INVESTMENT ETHICS

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Preface

Investment Ethics

The Need for Ethical Education

When talking about investment ethics, the typical response is, "Isn't that an oxymoron?" This old joke may be . . . well, old, but it also highlights the importance of teaching ethics along with the nuts and bolts of investments and financial analysis. The need for ethical education is as long-standing as the history of scandals that plague the industry. There were the insider trading scandals of the 1980s, the accounting scandals of the late 1990s, and most recently the financial crisis that began in the fall of 2008, fraught with excessive risk taking and an explosion of ever-larger Ponzi schemes. The recent crisis further underscores the importance of ethics to ensure the long-run health of our financial markets. Educators are at the forefront of instilling ethical values in investment professionals.

Unethical behavior occurs for two reasons. First, the raison d'être of the investment business is to make money: returns. There is nothing inherently unethical about the profit motive, but it can blur the lines between when you are *fairly* making money for yourself and your firm and when you are *unfairly* making money by taking advantage of others. Second, finance is a technical and quantitative world not immediately comprehensible to everyone. This creates both opportunities for unethical behavior and a natural suspicion of investment professionals.

Ethical education and standards are critical in protecting students entering into the profession from ethical pitfalls that can ruin their careers. Some have argued that ethics cannot be taught. That may be true. There will always be individuals who have no conscience. Yet, the profit motive coupled with technological complexity can create conditions where even well-intentioned individuals are corrupted.

Practical knowledge about ethical issues in investments can ameliorate the incidence of bad behavior. In turn, ethical professionals maintain the integrity of the business, which generates more interest and trust in financial markets for the average person on Main Street. This book provides students entering the investment industry with an applied and practical understanding of ethics.

Organization and Pedagogical Features

Chapter 1, The Case for Investment Ethics, sets the stage with a brief overview of the investment industry, regulations, and a history of scandals. In this chapter, we establish four fundamental principles of investment ethics, to guide the remaining chapters. We cite these four principles throughout the book as a wider platform to delve deeper into more specific and practical ethical issues.

The rest of the book tackles two roles that finance professionals play in investments. Chapters 2 through 5 address interactions and business dealings with various groups: clients, traders, employers, analysts, and other market participants. These chapters cover the laws, professional codes of conduct, and other guidelines for the behavior of investment professionals. It might seem simple to teach students to be ethical by reminding them to follow the Golden Rule—treat others as you would like to be treated—or the rule that says you shouldn't do anything that you wouldn't want to show up on the front page of the *Wall Street Journal*. But applying these rules in different situations can be confusing for new professionals who are trying to balance integrity and fairness with pressures to make money for both themselves and their firms. Further investments are complicated. These chapters provide practical

FUNDAMENTAL PRINCIPLES OF INVESTMENT ETHICS FOR PROFESSIONALS

Principle 1: ETHICAL UNDERSTANDING

Because investments are complicated, *you have an obligation not to knowingly engage in an investment transaction that either you or others do not sufficiently understand. This includes knowing the underlying source of returns or fees charged.*

Principle 2: ETHICAL USE OF INFORMATION

Because investments are information driven, *you have an obligation to ensure that you and others have access to relevant information and that you or others do not misuse or distort information in the investment transaction.*

Principle 3: RESPONSIBLE INVESTING

Because investments provide financial resources to others, *you have an obligation to ensure that you do not knowingly make or recommend investments that support activities that harm others.*

Principle 4: TRUST AND FAIRNESS

Because you are dealing with others' money either directly or indirectly, *you have an obligation not to abuse the trust that all others have either explicitly or implicitly placed in you to treat them fairly.*

guides that will help students navigate the ethical challenges they will face in their professional careers.

- Chapter 2, Fiduciary Duty of Investment Professionals: The Ethical Treatment of the Client
- Chapter 3, Ethical Reporting of Investment Performance
- Chapter 4, Ethical Use of Information
- Chapter 5, Analyst Integrity

Chapters 6 through 8 address the role that analysts play in making investment decisions and recommendations. The material in these chapters can help supplement the standard fundamental analysis taught in an investments or security analysis class. To be ethical, analysts need to consider the ethical practices of the companies and organizations they recommend: accounting practices, corporate governance, and social responsibility. These factors have recently been captured under the abbreviation ESG (environmental, social, and governance). The ability to analyze companies' practices in these areas can lead to better investment decisions. Analysts who can distinguish between true economic and sustainable earnings and those created by accounting gimmicks are likely to make investments in stocks that sustain strong returns. Similarly, firms with healthy corporate governance practices, such as boards that effectively monitor the top executive team and provide incentive compensation for the CEO and other top executives, are also likely to do well. Firms that are socially responsible are less likely to be the subject of scandal, lawsuits, and regulatory and legal fines and sanctions. In addition, there is a growing market for investors who care about social responsibility; these chapters will help prepare students to meet these clients' needs. But beyond earning good returns and keeping clients happy, these chapters can help students think about their larger role in society in evaluating the business practices of firms and directing capital toward those whose practices are beneficial to society overall.

- Chapter 6, Investing in Companies with Ethical Accounting Practices
- Chapter 7, Investing in Companies with Good Corporate Governance Practices
- Chapter 8, Socially Responsible Investing

Each chapter includes these features:

- Learning Objectives
- Chapter Outline
- Terms
- Review Questions
- Critical Thinking Questions
- Applied Student Project

- Recommended Cases
- References and Suggested Reading

The Learning Objectives give students a set of goals or specific tasks they should be able to accomplish after reading the chapter. With the chapter outline, these objectives help set up the chapter for them. All of the terms highlighted in the text are listed at the end of the chapter. Terms also help students acquire the common "language" of finance useful for their professional development. Review questions are designed to test students' most rudimentary comprehension of the chapter material. Critical thinking questions provide more thought-provoking questions. The applied student projects in almost all chapters incorporate ethics into more traditional investment exercises and security analysis. Additionally, these projects require students use the Internet for research and data collection. Chapter 3 has a project that asks students to construct a portfolio and manipulate various measures of risk and return relative to benchmark performance. Chapter 4 includes an event study. In Chapter 5, students are asked to develop earnings forecasts. Chapters 6, 7, and 8 each feature fundamental security analysis projects using a firm's quality of earnings and indications of earnings manipulation, corporate governance practices, and social responsibility. These projects are designed for students to apply investment theory and analysis; but they also integrate ethical considerations, which will become a very real part of their jobs as they move out of the classroom and into the workforce. All of the examples and projects use data from www.finance.yahoo.com. This website was chosen because it has a large amount of downloadable data; it's easy to use, and free. Related cases from Chapter 9 are also listed at the end of most chapters, and these cases can be used to spark class discussion and more thoughtful analysis of the issues raised in the chapter. In addition, each chapter provides a list of references and suggested reading.

We also include appendixes that review basics in investments and accounting that most students should have covered in other courses. These appendixes ensure that students have access to the most pertinent basics, so that they can understand each chapter on a stand-alone basis.

Chapter 9 comprises 30 "mini" cases. Each case begins with a brief factual overview, followed by four discussion questions. These cases can be used to supplement the material in the chapters or can serve as a spark for short discussions. The cases feature a mix of well-known companies and individuals as well as some that are more obscure. Finally, Chapter 9 can serve as a set of cautionary tales for students who don't adhere to the ethical guidelines provided in the earlier chapters!

This book is designed to supplement material in a standard investments or security analysis course. As an instructor, you could assign chapters in this book along with chapters from a standard investment text. You could then allow a 15-minute discussion about a particular case that is recommended in a chapter. The applied projects can be easily integrated with other hands-on assignments that students complete. Thus the material in this book is designed to be easily integrated into an investments course; it will enhance rather than detract from the standard material covered. This book can also be used to complement professional codes of ethics by providing a broader context for specific material related to codes of conduct, such as those dictated by the CFA®, CFP®, and FINRA organizations. The following table presents suggestions for how you can use chapters from this book with topics covered in a standard investments class.

Investment Topic	Investment Ethics Chapter
Introduction to Financial Instruments and Markets	Chapter 1, Introduction: The Case for Investment Ethics
How Securities Are Traded	Chapter 2, Fiduciary Duty of Investment Professionals: The Ethical Treatment of the Client
	Chapter 4, Ethical Use of Information
Portfolio Theory, Portfolio Performance Evaluation	Chapter 3, Ethical Reporting of Investment Performance
Portfolio Management	Chapter 2, Fiduciary Duty of Investment Professionals: The Ethical Treatment of the Client
Active Portfolio Management	Chapter 2, Fiduciary Duty of Investment Professionals: The Ethical Treatment of the Client
	Chapter 3, Ethical Reporting of Investment Performance
Market Efficiency	Chapter 4, Ethical Use of Information
Mutual Funds	Chapter 3, Ethical Reporting of Investment Performance
	Chapter 4, Ethical Use of Information
Security Analysis	Chapter 5, Analyst Integrity
	Chapter 6, Investing in Companies with Ethical Accounting Practices
	Chapter 7, Investing in Companies with Good Corporate Governance Practices
	Chapter 8, Socially Responsible Investing
Financial Statement Analysis	Chapter 5, Analyst Integrity
	Chapter 6, Investing in Companies with Ethical Accounting Practices

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