Finance and accounting
Meeting objectives and resisting conventions

A focus on institutional investors and long-term responsible investing

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Abstract

Purpose – *This paper seeks to unravel some of the challenges associated with responsible investment from the institutional investor's perspective, focusing on how dominant conventions influence investor behavior and their ability to invest responsibly.*

Design/methodology/approach – *The research draws from three longitudinal case studies that were carried out on UK institutions that have adopted a responsible investment policy.*

Findings – *Evidence of behavioral obstacles to responsible investing were found, including short-termism, gravitation towards defensible decisions and reluctance to integrate corporate responsibility factors into the core investment process. Based on the case study evidence these appear to be driven by the influence of prevailing dominant conventions, reinforced by institutional herding tendencies.*

Research limitations/implications – *The paper introduces some preliminary thoughts as to how conventions might be resisted and changed over time through the institutional herding mechanism. Further research is required (and is currently under way) to more closely examine the potential impact of investor collaboration for challenging dominant conventions.*

Practical implications – *Collaboration amongst institutional investors is key for mobilizing institutional herding tendencies so that responsible investment might get built into conventions.*

Originality/value – *The research combines responsible investment literature with behavioral finance studies on investor behavior, herding tendencies and the influence of conventions. It also illuminates the complexities in investor behavior from which other institutional investors might learn in implementing a responsible investment policy.*

Keywords *Social responsibility, Short-term planning, Conventions*

Paper type *Research paper*

1. Introduction

Corporate scandals have become a common headline in the financial news across the world over recent years, including high profile collapses such as Enron, Worldcom and Parmalat. At the same time societal expectations of what is acceptable corporate conduct has shifted, with concern expressed about the impact of corporate activities on the environment, local communities, labor standards, human rights and business practices in developing countries. This shift in societal expectations has corresponded with the birth of socially responsible investment (SRI) and increased shareholder activism. This will be referred to throughout this paper as long-term responsible investment (LTRI)[1], defined as the situation whereby investors integrate financial, corporate governance, social and environmental criteria into the investment process in the pursuit of long-term portfolio returns.

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As a large and powerful investor pool[2], institutional investors could potentially play an important role in promoting more responsible corporate behavior; indeed regulatory changes have been introduced in many countries to encourage their increased involvement[3]. Whilst some institutional investors have become more involved, such activities are still unconventional[4]; unless LTRI becomes more widespread then it is debatable as to whether the investment mechanism will be a viable vehicle for integrating corporate responsibility into the market system. The focus of this paper is to unravel the conventions and herding tendencies that act as obstacles to investing in a long-term responsible manner and to consider if/how these might be overcome.

The outline of this paper is as follows:

- section 2 begins with an overview of the relevant SRI literature;
- section 3 outlines the methodology adopted in carrying out the longitudinal case studies and data analysis;
- section 4 presents empirical evidence on the behavioral impediments to LTRI;
- section 5 builds on this evidence to explore how internal and external conventions might be altered as a means of mainstreaming LTRI through the institutional herding mechanism; and
- section 6 concludes and identifies areas for further research.

2. Academic contribution and aim of research paper

The academic writings in the SRI field have built a strong case for institutional investor involvement in the promotion of corporate responsibility from the business ethics perspective (Mackenzie, 1997; Cowton and Crisp, 1998; Sparkes, 2001; Sparkes and Cowton, 2004) drawing from the agency problem literature (Berle and Means, 1932; Jensen and Meckling, 1976; Coase, 1988) through to stakeholder theory (Freeman, 1984). There is also extensive associated literature on the performance implications of SRI and shareholder activism with varying results[5]. Whilst these studies have produced somewhat inconclusive results as to the benefits of shareholder activism and SRI, they found that there at least does not appear to be a performance penalty from such activities.

The vast body of normative studies on the subject of investor responsibility do not address the issue of what ''investor responsibility'' actually necessitates in terms of changing investor behavior (or whether such change is achievable). SRI has been researched from the perspective of individual investors to better understand their behavior (Lewis, 2002), but institutional investors' warrant closer attention given their aforementioned power as significant shareholders. Studies by behavioral financiers are relevant here and there is a need to link this body of research with the investor responsibility literature. Most relevant for the purpose of this paper is the evidence that institutional herding exists (Sias, 2004; Nosfinger and Sias, 1999; Grinblatt and Titman, 1989; Grinblatt *et al.*, 1995; Wermers, 1999, 2000) and the models of investigative herding outlined in Froot *et al.* (1992) and reputational herding of Scharfstein and Stein (1990). These insights will frame the analysis of the case study evidence presented in this paper to consider how conventions, reinforced by herding tendencies, affect institutional investor behavior and their ability to invest responsibility.

3. Methodology

The paper draws from qualitative data collected through longitudinal case studies on three institutional investors in the UK who have to varying degrees introduced a policy of responsible investment across the management of their assets. The institutions are large representatives of the UK investor community, together accounting for some £80 billion of assets as at the end of 2003 and span the insurance and pension fund sectors.

The research approach was inductive and set out with the aim of gaining a better understanding of investor behavior, the factors that influence it and how this might affect an institution's ability to invest in a long-term responsible manner. It was therefore important for participants to be free to tell the story from their own perspective and to feel that, as the

researcher, I was not there to judge the institution but to act as a co-inquirer of the environment in which they operate and the challenges the institutional investor community face in moving towards integrating LTRI into their investment philosophy and process. With this in mind, the method was influenced by the participatory action research (PAR) approach where participants become involved in both the questioning and sense making that informs the research with respect to a particular issue or development (Reason and Bradbury, 2001).

The case studies were carried out over a period of 6-12 months, which provided some degree of longitudinal analysis and insight into how each organization changed and evolved over that time. The data collection process involved: six unstructured ''exploratory'' meetings with individuals across the participating institutions to guide the nature and focus of the research project; textual analysis of documents produced by the participating institutions including investment philosophy documents and the ''statement of investment principles'' (SIP) that amounted to over 250 pages; 20 semi-structured interviews with fund managers lasting an average 1.5 hours that were recorded and fully transcribed for analysis; informal communication and observation of participants through meetings, ongoing e-mail correspondence and telephone conversations; and diary observations and self reflection on my role and the progress of the research.

The data was distilled into themes and analyzed through the development of grounded theory and the constant comparative method (Glaser and Strauss, 1967; Haig, 1995; Strauss and Corbin, 1998). The ground theory data analysis method was infused with elements of PAR in two primary ways: firstly, the participants were involved in the questioning and sense-making of the data at different stages of the research process (double-loop inquiry); and secondly, the diary observations and self reflections were referred to in analysis of the data. Grounded theory allowed the ''data to speak'' and for theory to emerge from the data, whilst iteration with participants and self-reflection as expounded by PAR acted as a means of validating the data and staying true to the research aim.

4. The case study evidence on institutional objectives and investor behavior

Analysis of the three case study institutions' policy documents revealed that they all use similar discourse when outlining their responsible investment policy; namely, the aim to be responsible long-term shareholders of companies and markets in which they invest. They also invariably refer to the need for fund managers to pay appropriate regard to corporate governance, social, ethical and environmental considerations in the selection, retention and realization of all fund investment, in so far as that is consistent with the institution fulfilling its investment objective and legal obligations.

Despite the fact that these objectives exist at the institutional level, it became apparent during analysis of the case study data that there are behavioral obstacles to overcome at the actual fund manager level[6] to meet these objectives. These ''behavioral obstacles'' fall within the following three categories:

1. The pull towards short-termism.
2. Gravitation towards the defensible.
3. The LTRI objective being viewed as separate from the core investment process.

4.1 The pull towards short-termism

Being pulled towards the short-term was repeatedly mentioned by some fund managers as a challenge that all investors grapple with, not only those who aspire to be ''responsible'' investors. In the behavioral finance literature, short-termism is most commonly referred to as myopic behavior and the resulting tendency to over-emphasize the present (near term cash flows) at the expense of longer horizons (Frederick *et al.*, 2002)[7]. Whilst all fund managers interviewed throughout the case studies felt that it was better to stay focused on the long-term given the nature of their respective institution's liabilities and the difficulties with trying to forecast short-term market movements, subsequent comments revealed that ''making forecasts'' within that period is seen as an essential requirement of an ''active'' fund

manager's job[8]. The following statement made by one fund manager illustrates some of these short-term pressures:

> . . . I mean it always tough, people talk about time scales, but the issue is more about size of out-performance. In other words, we're looking for things that we think we can outperform by 15-20 percent or more . . . that may come in a few months or it might take longer . . .

This statement, and many more like this throughout the interview process, suggest that in those institutions that operate an active fund management policy, there is a disconnect between what investors believe they should do in principle and what they actually do in practice. Investors focus on staying ahead of price movements and, where they are actively managing against a benchmark, maximizing the degree of out-performance relative to that benchmark; the time scale issue is seen as being a secondary consideration. Noteworthy is the observation that short-termism was not something that dominated the discourse of fund managers within institutions that operate a ''passive'' approach to fund management with the emphasis on active engagement[9], as these investors are not incentivized to ''beat the market'' as such but to own it and to improve its performance through engagement activities.

The convention of ''active'' management may therefore keep the focus of investors on shorter-term goals and more closely linked to the rest of the market as they in effect see themselves as competing for returns against other investors. Indeed, many investors argued that because the rest of the market invests with a short-term horizon, they feel they also have to do so. This fits with a paper by DeLong *et al.* (1990) that noted the main drawback with investing based on a long-term horizon is that the price may take some time to gravitate towards its fair value, hence the long-term investor will be vulnerable to short-term investors' dominating the determination of the market price for a prolonged period of time. To further illustrate this, the following comment was made by a fund manager in regard to the perceived risks with taking a long-term horizon:

> If the whole market became more long term and was trading on a ten year outlook then it would be fine [to be longer term], but they're not so you just have to trade on what they're trading on . . . it's just what you've got to do really . . . if I were to take a ten year forecast it would be hopeless . . .

The interviewee goes as far to say that investing over the long-term would be ''hopeless'' given that the rest of the market is ''trading'' on the basis of a short-term horizon. The discourse used, such as ''trading'' rather than referring to the task at hand as ''investing'' was how many interviewees described their job and further illustrates the disparity between investors' own objectives and that at the institutional level (as described earlier in this paper). From the fund manager's perspective, taking a longer-term view is riskier as they fear that if they got it wrong for a period of time then they would be penalized (through a lower annual bonus payment or even losing their job), as indicated by the following statement made by one investor:

> I think any fund manager will tend to focus more on short term goals because you have to be very brave to take a long-term, say a five year view, because if you get it wrong for the first three years, the chances are that you're going to get fired before the five year period is up!

As another fund manager stated, the institution's objective might be long-term, but in reality investors are pushed towards managing against shorter-term goals since that is the basis upon which their performance is measured and assessed:

> Trustees will tell you that they have a five year time horizon and yet they still focus on the quarterly performance numbers and don't half get stressed if over a quarter you're 3 percent below the index . . . you know, you're meant to be looking at it as a five year mandate, not on a quarter by quarter basis . . . but that doesn't really stop them.

Based on fund managers' descriptions, short-termism therefore appears to not only be a bi-product of ''active'' management, but is also a reflection of the shorter-term performance measurement and review cycle whereby quarterly review and annual bonus payments are conventional practices. Indeed, this is supported by a study by Baker (1998) where evidence was found to suggest that the quarterly relative performance monitoring process encourages short-termism.

4.2 Gravitation towards the defensible

Another challenge associated with LTRI that emerged from analysis of the case study data was the gravitation towards decisions that are considered by fund managers to be easier to defend (both internally to colleagues and externally to clients). Based on discussions held with fund managers, it appears that many believe that decisions based on more ''conventional'' criteria will be easier to defend than those that are unconventional or go against prevailing consensus opinion for any length of time. This apparent pressure to adhere to conventions is something that was mentioned by fund managers across all institutions, including those with a ''passive'' investment and active engagement policy.

The decision to either buy or sell a stock, or to engage with a company requires some action on the part of fund managers that they will need to justify to others. Consequently, the reason for their actions must be robust enough to be able to convince others about why they made a particular investment decision or chose to expend resources through engagement activities. The need to publicly justify the rationale for a decision and the pressure that investors come under is illustrated in the following comment made by one investor:

> . . . you have got to get it absolutely right, otherwise you can get talked out of it quickly – well, not really talked out if it but questions on why on earth are you in this thing will follow. So you've just got to get it absolutely right . . .

Tried and tested conventions that are accepted in the market reportedly make it easier for investors to justify their decision to others, hence minimizing the risk of getting ''talked out of it quickly''. Since responsible investment is still a relatively new development and is unconventional, investment decisions that are more heavily weighted to these issues might be harder to substantiate, as they are less widely ''trusted'' and applied across the market. Indeed, in the words of one fund manager, investors need to believe that they can trust people to support the basis of their investment decisions; the less trust that is in place the more they will be tempted to make decisions that are underpinned by more conventional and ''popular'' criteria that will be easier to defend in the event that it proves to be wrong:

> . . . if the trust is not in place, you are far more likely to get a fund manager making decisions looking over his shoulder. He tends to gravitate towards those decisions which can be most easily defended after the fact in case he gets them wrong. And that's a natural human instinct. And we don't want that.

The reference to ''trust'' made by this investor therefore refers to that which exists between the fund managers and the market (the degree to which fund managers believe they can ''trust'' the criteria upon which the market operates); and the strength of the relationship and degree of trust that exists between fund managers and the institution whose assets they manage. The weaker the level of trust that exists between the reliability of the investment criteria and the fund manager/institution, the higher the risk that investors will gravitate towards easier to defend decisions. As further evidence of this connection, one case study investor explained that loss of trust between ''customers''[10] and fund managers due to poor performance increases the pressure on investors to revise their investment decisions:

> When it goes wrong, customers run out of patience and they [investors] are forced to close the position . . . when customers lost their trust then you are forced to change your stance.

The power of ''customers'' to influence investment decisions is made clear by this statement, as is the fear that investors might be ''forced'' to close their position or change their stance. The risk that ''customers'' might run out of patience and lose trust in an investment process applies universally, but where there is a perception that the investment style is different to convention in some way then they may have even less patience or tolerance towards under-performance. Indeed, as Keynes (1936, p. 158) wrote:

> Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

This is an important point to consider in the context of LTRI because it is unconventional and may therefore be more open to criticism in the event that it ''goes wrong''.

4.3 LTRI not integrated into the core investment process

Another recurring theme that emerged during analysis of the case study data related to the difficulties associated with integrating and valuing the intangibles associated with LTRI. This was a factor that all fund managers within the participating institutions referred to as a challenge when making an investment decision or formulating their engagement strategy. Whilst most investors generally believe there is theoretical merit with taking these issues into account, in reality they explained that it is difficult to incorporate these into the prevailing and well-accepted (market wide) conventions, whereby valuations and investment decisions are largely underpinned by identifying short-term mis-pricings based on well accepted financial criteria[11]. The following statement was made by one fund manager on the subject of corporate responsibility:

> You know, it is all about customer relationships, supplier relationships, you know reputational risk, brand reputation, you know it's in there . . . so you've got to look at it. If you can somehow get it into a financial ratio somewhere it should be done . . .

The interviewee appears to believe that corporate responsibility is an important part of evaluating a corporation's long-term value and such issues should be taken into consideration; however, the discourse also suggests that incorporating these intangibles into financial ratios and therefore investment decisions is by no means a straightforward task, as illustrated by the use of words such as ''somehow'' and ''somewhere''. In the case of investors that favor engagement over divestment or ''active'' management, there still appears to be a lot of reluctance to go beyond corporate governance related issues for the same reasons cited above – because they are not confident, or do not trust, that such issues will add value to the companies in which they are invested and tend to view such issues as being ''separate'' to the core business model.

Reflecting the apparent different approach required for LTRI, the participating institutions have all hired an external or created an internal specialist team of ''responsible investment'' researchers that operate separately (but feed into) the core investment teams. At face value this could be seem to be an effective way in which investors might attempt to overcome the challenges with valuing intangibles and imbed these into their process. However in reality, based on the discussions held within the participating institutions, the teams appear to have different objectives, time horizons and minimal interaction with each other on a day-to-day basis. It could even be argued that the so-called ''two-team'' approach to responsible investing takes some of the pressure off core investors to incorporate these issues into their investment decisions, allowing them to continue investing on the basis of more conventional financial criteria, as indicated by the following comments made by two different investors:

> Tangible financial criteria is the most important thing . . . if we were going to bring in socially responsible factors then I'd only be interested in those if I thought they were going to have an impact on the tangible financials . . .
>
> It depends on what the market really looks at, you've got to know what's going to drive the share price and if it is responsible investment then you're going to have to be up to speed on those issues . . .

The statements that ''tangible financial criteria is the most important thing'' and that ''it depends on what the market really looks at'' re-state the interdependence of market agents and the important role that dominant conventions have on investor behavior. It also tells us that tangible financials are given a higher priority by investors than other less tangible inputs that might also contribute to long-term shareholder value; moreover, that these issues are considered distinct from each other. Follow up discussions on this topic revealed that some investors within the participating institutions are unconvinced about the merit of integrating LTRI into the core investment process and are actually slightly distrustful as to whether responsible investment would produce any benefits in terms of portfolio return, as one investor stated:

> The biggest hurdle that responsible investment has in trying to get accepted into the mainstream is that there is actually no proof that it works.

This distrust and lack of ''proof that it works'' builds on the evidence presented in the previous section that showed fund managers tend to gravitate towards easier to defend decisions based on criteria that are widely used across the market. Other comments made by fund managers suggested that some believe that the focus on responsible investment is a cyclical phenomena and therefore temporary, as the following quote reveals:

> I think it [responsible investment] is cyclical . . . if everyone was making lots of money no one cares . . . investors have a memory but it's not as long as they would like everyone to believe . . .

As the comment above illustrates, there is a degree of skepticism amongst some fund managers as to whether corporate governance and responsibility issues will remain at the forefront amongst market participants and it is therefore not necessary to integrate these into the core investment/valuation framework. The belief that this might be a temporary phenomena might also be related to doubts amongst some fund managers about whether the executive/trustees of an institution truly want these issues to be integrated into investment decisions, or if the stated objectives and policy documents are more for presentational purposes[12]. The lack of integration of LTRI might therefore not only reflect fund managers' beliefs about what factors will drive corporate performance but also to what extent they think that the executive/trustees of an institution is genuinely interested in having its assets invested in a long-term responsible manner.

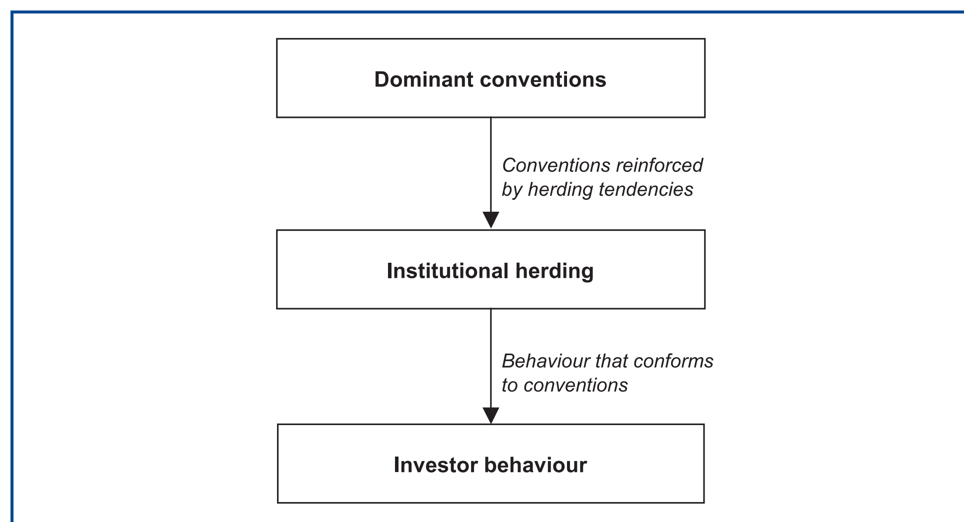
5. Conventions and institutional herding

Drawing from the case study evidence, the behavioral obstacles to LTRI all appear to be linked to the prevalence and adherence to dominant conventions – with institutional herding tendencies acting as the mechanism that reinforces these conventions (see Figure 1 for an illustration of this framework).

5.1 The herding mechanism

The Froot *et al.* (1992) model of investigative herding is relevant to interpreting the case study findings as it shows that when investors have a shorter investment horizon there is a tendency for them to ''herd'' and overuse short-term information (such as technical analysis) and underweight information that may be more relevant to long-term fundamentals (such as strategy, corporate reputation, stakeholder management, governance and environmental issues). The short-termist investor becomes intertwined with the rest of the market and will profit most from investments that are based on information used by other investors, such that it is subsequently incorporated into the market price. Extending the investment horizon and information set used by investors is therefore one of the challenges facing institutions that seek to invest their assets in a long-term responsible manner.

Figure 1 From ''conventions'' to ''behavior'' via the herding mechanism



Also of relevance to interpreting the case study evidence is the research by Scharfstein and Stein (1990) on reputational herding. Application of this model to the case study data suggests that herd behavior and adherence to conventions is a form of risk management given the need for investors to justify and explain their investment decisions on a regular basis (typically this is every quarter in a formal (external) sense, but investors also come under more informal (internal) scrutiny from colleagues on a daily basis). To the extent that engagement with corporations and incorporation of LTRI principles into the investment process is unconventional amongst institutional investors, it is considered to be riskier to integrate and therefore potentially damaging to their reputation and career prospects. The potential implications of both investigative and reputational herding tendencies in terms of mainstreaming LTRI are many; the focus for this (and ongoing) research is to consider how these tendencies might best be mobilized such that investors' perception of risk towards LTRI might be reduced.

5.2 To be or not to be conventional?

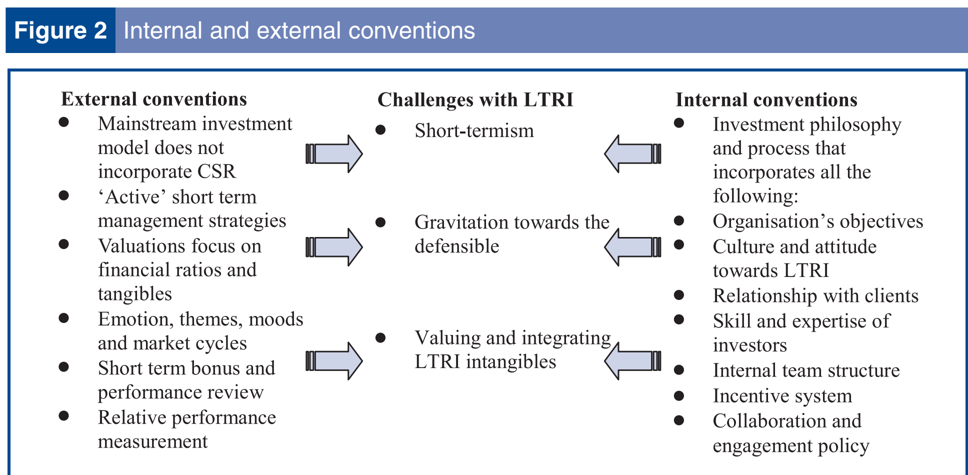
First and foremost we can safely say that it is still not conventional amongst global institutional investors to apply an active responsible investment policy across their asset base (Haigh and Hazelton, 2004). The case study participants and other investors that adopt a LTRI policy are therefore challenging prevailing conventions, outlined below in terms of those that are external and those that are internal to the institution.

External conventions refer to conventions that prevail across the wider market that all investors will be exposed to in some way. Figure 2 lists the external conventions (on the far left hand side) that were most commonly referred to by the case study participants in this study.

Many investors that were interviewed throughout the case study process actually felt that, as one institution, they would be unable to singularly re-define these external conventions and it is therefore easier for them to play by the rules of the market and follow the herd, despite their objectives being different to the mass. However, drawing from the insights of the ''investigative'' and ''reputational'' herding models described earlier, there may be alternative ways and means for individual institutions to offset or reduce the influence such external conventions have on investor behavior, such as through the design and implementation of the internal conventions within an institution. Internal conventions refer to those conditions that are particular to an investment institution (as listed on the far right hand side of Figure 2).

Drawing from Bandura's (1977) writings on social learning theory, if we accept that the interaction of social pressure and behavior of group members are interdependent (in this case how investors interact in the market), further consideration needs to be given as to how group members might be able to change prevailing conventions. That is, to think of this dilemma in terms of the role that investors can and do play in creating and reinforcing certain

Figure 2 Internal and external conventions



conditions and conventions through their collective actions. Going back to Figure 2, the case study evidence found that the internal conventions of most prominence in thwarting investors' ability to invest in a long-term responsible manner include the higher priority given to tangible financials than to LTRI in the investment process; benchmark investing and relative performance measurement; and the quarterly review and annual bonus cycle. Reconsidering the design and implementation of these internal conventions within institutions may be a means of overcoming some of the fears with challenging those market conventions that are detrimental to achieving an institution's goal of being a long-term responsible investor.

5.3 Exporting ''internal conventions'' to the wider market

In addition to re-thinking internal conventions that prevail, institutional investors could influence the dominant external conventions through their relationships with external market agents. For example, when investors ''engage'' with companies on wider issues related to their LTRI principles, they are conveying their expectations to the companies in which they are invested on appropriate corporate conduct. Furthermore, by seeking to be involved in collaborative initiatives with other investors, these institutions may be able to exert more influence over corporate behavior and long-term performance. In this way, the institutions' internal conventions are being transmitted to the companies (via engagement activities) and other investors (through collaboration initiatives) and act as a means of influencing the market conventions that prevail. There are some examples of collaborative initiatives amongst global institutional that seek to advance long-term issues relevant to an individual company or sector[13], although such activities on the whole remain at the margin across the institutional investor community. Increased collaboration between institutional investors could assist in overcoming and indeed mobilizing the investigative and reputational herding tendencies such that LTRI becomes an imperative rather than a risk.

6. Conclusion

This paper presented evidence to suggest that even in those instances where an institution has a LTRI policy, the influence of dominant conventions on investor behavior makes it difficult to achieve this in practice. The aim of this paper was not to criticize the participating institutions' approach to responsible investment but rather was an attempt to explore and illuminate the complexities and to highlight the areas that might require further consideration. In particular, it raises some questions about the important potential role of collaborative initiatives as a mechanism to mobilize investors through the apparent institutional herding tendencies. Further research on how collaboration might assist in overcoming some of the behavioral obstacles to mainstreaming LTRI is currently underway. Other areas worthy of further research include how internal conventions might be redefined to discourage short-termism amongst institutional investors (such as incentive systems and performance review) and the effectiveness of engagement and collaborative initiatives on changing corporate behavior.

Notes

1. LTRI is a broader concept than the widely adopted SRI, since the latter places more emphasis on the promotion of social, environmental and ethical (SEE) criteria and does not necessarily highlight the importance of engagement with corporations and the investment horizon *per se*. Defined in this way, LTRI encompasses corporate governance and corporate responsibility considerations and advocates a holistic rethink of the investment management conventions that prevail across the institutional investor community.
2. Davis (2002) adapted national balance sheet data to examine equity holdings across the G7 nations and estimated that the US and the UK own around 40 percent of domestic equity, approximately 20 percent in Germany, Japan and Canada and 10 percent in France and Italy (as at the end of 2000).
3. For example in the UK the July 2000 amendment to the Pensions Act requires a fund to disclose its policy on SRI in a Statement of Investment Principles; similarly, in October 2001 the SRI disclosure guidelines for insurance companies was issued by the ABI; and the Myners Review in March (Myners Review, 2001) recommended reforms to encourage fund managers in the UK to take a longer-term, more active approach to their investment management.

4. For example, Haigh and Hazelton (2004) report that SRI funds under management (retail and wholesale) accounted for no more than 0.4 percent of total funds under management in Europe between December 1999-2001; 0.2 percent in the US for the period September 2000-2002 and 0.3 percent in Australia over the same period.

5. For example, on the performance implications of SRI see studies by Statman (2000), Teoh *et al.* (1999), Verschoor (1998), Asmundson and Foerster (2001), Waddock and Graves (1997), and Guerard (1997). For studies on the performance implications of shareholder activism see Gompers *et al.* (2003), Davis (2002), Smith (1996), Nesbitt (1994), and Admati *et al.* (1994).

6. The fund manager(s) or investor(s) ultimately carry the responsibility for analysis, engagement and the decision to buy or sell securities that are held within an institution's portfolio. The distinction between the ''institution'' and the ''fund manager'' is important as an institutions' objective to be ''responsible'' should ultimately be reflected in investor behavior in terms of how that institutions' assets are being invested. The terms ''fund manager'' and ''investor'' are used interchangeably throughout but refer to the same group of people.

7. The case study evidence of short-termism is also supported by empirical evidence at the aggregate level (for example, Black and Fraser (2000) found evidence of short-termism across international markets, whilst Nickell and Wadhwani (1987), Miles (1993), and Cuthbertson *et al.* (1997) found some evidence of its existence in the UK).

8. Active management prevails when managers believe that, to varying degrees, the market is not efficient and there are opportunities to outperform an index or a benchmark (i.e. to ''beat the market'') that may prevail over shorter time periods. Active managers are typically paid an annual bonus that is linked to their ability to outperform a specified benchmark (Sharpe *et al.*, 1999, p. 799). When a fund is passively managed against a benchmark or index it means that managers believe the security market is on the whole, efficient, and therefore they do not attempt to outperform or exploit market inefficiencies. Passive management involves ''holding securities for relatively long periods with small and infrequent changes.''

9. ''Active engagement'' is the situation whereby investors can exercise their rights as owners of corporate equity to raise issues of concern with company directors/CEOs on matters that may impact on a company's long-term performance prospects. As Eurosif (2004) explains, engagement can take place at three levels: (1) general dialogue between investors and company directors/CEOs; (2) proactive dialogue when an investor raises a specific issue for the company to address and change; and (3) reactive dialogue when an investor reacts to a problem that has emerged and focuses on how best it can be managed and avoided in the future. This ''dialogue'' can take place through informal (private) means, such as through meetings or writing letters through to more formal (public) means such as filing resolutions at AGMs or divestment.

10. The term ''customers'' used here refers to trustees and/or the fund executive of wholesale institutional funds (pension and insurance funds that are company managed schemes not available to the public) or private individual investors of retail institutional funds (funds that are open to the general public).

11. The financial criteria most commonly referred to by interviewees as conventional in the market place include the net present value of the stock's expected income stream such that cash flow return on investment can be estimated. Close attention is paid to financial ratios such as return on equity, return on capital employed, sales growth, price/earnings ratios and technical/momentum indicators (see Hellman, 2000, for a comprehensive evidence based study of information used by institutional investors).

12. For example, an SRI survey conducted by Deloitte and Touche (2002) on 65 organizations who are responsible for managing some $US1,400 billion of assets on behalf of their clients reported that: ''. . . 48 percent of the fund managers surveyed felt that pension fund trustees had little or no real interest in SRI and had become engaged on the topic purely to protect their own reputations and deflect potential criticism from government or pressure groups . . .''

13. For example, the Pharma Futures group, led by institutional investment professionals, is aimed at bringing together the pharmaceutical industry and its stakeholders to better address the wider issues this sector faces in managing its long-term risks and opportunities in an environment of changing societal expectations. Available at: www.pharmafutures.org

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