

Identifying impediments to SRI in Europe: a review of the practitioner and academic literature

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For more than 15 years, the investment community and the academic community have written extensively on socially responsible investment (SRI). Despite the abundance of SRI thought, the adoption of SRI practices among institutional investors is a comparative rarity. This paper endeavours to achieve two goals. First, by integrating the practitioner and academic literature on the topic, the paper attempts to identify the many impediments to SRI in Europe from an institutional investor's perspective. Second, the paper proposes a unitary framework to conceptually organize the impediments to SRI by using insights from different relevant research perspectives: behavioural finance, organizational behaviour, institutional theory, economic sociology, management science and finance. The paper concludes by presenting the main shortcomings within both the academic and the practitioner literature on SRI and by providing conceptual and methodological recommendations for further research.

Introduction

The purpose of this paper is to examine impediments to the mainstreaming of socially responsible investment (SRI), drawing on both practitioner and academic literature and from different research perspectives including behavioural finance, organizational behaviour, institutional theory, economic sociology, management science and finance. The article attempts to construct a theoretical framework for the analysis of these impediments to SRI in Europe from an institutional investor's perspective.¹

The European Social Investment Forum (Euro-sif) defines SRI as the combination of 'investors' financial objectives with their concerns about social, environmental, ethical (SEE) and corporate governance issues'. SRI takes into account 'both the investors' needs and investment's impact on society'.² It is worth mentioning that SRI is a label that embraces a range of organizations and different SRI approaches and principles: e.g. negative and positive screening, integration of SEE risks into investment decision-making, engagement, shareholder activism, SRI research houses and SRI rating agencies.³

Expressing the early enthusiasm within the SRI field, Bruyn predicted in 1987 that 'what appeared as a trend in the 1980s may become a social movement in the 1990s' (quoted in Friedman &

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Miles 2001: 528). The early optimism was legitimate as the SRI field experienced significant growth in the late 1980s and the early 1990s. It was at this time that the first prominent SRI funds emerged in Europe: the Stewardship Fund and Merlin Ecology Fund in the United Kingdom; Varldnaturfonden in Sweden; Strategie 21 in France; and Het Andere Beleggingsfonds in the Netherlands (Louche & Lydenberg 2006). Later on, the amount of assets under SRI management increased dramatically (albeit from a low base) with the market entry of the powerful institutional funds such as pension funds (Friedman & Miles 2001).⁴ Between 1997 and 2001, pension funds and insurance companies added £183 billion of UK equity assets to the SRI investment universe, accounting for more than 80% of the total SRI market in the United Kingdom at that time (Sparkes 2002: 348).

After 20 years of practice and research in this domain, some authors are still optimistic and argue that mainstreaming of SRI is already under way (Friedman & Miles 2001, Sparkes & Cowton 2004). Others claim there is still a long way to go before institutional investors integrate environmental, social and governance (ESG) issues into their core investment decision-making (Coles & Green 2002, Horack *et al.* 2004, Sullivan & Mackenzie 2006, European Centre for Corporate Engagement 2007).

On the optimistic side, a study led by Mercer Investment Consulting (Ambachtsheer 2005) shows that 84% of European investment managers surveyed predict that the integration of social and/or environmental information will become mainstream within 6–10 years. In addition, as pointed out by the latest Eurosif report on SRI (Eurosif 2006), the consistent growth of the European SRI market reflects the increasing interest of mainstream investors (e.g. pension funds) in SRI products, the new regulatory environment and the emergence of prominent collaborative initiatives such as the Enhanced Analytics Initiative (EAI), Carbon Disclosure Project and the Institutional Investors Group on Climate Change (IIGCC). In the aftermath of the launch of the formal alignment between the UN Principles of Responsible Investment and EAI

announced in January 2007, mainstream institutional investors are further prompted to integrate the sell-side research on ESG factors into their investment processes.⁵

However, the SRI sector remains small relative to the financial mainstream community (Sustainability 2000). Haigh & Hazelton (2004) recently reported that between 1999 and 2001, SRI retail mutual funds under management accounted for no more than 0.4% of total funds under management in Europe.⁶ In France, they accounted for only 0.24% of the total capitalization of mutual funds at the end of 2002 (Dejean *et al.* 2004: 742).

In the United Kingdom, which is considered one of the leading European SRI markets, Sullivan & Mackenzie (2006) argue that pension funds, with a few exceptions such as Universities Superannuation Scheme (USS), have kept aloof from SRI and have sent weak demand signals to the sell-side side of the investment value chain. Other institutional markets in Europe are no better. In a survey of the Dutch corporate and sector pension funds, only 17% of the funds have a policy on SRI (Hummels & Timmer 2003: 7). Furthermore, the sell-side finance professionals show the same weak – while, indeed, growing – interest in the ESG aspects of corporate behaviour. A recent pan-European survey examining the views of sell-side research analysts reveals that two-thirds of the mainstream research analysts do not include ESG factors in their analyses and valuation of companies (European Centre for Corporate Engagement 2007). In the same vein, EAI, in one of its recent reports on the key ESG research trends, concludes that between 2004 and 2006, the integration of ESG issues into financial analysis remained disappointing, with only a few integrative valuation models available (EAI 2007).

The marginality of SRI is often reflected in the language: ESG factors are commonly labelled ‘non-financial’ or ‘extra-financial’ issues (Sustainability & Mistra 2004, O’Loughlin & Thamotheram 2006). When there is a compelling business case for an ‘extra-financial’ factor (e.g. greenhouse gas emissions have a tangible value after the implementation of the EU emission trading scheme), that criterion becomes part of

mainstream investment analysis and decision-making. However, this differentiation is not clear-cut. For example, Hendrik du Toit (CEO, Investec Asset Management) asserts:

When an investor systematically integrates all relevant variables into their decision making there is no such thing as an extra-financial factor: just enhanced analytics.

(Quoted in O'Loughlin & Thamotheram 2006: 3)

There is no doubt that the SRI community and market are growing. However, SRI still represents a small part of the mainstream finance landscape. Its marginality is often reflected in investment practice and discourse. Identifying the impediments to SRI should enable us to understand why SRI remains at the fringes and help those who wish to make SRI part of the mainstream.

Impediments to mainstreaming SRI

Much of the recent research work on SRI has been led by SRI practitioners and advocates. Professional coalitions and networks, such as the UK Social Investment Forum (UKSIF), Europe's Eurosif, UNEP Financial Initiative,⁷ Accountability,⁸ SustainAbility⁹ and EAI, all provide information on different aspects relevant to SRI.

While their reports on the matter contain useful practical information, they nevertheless tend to be descriptive and atheoretical. Most academic researchers pursue theoretical progress as a main objective, whereas SRI practitioners and advocates design the research with the aim of persuading the reader of the merits of SRI. The current project endeavours to critically combine both sets of information. There are three main themes that feed the current debate around SRI: the agency problem, fiduciary duty and financial performance (FP) of SRI.

The agency problem

Identified in the early works of Berle & Means (1982), the agency problem concerns the structure of the modern corporation and in particular the 'divorce of ownership from control'. The problem

has become even more salient in the context of corporate scandals such as Polly Peck and Maxwell in the United Kingdom and Parmalat and Skandia in continental Europe. Essentially, in the modern capitalist corporation, there has been a shift of decision power from the shareholders ('owners') to the corporate directors (the 'agents'). As self-interest tends to motivate agents, their accountability can be secured only through efficient monitoring and incentive systems (Pratt & Zeckhauser 1985). However, internal monitoring and the flow of information between the agent and the principal are often inefficient (Davis *et al.* 2006).

Referring to the Anglo-American 'shareholder capitalism', Monks & Sykes (2006) argue that there are two limitations to the governance of capitalist corporations, which may work against long-term societal interests: (i) corporate executives are not effectively accountable to their individual and institutional investors and (ii) investors are not effectively accountable to their ultimate beneficiaries – the millions of individuals who are members of pension funds. This is known as the 'double accountability deficit' (Monks & Sykes 2006: 230).¹⁰

As a reaction to the increasing autonomy of executives, two positions have emerged in the discourse of academics and practitioners: the shareholder view and the stakeholder view. The former supports the idea that the corporation should serve the shareholders' interests (Friedman 1970), while the latter, as originally thought of by Freeman (1984), contends that corporations and their institutional investors are left with wider societal responsibilities to other stakeholders such as customers, communities and suppliers (Donaldson & Preston 1995), who may lack the information or the power to directly influence corporate conduct. These views act almost as social paradigms within the finance community, facilitating or impeding the mainstreaming of SRI. Christensen & Guyot (2003) claim that, while the shareholder perspective is the prevalent one in the corporate governance debate, the stakeholder view is increasingly voiced by academics and practitioners, revealing a whole different perspective to SRI.

Fiduciary duty

A detailed analysis of developments in the field of fund management, particularly in the domain of pension funds across Europe, is beyond the scope of this paper. However, fiduciary duty needs to be mentioned because it is commonly invoked by finance professionals as a contra-argument to SRI.

Fiduciary duty requires trustees and, under certain circumstances, fund managers and investment consultants advising them, to act 'in the best interest' of their beneficiaries.¹¹ In cases of mismanagement, fiduciaries are liable and may be sued. One of the general duties stipulated by fiduciary duty is to act prudently. In common law jurisdictions (e.g. the United Kingdom, the United States), this duty is fulfilled by pursuing the modern portfolio approach in investment decision-making and management (Freshfields Bruckhaus Deringer 2005). The modern portfolio approach dictates that fiduciaries select an optimally diversified portfolio, ensuring a balance between different types of available assets such as equities, bonds, money market funds, stocks in a variety of industries and countries that offer different levels of risk. Civil law jurisdictions (e.g. France, Germany) also use a similar principle known as investment diversification equally applicable to pension funds, insurance reserves and mutual funds (Freshfields Bruckhaus Deringer 2005).

The best interest of the beneficiaries has been usually interpreted as the maximization of risk-adjusted returns (Mercer Investment Consulting 2005, Sullivan & Mackenzie 2006: 15), making it difficult to integrate the beneficiaries' long-term interests into the fiduciary responsibilities. According to the UN-sponsored Freshfields Report, perusing the law suggests that fiduciaries are actually left with the discretion¹² to consider ESG factors in the management of investment portfolios for the beneficiaries of pension funds, as long as it is not financially detrimental. Challenging the conventional wisdom on fiduciary duty, the study takes a step further by arguing that it is precisely because of the fiduciary duty that ESG factors must be considered when there is long-term potential for financial impact from them.

A recent perspective referred to as 'the universal ownership' has recently penetrated the contemporary language on SRI, leading to a fundamental re-interpretation of fiduciary duty. Hawley & Williams (2000, 2002) argue that in the fiduciary capitalism era, a handful of institutional shareholders hold such large and diversified portfolios that their shares represent a broad cross-section of an entire economy. As their FP depends on the macro-economic performance, 'universal owners' (such as USS in the United Kingdom or Calpers in the United States) should be involved in a 'universal monitoring' of their portfolio companies and the market impact of negative or positive externalities caused by them.

The financial return on SRI

The relationship between SRI and FP is the most researched and controversial aspect in the practitioner and academic literature. Money remains a crucial factor for both socially responsible investors and conventional investors (McLachlan & Gardner 2004). As long as the mainstream finance community believes that incorporating ESG criteria into investment decisions comes at the cost of portfolio performance (Derwall *et al.* 2005), mainstreaming of SRI is uncertain.

The relationship between SRI and FP has been studied from different angles: (i) the relationship between corporate social performance (CSP) and corporate financial performance (CFP); (ii) the performance of SRI funds vs. conventional funds;¹³ and (iii) the impact of engagement and shareholder activism on corporate FP.

There are several comprehensive reviews that extensively address the first inquiry (Wood & Jones 1995, Margolis & Walsh 2003, Orlitzky *et al.* 2003). The empirical studies exhibit contradictory results and a discussion of the various factors that could explain this inconsistent evidence surpasses the objectives of this paper. Margolis & Walsh conclude from the examination of 127 CSP–CFP studies that 'there is a positive association, and certainly very little evidence of a negative association, between a company's social performance and its financial performance' (Margolis & Walsh 2003: 277). In the same vein,

the meta-analysis of 52 studies from 1972 to 1997 led by Orlitzky *et al.* (2003) shows the same positive correlation between CSR and CFP. Furthermore, this study remarkably illustrates that CSP and CFP are mutually reinforcing as CSP may be both a determinant and a consequence of good CFP.

The second raft of literature suggests that, on balance, there at least does not seem to be a penalty for SRI. Studies run in the European SRI universe (Bauer *et al.* 2002, Schroeder 2003, Kreander *et al.* 2005) provide little empirical evidence to support the sceptics' belief that SRI funds underperform relative to their conventional counterparts. However, it also supplies scant evidence in support of claims that SRI outperforms others (evidence that is greatly desired by SRI advocates).

While controlling for investment style, Bauer *et al.* (2002) analyse 103 SRI funds in the United Kingdom, Germany and the United States and find no statistically significant difference between the risk-adjusted returns of SRI funds and conventional funds over the period between 1990 and 2001. Similarly, Schroeder (2003) uses a multifactor model to review the performance of 46 major SRI funds and eight screened indices in Germany, Switzerland and the United States. He concludes that, while different in their risk-return characteristics, SRI funds have no clear disadvantage with regard to their performance compared with conventional counterparts. Other European screened funds, such as the Swedish and Dutch ethical funds, show the same performance pattern (Kreander *et al.* 2005).

However, some authors bring forth evidence for a superior SRI performance. Derwall *et al.* (2005) demonstrate that the portfolios consisting of high eco-efficient¹⁴ companies provide significantly higher average returns than the low eco-efficient companies.

In reference to the third strand of literature, the evidence for the positive impact of SRI strategies on corporate FP is by no means definitive as it is difficult to isolate the impact of shareholder activism from other socio-economic and political factors that affect a corporation. Engagement seems to be a difficult matter to research, as it

often takes place behind closed doors (Sullivan & Mackenzie 2006).

Evidence based on case studies carried out by leading fund management houses such as Insight Investment (Waygood 2006) or Henderson Global Investors (Lake 2006) shows that investor activism can be effective in encouraging companies to improve their CSP. However, there is limited information on the positive impact of activism on stock returns (Sullivan & Mackenzie 2006).

Is SRI a tool for corporate change in the direction of better shareholder value? Haigh & Hazelton (2004) are rather sceptical, claiming that SRI funds in Europe (and elsewhere) are unlikely to trigger corporate change for three reasons: (i) the small size of the total SRI equity market measured against the total funds under management; (ii) the average size of an individual SRI equity fund vs. its conventional counterpart; and (iii) the small percentage of a company's shares held by any specific SRI institutional investors.

In conclusion, both academic and practitioner literatures suggest that the mainstreaming of SRI depends on three factors: filling accountability gaps; re-interpreting fiduciary duty; and legitimizing SRI by building solid business cases and disseminating examples of SRI financial successes.

Practitioner literature

The practitioner literature provides useful insights into the shared understandings of the SRI community. Moreover, it often contains financial insiders' views on the complex inter-relations between financial institutions and how these relate to SRI.¹⁵

Primary and secondary stakeholders in SRI: how does the structure of the investment value chain impede SRI?

Investment institutions, like any other organizational entity, involve different stakeholders with diverse and often incongruent objectives. In order to understand the institutional investment

community better, we should go back to the original definition of 'stakeholders':

Stakeholders are persons or groups that have, or claim, ownership, rights, or interests in a corporation and its activities, past, present, or future.

(Clarkson 1995: 106)

In addition, Clarkson makes a fundamental distinction between primary and secondary stakeholders: the former are those 'without whose continuing participation the corporation cannot survive as a going concern'; the latter group refers to those 'who influence or affect, or are influenced or affected by, the corporation, but they are not engaged in transactions with the corporation and are not essential for its survival'.

Now, applying these concepts to institutional investors, we can easily conclude that the 'primary stakeholders are not always "primary"'. The beneficial owners, like the pension policy holders, whose money is the 'lifeblood' of investment institutions, have often no 'say' in how their funds are managed.¹⁶ On the other hand, the practitioner literature shows considerable evidence of the domination of financial intermediaries such as investment consultants and brokers in investment decision-making.

The question arises: how interested are these stakeholders in aspects of responsible business and sustainability? A Swedish study of stakeholders' perceptions of corporate sustainability shows that, among the different stakeholder groups of the ABB Group,¹⁷ mainstream financial analysts, portfolio managers and even fund managers of ethical funds bear the least amount of fundamental knowledge of the environmental and social issues of the industrial sector (Swanström & Cerin 2006).

Between the buy-side¹⁸ end and the sell-side¹⁹ end of the investment value chain, there is a wide range of interests: those of trustees, investment consultants, fund managers and advisory councils, buy-side and sell-side analysts, rating agencies and so forth. Different authors argue that the future of SI mainstreaming depends heavily on the management of the conflicts of interest between these stakeholders, with respect to ESG and economic issues (Zadek *et al.* 2005, Sullivan

& Mackenzie 2006). Julie Hudson (2006: X), head of the SRI investment team in UBS Investment Bank, takes a step further by defining the field of social responsibility as 'the management of potential conflicts of interest between different societal groups, or stakeholders, with respect to economic, environmental, social and ethical issues'.

*Fund managers*²⁰

Fund managers are one of the key players in the SRI market as they are often left with the final investment decisions. Furthermore, they are potentially major drivers of CSP because, as a Just Pensions Report on this subject shows, they are often delegated to pursue a policy of engagement on behalf of the pension funds (Gribben & Olsen 2003). Among pension funds, company pension schemes are the keenest to delegate decisions on SRI policies to their fund managers (UKSIF 2000).

The performance of external fund managers is assessed by consultants and trustees on a quarterly or a yearly basis relative to three criteria: a particular index, e.g. FTSE 350; peers' performance; and other institutionalized models of 'success', which usually disregard the absolute return a fund achieves (Golding 2001).

Owing to their 'quantitative' background as former analysts or investment bankers, coupled with the conventional evaluation of their performance (Hildyard & Mansley 2001), fund managers often find it difficult to implement a longer-term investment horizon that integrates ESG criteria with financial criteria. Further discussion on this topic will follow in the ensuing sections. Nevertheless, European fund managers are increasingly interested in SRI for different reasons and some authors even argue that fund managers, together with analysts, are the main drivers of SRI (SustainAbility 2000).

The practitioner literature identifies four types of SRI fund managers (SustainAbility 2000: 35):

- (1) the 'monks' – SRI religious or values-driven pioneers both in Europe and in the United States; they adopt a conservative SRI

- approach, based mainly on negative screening (e.g. F&C);
- (2) the ‘crusaders’ – organizations that have actively developed positive screening and promoted SRI (e.g. NPI Global Care in Europe);
 - (3) the ‘merchants’ – mainstream fund managers who have sensed a business opportunity in SRI (e.g. Schroders Investment Management);
 - (4) the ‘pioneers’ – SRI players interested in innovation, value maximization and active engagement (e.g. Generation Investment Management).

It would not be hard to extend this typology as the growing SRI community of fund managers is becoming increasingly diversified.

Trustees

Mainstreaming of SRI depends significantly on the SRI demand from institutional investors such as pension funds. However, this demand remains weak. In 2006, FairPensions, the campaign for Responsible Investment, warned that most UK pension funds failed to integrate SRI in their fiduciary duty.²¹

What is the role of pension funds trustees in this lack of demand? Pension funds are supervised by trustees who have a legal responsibility to ensure that pension funds are properly run in the ‘best interests’ of their beneficiaries. Trustees may impede mainstreaming SRI as they often lack the financial incentives, time and expertise to independently favour the long-term interests of the beneficiaries (Myners Report 2001, Zadek *et al.* 2005). Because these deficits are augmented by liability pressures, trustees often seek to leave the major decisions, such as security selection and even strategic asset allocation, to the actuaries, pension managers, investment consultants or external fund managers (Horack *et al.* 2004).

Following up on our previous discussion of fiduciary duty and the prudent person rule, we conclude that there are three ways in which SRI could become part of the common responsibilities of trustees: (i) redefining the term ‘best interest of beneficiaries’ beyond financial return; (ii) provid-

ing more empirical evidence for the financial impact of ESG factors; and (iii) enhancing investment skills and a greater understanding of ESG factors among trustees.

Analysts

Analysts’ main responsibilities are to provide their clients – fund managers and traders – with recommendations for buying or selling shares, based on the use of valuation models (Hildyard & Mansley 2001). Both sell-side and buy-side analysts are assessed on the quality of their research and recommendations. In one of the most influential readings in the practitioner literature, Davis *et al.* (2006) argue that analysts are usually poorly incentivized to move their analysis beyond the drivers of short-term performance and market valuations. Similar to individual portfolio managers, analysts are often rewarded with bonuses computed on a quarterly or a yearly relative return. Furthermore, stock analysts have misaligned interests with investors’ interests (their clients) for the simple reason that they are caught up in countless conflicts of interest as companies that should be impartially evaluated and rated usually ‘pay the bill’ (Davis *et al.* 2006: 124). Consequently, institutional investors have developed their own internal research departments seeking to alleviate the bias inherent in sell-side research (Golding 2001).

Investment consultants

In between pension funds and fund managers, there are other key players. It is what the practitioner literature names ‘the gatekeepers’ (Kinder 2005, Davis *et al.* 2006). These powerful advisers provide a very wide range of services for their institutional clients – from advice on asset allocation, selection of benchmarks, to performance evaluation of both fund managers and an overall portfolio. Consequently, they are the key players who may help grow or hold back SRI. Generally, investment consultants have contributed to short-termism in capital markets by encouraging fund managers to prioritize risk management and FP on a quarterly basis

(Golding 2001). In the United Kingdom, Mercer Investment Consulting is one of the few consultants who have contributed to the growing legitimacy of SRI. After forming a pioneer internal team dedicated to researching SRI, Mercer launched a competent service that rates European fund managers against SRI criteria such as activism, engagement and incorporation of ESG analysis into portfolio selection and management (Davis *et al.* 2006, Whitaker 2006).

Conflicts of interest within the investment value chain

The SRI actors often subscribe to different interests, affecting their final decisions differently. The World Economic Forum report on responsible investment asserts that the integrity of financial markets depends on adherence to the following principle: complete independence of buy-side and sell-side analysts (Zadek *et al.* 2005: 23). However, in reality:

... those acting on behalf of the owners of capital are taking advice on how to value companies from those seeking to sell them corporate stock.
(Zadek *et al.* 2005: 23)

Examples of malpractice are rather frequent: not only are buy-side and sell-side analysts often located in the same institutions (Zadek *et al.* 2005: 23), but over 75% of fund managers are owned simultaneously, although not to the same extent, by investment banks (sell-side) and insurance companies (buy-side) (Monks & Sykes 2006). Furthermore, investment consultants, on whose advice pension fund trustees often depend, may sell, at the same time, information and affiliated brokerage services to investment management and investment banking firms, which consultants are expected to recommend impartially to trustees (Davis *et al.* 2006). Analysts are also prone to making biased recommendations as they may well own shares in the companies they evaluate (Daniel *et al.* 2002).

However, conflicts of interest are not omnipresent; some authors claim that public pension funds, in contrast to the private sector, are the most active institutional investors in the SRI market exactly because they are significantly less

affected by conflicts of interest (Monks & Sykes 2006).

Having said that, we conclude that the structure of the investment value chain is the cause of four major impediments to mainstreaming of SI:

- (1) competition, rather than cooperation, at all levels of the investment value chain;
- (2) the separation of ownership and executive control, which accounts for 'the double accountability deficit';
- (3) imbalanced power and diffused responsibility between trustees, fund managers and consultants; and
- (4) conflicts of interests that impede the development of a common strategy for SRI within the entire chain.

The state of SRI in Europe

The dominant culture within the European financial market

Louche & Lydenberg (2006) raise one of the most challenging issues of the topic: the historical, cultural and political embeddedness of SRI. One of the impediments to SRI has been the poor adaptation of the SRI message and SRI practices by the 'local' mainstream community. Kinder (2005) points out that mainstream investors prefer to avoid terms such as 'values-based investment' or 'ethical investment', even when they make use of SRI strategies.

Lately, in an effort to legitimize themselves, European SRI players have tried to adapt their strategies to the principles shared by the mainstream community: risk management and financial returns, sustainability and eco-efficiency (Louche & Lydenberg 2006). For example, in Europe, fund managers such as AXA IM, BNP PAM and brokers such as HSBC Securities have already shifted SRI from an ethics-driven concern to a pragmatic risk-management issue (Eurosif 2003). Furthermore, Cassandra Higgs, a Just Pensions Project Manager in the United Kingdom, finds evidence to support risk and shareholder value as the most effective way to frame SRI engagement (Higgs 2005). Moreover, the basic assumptions underlying financial markets

can also affect the selection and implementation of SRI strategies within a national context. Hudson (2006) claims that the predominant feature of the United Kingdom's financial culture, just as in the United States, is the strong belief in market efficiency and modern portfolio theory. However, the inflexibility of this conviction may be detrimental to the mainstreaming of a few SRI strategies.

The semi-strong form of the Efficient Market Hypothesis (EMH) states that asset prices instantaneously and fully reflect, in an unbiased manner, all publicly available information on security markets (Fama 1970, 1998).²² As security prices follow a random walk, only luck – not skill – can help investors to outperform the market. The EMH implies that all investors are rational mean-variance optimizers seeking to maximize return to risk at all times. The diversified portfolio, according to modern portfolio theory, is thought to bear an optimum risk-reward characteristic. Consequently, an asset is judged against the overall risk-return characteristics of the entire portfolio, rather than simply on an individual basis.

Without denying the proven value of a diversified portfolio in terms of risk management, behavioural economists have identified a number of shortcomings with the EMH (Thaler 1994, Ambachtsheer 2007). Against the predictions of EMH, stock prices are often excessively volatile, beyond the expected randomness (Shiller 1981, Seyhun 1990). Investors are subject to systematic biases such as heuristic simplification, self-deception and emotion-based judgements (Hirshleifer 2001). Furthermore, due to conflicts of interest and common behavioural biases, analysts are prone to making overoptimistic stock recommendations and earnings forecasts (Montier 2005). Furthermore, in order to price assets accurately and promptly, information must be distributed efficiently (Keane 1983). However, insufficient corporate responsibility (CR) reporting (Stittle 2002, ECCE 2007) and the lag between the occurrence of an ESG issue (e.g. EU's REACH Regulation) and its dissemination and integration into the market price (Waygood *et al.* 2006) cause serious informational deficits.²³ Consequently, as

the practitioner literature on SRI shows (Forum for the Future 2002, Sullivan & Mackenzie 2006), not all ESG factors are properly valued by the market and reflected in share prices.

There is also a growing strand in the behavioural finance literature that connects investors' behavioural biases to the distortion of market prices, which negatively impacts upon the overall efficiency of capital allocation in the economy (Daniel *et al.* 2002, Stracca 2004).

The strong belief in modern portfolio theory and the efficiency of the market, coupled with the fiduciary duty that comprises a 'prudent' approach to investment, may be used by trustees or fund managers to rationalize *ex post-factum* decisions that disregard long-term interests.

For all the reasons mentioned above, in the United Kingdom, negative screening is less popular among institutional investors – with the exception of churches and charities – for the simple fact that it runs counter to the principle of portfolio diversification.²⁴ Engagement with investee companies and (weighed) integration of ESG factors into core investment process are SRI strategies that avoid this problem (Hudson 2006, Sullivan & Mackenzie 2006). Consequently, a strong culture of active ownership and integration characterizes the United Kingdom's equity market – a fact that was confirmed by recent statistics (Eurosif 2006).

The compliance and risk-avoidance culture has further consequences for the European SRI market. Del Guercio (1996) finds empirical evidence to show that prudence distorts investment decisions and often results in institutional investors tilting their portfolios towards 'safe' equities such as large cap stocks. One can infer from this that both conventional and SRI fund managers will be prone to err on the side of caution to ensure their decisions are easy to defend. Guyatt (2006) suggests that the excessive focus on returns relative to an asset-based index discourages investors from optimally diversifying their portfolios by investing beyond the traditional pool of assets.²⁵ The first consequence is that the SRI domain becomes very restricted: in countries such as the Netherlands and Belgium, large caps make up almost 90% of SRI funds

(Eurosif 2006). The second consequence of the tendency is that engagement is severely limited to large companies. It is common among SRI practitioners to engage with large companies in the FTSE100, while ignoring engagement with smaller companies (Arthur D. Little 2003). This practice is quite unfortunate because active ownership might be more successful in smaller companies. However, fund managers may be less interested in engaging with smaller companies simply because smaller companies are in turn likely to represent just a very small part of the fund's portfolio.

Role of information in SRI

Information is the lifeblood of financial markets. When the available information does not capture the financial value of ESG factors, these factors are not reflected in share prices. This can often create the paradoxical situation in which responsible companies, sustainable or long-term, can be severely mispriced in the short term, while other companies causing serious negative externalities in the market can be overpriced. Even if sustainability pays off on a medium- or a long-term basis due to reputation benefits and increased profitability (Russo & Fouts 1997), damaging companies still make money from externalizing costs as long as governments, financial markets and consumers do not penalize them sufficiently (Sullivan & Mackenzie 2006: 24).²⁶ This fact means that analysts' equity valuations, and fund managers' and trustees' investment decisions, remain largely unaltered. Once again, the mainstreaming of SRI depends on the interplay between the sell-side and the buy-side, between the demand for ESG information and its supply.

Information disclosure

In Europe, governments, international organizations and industrial networks have attempted to ameliorate the informational deficits or asymmetries. On the side of information supply, European legal reforms are abundant. In France, a law known as the 'New Economic Regulation' was passed in 2001, making social and environ-

mental reporting compulsory for all listed companies. In addition, softer schemes such as the EAI financially incentivize the sell-side analysts to increase and improve the information on ESG factors. Signs of progress are already visible in British investment banks (Eurosif 2006).

On the demand side, key reforms demanding pension funds to disclose their policies on SRI have been passed in many European countries such as the United Kingdom, Italy, Austria, Germany and Belgium (Eurosif 2006). Furthermore, the Institutional Shareholders' Committee – representing mainstream institutions in the United Kingdom, such as ABI and NAPF – has been involved in the SRI field by formulating comprehensive SRI disclosure guidelines.²⁷

In reference to the desired level of disclosure, the pan-European survey of 319 sell-side analysts, covering 15 countries, finds that analysts believe that companies' ESG reporting has improved, but the level of reporting is still unsatisfactory (ECCE 2007).²⁸ However, among the buy-side institutions the demand for, and satisfaction with, current corporate reporting on ESG factors is uneven: whereas more than half of surveyed Dutch pension funds express their satisfaction with the ESG information they receive from companies, the majority of UK trustees show the opposite (Gribben & Olsen 2003, Hummels & Timmer 2003).

Information collection

In Europe, research analysts, who are expected to provide investors with accurate and thorough valuation views and recommendations, have been rather reluctant to incorporate ESG information into their reports on companies. The main reason for this is that they mainly fail to perceive most of the ESG factors, with the exceptions of brand and reputation, as value-driving factors (ECCE 2007). Indeed, a number of corporate executives confirm that they are hardly ever asked about ESG factors in their meetings with mainstream analysts (Sullivan & Mackenzie 2006).

Among the community of SRI analysts, the collection and use of ESG information is impeded by different factors. The disparate interests of SRI

analysts in ESG information differ from firm to firm and from sector to sector. Such a diversity of interests is expected, as offering new information is one of the marketing tools of analysts. However, the lack of consistency among SRI analysts holds back the ability of companies to respond to their requests and diminishes the credibility of the sector (Edmondson & Payne 2006, Wales 2006). Consequently, corporate executives have increasingly criticized the lack of standardization and transparency of the questionnaires delivered by SRI analysts and research agencies (Arthur D. Little 2003).

Until now, neither international consortiums nor industry groups have been able to develop a comprehensive set of extra-financial indicators (Entine 2003, Sethi 2005). There are many reasons for the slow development in this field: (1) corporations and industry groups fear new business risks and increased pressure from public-interest groups once the set of ESG factors is publicly acknowledged (Sethi 2005); (2) there is little incentive for short-term-focused brokers and other research providers to focus on ESG issues (Casson & Russell 2006: 169); (3) SRI analysts and mainstream analysts have misaligned research interests due to different educational and professional backgrounds (Wales 2006: 258); (4) there is a disparity between the factors analysts research and the factors fund managers incorporate into investment decisions (O'Loughlin & Thamotheram 2006); and (5) ESG criteria are often imprecise and difficult to quantify.²⁹ There is a great need for research into the development of a set of agreed extra-financial factors that can become the core of ESG valuation models. This is one of the achievements expected from the collaboration between UN PRI and EAI.

Materiality

Originating in the field of financial auditing, 'materiality' raises conceptual difficulties when applied to ESG issues:

While recognising that a range of social, environmental and economic issues may be of relevance to different stakeholder groups, these issues are only considered to be material where they have actual

or potential impacts on a company's investment value.

(SustainAbility & Mistra 2004: 7)

The final report of a qualitative study prepared by Arthur D. Little (2003: 4) in collaboration with UKSIF mentions that 'material' matters are CR issues that 'really affect value'. Through interviews conducted with SRI fund managers, rating agencies and investor relations managers, the study reveals that one of the main impediments to SRI is the lack of meaningful dialogue between investors and companies on the business value of CR. SRI analysts' poor understanding of the materiality of CR issues and the companies' heavy reliance on the business case for CR are obviously misaligned. On the other hand, buy-side analysts are under the same pressure of providing material information on ESG factors. Specializing in the research on a small number of specific sectors increases the prospects of internal analysts providing material information on ESG, which can further feed into the engagement activities led by fund management houses (Higgs 2005). Under the pressure of fiduciary duty, trustees are also interested in the financial impact of the ESG information. However, trustees from different-sized pension funds in the United Kingdom differ as to the emphasis they place on 'materiality' (Gribben & Gitsham 2006). The lack of clear financial benefits of ESG information is more likely to deter trustees of larger pension funds from integrating ESG into the core investment process.

In response to the increased concern for materiality, Kinder (2004) criticizes the restrictive meaning of 'materiality'. Defined in terms of 'investment value' by SustainAbility Mistra (2004), 'materiality' is a limited concept that excludes factors that may be highly relevant to society and sustainable development but poorly covered in the sell-side research. If materiality is only about economic efficiency and what the clients want, it will end up being just another 'beat-the-market' tip.

Integration of information

'Integration' as an autonomous SRI strategy is defined by UKSIF on their website as 'the

inclusion by asset managers of SEE/CG-risk and opportunities into traditional investment analysis and stock weighting and/or selection processes'. In Europe, integration is uneven, with the United Kingdom leading in the use of engagement and integration and countries such as Austria and the Netherlands showing less enthusiasm (Eurosif 2006: 8). Nevertheless, integration among UK pension funds, which are considered some of the best managed in the world (Davis *et al.* 2006), is inconsistent. The trustees' and fund managers' self-reported enthusiasm evidenced in the latest Just Pensions report (Gribben & Gitsam 2006) does not provide us with any information about the actual integration of ESG information into the investment decision-making or engagement. Indeed, in 2004, Britain's Department of Work and Pensions released a gloomy report on trustee boards where only 18% of schemes had explicit SRI policies of their own (Horack *et al.* 2004).

Short-termism: a pervasive impediment to SRI within financial markets

There is wide consensus among academic and practitioner researchers that short-termism is a strong and pervasive impediment to SRI in financial markets throughout the world. It requires special attention as it is intricately related to the individual, organizational and institutional impediments to SRI.

Since September 2005, the CFA Centre for Financial Market Integrity has been running a symposium series addressing short-termism at the corporate and investment decision-making level; participants have included corporate leaders, investment analysts, fund managers, institutional and retail investors, regulators and media representatives. Short-termism is defined as 'the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation' (Krehmeyer *et al.* 2006: 3). The results of the symposia confirm the findings of academic research on the negative impact of short-termism on long-term value. The

formulated solutions for overcoming short-termism focus on five critical aspects:

1. The reform of earnings guidance practices;³⁰
2. The redesign of incentive systems for corporate executives and portfolio managers based on a long-term performance evaluation;
3. The need to encourage corporate executives and shareowners to bring about organizational change for long-term value creation;
4. Better alignment between the reported information by companies and stakeholders' interests; and
5. Educating all stakeholders, especially the pension fund sponsors and trustees who often lack the specific expertise, about the benefits of long-term thinking and the costs of short-termism.

Elsewhere, Marathon Club, which is an advocate of long-term investing, pinpoints three major factors of short-termism at the level of institutional investment: focus on quarterly performance, overuse of stock market indices and the measurement of long-term liabilities on a short-term basis (Marathon Club 2007: 4).³¹ Addressing these issues, Marathon Club recommends that trustees should initially clarify their attitudes towards risk, returns and investment styles. Second, trustees should endeavour to set clear investment objectives for risk and return according to their pre-specified investment beliefs. The implementation of a long-term mandate is then achieved through the selection of the investor managers whose skills and track records fit such investment objectives. The alignment between trustees' and fund managers' objectives is ensured by encouraging fund managers to personally own a significant part of the funds they manage. The last condition warrants a long-term relationship between trustees and managers, marked by review meetings focused on long-term objectives rather than on quarterly performance evaluations (Marathon Club 2007).

At the level of investee companies, a recent survey conducted by McKinsey & Company (2006) reveals that corporate executives also feel pressured by short-termism. The pressure comes from investors and analysts themselves who request

companies to maintain the business tradition of issuing short-term earnings announcements. In an attempt to address the vicious circle of short-termism, the participants in the CFA symposia recommend that the incentive systems for asset managers are aligned with corporate executives' compensation taking into account a three-to-five-year performance metric (Krehmeyer *et al.* 2006).

Short-termist pressures on fund managers are particularly detrimental to the long-term vision required by an ESG-driven investment strategy. For instance, Matthew Kiernan from Innovest claims that an ESG-driven strategy may take 24–36 months to materialize in the financial metrics (in Sullivan & Mackenzie 2006). One might argue that financial metrics are capable of capturing long-term benefits as it is common that companies make investments that will only pay off later on (e.g. R&D in the pharmaceutical sector). Here, a distinction (although the literature is not clear on this matter) needs to be drawn between intangibles in general and ESG factors. Intangibles, which encompass a higher number of issues such as brand name or customer satisfaction, seem to be more directly linked to company profitability in a specific sector, and potentially have an ascertainable market value.³² On the other hand, according to EAI,³³ ESG factors such as human rights and climate change are often more difficult to quantify and have a stronger focus on public concern and market externalities. Consequently, we consider that short-termism is especially detrimental to ESG-driven strategies, which involve more uncertain and long-term benefits.³⁴

Organizational procedures can significantly contribute to the existence of competency gaps, which impede the development of a longer-term business strategy. A recent series of roundtables organized by the World Economic Forum (2003–2004) concluded that a long-term investment approach would require upgrading current *incentives, skills* and *information* along the entire investment value chain (Zadek *et al.* 2005). For instance, few fund management houses encourage organizational learning and an intensive research culture. As a result, the typical career path in fund management houses discourages the use of proper skills in the proper place. Successful and skilful

research analysts are promoted to become fund managers, and if they are successful in the new position, they are then further promoted to business leaders. In this way, the skilful analysts are often replaced by relatively inexperienced research analysts who are less able to 'compute' the social and environmental factors.

We conclude by acknowledging that the debate on short-termism has made significant progress in identifying the actual causes of short-termism. However, the suggested solutions still raise practical problems. For example, incentivizing fund managers through co-investment in the funds they manage might not be very efficient, as the average holding period of stocks has decreased dramatically over recent decades (Montier 2005).

Academic research

This section has two objectives. First, it will succinctly cover the main academic studies that help us unravel the impediments to SRI. In a previous section we have already laid down the central concepts that cross both the practitioner and the academic literature. We also have to mention that there are few academic studies that are focused on the impediments to SRI *per se*.

The second objective is to combine practitioner and academic literature on SRI within a unitary framework. We do not intend to construct a comprehensive model of the behavioural impediments to SRI. Rather, we endeavour to present a framework that allows the reader to conceptually organize the heterogeneous literature on SRI. We therefore propose a multi-level framework for the behavioural impediments to SRI: an individual/psychological level; an organizational level; and an institutional level. The idea for this framework is inspired by similar theoretical constructions developed in the field of corporate environmentalism (Bazerman & Hoffman 1999, Hoffman & Bazerman 2005, Cabantous & Pearman 2006).

Individual barriers to SI practices among institutional investors

There are two major sources of academic research that facilitate our analysis of the individual

impediments to SRI. The first source is behavioural finance, which, through insight into the decisional heuristics, explains the observed market behaviour (De Bondt 1993, De Bondt & Forbes 1999, Wärneryd 2001, Daniel *et al.* 2002).

As we acknowledged previously, there is already a great bulk of empirical evidence that runs counter to the predictions of the EMH. Informational inefficiencies, systematic mispricing and investor credulity, ignorance or limited attention make investors subject to fads (Shiller 2000), overtrading (De Bondt & Thaler 1995) and manipulation by interest groups such as brokers, analysts and advisors (Daniel *et al.* 2002). The growing behavioural literature that questions the assumptions of the rational economic actor is a challenge, given that the rationality of investors is the foundation of modern finance (Statman 2004). Indeed, investors display common human flaws: overconfidence in their judgements causing excessive trading and trading on 'noise' (Thaler 1993, Shefrin & Statman 1994); heuristic simplification and emotion-based judgements (Hirshleifer 2001); overvaluation (of the best stocks) and undervaluation (of the worst) driven by extrapolation of recent performance (De Bondt 1993). Moreover, investors' short-termism and myopic behaviour have also been found to be persistent in financial markets (Black & Fraser 2002). Interestingly, investors' tendency to underestimate future cash flows varies cross-culturally.³⁵ From five different markets under consideration – Australia, Germany, Japan, the United Kingdom and the United States – the United Kingdom's financial market faces the most severe short-termism (Black & Fraser 2002). The phenomenon of herding has also grabbed the attention of researchers who have brought extensive empirical proof for its existence in the institutional market, specifically in pension funds (Sias 2004) and mutual funds (Wermers 1999).

If the neo-classical assumption of rationality is applied to SRI, the main prediction is that SRI investors decide 'ethically' because they expect: similar returns at a lower risk than in the case of unscreened funds or higher returns for the same level of risk as conventional funds (Beal *et al.*

2005). However, this assumption is not supported by Lewis (2002), who shows that ethical investors do not perceive SRI funds as less risky and seem prepared, under some circumstances, to accept a degree of financial loss in order to achieve their ethical ends (although it should be noted that McLachlan & Gardner (2004) found no significant difference between SRI and conventional investors in the importance placed on financial return when investing). Lewis (2002) also reports that individual SRI investors are more likely to be religious, contributors to charity and supporters of 'liberal' causes: SRI appears to be part of a preferred lifestyle where morality and money are intertwined.

Beal *et al.* (2005) incorporate 'psychic returns' into the utility function by arguing that happiness or experienced utility alongside the financial returns may be a strong motivation for ethical investment. Authors such as Nagy & Obenberger (1994) confirm that (retail) investors use diverse investment criteria when choosing stocks. Non-financial factors such as 'feelings for firm's products and services' (40.6%) and 'perceived ethics of firm' (24.1%) are often invoked. However, financial and non-financial motivation should not be viewed as being antithetical as there are mixed motives involved: the motive to bequeath can override some ethical concerns, for example (Lewis 2002).

In reference to this second raft of literature, we have to show prudence in applying these results to the 'psychology' of institutional investors. Most of the research on behavioural analyses of responsible investment has been carried out from the perspective of the individual retail investor. Further work on the motivations of institutional investors needs to be carried out.

Organizational impediments to SRI

Ryan & Schneider (2002, 2003) draw attention to the organizational complexity and variety among institutional investors: private/public pension funds; mutual funds; insurance companies; and banks. These categories of investors differ in terms of their fund size, investment time horizon, active/passive management, location of fund

management, legitimacy and power over portfolio firm managers.³⁶ For example, pension funds are significantly different from mutual funds. Pension funds are frequently large and powerful funds, with long-time investment horizons, highly regulated and often managed externally. On the other hand, mutual funds present a different profile with variable fund sizes, shorter-term investment horizons due to higher liquidity requirements and with considerably milder legal liabilities.

Applying the model in the United Kingdom, Cox *et al.* (2004) draw a line between: (i) the 'long-run investors' (e.g. pension funds, charitable funds) who typically have predictable cash outflows, longer time horizons and publicly/legally scrutinized social performance and (ii) the 'short-run investors' (e.g. unit trusts, investment trusts) with short-term investment horizons, purely financial interest in investee companies and a lack of regulatory pressure to embark on SRI policies.

The problem of internal vs. external location of fund management particularly creates implications for SRI policies of pension funds. Ryan & Schneider (2002) hypothesize that external portfolio managers are likely to have more power and resources to engage with investee companies than internal managers. On the other hand, while testing the hypothesis in the UK stock market, Brammer *et al.* (2003) find that internally managed funds display a higher preference for CSP than those managed externally. For Brammer *et al.* (2003), this is largely due to three internal factors: the length of mandate; compensation; and performance evaluation. External fund managers usually perform under a three-year mandate, face dismissal in case of poor quarterly performance, are typically evaluated on a quarterly basis and are annually compensated against benchmarks (Brammer *et al.* 2003). In contrast, internal fund managers have the status of paid employees, have more stable mandates and are compensated in the form of salaries rather than short-term bonuses or percentages for assets under management.

Organizations are not only structural entities but also political systems (Pfeffer 1992). Hoffman & Bazerman (2005) emphasize the contribution that the internal political divisions and segmented responsibilities make in keeping environmental

concerns separated from economic objectives. In the realm of institutional investors, Guyatt (2006) identifies an imbalance in terms of power, legitimacy and remuneration between, on the one hand, internal teams of conventional analysts and fund managers and, on the other, SRI teams. Internal SRI teams (consisting of SRI fund managers and/or analysts) are mainly perceived as an adjunct to the core investment process: they have weaker access to top management and less power to influence buy/sell and portfolio decisions compared with traditional investment teams.

It seems that responsible investment practices have often been developed as specialized, separated and public functions whose main objectives are to ensure that the company is deemed compliant with recent regulations in the United Kingdom, so that the core investment process can remain focused on financial returns. Organizational decision-making theories can provide several explanations for this segregation of functions and information structures. Some authors (e.g. Feldman & March 1981) show that formal decisions can be pursued for symbolic and communication purposes rather than for efficiency reasons. Information in organizations can be collected and treated as 'symbols' of power, competence and rationality as opposed to instruments used for more efficient decisions.

Organizational culture – comprising organizational artefacts, values and underlying beliefs (Schein 1990) – may be an additional impediment to ESG integration in the core investment process. In a case study of the core investment decision-making process in three investment institutions in the United Kingdom, Guyatt (2006) points out that the internal environment is dominated by a pull towards short-termism, herding/gravitation towards defensible decisions and a lack of integration of ESG aspects. She maintains that the determinants of the three identified impediments to long-term investment stem from the existence of several dominant 'internal conventions': short-termist performance review process; segregation between conventional and SRI teams; and rigid criteria for selecting fund managers.³⁷

A few authors have proposed several strategies to pension funds for addressing organizational

impediments to SRI. Ambachtsheer *et al.* (1998) formulate practical recommendations for improving the organizational design within pension funds. First, the pension fund design should clearly delineate the function of trustee governing from the function of investment management. More specifically, as trustees often lack investment expertise, their main role is to define clear goals and overall risk policies for the pension fund rather than to run the daily investment activities. The latter are the responsibility of operating asset managers who manage the portfolios. Furthermore, as trustees' time and expertise may be limited, it is recommended that management executives are hired in order to closely monitor internal asset managers and run the business plan consistent with trustees' overall policies.

Inspired by the theory of organizational conventions (Gomez & Jones 2000), Guyatt (2006, ch. 3) advocates a four-pillar approach for change. First, *tailoring benchmarks to liabilities*, as opposed to a relative asset-based index, could have the potential to align fund managers' interests with the wider interests of final beneficiaries. Second, the system of *measuring risk and return* should be adapted to the liability-led investing approach. Third, once the benchmarks become tailored to liabilities, the system of *performance review and compensation* should also change. While the monthly and quarterly reviews may be preserved, the suggestion is to review the performance quarterly on a rolling 5–10-year basis and reward performance by computing the bonus payments on a similar basis, relative to the liability benchmark. Fourth, Guyatt proposes changing the excessive focus on short-term returns relative to the benchmark in the *internal meetings* between fund managers and fund executives.

There are limitations to these propositions.³⁸ First, liability-driven investing (LDI) involves short-term matching of assets and liabilities and it may also lead to short-term volatility (Marathon Club 2007). Thus, LDI might not result in long-term investing, but in more short-term trading. Second, LDI forces pension funds to use investment vehicles such as derivatives that might add new and often unknown sources of risk in the portfolio.³⁹ Third, this type of investment

raises several challenges at the level of fund management as it requires new staff skills, risk measures and incentives. Clients need to be educated in that respect, as LDI strategies depend on clients' risk appetite and mandate constraints (Garrido 2006).

Institutional impediments to SRI

Institutional theory is a robust starting point for understanding organizational change and grasping the adoption of new managerial practices (Greenwood & Hinings 1996, Dorado 2005). This approach moves the perspective from the individual and organizational level to the level of 'cultural and institutional systems of which organizations are a part' (Hoffman 2001: 134).

The theory may offer several explanations for the observed 'institutional isomorphism' within financial markets. DiMaggio & Powell (1983) point out that organizations are faced with three types of pressuring mechanism: coercive (regulatory), normative and mimetic processes. The first category of mechanisms encompasses the legal constraints that organizations need to comply with. Applied to the finance field, investment managers and trustees, in their fiduciary capacity, are legally expected to behave in the manner of a prudent person. By trying to avoid legal action against them, managers are trapped in a compliance mindset of following the central objective of return maximization (Guyatt 2006).

DiMaggio & Powell also indicate that organizations face normative pressures. These pressures originate in professionalization, educational curricula and peer influence within well-formed professional networks. Institutions choose to conform to the contextual expectations of appropriate organizational forms in order to gain 'legitimacy and resources needed to survive' (Meyer & Rowan 1991).

The third category of pressures, suggestively called 'mimetic pressures', is particularly strong in environments with a high degree of uncertainty and where decisions are associated with high risks (DiMaggio & Powell 1983). Investment organizations are more responsive to their institutional context because they fear reputational damage

and high financial risks in the case of non-conformity (Guyatt 2006). Furthermore, the 'mimetic homogenization', best described as the process in which an organization models itself after other organizations perceived as successful in the investment community, is much higher due to increased levels of inherent uncertainty in this domain. The result is a 'herd mentality', meaning that institutional investors have the tendency to follow each other in and out of the same securities.

Under these pressures, the field of professional investment becomes highly structured and impregnated by legitimated organizational templates and mechanisms of compliance monitoring. The adherence to existing practices is reinforced by the relatively high level of uncertainty specific to this environment.

Indeed, classic themes in economic sociology such as 'conventions' are used to explain the organization and stability of market capitalism (Biggart & Beamish 2003). Guyatt (2006) finds evidence for the existence of such conventions among institutional investors at a market level. The identified 'external' (or institutional) conventions include short-termism, rigid emphasis on relative asset-based index returns (rather than on absolute returns) and the pervasive use of valuation models heavily weighted towards tangible financial criteria, to the detriment of intangible criteria. In a feedback loop, the 'external' conventions are systematically reinforced by the 'internal' conventions within investment institutions: short-termist performance evaluation, segregation between SRI and conventional teams and lack of integration of ESG criteria in the core investment process.

Nevertheless, this paper takes a position between the institutional determinism and intra-organizational dynamics. We agree that, as the institutional theory predicts, the prospect of radical change towards mainstreaming SRI in the investment field may be rather limited. This is because change tends to be slow and more difficult to implement in highly structured institutional fields (DiMaggio & Powell 1983).

We also acknowledge (similar to recent critics of the institutional theory – Dorado 2005) the

potential of human agency in the process of mainstreaming SRI. In this sense, 'institutional entrepreneurs' are 'organized actors with sufficient resources (who) see the opportunity to realize an interest that they value highly' (Di Maggio 1988, in Dorado 2005). Indeed, in an empirical study of the institutional transfer of American practices of SRI to France and Quebec, Boxenbaum & Gond (2006) reveal rich information on the role of CEOs in the process of cross-cultural transfer. 'Champions' were involved in filtering the imported SRI model to adapt it better to the new host society. More specifically, a CEO in Quebec downplayed the American origin of SRI, presenting this new form of investment as a global business practice supporting sustainable development (Boxenbaum & Gond 2006: 14). In France, a small entrepreneurial company – ARESE – started pioneering SRI by proposing feasible measurements for the CSP of companies. The role of the CEO was to filter the ethical and religious fundamentals of the American model of SRI by highlighting the business opportunity and a rigorous methodology for measuring CSP. This is confirmed by other previously discussed studies, which show that, in Europe, the SRI case has been presented in the mainstream investment language that centres on 'the business case', 'risk management' and 'triple bottom line investing' (Louche & Lydenberg 2006).

What are the impediments that SRI pioneers need to resolve? We have to draw some lessons about the impediments to SRI from the available success stories. In the United Kingdom, Meg Brown, UKSIF's sector analyst from 2003 to 2005, argues that the Just Pensions programme, aiming to persuade mainstream institutional investors to integrate ESG in their investments, would have had even greater success if a mainstream investment organization, such as ABI, had undertaken this massive work (Brown 2006). In continental Europe, by looking at the French case of the successful 'environmental and social rating agency' – ARESE – Dejean *et al.* (2004) conclude that institutional entrepreneurs firstly need to legitimize themselves within the mainstream finance community in order to survive and develop. To achieve legitimacy, SRI pioneers first

have to show compliance rather than innovation. ARESE legitimized itself in France by developing quantified measurement systems of CSP and using the language of the business case for SRI. It represents the 'magic' interplay between convention and innovation.

Discussion and conclusions

Essentially, the financial market is a social mechanism. Just like any other social interaction, understanding it requires reference to various disciplines. This principle is particularly relevant to any effort to comprehend SRI. This paper therefore tries to build on the various positions taken in both the practitioner and the academic research on SRI, with a focus on the impediments to SRI within the European market.

Building on the empirical and anecdotal evidence and paying tribute to the fields of behavioural finance, organizational and institutional research, the paper proposes a theoretical framework for the institutional, organizational and individual barriers to the adoption of SRI in the mainstream investment community that is summarized in Figure 1.

There are two main categories of individual impediments – cognitive and belief systems. At the cognitive level, even experienced investors acting as individuals or in groups are susceptible to biases, which include overconfidence, herding, proneness to fads and using information in non-systematic ways. A belief among actors at every level that moral and environmental concerns are incompatible with financial decisions, together with the belief that the model of rational economic man is an accurate description of human nature, is a major impediment.

While individual impediments have been addressed extensively by behavioural finance and economic psychology, organizational and institutional impediments have not been explored and applied to the understanding of financial markets to the same extent. Organizational impediments to SRI include: short-termist performance evaluation and remuneration systems for fund managers and analysts; hierarchy of power, legitimacy and

remuneration between SRI and conventional teams of stock analysts and fund managers; dysfunctionalities in organizational structure and communication; career management systems that discourage the formation of the robust skills necessary for integration and engagement; and unsympathetic organizational cultures.

Regarding institutional impediments to SRI, we acknowledge the importance of: pervasive conflicts of interest and accountability deficits alongside the investment value chain; the role of regulatory, normative and mimetic pressures; and the ethos of financial markets stemming from market conventions such as short-term returns relative to benchmarks, valuation models focused on tangible financial criteria and short-term performance review and reporting.

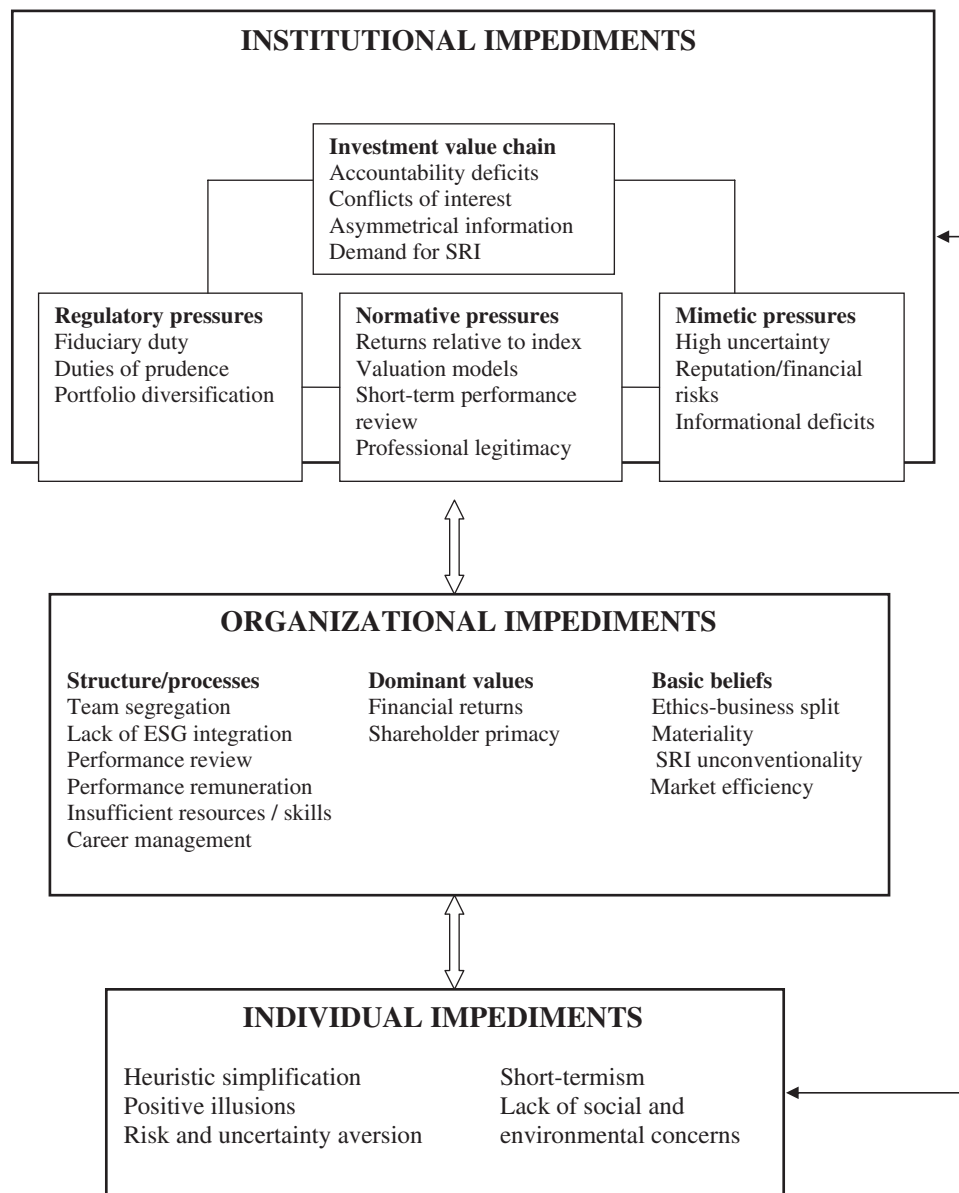
Figure 1 describes a feedback loop determined by the interaction between the three levels of impediments. Individual biases feed into organizational decision-making, while organizational cultures mould individuals' attitudes and practices towards SRI. Furthermore, organizations are placed in an institutional context that reinforces the impediments to SRI through rules, norms and deeply rooted beliefs. The detrimental effect of the regulatory, normative and mimetic pressures is augmented by the existence of structural problems along the entire investment value chain. One might place this framework against the background of the capitalist economic system, driven by consumption, growth and short-termism.

The pillars of change towards mainstreaming SRI formulated by Ambachtsheer *et al.* (1998), Guyatt (2006) and Zadek *et al.* (2005) require adjustments at the organizational level as these changes must address aspects of organizational culture, structure, legitimacy and power, leadership skills and entrepreneurship capacity.

The authors of this paper argue that any initiative to tackle the impediments to SRI must pay attention to the interaction between the three levels of analysis. Let us take short-termism as an example.

Tackling short-termism is challenging. This pervasive impediment is to be found at all three levels: under the forms of individual biases,

Figure 1: Multi-level analysis of the impediments to SRI



short-termist organizational incentives and conventional accounting and reporting systems. Recent actions at the organizational and institutional level try to break ‘the short-term circle’. For example, Generation Investment Management have introduced 3-year rolling performance appraisals and have fully integrated SRI experts into their investment team. At the institutional level, an increasing number of companies have stopped issuing quarterly earnings guidance, opting for annual projections (Krehmeyer *et al.* 2006).

However, the solutions to the impediments to SRI must emerge from the primary level of analysis – the individual level. Looking at cognitive biases first, Bazerman & Hoffman (1999) believe that if decision-makers can be educated to understand their own susceptibility to heuristic biases they can partly inoculate themselves against them. This tall order is eclipsed by the task of changing belief systems; beliefs about rational economic man and how markets work are deeply entrenched. One way forward, as

many SRI entrepreneurs have done, is to make the 'business case' for SRI (Juravle & Lewis, under review). This does not require a fundamental change of beliefs and gathers momentum as competitors behave as though ESG criteria have tangible financial benefits. It is much more difficult to persuade players in The City (the financial sector) that a more realistic model of man, a *homo realitus*, with moral preferences and biases, is a more useful assumption than the dispassionate *homo economicus*.

Besides theoretical and practical matters, future studies also need to tackle the methodological shortcomings found in the practitioner literature. The majority of practitioner studies on SRI have been carried out with successful SRI practitioners or advocates; the voice of those unsympathetic to SRI or those who have failed and anonymously left the SRI market is still unheard. It is clearly a difficult task to bring people who are in favour of SRI and those who are not to the same table. Nonetheless, this should be a priority for future research.

It is easy to say that new research needs to be carried out, but of what kind? We prioritize two areas. The first is to continue the task of conceptual clarification and theorization of SRI, while the second is to gather more opinions from the other side of the 'barricade'. In addition, the reason why some institutional investors (e.g. insurance companies and private pension funds), less covered by research, lag behind public sector pension funds needs further investigation. Furthermore, more in-depth studies that disclose information on the intra-organizational dynamics within asset management houses and institutional investors are needed in order to understand issues of organizational change, leadership and 'issue selling' in the process of mainstreaming SRI.

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Notes

1. The paper also integrates research studies that focus on US practices, when these studies shed light on impediments to SRI in Europe (e.g. Ryan & Schneider 2002, Krehmeyer *et al.* 2006). However, in drawing these parallels, due attention must be paid to the inherent differences between the Anglo-American institutional investment governed by strict fiduciary regulations and the Continental European investment industry governed by a different legal system.
2. For more information on Eurosif's definition of SRI, see www.eurosif.org.
3. For a comprehensive description of SRI strategies, products and actors in Europe, consult Eurosif's latest edition on SRI. Available at: www.eurosif.org.
4. We mention from the outset of the paper that the use of the terms 'Europe' and 'European' follows the continental European use of these terms (i.e. it includes the United Kingdom).
5. Available at: http://www.unpri.org/files/PRI_EAI_announce_collaboration.pdf.
6. Mutual funds, also known as unit trusts in the United Kingdom, are collective or pooled investment funds managed by portfolio managers.
7. UNEP Financial Initiative is a global partnership between UNEP and over 100 financial institutions.
8. AccountAbility is a non-profit, *membership* organization actively promoting accountability innovations that advance responsible business practices.
9. SustainAbility is a global strategic management consultancy and think-tank advising leading companies, expert networks and NGOs on corporate responsibility and sustainable development.
10. It is important to mention that 'the divorce of ownership from control' is typical in the Anglo-Saxon capital markets. In contrast, in continental Europe (e.g. Germany), the ownership of large quoted companies is usually concentrated in the

- hands of very few shareholders, primarily families (Franks et al. 2004).
11. Originally, many pension funds used to be managed internally by in-house investment managers. Recently, trustees have tended to place funds externally with professionals from asset management houses, insurance companies or investment banks (for more information, see Golding 2001).
 12. The authors agree that the amount of discretion is rather variable across jurisdictions and countries.
 13. We use the term 'SRI fund' as defined by Haigh & Hazelton (2004: 60): '... any managed investment scheme that openly advertises and markets its use of self-defined social and environmental guidelines to construct investment portfolios'.
 14. Derwall et al. (2005: 1) define the term 'eco-efficiency' as the 'economic value a company creates relative to the waste it generates'.
 15. Examples of such 'inside' accounts include Hildyard & Mansley's 'Campaigner's Guide' (2001) and *The New Capitalists* by Davis et al. (2006).
 16. In the United Kingdom, recent regulations have tried to ameliorate this accountability deficit. For example, The Pensions Act (2004) requires at least one third of trustees to be member-nominated and also lays down the procedures by which trustees are elected.
 17. ABB Group is 'a global leader in power and automation technologies that enable utility and industry customers to improve their performance while lowering environmental impact'. For further information, see the official website <http://www.abb.com>.
 18. 'Buy-side' refers to institutions that buy and hold securities with the expectation of a return on investment.
 19. 'Sell-side' refers to institutions that sell equities to investors for a percentage commission.
 20. 'Fund managers' refer to both the organizations and the position of the people that actually decide which companies' shares to buy and sell.
 21. For more information, see the official website of FairPensions: <http://www.fairpensions.org.uk/>.
 22. The authors draw attention to the fact that the literature on EMH distinguishes between three forms of efficiency – weak form, semi-strong form and strong form of efficiency (see, e.g. Keane 1983, Sharpe et al. 1999). Our reference to market efficiency refers to the semi-strong form and weak form.
 23. REACH stands for **R**egistration, **E**valuation, **A**uthorisation and **R**estriction of **C**hemical substances. The law came into force on 1 June 2007 with the aim of improving the protection of human health and the environment.
 24. According to Freshfields Bruckhaus Deringer (2005: 82), this statement is a common erroneous belief rather than an accurate interpretation of law and modern portfolio theory.
 25. An asset-based index/benchmark refers to the use of indices in the measurement of investors' performance. An index consists of a basket of securities that cross an entire asset class and/or investment style (e.g. S&P). Deviating from a pre-specified index constitutes a risk (tracking error).
 26. In the SRI literature, ESG factors are deemed to be of 'a medium- to a long-term nature' (O'Loughlin & Thamotheram 2006: 5). However, the timing of their impact on financial performance might be far more complex, being influenced by industry growth and organizational resources (Russo & Fouts 1997).
 27. ABI and NAPF stand for Association of British Insurers and National Association of Pension Funds, respectively. The ISC statement can be found at www.napf.co.uk.
 28. ECCE stands for European Centre for Corporate Engagement (<http://www.corporate-engagement.com>).
 29. For a succinct description of the extra-financial factors, see the official website of Enhanced Analytics Initiative (<http://www.enhancedanalytics.com>).
 30. 'Earnings guidance' presents forecast information, usually provided by a company director on a quarterly basis, about the company's outlook, especially in terms of earnings. For more information, search the web investing glossary at: <http://www.investorwords.com>
 31. The Marathon Club is a direct follow-up project to the competition run by USS Ltd and Hewitt (with support from FTfm) entitled 'Managing pension funds as if the long-term really did matter'.
 32. For example, brand name is an intangible asset, officially recognized by IAS 38 (International Accounting Standards). Internally generated intangibles may potentially be given a certain market value, hence capitalized (Elliott & Elliott 2006: 476).
 33. For further information, see www.enhanced-analytics.com.

34. Attention needs to be drawn to the fact that the literature on SRI does not usually draw such a distinction. ESG factors are encompassed in the much larger list of extra-financial factors (see, e.g. O'Loughlin & Thamotheram 2006). It is also worth noting that the (in)tangibility of ESG factors heavily depends on sector and company. Environmental pollution and climate change issues are more tangible for the oil and gas sector than for the software sector.
35. The tendency to underestimate future cash flows, which underpins short-termism, is not only linked to differences in discount rates. Alternative explanations imply that short-termism can be a function of 'speed of information arrival and changes in technology and financial products' (Black & Fraser 2002: 154). Furthermore, David Miles (1993) suggests that short-termism can be explained in terms of variable and increasing risk, which might even be consistent with the EMH.
36. A pension fund may be managed internally by the fund sponsor or may be outsourced to asset management houses, insurance companies or banks. Nowadays, a high proportion of mandates are given to external fund managers.
37. Biggart & Beamish (2003: 444) provide a comprehensive definition of conventions: 'Conventions – and related concepts such as habits, customs, routines and standard practices – are understandings, often tacit but also conscious, that organize and coordinate action in predictable ways'.
38. We thank Danyelle Guyatt and Rory Sullivan for their insightful comments on this matter.
- 39 In finance, a derivative is a contract between two or more parties, based on an underlying asset (e.g. stocks, bonds or commodities). Its value is 'determined by fluctuations in the underlying asset' (see <http://www.investopedia.com/terms/d/derivative.asp>).

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