Ethics and Sovereign Wealth Fund Investing

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This paper focuses on the ethical investing dilemma face by Sovereign Wealth Funds. While most funds cast their goals within the standard risk-return model, many Funds face ethical investing issues. We focus on the ethical investing issue in the context of maximizing ownership utility. We analyze how ethical issues impinge on the investor utility function, offer a menu of strategies for managing ethical issues, discuss the relationship between ethical investing and the desirability of risk reduction and earning greater returns, and create an example of how a Sovereign Wealth Fund might employ our taxonomy to create an ethical investment strategy.

INTRODUCTION

Sovereign Wealth Funds (SWF) are investment funds owned by the citizens of the country in which they are instituted. SWF are generally funded from excess foreign currency reserves (currency reserves beyond those needed for liquidity and foreign exchange purposes) either earned through natural resource trading or through trade balance surpluses. SWF have recently received attention both due to their size and host country sensitivity to their investment motivations (Summers, 2007, Truman, 2007, Balding. 2008 and Nuno, 2009). This paper focuses on a specific issue faced by many SWF which is the ethical investing dilemma. While most funds cast their goals within the standard two parameter utility function (return and risk), many of these funds face ethical investing issues. For example, the Norwegian Pension Fund Global, one of the most analyzed funds due to its openness, is prohibited from investing in a small portfolio of firms whose main work focuses on either weapons creation, or who conduct business in a manner that is deemed to violate Norwegian standards with respect to the environment or the treatment of the firm's labor force. There are, of course, many possible ethical dilemmas which SWF are likely to face. This paper focuses on the ethical investing issue in the context of maximizing ownership utility. The paper proceeds to discuss why SWF need to construct an ethical investing policy. We then offer a menu of strategies for managing ethical issues. The next section focuses on maximizing ownership utility. We then present an example of how the menu of strategies can be used to deal with an ethical issue. The paper concludes with a summary of the key points.

WHY IS AN ETHICAL INVESTMENT POLICY NEEDED?

A clear policy with regards to ethical investing is required because when an additional variable is added to the maximizing function it impinges on the other variables. The citizen-owners of the Fund *should* have a right to know about policy variables that will impinge on the Fund's performance. Similarly, the Fund portfolio managers need to be held both accountable for ethical investing violations but also be protected by making clear the impact on risk and return caused by adding an additional variable to the maximizing function.

Ethical investing might reduce the portfolio of possible investments thereby reducing the ability to fully diversify the portfolio and, assuming some level of inefficiency in the market place, reducing the menu of possibly undervalued securities. The impact of choosing to trade off risk diversification benefits and possibly accepting lower returns in order to gain ethical value needs to be made clear to interested parties but should not serve as an excuse for poor portfolio performance. Obviously, managing the fine line between the negative impact of reduced investment possibilities and poor management performance is not a simple task.

We assume here that meeting the obligations of statutory law is part of all investment portfolios including those who perceive themselves as having the standard risk/return maximizing function. Therefore, ethical investing refers to a policy choice not a legal obligation. We define ethical investing as a positive variable in the Fund's maximizing function.[2]

FIGURE I
SOVEREIGN WEALTH FUND MAXIMIZING FUNCTION

$$U = U[E(R_P), \sigma_P, ETH_P]$$

Where:

U = the utility or maximizing function of the Fund's owners.

$E(R_P)$ = Expected Return of the Sovereign Wealth Fund's Portfolio.

σ_P = The Risk of the Sovereign Wealth Fund Portfolio as Measured by the Standard Deviation of Returns.

ETH_P = The Ethical Value of the Sovereign Wealth Fund Portfolio Investment.

The partial derivatives are: $\delta U/\delta E(R_P) > 0$, $\delta U/\delta\sigma_P < 0$, and $\delta U/\delta ETH_P > 0$.

ETHICAL CHOICE STRATEGIES

The menu of possible ethical investment issues is probably inexhaustible. We will concentrate here on the strategies for dealing with ethical issues rather than on particular ethical issues. Ethical investing needs to reflect the choices made by the Sovereign Wealth Fund Board. However, the Board is obliged to maximize the welfare of the citizen-owners of the Fund. The portfolio managers do not develop the ethical rules, but they need to have the right and, indeed, have an obligation to make clear the impact on the Fund performance resulting from including ethical issues in the maximizing function. We see many possible responses to the ethical investing issue in order to maximize citizen-owner utility. In all cases, the Board overseeing the Sovereign Wealth Fund needs to agree to the strategy. While an exhaustive discussion of the possible strategies is not possible, we will focus on several general policy alternatives.

Do Not Alter Portfolio Investment Decisions Due to Ethical Values

Probably the strategy favored by most SWF managers would be this strategy. The basic position is two tiered. First, allowing for the full universe of potential investments creates the opportunity to fully diversify the Sovereign Wealth Fund portfolio and the policy also permits the portfolio manager to seek out among all securities those that are most undervalued (assuming some level of market inefficiency).

This strategy takes the position that maximizing return for a given risk level is the job that professional portfolio managers do best. Earning the greatest return for the risk is the most virtuous thing the portfolio manager can do. It is then up to the representatives of the citizen-owners of the Fund or other agencies of the government to allocate some of the return to meet ethical ideals. The basic concept is that other agencies are better equipped to deal with ethical issues than are portfolio managers, and that portfolio maximization is also a virtue that allows the beneficiaries more opportunities, if they choose, "to do the right thing".

Dedicate the Earnings from Specific Investments for Ethical Reinvestment

A second strategy also takes the position that the portfolio manager should invest over the complete universe of securities but dedicates returns on ethically questionable investments to fighting the problem. This strategy takes the view that portfolio maximization is better managed through maintaining the two parameter maximization function but differs from the first strategy by dedicating specific returns to improving the specific ethical problem. For example, rather than prohibiting the Norwegian Pension Fund Global from investing in Wal-Mart, due to their labor practices, the returns on the Wal-Mart investment would be dedicated either to fixing the labor problem at Wal-Mart or to improving the plight of labor in general.[3] Of course, one can speculate that if Wal-Mart's profitability stems mostly from their labor policies, then fighting to alter those practices could have significant return ramifications.

Reduce but Do Not Eliminate Ethically Questionable Investments

Strategy three is probably the most consistent with financial theory. The strategy is to skew investments away from ethically questionable investments but not eliminate them altogether. Some portfolio diversification benefit is lost and possibly some return, but investments are not completely prohibited. In a sense this strategy identifies the extent of the ethical violation and penalizes the firm for their behavior. Of course that penalty may be shared by the Sovereign Wealth Fund's investors through poorer diversification and possibly lower return.

Prohibition of Identified Investments

This is the most likely model to be undertaken because it is the most simple. Unethical activities or unethical management policies are identified and firms who indulge in such activities and management strategies are eliminated from investment consideration. From the ethical management point of view this is the easiest strategy. All the Board needs to do is monitor that no investments are made in the specified companies. However, this strategy is also the one most likely to maximize the negative impact on Risk/Return performance.

MAXIMIZING THE UTILITY OF THE CITIZEN-OWNERS OF THE SOVEREIGN WEALTH FUND

The job of the Sovereign Wealth Fund Board is to make sure that the managers of the Fund understand the maximizing function and carry out their duties appropriately. It should be well understood that the ethical investing strategies noted above will impinge on the risk return possibilities of the fund. Even when the portfolio manager invests wherever he or she pleases, allocating returns to deal with ethical problems reduces the ability to pay out or reinvest earnings as the manager sees fit.

Under an assumption of efficient markets, the portfolio manager will try to select a buy and hold strategy that maximizes the utility of the Fund's owners. In cases where certain investments are prohibited, or reduced in allocation, unsystematic risk taking will evolve. The inability to diversify properly should be noted explicitly in the Sovereign Wealth Fund's annual report and any additional risk due to the lack of diversification possibilities should not be held against the portfolio manager's performance evaluation. This does not mean that the investors are made worse off. In fact, the idea of ethical investing is that the benefits of ethical investing exceed the cost of lost diversification. It is well known that in an efficient market diversification does not impact expected return directly. Therefore, in an efficient market environment, the trade-off in the utility function is the taking on of additional risk to gain ethical investment benefits. The latter should, of course, exceed the former. If the value of ethical investing does not exceed the additional negative utility of taking on more risk, then ethical investing should not be conducted.

If we allow for some inefficiency in the market place, then the trade-off of greater ethical benefits can come from increased risk and/or decreased return. In this case, the argument is that limiting either the investments in which the portfolio manager can make or reducing the extent of investments, could lead to poorer return performance as well as greater risk taking. Depending on the Board's viewpoint on the issue of market efficiency and their agreement with their Fund manager, adjustments for management performance must be made.

It is also important that the issue of trading off ethical investment benefits for more risk and possibly lower return be made public. The citizens of the Fund country own the Fund and they should be informed concerning the Fund strategy with respect to ethical investing.

EXAMPLE: THE QATAR INVESTMENT AUTHORITY AND THE INVESTMENT IN ALCOHOLIC BEVERAGES

The Qatar Investment Authority (QIA) is one of the largest Sovereign Wealth Funds in the World. The QIA has significant investments both at home and abroad. In Qatar, the consumption of alcohol is quite restricted following the religious and ethical beliefs of many of Qatar's citizens. What policy can the QIA take towards alcohol investments? We will analyze the four strategies noted above. Strategy one is to ignore the direct issue of investing in ethical investments. Here the Fund manager is allowed to invest wherever he/she pleases and some of the overall returns to the portfolio may be allocated to deal with the negative issues of alcohol consumption. This is the most liberal strategy from the point of view of the portfolio manager. In an efficient market, it will allow the manager to maximize the utility of the investor through complete diversification. In an inefficient market this strategy allows the portfolio manager to take advantage of the full universe of possibly undervalued securities. In short, the portfolio manager maximizes the return to risk and the Board can decide to allocate some of the maximized profitability to fighting the problems of alcohol consumption. In principle this strategy will give the Fund, in any given period, the most money to work with given the risk profile of the Fund. Of course, monies withdrawn from the fund cannot be reinvested, so that future returns will be lower than they would otherwise be.

The second strategy is to allow the portfolio manager to invest in any security, but to allocate the returns on *unethical* businesses to fighting the problems they cause. In this case any investment returns in alcohol producing companies would be allocated specifically to fighting the problems caused by alcohol consumption. While this strategy has the virtue of encouraging the full diversification of risk, the fact that all or some of the returns will be allocated away from the portfolio manager, encourages the manager to avoid the investment. That is, while such an investment can look good for management performance in the year the investment is undertaken, the inability to reinvest returns from the investment back into the Fund is limiting. We suspect most managers would tend to avoid the investment in alcohol beverage companies altogether; a response that misses the key point of the strategy.

The third strategy is to simply skew the investment down. For example, if the Fund would typically invest one percent of its portfolio in the alcoholic beverage market it would choose to only invest, say, one-half of one percent in the industry. Strategy three penalizes the industry by investing a smaller percentage of the Fund in the industry. This strategy, as noted earlier, might fit best the idea of trading off diversification benefits with ethical benefits. That is, this strategy tends to deal more finely with the trade-off of one good thing (risk reduction) for another good thing (ethical investing).

The fourth strategy is probably the most appealing to the Board. Prohibit the Portfolio manager from investing in firms who produce or sell alcoholic beverages. The cost here is clear cut with respect to lost diversification and, depending on market efficiency, could also most damage portfolio return performance. In any case, this strategy is likely to maximize the cost of ethical investing by doing the most harm to the risk/return nexus.

The job of the Board of the QIA is to maximize citizen welfare. The strategy selected should do that. However, in choosing a strategy, transparency with respect to the policy implications is important. Transparency should include noting the costs and benefits to the portfolio of ethical investing and making adjustments to the portfolio manager's evaluation.

SUMMARY

Sovereign Wealth Funds are owned by the citizens of a country or other government entities (e.g. Alaska Permanent Fund). There is a significant likelihood that the issue of ethical investing will arise. We present a menu of ethical investing strategies and discuss their implication for maximizing Sovereign Wealth Fund performance. We assume that the goal of all SWF is to maximize owner utility. We argue that two ancillary conditions for ethical investing are portfolio manager performance adjustments and transparency. In sum, adjustments to portfolio management performance evaluation and ethical adjustments to investment allocation strategies, even if the latter is only the dedication of returns to ethical issues, need to be evaluated with rigor and with investor utility maximization as the goal.

ENDNOTES

1. Walt Schubert wants to thank the Fulbright Scholars program and the School of Business at Qatar University for their invaluable aid in this project.
2. For a view of the more general issue of Sovereign Wealth Fund Maximization and the issues of transparency see (Schubert and Barenbaum, 2010)
3. The Norwegian Pension Fund Global is currently prohibited from investing in Wal-Mart due to their perceived labor and human rights practices.

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