ETHICAL FUNDS AS A TOOL FOR PROMOTING ETHICS IN BUSINESS

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Abstract (1)

Studies on ethical funds (2) have usually focused on how to establish the criteria for choosing stock in which to invest, which are the most commonly used criteria, ethical funds' relative return, the unique features of their management, etc.

In contrast, this paper focuses on deeper dimensions of the behaviour of investors and fund managers. First of all, it considers the personal process followed by the investor who is aware of his responsibility and seeks instruments in which to invest his assets that will enable him to achieve a return while, at the same time, fulfilling that responsibility. And, secondly, it looks at the answer offered by the promoters and managers of ethical funds.

The paper starts with a brief description of the situation as regards ethical funds in Spain. It continues with a discussion of the investor's moral responsibility based on the traditional theory of responsibility within the framework of co-operation with third party actions, and the difficulties that arise in exercising it. This is followed by an overview of the solutions offered by financial institutions (ethical funds) and the main problems that arise in promoting and managing such funds. The paper closes with some conclusions.

(1) We thank Javier Farrero for his valuable collaboration. This article is part of a research project on the recent history of business ethics in Spain, within the activities undertaken by the IESE Economics and Ethics Chair.

(2) In this article, we will use the expression "ethical funds" to refer to those "focused" funds that incorporate moral, environmental, social, solidarity, etc. criteria in their investment decision process. However, as any ethically managed fund takes such criteria into account, what distinguishes an "ethical fund" is the public statement of such criteria and their use as a means for winning potential customers who are responsive to these arguments.

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Ethical funds in Spain

Although ethical funds in Europe date back to 1973 and experienced strong growth after 1984 (particularly in the United Kingdom), they did not appear in Spain until 1994. Their growth has been slow since then (see Exhibit 1), perhaps because investor demand has been limited, but also because they were not regulated until 1999. In fact, the first ethical fund to follow the criteria applied in Anglo-Saxon countries was introduced in 1997 (3).

In Spain, the stock markets and collective investment institutions are supervised and monitored by the Spanish Securities and Investment Board or CNMV *(Comisión Nacional del Mercado de Valores)*. The CNMV commissioned the Association of Collective Investment Institutions and Pension Funds, Inverco *(Asociación de Instituciones de Inversión Colectiva)*, to self-regulate the ethical funds, or more accurately, to self-regulate the use of the terms "ethical", "ecological", etc. This was done in the Circular published by Inverco's Ethics Committee on 15 November 1999 (approved by the CNMV in December of the same year).

This Circular gives certain *general criteria:* 1) The use by a collective investment institution of the term "ethical" should not be interpreted pejoratively for the others, as if they were not ethical or did not invest in ethical companies. 2) As each investor has his own idea of what is ethical, ecological or socially responsible, each institution should have its own declared ethical principles. 3) Ethical, ecological or socially responsible collective investment institutions (that is, those which invest in accordance with such criteria) should not be confused with solidarity funds (which donate part of their management fees to certain charities or NGOs), although in Spain all solidarity funds follow certain rules regarding the content of their investments (see Exhibit 1).

The 1999 Circular gives two types of *rating criteria:* 1) *Negative*, i.e. criteria which exclude investments in companies whose revenues or profits come, wholly or in part, from activities that go against the investor's convictions. 2) *Positive*, i.e. criteria which support investments in companies that contribute positively to the furtherance of the investor's convictions. The Circular also indicates that both types of criteria can be applied simultaneously (which is also common in Spanish funds) and different scales are accepted in their application.

(3) The Exhibit includes two funds, Iberfondo 2000, created in December 1994, and Iberfondo 2020 Internacional, created in October 1997, which specialise mainly in investing assets for Catholic religious institutions. The same group (Banco Santander Central Hispano, BSCH) has another fund, Horizons, registered in Luxembourg and specialising in investments for Latin American religious institutions. Moreover, Banco Santander (also of the BSCH Group) has the Santander ONG Fund, designed to place the investments of NGOs and other not-for-profit organisations.

As regards the *requirements* that collective investment institutions must meet in order to be able to use these terms to describe their funds, Inverco states: 1) The ethical code must be included in the brochure that funds are obliged to issue to prospective customers. 2) The securities that are eligible for investment, in accordance with each fund's code, will be chosen by an Ethics Committee that has been appointed for the fund (unless it invests only in securities included in ethical indexes published by third parties or drawn up by specialised agencies). 3) In order to avoid misleading advertising, the fund must refer prospective investors to the ethical code contained in the brochure. 4) The fund's quarterly reports will include information about their ethical principles, their Ethics Committee, and the Committee's decisions.

This information shows that: 1) ethical, ecological, etc. funds have experienced very little growth in Spain; 2) to date they have attracted only a very limited volume of capital (4); 3) they are usually fairly conservative in their fund placement strategies (5); and 4) both their regulation and their development, functioning, etc. follow closely the practices used in other countries.

The investor's moral responsibility

As we said before, our intention here is to reflect on the decisions of investors and fund managers from an ethical point of view. Our starting point will be an investor (an individual, a family, a company or a non-financial organisation) who wishes to place his capital in financial assets that offer him a return, certain defined risk conditions, liquidity, a suitable term, satisfactory tax treatment, etc., while also taking into account other dimensions which will be particularly relevant in our analysis (6).

The first thing to remember in any investment decision is the *principle of freedom:* the agent is responsible for his own life (and, if applicable, that of his family) and, therefore, it is incumbent upon him to freely administer his assets (7).

The second thing to remember is the *principle of responsibility* inherent in any freely made decision: the agent is responsible for his free acts (8). This means that the ultimate responsibility lies with the investor, and this responsibility must be judged applying the criteria traditionally used in ethics: the nature of the action (lending or investing money is, in principle, a morally correct action), the agent's intention (which we will assume to be morally correct), and the circumstances, primarily the effects of his action.

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(4) In March 2000, the funds listed in the Exhibit managed assets amounting to about 500 million euros. The assets managed in all Spanish funds amounted, as at 29 February 2000, to 204,424.7 million euros (with a growth of –2.4% in the previous twelve months).

(5) This is shown by the type of fund (Exhibit 1): fixed-income (FI) funds invest their entire portfolio in public or private fixed-income securities (with the result that the ethical criterion only appears in private fixed income or discriminating against debt issues by non-democratic countries, etc.); the mixed fixed-income (MFI) funds, more than 70% in fixed income; the mixed variable income (MVI) funds, between 30 and 75% in variable income; and the variable income funds (VI), more than 75% in equity (according to Inverco criteria).

(6) We assume that the actions that have led to this decision do not raise moral problems, that is, the wealth has been obtained licitly, the appropriate taxes have been paid, etc.

(7) This is not an absolute right, or at least that is what many schools of morality say.

(8) We refer to moral responsibility, not legal responsibility. Investment decisions usually meet the requirements for an action to be morally imputable to the subject when such action is free, the investment action is known, and its effects are reasonably predictable, in spite of the natural uncertainty that is inevitably associated with this type of decision.

These effects include, first of all, the *direct* effects, which will primarily be those affecting the preservation and growth of his wealth, in accordance with the rules of prudent financial management. And, second, the *indirect effects*, because, with his investment decision, the saver helps to fund certain activities and, therefore, becomes *jointly responsible* for their morality.

This responsibility must be understood not only in the light of its positive effects –whether what is being funded is a morally good activity– but also in the light of its negative effects –whether the activity is morally reprehensible. Therefore, the action of investing wealth may give rise to a co-operation with good or with evil, with the positive or negative ethical judgement this entails (9).

Exercising responsibility in ownership always has an ethical dimension, even though the *motives* that move investors to exercise it may vary: strictly ethical (that is, related to the fulfilment of certain moral duties), with a greater social content (moved, perhaps, by a spirit of service to others) (10), environmental (when what is sought directly and immediately is the preservation of the environment and sustainable growth), political (the investments are made considering political criteria, which may or may not be partisan), or solidarity (when the investment benefits a social or welfare organisation) (11), etc.

It is often argued that the existence of a moral responsibility in the investor's decision goes against *economic rationality*. Just as it is said that the company's (sole) purpose is to maximise the value of its shares, so the (sole) purpose of any investment decision must be to obtain the highest possible return, or better still, a return-risk mix that matches the agent's preferences (risk aversion). This is reasonable, but before passing it as morally acceptable, we must understand why it is reasonable (12).

If certain conditions are met (13), and if all companies make decisions so that the value of their shares is maximised, and if all investors act in such a manner as to maximise the yield of their portfolios (subject to the above-mentioned risk level), an optimum will be achieved and economic efficiency will be maximal – in the sense that, given the resources available, it will not be possible to obtain higher production volumes and no subject will be able to increase his utility without decreasing that of another subject.

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(9) Although we often refer to the businesses of the companies funded by the investor with his funds, we should not forget the not-for-profit organisations, the international agencies, the governments, etc., which also benefit from this funding. Normally, this point is overlooked, assuming, for example, that the purchase of governments' public debt does not raise any moral problems. The fact is that such problems are raised, just as in the case of companies, and investors take them into account, particularly in the case of corrupt, predatory, or belligerent governments or governments who act harshly against their own citizens or other countries. However, investors and funds tend to be more demanding of companies (for example, for contributing to pollution, for their improper behaviour towards their employees, or for their lack of attention to safety in the workplace) than of governments (for their failure to protect the environment, for the human and social problems in their jails, or for the practice of abortion in public hospitals).

(10) Which is also ethical, of course. We have already pointed out that ethics is a dimension that is present, one way or another, in all these alternatives.

(11) We will not develop here the figure of the so-called "solidarity funds". These are funds whose owners give part of their incomes to charities, NGOs, etc. (the solidarity is then the owners', not the investors').

(12) For a deeper discussion of this subject, cf. Argandoña (1995, 1996, 1998a,b, 2000). Cf. also Elegido (1998).

(13) With respect to the independence of the economic agents' preferences, the completeness of present and future markets, the existence of atomistic competence, of perfect information freely available to all participants, etc.

Maximising share value or portfolio yield is therefore dependent upon a certain conception of the economic system's rationality. When it is said that companies or investors "must" act in this manner, what is actually being said is that, by this means, the economic system as a whole will achieve the optimum that is supposed to be its goal.

But this requires a few clarifications. First: in order to achieve the economic optimum, a necessary prerequisite is that the above-stated conditions be met; but in real life this normally never happens. Consequently, maximising the shares' value is not a practical rule for company management, nor is maximising a portfolio's yield; these are no more than theoretical conditions for the system's efficiency.

Second: the statement that the system's purpose is efficiency is not made by economic science but originates elsewhere (14).

Third: the economic concept of efficiency refers to the use of certain resources to obtain certain results. In economics, raw material, energy, financial, labour and other expenses are usually included under "resources", and revenues under "results". However, the decision to include certain costs and revenues and not others (such as environmental damage, executive stress or the employees' moral degradation) is a metaeconomic decision (15).

Considering what has been said so far, it can be stated that maximising the shares' value is one of the company's goals but not the only one. Likewise, maximising the portfolio's yield must be one of the goals pursued by investors –and it would be very odd if they systematically did not pursue it– but it cannot be the only action criterion. And this is why a substantial number of investors are concerned about the ethical aspects involved in investing their assets, without this detracting from their rationality (16).

To summarise, we would say the following:

1) Beyond obtaining an optimal or maximal return (given the desired or accepted risk level), investors have a *moral responsibility* in their asset placement decisions. This is an idea that has been around for a long time in ethical literature (17).

2) This responsibility mainly concerns the choice of the companies the investors are directly or indirectly financing.

3) In making this choice, the primary determinant will be the activities performed by such companies and how they perform them (18).

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(14) In addition, the optimum defined previously is only optimal within the framework of a utilitarian ethics, and ceases to be so for other moral conceptions if, for example, importance is ascribed not only to the satisfaction of the subject's preferences but to these preferences' morality, or the morality of the economic and social processes leading to the supposed optimum. Cf. Buchanan (1985), Hamlin (1986), Sen (1979).

(15) "Efficiency is a quality that is mentioned when one considers that something 'is useful for' or 'is valid in order to', i.e., when we are in the context of the connection or relation between means and ends (...) Undoubtedly, all statements referring to efficiency imply a value judgement – it is assumed or accepted that a subject, instrument or action is suitable for producing a specific effect. However, due to its own structure, the statement refers us to a subsequent judgement, this time concerning the effect, objective or aim which the subject, instrument or action produces (...) A discourse developed in terms of efficiency is, therefore, an incomplete discourse, suspended in a vacuum; or, in other cases, it is a discourse which does not clearly state its implicit assumptions because it takes a specific objective for granted, although sometimes this is not clearly shown" (Illanes 1994, 31).

(16) It seems logical to talk about the individual's rationality, without opposing an "economic" rationality to an "ethical" rationality or a "political" one.

(17) And, of course, much before the advent of ethical funds. For example, Koslowski (1995) quotes Messner (1955) as a traditional and not a new formulation.

(18) We assume that the other conditions for the investment decision's morality are met, as we have already explained earlier on.

The difficulties encountered in exercising the investor's moral responsibility

When the investor sets out to exercise his responsibility as an owner, he can do so from a negative viewpoint (not causing harm, that is, not contributing with his capital to finance immoral activities) or from a positive viewpoint (trying to obtain morally superior results) (19). The positive exercise of responsibility can be achieved either by investing only in companies whose activities are morally excellent (a category which, obviously, can contain many different grades), or by trying to change the decisions made by the companies which the investor has already invested in or may invest in, so that, at least, they do not act immorally and, if at all possible, they become morally excellent.

This diversity of options corresponds to the conception of ethics as a minimum which must be met if man and society are not to deteriorate (not do evil), above which there is plenty of room for the ethical development of people and society (do good) (20).

However, this is not an easy task. Any investor who wishes to act ethically will encounter, at least, some of the following difficulties (21):

1) Lack of *information about the companies* that engage in morally reprehensible or morally excellent activities. The same is true for investments made through intermediaries, for example, deposits in a bank which, in turn, lends to companies, etc.

2) Lack of *information about the functioning of investment mechanisms*, very rare in countries with a financial system developed to a certain minimum level (22).

3) *Inability to steer investments* towards ethically correct companies – for example, because they are not listed (23).

4) *Inability to change the company's conduct* because the investor is a small shareholder with no voice on the board of directors or at the shareholders' meeting, or because the company is very clear about its purpose and has been behaving this way for many years, etc. In any case, given the need to diversify the portfolio to reduce the risk, it is unlikely that many investors will have significant equity holdings in certain companies (24).

5) Lack of *knowledge about the criteria* used by the company in making its decisions. For example, companies in which it is possible to invest may have both positive aspects (manufacture of pharmaceuticals for improving human health) and negative aspects (staff discrimination policies against minorities) (25).

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(19) Cowton (1999) calls the positive criteria "supportive" and the negative criteria "avoidance".
(20) Cf. Polo (1996).
(21) Basically, there are two: knowledge and ability.
(22) The investor may think that if he buys shares that have already been issued, his funds do not go directly to the company engaging in the activity but to a previous investor. However, this does not justify the decision from an ethical viewpoint.
(23) In theory, each investor could create whatever portfolio he likes. In practice, however, this is not true due to information, transaction costs, etc.
(24) Cf. Argandoña (1996).
(25) All of these arguments are weak but they cannot be ignored. Indeed, as in any decision, placing assets requires a prudential consideration, since the action's positive and negative effects are not immediate nor sufficiently known nor can they be readily quantified or valued. This means that an outside observer's judgement is not reliable, as he does not know with what information and in what circumstances the decision-maker is acting. In any case, our goal is not to discuss the conditions in which it may be justifiable to invest in companies with unethical behaviours but rather the opposite situation: to study how to avoid this type of co-operation and how to choose companies that have a positive moral disposition. On co-operation with evil, cf. Melé (1986, 1987).

In addition to the above, the investor also finds himself today in an *environment* in which:

1) Investment decisions usually *exclude active involvement in the company's management*, because they are considered exclusively as asset placement measures.

2) Often, the *incentive to find out about the company* one is investing in (its products, markets, technologies, human resources, etc.) is insignificant. The only items of interest are certain abstract variables which are used to obtain the information about return, risk, etc. that is needed for the decision.

3) Alternative placements are often presented in packages with preset features (expected return, term, tax conditions, liquidity, risk, etc.): mutual funds, pension funds, insurance, etc.

4) Placements are assessed in accordance with strict criteria, mainly return and risk. Risk management requires diversifying the portfolio and resorting to more or less complex hedging operations (26).

5) The information and technical demands of investment decisions advise in favour of leaving them to experts.

6) Decisions can be *reviewed frequently*, thanks to the abundance of information and low transaction costs. This means that a company's shares may have a high turnover in an investor's portfolio.

These considerations induce many investors to invest their assets through *specialised organisations*, through the purchase of secondary financial products (that is, products that represent other financial assets), through intermediaries (banks, insurance companies, mutual funds, pension funds, etc.), and with return-driven (and risk-driven) goals. And they exclude, almost from the outset, the possibility of the owner's exercising his responsibility, as textbooks on business or financial ethics stated until relatively recently.

Does this mean, then, that the investor's responsibility, as we have defined it earlier, disappears? No, it does not disappear, because the investor continues to co-operate with the company's activities. What will change is how the investor exercises it.

Ethical funds

The demand for securities in which investors can exercise their moral responsibility (27) is met by the *supply* –the financial intermediaries create specialised or focused funds

(26) The pursuit of return, the portfolio's mobility and the valuation of funds by their monthly or quarterly performance may lead to attitudes driven by short-term considerations, in which the funds' managers only seek to maximise the shares' value in the short term. Insofar as it exists, this attitude (short-termism) works against the long-term holding of investments and, therefore, the exercise of responsibility within the companies' ownership structures. Cf. Argandoña (1995).

(27) The demand for socially responsible investments may be a response to moral incentives, but also to other types of incentive. For example, concern about the environment is, from the financial viewpoint, a "luxury" item whose demand increases proportionately more than the growth of income (for very low income levels, it may be much more useful to consume than to avoid pollution. However, it becomes more significant beyond a certain standard of living). This means that the demand for environment-friendly investments may derive from economic incentives and the investor's personal interest, and not (or not only or not mainly) from his social responsibility.

(ethical, socially aware, responsible, ecological, etc.) (28), following the tendency to offer standardised investment packages as regards return, term, currency, risk, etc.

Ethical funds are therefore a *standard response* (albeit varied) to the demand. As we have already pointed out, the responsible investor decides between a minimum (not investing in clearly immoral companies) and a broad range of increasingly excellent opportunities, from financing companies which stand out for their ethical, socially aware or responsible conduct, to trying to influence companies' management so that they cease to act immorally or improve their ethical quality.

Thus, we can define four main groups of decisions that must be made by ethical funds (29):

1) Determining the *selection criteria* used to choose the industries and companies in which the fund will (positive criteria) or will not (negative criteria) invest (30). At this stage, the fund defines its investment profile and thus also its products' appeal to the public, in an attempt to provide what its prospective customers want or to "create the need" to invest in accordance with the chosen criteria and not with others.

   If the fund's promoters or managers have *definite ethical attitudes*, these attitudes will show in the criteria chosen (31). If they do not have such attitudes, they will formulate generic product packages targeting customers with imprecisely specified preferences. In this case, the criteria set will be generic and based on sociological rather than ethical criteria (32).

   As there is no single, unquestioned definition of what an ethical company is, there will never be unanimous agreement with respect to the criteria chosen. Furthermore, this process is associated with at least two practical problems. First: the more criteria there are and the more specific they are, the smaller the number of companies which can be invested in. Second: the positive criteria can be added to the negative criteria or used to offset them (33).

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(28) And not just funds, but also socially aware savings instruments, social banks, regional development funds, co-operative banks, savings banks (which allocate part of their profits to supporting social activities), community-oriented ventures, etc.

(29) This is not the place for a discussion of who is responsible for making these decisions within the funds' structure (board of directors, manager, ethics committee, analysts, etc.). As we will indicate further on, all of them should share responsibility for the fund's ethically significant decisions.

(30) This is not a new task; all funds must define the economic, financial, political, image, etc. criteria which they will apply in their investments. In the case of ethical funds, the field of decision is enlarged, although it may be also divided so that the ethical decisions are left to the ethics committee, while the analysts, managers, members of the board, etc. take the "technical" decisions.

(31) In a way, we are proposing to distinguish between funds that are created out of a genuine ethical, social or environmental concern, and those that simply offer investments with that feature, not out of personal conviction but as a sales strategy. This distinction – a very difficult one to draw from outside the fund – has little effect on the investor's motivations, who is only looking for a suitable instrument in which to responsibly invest his assets.

(32) It is likely that many funds have implemented certain measures more as a reaction to social or political events rather than to true ethical problems or, at least, have not performed an exhaustive ethical analysis. This would be the case, for example, of the investment boycott in South Africa in the years of apartheid.

(33) Behind this dilemma, it is possible to see two different (although not necessarily opposing) conceptions of ethics: as strict rules that must never be broken, or as possible, but not optimal, solutions to complex problems for which there can be several possible solutions (this should not be confused with moral relativism).

The fundamental criterion is usually *the nature of the products or services* offered by the company, whether because they are directly immoral (as would be the case of pornography or prostitution) or because they are theoretically beneficial for human welfare (education, health, etc.), because of their likely or possible non-ethical use (arms), or the possible effects that their production or use may have on the environment or on public health (nuclear energy, tobacco, chemicals using environmentally damaging or hazardous processes, child labour, etc.) (34). Often, other criteria are added, such as the company's labour policy (equal opportunities, for example), their attitude towards the local community (support for social initiatives), their co-operation with certain political regimes, etc (35).

What role should the responsible investor perform in this stage of the process of defining the fund's strategy and policies? The currently prevailing model seems to be *supply-driven*. As we have already said, given a relatively non-specific demand, the supply responds with different types of funds and different investment criteria, and depending on the way each proposal is received, adjusts its offering to the demand. This seems reasonable, considering that investors usually do not have a very clear idea of what is or is not ethical (36).

2) *Choosing the companies* to invest in. This is associated with information problems and problems arising from the prudential application of the principles described above.

Ideally, companies should provide the funds with abundant *information* on their products, markets, technologies, production process, personnel policies, customer relations, etc., so that the funds can make informed decisions. However, this information is usually not given, either because the companies themselves do not have it, or do not have it in a systematic and readily transmittable form, or because they do not want to give it, or because the information they give is incomplete, confusing and non-verifiable. The existence of impartial agencies may go some way towards alleviating this problem.

Once they have obtained the information, the funds must assess it and choose the industries and companies in which to place the funds they receive from their customers. The fact of having precise rules (for instance "do not invest more than x% of the portfolio in a particular type of security") does not obviate the need to make *prudential decisions* (37).

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(34) The description of these criteria does not assume that a consequentialist ethics is being applied, because what it is being assessed is not (only) the consequences of companies' actions but also the principles on which they act. And, as we have already pointed out, the investment decision's intrinsic morality and the investors' ethically correct intentions are taken as given.

(35) It is easier to define the negative criteria than the positive ones, particularly because one can have as many of the latter as one wishes. In practice, these criteria are expressed in terms of (maximum, minimum or recommended) shares or percentages of the portfolio. Some of the criteria used are highly debatable: for example, in the United States, some funds consider that companies that do not allow trade unions to operate in their plants are at least suspicious of abusive personnel practices. However, this need not necessarily be so. A typical example could be the centenary Lincoln Electric Company. Though highly rated for its personnel policies (compensation, job security, employee empowerment, etc.), this company is completely non-union (and, what is more, its employees do not want any unions).

(36) If an investor knows what he wants, he can (at least in theory) administer his assets himself or give precise instructions to his manager. He also can try to change the criteria used by his fund or promote a new fund.

(37) Cf. Joly (1993). The same is true of technical, financial and economic criteria, unless one chooses to delegate stock purchase and sale decisions for the fund's portfolio to a computer program, which does not seem to be a good way of exercising responsibility.

The choice of companies reminds us of a problem that is closely tied to the ethical funds' basic criteria. From the financial viewpoint, the selection is made in accordance with *future* performance, that is, in accordance with the companies' expected return. From the ethical viewpoint, the focus is on past performance. This is because it is assumed that companies whose behaviour was ethical in the past *will continue* to behave ethically in the future, because their personnel have developed virtues that facilitate morally correct action. However, this conception has a number of drawbacks. First, investors invest in a company because they believe its conduct will be ethical in the future, not as a reward for past performance. Second, a company must be allowed to make mistakes and perform immoral actions, provided that it rectifies, apologises and tries to behave ethically in the future (38).

It is important to stress that the fact that an ethical, social, responsible, ecological, etc. fund includes certain securities in its portfolio should not be understood as a denial of the ethical, social, responsible or ecological qualities of the companies not included in the fund. To put it another way, the fund guarantees its customers that the companies included in its portfolio meet certain minimum standards or certain criteria, but nothing more.

3) Setting the *investment maintenance and replacement criteria*. For ordinary funds, these criteria are clear, mainly in terms of return and risk. However, ethical funds must also take into account a third dimension, the moral one, by making prudential decisions, as indicated above (39).

4) Establishing the *policy regarding the fund's relationships with the management of the companies* whose shares are included in its portfolio. This involves, first of all, deciding how the fund will use its *voting right* at shareholders' meetings (if it has such a right); how the customers' instructions, if any, will be taken into account; for whose benefit the voting right will be exercised, etc. (40).

A related issue is that of the fund's attitude towards the *definition and implementation of the company's goals and strategies*, which we could call the fund's "activism" (not only ethical, but also economic, political, etc.). Should the fund seek to influence the decisions of the companies in which it has invested? Do its managers have the necessary knowledge and information to do this efficiently and fairly? (41) Does the fund have enough strength to effectively apply this pressure? (42)

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(38) A typical case is that of the companies specialising in recycling radioactive waste, which are usually the same companies that produced it in the past, or continue producing it now. Cf. Joly (1993).

(39) Another thing is how they communicate this to their customers. That is why managers sometimes have to take drastic decisions, such as totally excluding a company's shares from the fund's portfolio in order to preserve its image and its customers' good opinion of it, even though perhaps it would have been more reasonable not to do anything. However, the same thing happens in other decisions: if, for example, the markets expect a currency to depreciate, a fund's manager will perhaps have to reduce the share of his portfolio invested in securities in that country, even though he thinks that it is a passing event and that it would be more reasonable to keep those securities as part of a medium-term strategy.

(40) Cf. Löhnert (1995), for the case of the German banks.

(41) Cf. Werhane (1995).

(42) Funds usually do not hold large interests in companies, perhaps because this is not permitted by law or because financial prudence advises otherwise. Also, they may be more interested in frequently changing their portfolio's composition, which makes it difficult to gain a position within the company that would enable the funds to have a say in the company's management.

What is the investors' attitude on this issue? If their goal is simply to place their assets in ethically correct businesses, they will prefer that the fund adopt a passive policy, confining itself to disinvesting in companies that behave inappropriately. However, if the investors take a more active attitude to the application of their ethical preferences, they will ask that the fund have a greater involvement in the companies' management and will even be prepared to suffer economic setbacks for that very reason.

All of the above is summarised in a series of rules that ethical funds should follow (43):

1) *Gross impropriety rule:* ethical funds should not invest in companies or industries whose activities go against society's moral requirements: drug trafficking, pornography, etc. (44).

2) *Controversial issue rule:* when an investment goes against the moral requirements of a large social group, the fund should identify and exclude it: nuclear energy, tobacco, arms dealing, etc. (45).

3) *Prudence rule:* assess all companies so that their performance in all relevant areas can be identified (the environment, treatment of individuals, etc.).

4) *Proportionality rule:* the larger the (absolute or relative) volume of the funds placed in a company, the more attention should be paid to the economic, moral, social or environmental consequences arising from the company's activity.

5) *Accountability rule:* reports on the fund's investments should include not only the companies' financial performance but also any extraeconomic data that may impact on the decision to invest in or divest the security in question.

6) *Controversiality rule:* the fact that an investment is controversial does not mean that the fund should pull out of it, merely that it should be studied (46).

7) *Negligence rule:* managers of ethical funds should be aware of all the possible consequences of their decisions. Ignorance is no excuse.

8) *Same boat rule:* it is desirable that the fund's managers should commit at least part of their personal assets (47).

9) *Collective and individual responsibility:* responsibility should be shared by all those who take part in the fund's decision: board of directors, managers, advisors, ethical committee, analysts, etc. (48).

10) *Dilemmas:* the solution to dilemmas is not to ignore them but to study them (49).

(43) Cf. Joly (1993).
(44) We consider that these criteria are ethical, not (only) sociological.
(45) These criteria may be ethical, but they can also be ideological and sociological. Given the abstract, generic nature of the supply of ethical funds, it is logical that such exclusions should be made, even though some investors or fund managers may not have any moral misgivings about, for example, companies that build or operate nuclear power stations, if the necessary safety and environmental protection measures are implemented and applied.
(46) But see our previous remark about the drastic decisions that fund managers sometimes have to make.
(47) This rule seems to be reasonable for the manager's motivation, but not from the risk diversification viewpoint.
(48) Each one according to his position in the company. For the virtues that should be practised by the managers of financial institutions, which includes fund managers, cf. Termes (1995, 1998).
(49) Other rules are preserving the fund's independence and impartiality, preserving the confidentiality of the information received on companies, distinguishing between facts and opinions in appraising companies, etc.

Conclusions: are ethical funds ethical?

Under the generic name of *ethical funds*, we have analysed a series of financial institutions (and products) that may attract prospective investors who wish to invest not only profitably but also exercising a responsibility which, in general terms, we have called ethical, but which can also be social, environmental, political, etc.

Ethical funds perform an important function: they are the response of the supply (financial institutions) to the demand (private investors) for investment instruments that enable that responsibility to be exercised. They are not the result of the hypocrisy or opportunism of their promoters or managers nor of their investors, although it is possible that some may act for these reasons (50). Neither are they a panacea for ethical behaviour in finance (51).

They are simply a *means* by which investors who are not able to exercise their responsibility as owners directly can do so in a simple and profitable manner (that is, investors who cannot personally choose the companies they will invest in or seek only those placements in which their money will have a greater impact, not only in economic terms but also in terms of social or ethical performance, and who cannot lobby the companies' management to try to continually improve the moral, environmental, social, etc. outcome of their strategies and policies).

Ethical funds are not the *only way* of exercising that responsibility, but they are *one way* of doing it, and possibly a highly recommendable way from a moral viewpoint, particularly for people who are not able to perform more complex ethical (and economic, financial, etc.) analyses. It should also be remembered that a person's moral duties do not end with the placement of his wealth in ethical funds, just as they do not end when he regularly donates funds to charity.

The *ethics of investing* in ethical funds must be judged in the same way as the ethics of other actions. Basically, the most important thing is to lead a *morally full life*, and that encompasses one's whole conduct (52). However, *moral learning* is very important. A person who shows himself to be interested in fulfilling his responsibilities in the placement of his wealth, even if he is immoral in many other aspects of his life, has taken a first step towards understanding how he should live and, above all, learning how to do this: he will have started to develop his virtues and is likely, little by little, to discover other aspects of his life in which he can and should behave ethically.

The outcome of all this will be an improvement in the individual's moral quality. And even though his contribution to the funding of morally desirable activities (and the non-funding of morally undesirable activities) may be minimal, it will also have started a *social learning* process by which other people will have found out about the existence of ethical funds and will have heard about their responsibility as owners and the means they have to exercise it. Likewise, the promoters and managers of ethical funds are also likely to start thinking about their duties as owners and managers. And, finally, those companies whose conduct is morally correct will be benefited by the increased investment opportunities.

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(50) The ethical assessment of any action cannot ignore the agents' motives. We have not included here any discussion of such motivations because they are usually unknown to those who are not directly involved in the decision.

(51) It does not seem appropriate to stress the ethical funds' economic yield because the people who invest in them are not only looking for a financial return but also for a responsible investment: one must be ethical, but not in order to make more money. Another thing is to show that ethical funds can be a good investment, perhaps as good as the other funds, and sometimes even better than them, because anyone prepared to invest responsibly is entitled to obtain a good return on his capital.

(52) Cf. Cooper and Schlegelmilch (1993), Cowton (1999).

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Exhibit 1

ETHICAL, ECOLOGICAL AND SOLIDARITY FUNDS IN SPAIN
(31 March 2000)

Name	Creation	Type#	Manager	Criteria	Solidarity*	Assets &
Iberfondo 2000	December 1994	MF	BCH Gestión (BSCH Group)	Activities not against Catholic morals	NO	315,328
Iberfondo 2020 Internacional	October 1997	MV	BCH Gestión (BSCH Group)	Activities not against Catholic morals	NO	107,100
Arco Iris Ahorro Corporación	November 1997	V	Gesinca (Ahorro Corporación)	Ecological: companies specialising in environmental technology and preservation of the environment	NO	4,954
BCH Solidaridad	February 1999	MF	BCH Gestión (BSCH Group)	Does not invest in companies that use child labour, manufacture arms or perform environmentally damaging activities	0.5%	10,547
Fondo ético AB Gestión	March 1999	MF	AB Asesores	Does not invest in companies that violate human rights, manufacture or trade in arms, perform activities that are harmful for the environment or public health	0.25/0.5%	12,603
Foncaixa Cooperación	April 1999	MV	Gescaixa (Grupo laCaixa)	Does not invest in companies operating in industries related with gambling, greenhouse effect, polluting chemical or paper companies, mining or metal companies that harm the environment, tobacco producers or distributors	0.7%	15,969
Ecofondo Renta 4	June 1999	V	Renta 4 Gestión	Preservation of the environment	0.7%	4,757
Solidario Pro Unicef	June 1999	MF	Gesmadrid (CajaMadrid)	Does not invest in companies that use child labour, manufacture arms, alcoholic beverages, tobacco	0.5%	18,662
Santander Solidaridad	February 2000	MF	Santander Gestión (BSCH Group)	Social and environmental criteria	0.5%	3,021**
BBV Solidaridad		F	BBV Gestinova		...	6,896
<u>Funds being created or under study</u>						
Caixa Catalunya Solidaridad			Caixa Catalunya Gest.	Solidarity	YES	
DB Ecoinvest			Deutsche Bank Gest.	Ecology	...	
BNP Fondo de Solidaridad			BNP Gest. Invers.		...	

F: fixed income; MF: mixed fixed income; V: variable income; MV: mixed variable income.
* Part of management fees donated to NGOs or charities.
& Thousand euros, 31 March 2000 (Source: *Expansion,* 1 April 2000).
** As at 31 December 1999.