviewed

Tessa Tennant

Originator of *Merlin (Jupiter) Ecology*, first environmental fund in Europe still in existence, head of ethical research at NPI/Henderson 1994-2000.

Charles Jacob (MBE)

Originator of *Friends Provident Stewardship*, biggest ethical fund in Europe, and one of the first ethical funds in Europe, founded 1984, but original prospect dating back to 1973. Investment manager for Central Finance board of the Methodists 1972-1987.

In addition to formal interviews informal discussions have been conducted with the following organisations:

Bank Sarasin (Switzerland)
Central Finance Board of the Methodist Church (UK)
Calvert (USA)
CGNU/Morley (UK)
Commerzbank (UK)
EIRiS (UK)
Ellipson (switzerland)
Ethibel (Belgium)
Jupiter (UK)
Kinder, Domini and Lydenberg (USA)
NPI (UK)
Pictet (Switzerland)
Robur Asset Management (Sweden)
Scottish Amicable (UK)
Storebrand (Norway)
Suomen Teologinen Instituutti (Finland)
Sustainable Asset Management (Switzerland)
SustainAbility (UK)
University of Aberdeen (UK)
University of Edinburgh (UK)
VBDO (The Netherlands)

Appendix 9.2 Interview Protocol

Niklas Kreander, University of Glasgow
Accountancy & Business Finance

Organization interviewed:

Contact information:

Person Interviewed & date:

Size of Fund(s):.....(Age).....

Number of companies in portfolio:.....

Investment Universe:.....

1. The basis of the fund's ethics and its approach to ethical stock selection

1.1 Where does the notion of ethics used by the fund come from?

– Common concerns among people

– Environmental issues

– Christian values

– Other (please specify)

1.2 Do you have a formal definition of the term ethical and what is it?

.....
.....

1.3 Does the definition of ethics employed change over time and if so, how and why?.....
.....

1.4 How do you identify ethical investments (screening, best in class, engagement, future scenarios)?.....
.....

1.5 How many companies are approved for investment?
.....

1.6 How is the ethical component audited/checked to ensure it is ethical?.....
.....

1.7 Are there any other points that you wish to raise on the definition and selection of ethical investments?.....
.....
.....

2. The implication of the ethics and the relationship with investee companies

2.1 How would you characterise the relationship with a company in the portfolio?

- Time horizon (years)
- Closeness (contact).....
- Frequency of meetings.....

2.2 Does the fund actively try to influence company policies (ethical/environmental)?

.....
.....

2.3 Could you describe cases where this has happened (how, why in what way?)

.....

2.4 Does the fund vote its shares at the AGM in accordance with its ethical policies?

.....

2.5 Has the fund sold shares in the portfolio for ethical or environmental reasons?.....

2.6 Are companies informed if a disinvestment is made because of ethical concerns?.....

2.7 Connection to Christian ethics & Other points.....

2.8 Could you tell the story of why the ethical fund was started (Christian roots)?

.....

2.9 Could you outline the story of your latest ethical investment?

.....

2.10 Views on other ethical funds & initiatives.....

3. Situations of conflicts

3.1 Have there been cases of conflict between ethical/financial performance for the fund (please give details)?.....

3.2 What would an optimum ethical portfolio look like if there were no financial constraints?.....

3.3 What is the fund policy if there is a conflict between environmental and ethical performance? (for example a company with good environmental performance laying off large numbers off personnel, despite being profitable)

3.4 What is the fund policy if there is a conflict between environmental/social and financial performance? (a company with excellent environmental/social performance, but with a declining share price)

3.5 Who decides whether to invest or disinvest in a company?

3.6 What would be an acceptable trade off between ethical and financial performance (priority ethics/returns)?

3.7 How are the ethical fund(s) perceived by the rest of the financial company?
– Enhancing reputation
– A threat
– Influence

3.8 How are the views of investors in the fund fed into policy decisions?

3.9 Other points

4. Does the fund consider sustainability issues?

Appendix 9.3 Engagement and Voting

A number of financial institutions have recently adopted an engagement strategy on ethical issues for some of their other funds in addition to their ethical fund(s). For example Friends Provident have developed their Responsible Engagement Overlay *reo*TM for all their funds with the exception of Asian stocks, fixed interest or property investments. The funds which are effected by this amounts to more than £15 billion. *Reo*TM does not focus on voting shares or launching shareholder resolutions but rather the aim is “ongoing constructive dialogue with senior managers of the companies we invest in” (Friends Ivory & Sime, 2000). It is suggested that this approach is most effective when the focus is on a limited number of companies. In contrast to the approach taken by the *Friends Provident Stewardship* fund, the *reo*TM approach does not stop a fund manager from investing in some sector, such as tobacco. The aim of *reo*TM is to work with companies to improve environmental management and firm policies on a number of ethical issues. A recent example is a two year engagement between Friends, Ivory & Sime and the UK textile retail industry relating to human rights and child labour issues. This engagement involved written communication industry benchmarking, seminars and resulted in improvements in all 11 companies (ABI, 2001).

Another example where the policy of engagement is actively pursued is provided by Co-operative Insurance (CIS). They have adopted a responsible shareholding scheme for all their unit trusts in addition to a strategy of engagement with companies. The responsible shareholding scheme is a part of the social accounting and reporting process of CIS, and the approach is largely based on the processes of the *CIS Environ* fund. The responsible shareholding initiative involves voting shares and influencing companies, but unlike the *CIS Environ* fund, which considers various environmental and ethical issues in detail the responsible shareholding scheme is mainly limited to corporate governance issues.

NPI has adopted an ethical policy for all their life funds and the parent company. AMP, has adopted a sustainable development policy. Since 1994, *NPI Global Care* has been among the most active ethical funds when it comes to

engagement with companies. Standard Life has a corporate governance team, which actively addresses issues such as executive compensation and implementation of the recommendations by the Cadbury, Hempel and Greenbury committees on corporate governance.

Perhaps most significant in terms of the increase of engagement is that 39% of 171 of the largest UK pension funds mentioned engagement in their investment principles and 8 of the pension funds had put some money into ethical funds (UKSIF, 2000). A challenging aspect with engagement is the reliability of information. One interviewee argued that “when we meet company representatives we hear beautiful stories, but when we research the companies... it is not worthwhile to include them in our funds”.

In the Netherlands the Dutch Association of Investors for Sustainable Development, VBDO, attended company AGMs and raised issues on behalf of all of the Dutch ethical funds. One of the interviewees pointed out that they had made a “contribution to (a change) in climate” in that sustainability is now an issue for the management of companies. In Finland the ethical funds do not usually vote their shares. Shareholder activism on environmental and ethical issues was rare in northern and central Europe.

Voting at company annual general meetings

A sensitive issue for most ethical funds seems to be voting at annual general meetings and asking management for new and improved practices. In terms of voting the recent shareholder resolution at the 2000 BP annual general meeting relating to arctic exploration and solar power was interesting. Ethical fund L voted against BP management and exploration of oil in Alaska. The financial institution of Ethical fund F, voted for BP management on the grounds that additional investment in solar power would not have been economically viable at the time and they believed that it is not the funds task to manage the company. The ethical fund F itself does not hold BP shares. A third ethical fund abstained from voting. Despite this mixed voting by ethical funds, 13.5% of the votes were cast in favour of the resolution. Ethical fund managers, in a personal capacity, generally supported the shareholder resolution against Rio Tinto, but

as the ethical funds couldn't invest in the company, most ethical funds were unable to participate in this resolution. Yet 20% of the investors voted against Rio Tinto on an issue relating to corporate governance and 17% voted for the resolution that Rio Tinto should adopt a code of practice on labour standards (EIRiS, 2000b). This is in line with findings in Friedman and Miles (2001) that ethical funds have not voted actively in the UK. Mallin (2001) reported that according to a number of studies around 40% of the shares of UK listed companies were typically voted at an AGM. This would indicate that non-ethical funds are sometimes passive in voting as well.

Appendix 9.4 Companies in ethical funds

Nokia (9), Ericsson (6), Vodaphone (5), Skandia (4), Abbey National (2), BT (2), Intel (2), Royal Bank of Scotland (2), Sage (2)

This table reports common holding in the 20 ethical funds in Chapter 9 and 10. It is only based at the top 3 holdings and thus it does not reflect the entire portfolios of the 20 funds. The table is based on the situation in the year 2000.

BT (13), British Polythene Industries (12), Railtrack (12), Body Shop (11), Wessex Water (11), Abbey National (10), Halma (10), Powerscreen International (10), RPS Group (10), SIG (10), Bicompatibles Int. (9), Polypipe (9), Protean (9)

The table reports the most common holdings in 29 UK ethical funds in 1998. The number in brackets report how many funds held the stock (Hancock, 1999).

Cisco Systems (14), Intel (13), Microsoft (13), IBM (10), Merck (10), Vodaphone (8), MCI WorldCom (8), BT (8), SBC Communications (6), Lucent Technologies (6), Coca-Cola (6), Johnson & Johnson (6), Nokia (6), Schering-Plough (5)

This table is based on the most common holdings in 154 American and European ethical funds. It is based on the situation in 1999 and US ethical fund holdings dominate the list (Goodman, 2000).

Vodaphone (44), Cable & Wireless (40), British Telecom (37), Reuters (37), Firstgroup (36), Halifax Group (36), Pearson (36), Abbey National (34), National Express Group (33), ARM Holding (31), BG Group (31)

This table reports the top holdings of UK ethical funds in March 2001 (Personal Finance, December 2001).

(1) Vodaphone, (2) Nokia, (3) GlaxoSmithKline, (4) Johnson & Johnson, (5) Royal Bank of Scotland, (6) Pfizer, (7) British Telecom (8) Ing Group (9) Ericsson, (10) First Group, (11) BP, (12) AstraZeneca

This Table report the most frequent stocks in European ethical funds in June 2001 (Bartolomeo and Daga, 2002).

Appendix 9.5 Personal Ethics of Interviewees

The personal ethics could affect the composition of the portfolios. At least one interviewee directly mentioned this possibility. Table 10.2 details whether the interviewees were members of a Christian Church or some NGO.

Possible Influences on the Personal Ethics of Interviewees

Interviewee	Organisation	Position	Church Member	NGO Member	Location
A	A	Managing Director	YES	NO (3)	Netherlands
B	B	Ethical Researcher	YES	YES	Netherlands
C	C	Fund Manager	YES	NO	Sweden
D	D	Fund Manager	?		Sweden
E	E	Ethical Researcher	NO (1)		UK
F	F	Ethical Researcher	NO	NO (3)	UK
G	G	Fund Manager			Finland
H	H	Ethical Researcher	NO	YES	UK
I	I	Fund Manager	NO	NO	Belgium
J	J	Managing Director	YES		Finland
J2	J	Fund Manager	YES	NO	Finland
K	K	Director of SRI	YES	NO	UK
L	L	Marketing Manager	YES	YES	UK
M	M	Ethical Researcher	YES	YES	UK
M2	M2	Fund Manager	YES	NO	UK
N	N	Fund Manager	YES	YES	UK
O	O	Fund Manager	YES	YES	UK
P	P	Ethical Researcher	YES	YES	UK
Q	Q	Fund Manager	YES	YES	UK
R	R	Ethical Researcher	NO	YES	UK
S	S	Managing Director		YES	UK
SHORTER	INTERVIEWS				
G2	G	Managing Director	YES		Finland
G3	G	Fund Manager	NO (2)		Finland
G4	G	Fund Manager			Finland
H2	H	Ethical Research	NO	YES	UK

This Table shows that 14 of 21 respondents or 67% were members of some Church, while 11 of 18 respondents or 61% were NGO members. (1) Interviewee E was not a member but used to go to a Church and (2) interviewee G3 planned to join a Church. (3) Interviewee F is not directly an NGO member but supports some charities financially.

In terms of influences on the personal ethics of interviewees, most of them were members of some Church. In most cases this was a “national” Church such as the Church of England, Church of Finland, Church of Scotland or the Church of Sweden although other groups such as the Methodists were represented. Many interviewees were also members of non governmental organisations (NGOs)

such as Amnesty or Friends of the Earth. Both of these organisations have recommended that if their members make stock market investments they should consider ethical funds (UKSIF, 2000b; Friends of the Earth, 2000). The personal ethic may be significant an English fund manager after outlining the fund ethical policy said that “unit holders get me”. Another fund manager mentioned how he had avoided some companies on ethical grounds although they were in the investment universe. Interestingly, one interviewee who was both a Church and an NGO member described herself as “not very ethical”. Charles Jacob who is also both a Church and an NGO member did all his work for Stewardship between 1973 and 1985 without pay and despite sarcastic comments from some “colleagues”. For example, the Friends Provident Stewardship fund was called “The Brazil Fund” because the idea of an ethical fund was “nutty”. Peter Webster campaigned as a young Quaker for a more comprehensive ethical investment policy for the Quakers. In 1983 he became the first Executive Director of EIRiS, an organisation which he still leads in 2002.

An English interviewee mentioned that it is the individual investor who brings together different types of investment such as community investment, ethical and non-ethical funds. Indeed, Professor Alan Lewis mentioned at a seminar on ethical investment in London that his research demonstrated that many investors had investments in Shared Interest, ethical funds and ordinary funds. He further suggested that the proportion in the first two categories may serve as a proxy for the “ethicality” of the investor.

Appendix 10.1 Companies bought and companies sold for ethical reasons

Company sold for ethical reasons	Reason given for divestment
Boots	Animal Testing, transparency
BT	Military contracts
First Group	Railway accidents
Hewlett Packard	Software for US air force
Marks & Spencer	Lack of reporting, poor transparency
Lee Interest	Environmental offender
Nestle	Neste approved and mistaken for Nestle
Premier Oil	
Scottish Hydro Electric	Link to nuclear power at the time
Scottish Power	Environmental breach
Stagecoach	Complaints from unit holders over aggressive business practices
Stork	Military (bought Fokker)
United Newspaper	Gambling
United Technologies	Military (parts for combat helicopters)
Vodaphone	Human rights/oppressive regimes (China, Saudi Arabia)

One ethical fund sold a Hydropower utility after it expanded to other fuels. Another ethical fund avoided investment in Petrochina because of human rights / oppressive regime concerns. Many interviewees said their fund(s) had never sold a company for ethical reasons.

Also Body Shop was kept in a portfolio for ethical reasons, although financial reasons would have favoured divesting it.

Latest/recent “ethical” investment	Reason given for investment
Ballard Power systems	Promising fuel cell technology (economy & environment)
BP Amoco	Positive financial “house view” of stock
Hennes & Mauritz	
Mitie	Met positive ethical and financial criteria
NEG Micon	Renewable energy, windpower potential
Philips	
Scipher	Interesting technologies
Sony	Leading company in consumer electronics Environmental management & reporting
Vodaphone	
Worldcom	

A number of interviewees were not able to answer this question. For example, one ethical researcher claimed that they managed so many ethical funds that she could not remember the answer for the particular fund in this investigation.

Appendix 11 Biblical Principles for Economics and Christian Stewardship

Biblical Principles for Economic Life (Hay, 1989)

1. Man must use the resources of creation to provide for his existence, but he **must not waste or destroy** the **created order**.
2. Every person has a calling to exercise stewardship of resources and talents.
3. Stewardship implies **responsibility** to determine the disposition of resources. Each person is **accountable to GOD** for his stewardship (Luke 19:11-27)
4. Man has a right and an obligation to work.
5. Work is the means of exercising stewardship.
6. Work is a **social activity** in which men **co-operate** as stewards of their individual talents and joint stewards of resources
7. **Every person** has a right to **share in God's provision** for mankind for their **basic needs of food, clothing and shelter**.
8. Personal Stewardship of resources does not imply the right to consume the entire product of those resources. **The rich have an obligation to help the poor** who cannot provide for themselves by work (Luke 12:13-21, Luke 16:19-31, Mark 7:22).

These Biblical principles for economic life were developed in Hay (1989). Some of these principles are broadly consistent with some ethical criteria of the funds. For example the first principle is consistent with various exclusionary environmental criteria. Some human rights, workplace related criteria are consistent with principles 6 and 7. Other principles such as 7 and 8 go beyond the activities of ethical funds towards alternative/community investments and charity.

Principles of Christian Environmental Stewardship (Enderle, 1997)

1. Stewardship
2. Ethical Responsibility
3. Sustainable Development
4. Corporate Mission
5. Environmental Accounting and Reporting
6. Stakeholder Consultation About Corporate Activity and Policy
7. Eco-efficiency
8. Benign Conditions of Competition
9. Market and Regulation based Initiatives to reduce Environmental Impacts

These principles were suggested by business ethicist Georges Enderle, who aimed to propose broadly acceptable ethical principles for dealing with the environmental problems derived from a Christian perspective.

Possible Principles for Christian Investment

1. God first (Ex 20:3-4, Deut 5:7-8, Matt 19:20-21, Mark 12:29-31)
2. Honesty (Ex 20:16, Deut 5:20)
3. Engagement (Luke 19:1-10)
4. Avoidance (2Peter 3:11)
5. Positive Development (Genesis 2:15)
6. Long term investment and development (Acts 2:37-41)
7. The focus should not be on large companies (Deut 24:17-22, Mark 4:30-32)
8. Truly Global investments (Mark 16:15)
9. Tithe-Charity (Deut 14:32 Malachi 3:8-12)

These tentative principles were derived by the author based on Wesley (1760), Church of Scotland (1988), Hay (1989) and first and foremost the Bible.

