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Socially Responsible Investment by Trustees
of charities and occupational pension funds
(SRI)

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Abstract

This paper initially explores the rationale and growth of corporate social responsibility by companies. The paper then charts the development and legislative background to the regulations to the Pensions Act 1995 and the forthcoming Charities Act 2005 which for the first time obliges charities and pension scheme trustees to state in their statement of investment principles a policy on SRI. But what is SRI? What are the current key SRI concerns. This paper then explores current information providers and performance indicators for charities and pension funds wishing to invest in socially responsible companies. The paper concludes with proactive strategies and observations on future developments in SRI. This paper does not consider legal issues or the current ethical funds now available.

1. SRI- from way-out to mainstream?

It is rare in the modern British Parliamentary System for a radical government to be elected. The first-past-the-post system inevitably means that only two major groups can contest to win power and, to get the majority of votes, they are drawn to the centre. In the election of 1979, for the very first time, a radical government committed to major changes was elected. The Labour Government of Atlee of 1945-51, which created the Welfare State, was not particularly radical as corporations and services that became nationalised industries were already state-controlled and an embryo Welfare State had effectively been in operation during the war years. If anything, the Atlee Government, for example in the provision of child care for working women, was reactionary as it expected women who had worked and received free child care to return to the home. The Labour Government of 1945 delivered on the vision of the Beveridge Report of 1942, which had promised a welfare system to the people of Britain. There was no taste for a return to the *'laissez-faire'* policies and poverty of the 1930s. As the historian Eric Hobsbawm comments:

“ By the middle 1930s ‘Laissez-faire’ was therefore dead even as an ideal, except for the usual financial journalists, spokesmen for small business, and the economists ... Two economic policies therefore faced each other, both equally remote from John Stuart Mill. On the one hand, there was socialism, based essentially on the aspirations of the working class movement, but gradually strengthened by the experience of the USSR, which impressed even non-socialist observers by its apparent immunity to the great slump. It contained little by way of precise policy except the ancient demand for the nationalisation of the means of production, distribution and

exchange and the slogan of planning which the Soviet five-year plans made extremely fashionable. On the other hand there were those – mainly economists who came from liberalism (like J.A.Hobson) or who still remained liberals (like Keynes and Beveridge) – who wished to save the essentials of a capitalist system, but realised that this could now be done only within the framework of a strong and systematically interventionist state; or even through a ‘mixed economy’. In practice, the difference between these two trends was sometimes hard to discern, especially as some Keynesians abandoned the liberalism of their inspirer for socialism, and as the Labour Party tended to adopt the Keynesian policies as its own, in preference to the more traditional socialist slogans. Still, broadly speaking, the socialists favoured their proposals because they were for social equality and justice, the non-socialists theirs, because they were for the efficiency of the British economy and against social disruption. Both agreed that only systematic State action (whatever its nature) could get rid of and avoid slumps and mass unemployment” (Hobsbawm 1969, pp 244-245).

By 1979, however, the mood of the populace was very different. Both Labour and Conservative Governments for thirty years had adopted policies that were very similar. Beyond the steel nationalisation debate, the Conservative Governments had kept the nationalised industries and the Welfare State apparatus. Labour in turn was content for mild, as opposed to radical, reform in wealth distribution and other inequalities. However, the Labour Government of 1974-79 went through a period of industrial disruption, with unemployment exceeding a million, and was humbled as it had to seek a loan from the International Monetary Fund, a device usually reserved for ‘bankrupt’ economies. The Conservatives elected as leader the ‘right-of-centre’ Margaret Thatcher, who subsequently came to power. The Thatcher Government was fuelled by a revived ‘*laissez-faire*’ political and economic ideology, which rejected the Keynesian orthodoxy, which had dominated the post-war years. The importance of Mrs Thatcher’s legacy for the debate on SRI in the UK and of her ‘soul mate’ Ronald Reagan in the US cannot be overestimated. In essence, we would not be discussing SRI and Corporate Social Responsibility (CSR), if there had been no Conservative Government in the 1980s. If Labour had won in 1979, the country today would be similar to the social democratic style found in France and Germany. As Hamil explains:

“ Indeed in continental Europe CCI {Corporate Community Involvement} has long been frowned upon even by political conservatives on the basis that corporations’ social role is to provide the financial resources that the state can then use for the betterment of every citizen through the provision of public services”(Hamil 1999).

The underlying philosophy of the Thatcher Governments was to reject the ‘gradual decline’ hypothesis that had ruled much of British post-war thinking. Instead, Mrs Thatcher believed that the problems of the British economy stemmed from a dependency culture based on high taxation and regulated labour markets. If British business became free from such constraints, then enterprise would follow. Reforms in labour law, reductions in direct tax and a strict ‘non-intervention’ policy in failing companies resulted.

While much of the anger and attention in these years and since has focused on the decline of British manufacturing, the coal strike, mass unemployment and community deconstruction, little attention has focused on the radical change that was occurring in

that most conservative of institutions, “the City of London” (*City*) and financial services. Margaret Reid captures the change aptly in her 1988 book title “*All-Change in the City*”. *The Revolution in Britain’s Financial Sector*. A man working in the City in the early 1980s (and the emphasis on ‘man’ is deliberate) would have seen little changes from his predecessor of the early 1880s. However, the members of the global community who now work in the City would not recognise the City of the early 1980s. In the reform referred to as ‘*Big Bang*’, the City opened itself up to outsiders in order to stay as one of three major global financial centres. City institutions such as investment banks and fund managers, which had been privately owned, were bought by US and other overseas financial institutions. The US, which had in turn been ‘re-energized’ by Ronald Reagan after Vietnam and Iran, had always been committed to a free-enterprise economy. The pursuit of wealth at all costs, rewarding hard work and enterprise, and the cult of the individual became the new mantra. The film ‘*Wall Street*’ aptly summed up the time.

Unlike the US, which had always embraced an unfettered capitalist philosophy, the experience in the UK for much of the twentieth century had been different. In part due to geographical size and, most importantly, the experiences of two world wars in the twentieth century where danger and much hardship were shared, the concept of one nation and social responsibility was much stronger. Such traditions are not new. Feudal society had always exhibited a two-way dependency between Serf and Lord, and concerns about the effects of the Industrial Revolution had resulted both in the growth of welfare charities and in responses from philanthropic employers such as Cadbury and Rowntree, reflecting their Quaker beliefs. Radical steps in responsible capitalism were undertaken by Robert Owen, which also saw the emergence of the Cooperative movement. The University settlements established in the late nineteenth century in the poorer boroughs of London saw ‘Oxbridge’ students living and working in poor communities, offering assistance and support in numerous programmes.

With the odd exception (the stockbroker and later fund manager Phillips and Drew (now UBS Global Asset Management), for example, had a policy of not appointing the children of partners in the business), most City institutions were in effect ‘closed shops’ with restrictive employment practices as bad as the print trade and dock workers that they criticised. As a new meritocracy began to replace ‘old school’ traditions, however, an unexpected side-effect began to emerge. Control and behaviour for the City and financial services had been self-regulating. Self-regulation, it was argued, was appropriate because of complexity. Supporters of self-regulation claimed it was easier for finance professionals to ‘police’ themselves rather than have an external supervisory institution. A ‘rotten egg’ would be discovered and dealt with more effectively in a self-regulation system. The Financial Services Act 1986, following the Gower Report, continued to support the principle of self-regulation, although it did introduce a statutory body to oversee the self-regulatory organisations.

Such ‘gentlemanly’ behaviour, however, was soon to experience shocks to its foundations as a series of scandals hit the financial community in the early 1990s. From the collapse of banks and pension fund disappearance to the misselling of personal financial products, a crisis of confidence in financial services began to emerge. The naked greed in the City had also, it seemed, infected the public service,

as the conduct of both elected and paid officials was criticised for both dishonesty and failing to put the public interest first. The ‘revolution’ that had changed the British economy from ‘basket case’ to the fourth largest in the world had created something rather nasty. As Walter Stewart aptly concludes in his book *‘Too Big to Fail the story of Olympia and York’*, about the greed culture:

“ If society is concerned, first and foremost, with doing only those things that pay off, we can hardly complain when we find private hands in the public till. If everything is for sale, nothing has any value.” (Stewart 1993 p275).

For financial services, like democratic governments, to work there is the need for people to have confidence in the integrity of the system. In the same way that only an insane person would gamble in a ‘rigged game’, people will not invest in companies if they believe that the owner is dishonest. To restore the confidence of the public in the 1990s the term ‘governance’ increasingly appeared. For the corporate sector, the Cadbury Report of 1992 was a major landmark. The Cadbury Report was an attempt to reconcile the self-regulatory system by suggesting a model of governance based on principles which board structures should meet, rather than describing process, and defined governance as ‘The system by which organisations are guided, directed and controlled at a strategic level’.

Cadbury has been followed by a series of governance reports, now over twelve, which have attempted to curb what is seen as undesirable corporate behaviour, from abuse of power to excessive remuneration. Of these reports, it was the Turnbull Report (1999) which is perhaps the most interesting. Turnbull related corporate failure to risk and, in particular, focused on reputation risk. By linking governance to profit the stakes had changed. Before Turnbull, despite the endorsement of the major financial and management associations, the concept of governance and social responsibility had been viewed as a rather marginal activity to the main purpose of business, which was famously expressed by Milton Friedman as:

“That responsibility [to the owners of the business by the manager] is to conduct the business in accordance with their [the owners’] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom” (Friedman 1970)

The integrity of companies and their role in the wider community were therefore linked to the mantra of profit. If a company spent millions on developing a brand image, it was argued, it would be foolhardy to suddenly see that money lost if the company was to then engage in bad behaviour. For example it is estimated that 96% of Coca-Cola’s stock market value is in intangibles, such as reputation, knowledge and brand (Grayson and Hodges 2001). A defining point in the UK was the campaign by Greenpeace against Shell, a multi-national oil company, for its plan to dispose of its Brent Spar oilrig in 1995. The Guardian newspaper reported on 30th January 1998 that the final decision to comply with Greenpeace's demands had cost Shell some £38.5 million over what it would have cost if it had kept to its original decision. The humbling of one of the largest companies in the world by a small activist organisation is cited along with the McDonalds’ libel action as a turning point in the behaviour and attitudes of corporations to activity pressure groups (Deegan 2001). The power of modern communication through the Internet has undoubtedly meant that a shift of

power from the corporation to the activist occurred. No longer constrained by the official media, pressure groups through the Internet were able to convey their message; corporations like Shell and McDonalds quite simply lost the public relations battle:

“ We have learned that we must change the way we identify and address issues, and interact with the societies we serve”. (Shell Management Report 1998)

Pryce (2002) outlines five different drivers that have focused companies on social responsibility:

“ Corporate social responsibility (CSR) has moved rapidly from off-stage to centre-stage. It is now an issue that cannot be ignored by business.... To understand why this is the case, it is important to understand why CSR has moved so quickly to be a must-respond issue for businesses. This has been driven by five forces: customer pressure, changes in business procurement, government legislation and pressure, the rise of socially responsible investment and the changing expectation of employees.” (Pryce 2002 p 140)

Pryce then provides a rationale and supporting evidence for these drivers:

1. Change in Customer Demands: While brand and price are important, polls on consumer behaviour have found that consumers are also concerned about the corporate responsibility of their supplier to influence purchasing decisions. High profile consumer boycotts, whatever the individual causes, are fundamentally a protest at the perceived irresponsible behaviour of the company concerned.
2. Business Procurement: Companies are focusing on responsible purchasing, which has been forced on them by pressure groups exposing bad practices e.g. Nike's child labour scandal and the rise of socially responsible investing.
3. Government Legislation: the change in the UK government in 1997 saw the government support CSR and SRI through its roles as a major purchaser, through legislation (European Convention on Human Rights charter incorporated into UK law) and encourager of good corporate behaviour through corporate reporting initiatives.
4. Investment Community: While there are only a few ethical funds, many fund managers have adopted positive criteria towards investing in companies and the formation of indexes such as FTSE4Good have accelerated these moves.
5. Employee expectation: Surveys on employee behaviour have consistently found that employees do care that their employer acts responsibly.

The City and financial services saw self-regulation in the UK being abandoned by the Financial Services and Markets Act 2000, which established the Financial Services Authority, an independent non-governmental body with statutory powers. The role of the FSA is as follows:

“ The Financial Services broad task is to achieve a marketplace that is run in an efficient, orderly and clean manner whilst ensuring that consumers receive a fair deal by being properly informed and appropriately protected. Ultimately the FSA is all

about maintaining confidence in the United Kingdom's financial market place for the benefit of everyone” (FSA website)

Secretive financial institutions were now required to comply with a well-resourced and all-powerful regulator in the UK. In the US the regulation was further tightened in 2002 by the Sarbanes-Oxley Act following a number of major corporate and accounting scandals, notably Enron and WorldCom. This required all companies (including foreign companies) that are quoted on American exchanges and registered with the Securities and Exchange Commission to comply with various regulatory and corporate governance requirements. A legal requirement on directors to declare not only that systems were in place but that they also actually worked meant that the time of the compliance officer had arrived. A second influence followed the awful events of the 11th September 2001 when terrorists attacked the World Trade Centre in New York. Following these attacks Governments introduced legislation that targeted all organisations to ensure they were not involved with providing support to terrorist organisations.

Another influence in the UK was driven by the election of a Labour government committed to a ‘third way’ economic and social policy combining a market economy with a social concern strongly motivated by a human rights agenda. An early example, following extensive negotiation, was the requirement in 2000 for the trustees of occupational pension schemes to declare their policy with respect to social, environmental and ethical considerations within the criteria established for management of the funds. As Sparkes identifies:

“... it is my belief that history will consider the day the UK’s SRI pension fund regulations came into effect, 3 July 2000, as a momentous day in the evolution of investment management. It was a date of global rather than of local importance. For the first time ever pension funds, the building blocks of the world’s capital markets, were legally obliged to consider non-financial issues in setting their investment policy” (Sparkes p4 2002)

In less than twenty years the hostility of Governments, regulators and corporations who had initially opposed ethical investment funds, paid lip service to social responsibility and saw corporate community involvement much as their Victorian forefathers had done, has changed. However, what do we mean by “Social Responsibility”? What are the issues for trustees of charities and pension funds? How do you transfer legitimate concerns into a working policy? Is there a difference between a well-run company and an SRI company?

2. What is Social Responsibility – from ethics to key issues?

Rushton (2002) provides the following practical definition:

“ Many people struggle with the terms ‘ethics’ and ‘corporate social responsibility’. For me ethics is the application of moral principles in making choices between right and wrong courses of action. Business ethics is the application of those moral principles in making business decisions ... Social responsibility has come to mean those positive actions or responses a company takes to help discharge its responsibilities to external stakeholders such as the communities in which it operates

and to the environment. Put simply, it is the ethical behaviour of a company towards society. (Rushton 2002 p 137)

Through our genetics and external environment, we acquire a set of personal values and concerns about issues. What is of passionate concern to one person may not be to another. Gail Moss (1999) aptly distinguishes ethical and socially responsible investment as:

“ Ethical means excluding specific companies; SRI means seeking out particular companies to invest in”.

On this basis the function of fund managers and the approach of trustees moves away from a conservative screening-out avoidance process to instead a proactive function supporting the positive aspects of a company’s approach to business (Taylor 2000). In practice this means trustees and their fund managers undertaking a two-part strategy focusing on external analysis of socially responsible issues and secondly on the management of the organisation itself.

Within the field of social responsibility, Hancock (2002) identifies the following external issues:

1. Alcohol – beyond religious objections the principal problem with alcohol refers to the regrettable side-effects found in alcoholism with its subsequent personal cost to the individual and their family and in monetary cost to the NHS. The second aspect is the anti-social behaviour from excessive drinking.
2. Tobacco – quite simply, tobacco kills.
3. Gambling – is similar to alcohol. For some religious people the very act itself is wrong. For the pragmatic, it is the addictive aspect of gambling that is the concern and the misery that can result.
4. Pornography and adult entertainment – the principal objection is the concerns that it exploits people who need money and can only get it by using their bodies. Of particular concern is the exploitation and effect on vulnerable people, most obviously children.
5. Human rights – the definition of this issue is set out in the United Nations Universal Declaration of Human Rights and contends that an individual is entitled to fundamental and inalienable rights, including the right to freedom, to lead a dignified and independent life free from abuse and violations. This means that an individual who has contact with an organisation has the right to be treated justly and fairly, equally and consistently, irrespective of their gender, ethnic origin, creed, colour, sexual orientation or disability.
6. Health and Safety at work – it is the responsibility of an organisation to provide healthy and safe working conditions
7. Third World exploitation – this includes both the exploitation of third world products at low prices and the selling of undesirable products, for example armaments and tobacco. The issue has also expanded to Third World debt and the recognition that the repayment of this debt is preventing those countries from moving forward.
8. Animal testing – concern divides into two groups. The first is a universal acknowledgment that testing of animals for cosmetics should be banned and,

in 1998, the UK government stopped the future issuing of licences. The use of animal testing for medical research is, however, more complex.

9. Intensive farming methods – while vegetarianism is a growing movement, it is still very small. The major issue is ensuring that animals are kept decently and slaughtered according to the highest standards.
10. Genetic engineering – has become a separate issue, and relates to both animals and crop production.
11. Armaments – opposition reflects the pacifist tradition. For others it is linked to third world and oppressive regimes but takes a pragmatic perspective, recognising that peacekeepers need to be armed.
12. Nuclear energy – linked to arms, it is also the issue of damage to the environment and waste disposal and leads to a whole host of concerns under the term ‘Ecology and Environment’.
13. Ecology and Environment – issues here include greenhouse gases and ozone depletion, loss of forested areas and non-replacement of tropical hardwood, water pollution, pesticides and roads.
14. Banking – issues around banking are synonymous with the anti-apartheid campaign against South Africa. The key issues now relate to Third World debt, financial exclusion, domestic debt and responsible lending.
15. Irresponsible marketing and advertising – the key issues are about the truth claimed in a product and the inappropriate use of sex, disadvantage, race and creed to sell a product.

Hancock’s list and Rushton’s definition related to an external analysis of social responsibility. The second aspect concerns the ethical conduct within the organisation itself, which internally focuses on the managers and employees. Driscoll and Hoffman (2000) have developed a ten-point programme for implementing “values-driven management”:

1. Self-Assessment: the organisation analyses its structure, the corporate culture and the business environment to identify potential risks and determine levels of responsibility.
2. Commitment from the top: to be successful in the long term, any values initiative needs the explicit commitment of the most senior levels of management.
3. Code of ethics: there should be a document which includes a general statement on corporate principles and specific rules of behaviour making explicit what employees need to do – and should not do - to implement them.
4. Communication: a two-way communication process must be in place to transmit to all organisational members the company’s philosophy and core values.
5. Training: to enable all organisational members to understand, share and apply the values stated in the code of ethics. The purpose of ethical awareness training is to provide tools for ethical reasoning and action that in turn will facilitate ethical leadership.
6. Resources: organisational structures and activities must provide further support to ensure an effective application of the code of ethics in daily decision-making processes. They include an ethics officer, an ethical help-line and whistle-blowing mechanisms.
7. Organisational ownership: the organisation’s business ethics programme needs to be reinforced by widespread ownership throughout the different departments and

functions of the organisation, from the ethics officer to local employees in overseas offices.

8. Consistent standards and enforcement: core values must be consistent across the whole organisation. However, given different roles and responsibilities, or by reason of geographical and cultural differences, standards of behaviour can vary so as to be more effective.
9. Audits and evaluations: the organisation should constantly measure how effective the values programme is by reporting and investigating potential violation. Audits should also assess the programme itself, for instance by consulting employees on their knowledge and use of ethical resources made available by the organisation.
10. Revision and reform: any values programme is a living instrument and should be able to evolve as the external environment changes and as a result of an ongoing learning process.

3. Measuring and determining a socially responsible policy.

From the inception of ethical investment in the 1980s, there was an assumption that because ethical funds would not be exposed to the full market due to the exclusion of major stocks in tobacco, alcohol, armaments etc the performance of such funds would suffer. In essence, a premium for underperformance for being ethical would have to apply. Forever on the defensive, ethical fund managers would claim at best that they could match the performance of other funds. In the late 1990s some ethical fund managers began to claim that their funds outperformed the general index. However, it became apparent in the subsequent “Bear Market” that such performance had been based on an overexposure to technology companies, which subsequently had poor performance relative to other sectors. Responsible advocates of ethical funds generally conclude to a neutral perspective on the relative performance of ethical against general funds (Hancock 2002; Sparkes 2002). Clearly, such benchmarks and performance statistics are important for established ethical funds. However, against the wider proactive debate and from the perspective of the trustee, are such benchmarks relevant? An alternative is to discover:

- Whether the organisation's investment objectives have been met.
- Whether there is a workable policy on socially responsible investment and how much it costs.

It is important to remember that the trustees’ primary objective is to ensure that a fund’s financial assets provide the greatest possible contribution. A joined-up strategic plan, which combines the organisation’s objectives with an investment strategy, including an appropriate asset allocation, is vitally important. However, once an investment manager is appointed and a strategy agreed, how do you know if your investments and the manager are achieving those objectives? Finding an appropriate benchmark is vital to this process but often organisations fail to appreciate what is an appropriate benchmark and how to set and monitor one, particularly when trying to balance this with ethical and socially responsible policies.

Setting those financial objectives is about understanding and being very clear on specialist ethical constraints and adopting a social responsibility policy. It is then concerned with monitoring the investment manager’s performance to ensure it is

meeting the organisation's investment objectives. Monitoring requires as much management time as the original decision-making process. Monitoring is an ongoing dynamic activity that goes beyond the passive receiving of quarterly valuation reports and biannual meetings.

According to the UBS Glossary of Investment Terms, a benchmark is a yardstick against which the investment policy or performance of a fund manager can be compared. Asset allocation benchmarks vary from peer group (e.g. the "average" fund as measured by one of the numerous performance surveys) to customised benchmarks tailored to a particular portfolio's requirements.

There are two principal methods of measuring investment performance: absolute and relative. Absolute performance (not to be confused with absolute return) is based on the principle that the constraints placed on the fund's investment manager, e.g. ethical issues, mean that the trustees decide to set their own bespoke benchmark. This will require the trustees to define very carefully their investment objectives and will include having a clear income target, defining precisely the constraints that will apply and the degree of risk they will allow to occur. The alternative is relative performance, which measures the fund's performance against an external index. This requires the trustees to select a suitable yardstick against which to measure.

There are currently two major relative performance services used by charities and pension funds. Established in the 1970s initially for pension funds the WM Company established a Charity Service in 1984 and its total charity universe at the end of 2003 was made up of 306 funds with total assets valued at £7.7bn. The WM Company recognises that all charity funds do not have the same characteristics and has created three sub-universes determined by investment objectives: an unconstrained fund universe focusing on UK charity funds with discretionary mandates; a fund constrained by income; and a fund constrained by asset mix. The other service is CAPS (Combined Actuarial Performance Services), which was established in 1984 to provide performance measurement services to the pensions industry and is now run by Russell/Mellon. CAPS offer two dedicated charity services reporting respectively on segregated funds and common investment and deposit funds.

In addition to these two well-known relative performance services a number of other benchmarks exist. The one of greatest interest to those interested in socially responsible investments is the FTSE4Good Index, which was launched in 2001. The index tracks the performance of companies that meet the 'FTSE4Good' criteria which generally means that eligible companies must meet various requirements in three areas; environmental sustainability, positive relationships with stakeholders and the recognition and support of universal human rights. The sectors excluded from the index include companies involved in tobacco products, nuclear weapons, nuclear power stations, the manufacture of whole weapon systems, and uranium extraction and processing.

The desire for performance benchmarks began with the pensions sector in the 1970s and has become an essential for the investment strategy of any institutional investor. A benchmark helps identify for trustees both strategies and expectations and to set targets for fund managers. Originally, most benchmarks were customised to the specific requirement of the fund but the desire to see how other funds were

performing led to the introduction of peer-group benchmarks. However, there are problems with peer-group benchmarking as Blake and Timmerman for the Pensions Institute identify:

“ Benchmarks influence the type of assets selected and, equally significantly, the type of assets avoided. Peer-group benchmarks have a tendency to distort behaviour, particularly when combined with a fee structure that does not promote genuine active management. The outcome tends to be herding and closet index matching.” (Blake and Timmermann 2002 p1)

The implications of the Blake and Timmermann research raise interesting issue for trustees seeking to compare their performance. Charities are being subject to a more ‘hands-on’ regulatory regime by the Charity Commission whose recent research report on transparency and accountability found that of the 178 examined annual reports on charities with investments, eighty-three gave some comments on investment performance against targets, but ninety-five (53%) gave no comments at all. The finding was confirmed by the larger study undertaken for the NCVO Almanac, which involved reviewing 3,000 charity accounts. Most charities failed to mention any form of performance indicator when they had investments and the few who did either explicitly referred to being a member of a service like the WM or claimed to be informally tracking an index. However, is just following an index good enough?

Blake and Timmermann suggest that following peer-group benchmarks can encourage complacency. They pose the following questions: are they set too low, making them easy to beat? Alternatively, are they set too high, making them hard to beat unless fund managers take on excessive risk? Is the frequency of assessment against the benchmark (typically on a quarterly basis, appropriate for long-term investors? Do they introduce unintended (and undesired) incentives such as the incentive for fund managers to herd together or to avoid holding securities (such as small start-up companies) that are not included in the benchmark? How, if at all, should performance against the benchmark influence the fund manager’s compensation? There is also the issue of liabilities.

Therefore, what are the alternatives to a peer-group benchmark and why should charities and pension funds consider them?

According to Blake and Timmerman, pension funds are moving away from relative benchmarks to customised benchmarks. However, charities seem to be moving in the opposite direction. Catherine Wood in her book *‘The Good Investment Guide for the Voluntary Sector’* defines absolute performance as the performance of the fund as measured against the organisation’s own investment policy. Absolute standards may include, for example, compliance with investment policies, maintaining the portfolio within the agreed asset allocation ranges, maintaining the agreed liquidity requirements, meeting the agreed absolute return targets, etc. Wood sets out a clear and straight-forward process for measuring absolute performance, which argues that charities must look at the whole financial picture in devising their investment policy. Are bespoke benchmarks more appropriate for charities and should they follow pension funds? Unlike pension funds, charities are much more diversified and they do not have the same explicit time-liabilities of pension funds. They are also very

different. A fundraising charity, for example, which also has investments, is going to have very different liability needs from a permanent endowed trust and their investment policies should reflect this. It would therefore seem that a bespoke benchmark would be more appropriate. Devising a bespoke benchmark need not be complicated, as Wood identifies with the following three stages:

1. Objectives – making sure the investment objectives are clearly linked to investment policy, which in turn should be incorporated in the wider financial strategy.
2. Procedure – effective reporting (both written and face-to-face) on performance and strategy.
3. Timing – investments should not be based on short-term considerations and nor should performance take a longer-term view and base performance against that time-scale.

The additional stage for a social responsibility fund is to determine appropriate ethical and other social responsibility considerations. For pension fund trustees there is now statutory regulation, which requires them to make a statement on social responsibility. Submissions to the new Charities Bill have requested that charities of a certain size should also be required to do the same. Determining such a policy, particularly for a charity, is, however, much more complicated, as Craig Mackenzie illustrated when he commented on the FTSE4Good launch “ FTSE takes a different view to ethical investing. It’s a pragmatic view, whereas we take the purist view”.

Terminology such as ‘dark green’ and ‘light green’ reflects the divide discussed earlier between what is meant by ethical and social responsible investing. As human beings, both through our genetics and our growing environment, we acquire a set of beliefs and opinions that change over time. For example, one hundred years ago the role of women was very different to that of now. The very nature of charity, like the world of politics, attracts people who have a burning desire to change or do something. In essence, that is at the very heart of the problem of charity ethical and socially responsible investment. We all have individual moral and value judgements, which gives us opinions on the charitable organisations we work in or that we are trustees of. The traditional perspective argues that charity trustees must resist the desire to place their personal moral opinions into determining the charity’s investment policy. The problem with this approach is that it fails to recognise that charities do not exist in a vacuum. Charities exist in a wider society and have a myriad of stakeholders whose views they must respect. As organisations, charities and pension funds are equally open to the same scrutiny and accountability placed on corporations.

Developing a socially responsible investment policy revolves around three key definition criteria. The first is our personal beliefs, which should be declared, openly debated and maybe have to be pragmatically reconciled in determining an investment policy which is the best for the charity. The second criterion is ethical policy as determined for charities by their charitable objectives. These points accord with the Charity Commission guidelines and case law. In essence, if the purposes and nature of the organisation is to campaign against smoking then clearly a no-tobacco-company

ethical policy is quite rightly applied. The issue for the charity and its financial advisors is to determine the appropriate level of screening and to use an independent and quantified determinant such as turnover or profit to decide at what point a “no-investment- in” policy should be agreed. Trustees need to understand that the lower the level of determinant the more expensive the screening process becomes. Screening stocks to meet ethical or socially responsible criteria can be undertaken either by the fund manager themselves or, more usually, they will use the services of an ethical research specialist such as EIRIS who provide reports on companies against the requested criteria. Such services have to be paid for and trustees should seek separate billing for this service so they have both transparency and an understanding of cost. For screening to work effectively the trustees must give a clear lead to the fund manager of which areas they wish to avoid and not issue a general instruction sentence such as ‘no alcohol’ as it is impossible for a fund manager to even start devising an investment strategy based around such a requirement. Why this is important becomes obvious if we look at the example of alcohol. To say “no” to any alcohol would clearly rule out brewers, spirit producers and wine merchants but would you also exclude the major high street supermarkets that also sell alcohol? This is why deciding an appropriate determinant level becomes important. To set it at 0% would effectively remove the majority of the high street retailers, but should you also then avoid the banks that provide services to alcohol companies? This is why setting a clear policy and taking an independent measure such as turnover or profit, and deciding at what levels, are important. Many trustees fail to involve the fund manager, who can give clear advice as to what is possible and what costs are likely to be incurred. It is not in the interests of the fund manager to get it wrong for the client.

The third area is social responsibility. We explored earlier the views the economist Milton Friedman, who believed that the sole purpose of the firm was to maximise the wealth of its owners. This is a perspective that is not relevant to the charitable sector whose ethos is public benefit. For pension fund trustees, too the issues are more complex than the Milton Friedman view might suggest, as is discussed in Chapter 4. Charitable organisations should follow an investment policy, which has a twin policy of requiring companies to get a good financial return on the funds invested but also to accord with the highest standards of behaviour relating to corporate behaviour and wider society, defined by Grayson and Hodges (2001) as Ecology and Environment; Health and Well-Being; Diversity and Human Rights and Communities.

4. The Case for SRI and CSR.

The debate about corporate community involvement and companies being socially responsible is relatively new. Some of the top business schools have now introduced business ethics modules on to their management masters, reflecting not only the academic interest but also the reality that a number of leading organisations now have at main-board level a director with a responsibility for community affairs. Traditionally companies became involved in such activities for philanthropic reasons as evidenced by Cadbury’s and Rowntree’s reflecting the family’s religious beliefs. More recently, it has been claimed companies have become involved due to mutual benefit derived from developing partnerships as evidenced by the “*Business in the Community*” initiatives. Criticism of companies being socially responsible has primarily come from those who believe such activities divert the directors from their

primary purpose of making profit or, more cynically, are a mild diversion for the directors who can have their egos massaged as they give to worthy causes and hopefully acquire a suitable honour at the shareholders' expense. An alternative view is offered by stakeholder theory, which argues that the world in which companies operate is complex and there are many stakeholders out there. Companies are required to take in wider views not only at the behest of their stockholders but also in recognition that customers, suppliers, staff and governments have opinions. The fact that it also good for business is seen as a win-all strategy, as Lord Sieff, the former chairman of Marks and Spencer, observed in 1990:

“ ... business, like an individual, should carry out its responsibility to the community as a moral obligation...[an employer]... should see it as his duty to pursue the best possible relationship with the community, a relationship inspired by the notion of giving, and not just taking... Good works will be rewarded. not only by support, but also by good publicity, ranging from word of mouth to reports in the mass media. And if I end with a word for cynics who believe that nothing should be done unless it is profitable, responsibility to the community will enhance, not diminish, the bottom line”. (Sieff, quoted in Hamil 1999)

Hamil is, however, highly critical of the mutual benefit approach. He cites the following arguments. First, over-reliance or dependency culture can arise which can leave the recipient open to manipulation or abuse for corporate ends. The case of Procter and Gamble and their programme in Cincinnati in the United States is cited as an example of a company abusing a corporate community programme. Secondly, companies with bad news may use such programmes to manipulate a “damage limitation” public relations exercise. This is certainly the reason, critics claim, why ‘sin-products’ companies such as Camelot, the UK lottery operator, and BAT, the tobacco company, publish extensive social responsibility reports and make sizeable charitable donations. In the case of Camelot, critics argued that it justified the Government’s decision to award them the lottery franchise over the not-for-profit bid consortium led by Richard Branson following criticism of both corporate behaviour and excessive director remuneration at Camelot.

The third criticism of the mutual benefit argument is the reverse of the second. In this case, what are the instrumental benefits for companies involved in corporate giving? Critics claim they are not verified because they do not exist. Citing the Charities Aid Foundation (CAF) studies on corporate giving, critics claim that it explains why it is so difficult to ascertain what is the true extent of charitable giving. Companies, while wishing to raise positive news coverage, are at the same time reluctant to show the true extent because it would raise questions from shareholders or even staff. Using an alternative methodology the NCVO almanac was able to establish an authoritative figure for direct charity giving which discovered that direct corporate giving amounts to some 4% of total charity income or just under £1 billion. However, as the broader range of social responsibility goes beyond that of registered charities they also state

“ Nevertheless, increasing awareness of Corporate Social Responsibility has paradoxically made it more difficult to track company giving. This is particularly due to the increased use of in-kind donations from private corporations (employee volunteering, capital gifts, gifts of professional services). (NCVO 2004 p63)

A variant on the cost criticism comes not from hiding the costs of giving but the costs of having to now comply with the various organisations that ask companies about their policies (Fuller 2004). To resolve these problems the London Stock Exchange has launched a Corporate Responsibility Exchange. Developed with the UK Social Investment Forum this new report combines the current questionnaires of FTSE4Good, the Dow Jones Sustainability Index and Business in the Community. However, companies themselves could also do more by adopting a reporting strategy, which clearly identifies both cash and in-kind donations in their annual accounts and reports. Financial donations are clearly identifiable in the accounts, and using a volunteer costing model (Palmer and Randall 2002) it is possible to give a quantified value on gifts in kind such as volunteering.

Final criticisms of corporate involvement come from conspiracy theorists usually drawn from the political left who argue that corporate donations and tax relief deriving from them give Governments excuses to reduce resources. However, given the relatively small amount of corporate donations against total welfare expenditure (less than a day's funding), this argument, with the absence of any evidence, is discounted.

Moving to a proactive social responsibility agenda must rest on a view that a mutual benefit exists. This was the basis of the *Business in the Community* and NCVO vision for future relations between business and the voluntary sector. The key words were "a two-way street" based on independence, mutual benefit and partnerships to tackle key social issues, a view that goes against the perception that there is little in common between business and community organisations, as Rice explains:

"I read about two communities, the business community and the human rights community and about our 'opposing perspectives'. I think this is not only wrong, but also counterproductive. Why imply that my company – or any other company for that matter – isn't part of the human rights community? Why imply that human rights organisations are somehow different in values terms or in their ethical principles from business? It's too oppositional a way of looking at this complex matter. Our view at BP is that we all belong to the same community – the community that believes in human rights and strives to see them upheld" (Rice 2002 p134) Rice further adds: "We believe, and our senior executives have said so publicly on a number of occasions, that societies where human rights are respected are societies which are good for business (Rice 2002 p135)

Despite endorsements from corporate executives like Rice, there are still major problems associated with corporate socially responsible policies and a backlash has been developing, focusing on the benefits and costs involved. In 2003 KMPG surveyed some 300 global executives and found that executives are increasing the amount of time spent on corporate governance issues in spite of widespread doubts about the value of doing so and commented:

"There is an apparent disconnect between the time and effort companies are putting into governance and the impact of these initiatives on both the general level of trust in business and the share price of individual firms" (IIA 2003 p7)

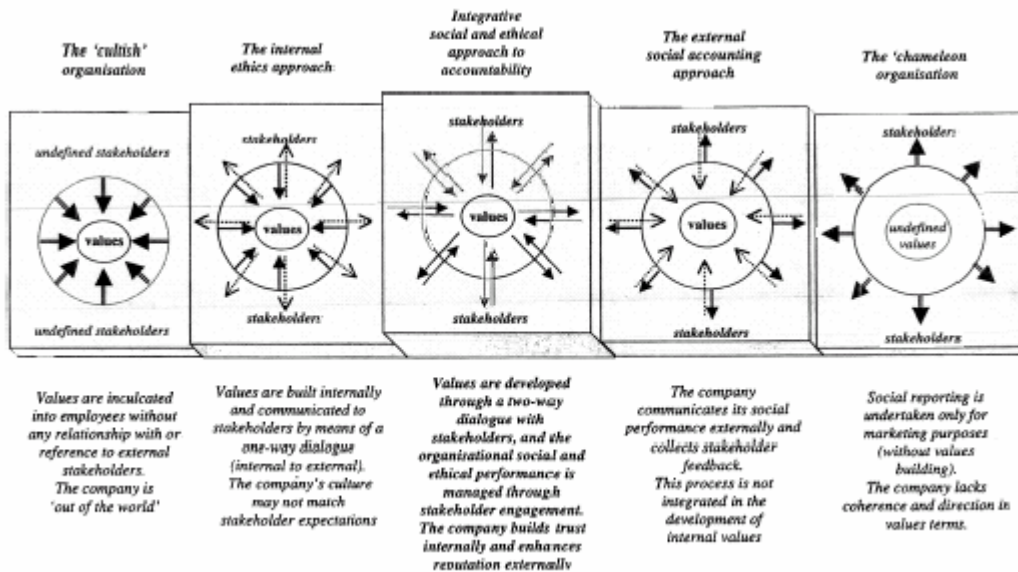
Hank Greenberg, chairman and chief executive of insurance giant AIG, commenting on the costs of complying with Sarbanes-Oxley, said his company was spending almost \$300million to comply with various regulatory and corporate governance requirements (IIA 2004).

Despite the opening statement that top business schools are now teaching ethics and the plethora of governance reports and statutory regulations, is there a major problem with CSR and SRI? The academic literature and theories of social accountability may offer an explanation. Colle and Gonella identify two main approaches undertaken by companies:

1. Internally-focused approaches dealing with ethics (behavioural) issues. This approach is most commonly characterised by companies' developing a code of ethics, i.e. a document which states the fundamental ethical principles or values that the company is to follow in the relationships with all its stakeholders. Typically the motivation here is deepening internally-shared values and establishing systems to ensure appropriate alignment of company policies and processes and individual behaviours with the stated values;
2. Externally-focused approaches dealing with social (external stakeholder) issues. This approach is most commonly used by companies concerned with meeting the challenges of public accountability and is characterised by the development of a public (often verified) social report. The key focus is on understanding and communicating the impact of the company on key, and particularly external, stakeholders.

(Colle and Gonella 2002 p86)

Acknowledging that their model is a simplification of reality, they argue that distinguishing these approaches enables debate and perhaps explains the confusion that exists in much of corporate thinking about social responsibility. SRI does not enjoy the same focus of traditional for-profit value maximisation, supported by the various traditional financial and auditing techniques. Colle and Gonella therefore identify an integrated approach to social and ethical accountability, which can help organisations to achieve their goals and define them more clearly. They describe the various approaches diagrammatically as:



Source: Colle and Gonella 2003 p93

Adopting the integrated theory in practice requires organisations to answer the following questions:

- Code of ethics development: Has the code of ethics been developed with explicit linkages to societal expectations?
- Defined shared values: Was employee participation encouraged in the code of ethics development? Are employees continuously informed and trained on the code?
- Effective compliance: Is an internal audit programme in place? Is it taking into due consideration external stakeholders' perceptions and claims?
- Stakeholder engagement: Is stakeholder engagement (i.e. communication and dialogue) encouraged throughout all the phases of the SEAAR (social and ethical accounting, auditing and reporting) process? Are stakeholders' views communicated in the social report?
- Key performance indicators: Are the key performance indicators generated by the SEAAR process being used to drive the business and make decisions?
- Internal and external assurances: Is the company providing internal (to the management) and/or external (to stakeholders) assurance over its social and ethical accountability programme and policies?

Proponents of the integrated approach argue that it is a mutually reinforcing process that builds trust and cohesiveness internally and enhances credibility externally.

5. Conclusion

To conclude - the profile of corporate social responsibility continues to grow. There are, however, still many problems associated with understanding, communication, information, standards, audit and even fundamental philosophy as we have outlined. The growing literature can help overcome some of these issues but real advances will

only be made once SRI and CSR objectives are seen as being integral to profit and wealth maximisation. For example, the introduction of a standard in social and ethical accounting, auditing and reporting by the organisation AccountAbility (AA1000) is welcome but this initiative does not enjoy the same statutory or professional support as conventional financial accounting and auditing standards. More worrying, as Gray explains, are the foundations upon which new developments in social and ethical auditing are being developed:

“ A lack of theoretical rigour and the triumph of optimism and pragmatism over clarity of purpose are leading to a *melange* of stakeholder dialogue, sustainability reporting (sic), and community reporting which will not necessarily move us towards a more sophisticated and substantive democracy” (Gray 2001 p10).

Similar concerns about research rigour also apply to the various ethical and SRI screening services. The specialist operators are relatively small and whilst a leader like EIRIS has developed a global network it is the first to admit that it has major problems in obtaining information from companies.

Education is a vital key to improving SRI and corporate behaviour. Despite our earlier statement about ethics now being taught at business schools, these developments, as Broadhurst outlines, are still marginal:

“ Business ethics is still a relatively new sub-discipline in business studies and still lacks the established coherence of older traditions. Even less well developed is the assessment of business ethics in practice” (Broadhurst 2000 p86)

Criticism that there are too many meaningless codes and an increasing burden on business does have justification. Increasingly, however, many fund managers also report that the governance information supplied by companies has dramatically improved in recent years. As we posed earlier is there now a difference between a well-run company and an SRI company? Attempts to streamline codes and set up a Corporate Responsibility Exchange by the London Stock Exchange and the UK Social Investment Forum are clearly welcome. But the very success of such initiatives may lead to a rethink of the way we view SRI and ethical funds. For example, EIRIS's global partners reported that the inclusion of the FTSE4Good has meant that the valuation of SRI funds, previously linked to ethical funds and comprising less than 1% of the major quoted exchanges, has suddenly moved to valuations of more than 50%. If SRI is linked to the mainstream corporate governance initiatives then pure ethical funds will remain small and marginal and geared to particular single-screen issues while SRI becomes embedded in the mainstream. The opposite view is that such measures are mere pruning at the edges. To conclude, serious investment in developing a body of robust theory and practice is required if SRI and CSR are really to become mainstream. A need to understand CSR and SRI is vital for all trustees if they are to respond to their own stakeholders and exercise their trusteeship.

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