MIDDLE MARCH
Will an expanding global middle class open doors for investors and the world economy?
The Challenge of Ethical Leadership

Now more than ever, the investment industry needs strong ethical leaders. So why do firms often engage in practices that betray their own principles (and best interests)?

BY JIM WARE, CFA

If a person lives long enough and makes enough predictions, invariably he gets one right. In 2000, I made a presentation to 13 people in a giant ballroom in Philadelphia at an ethics conference. (In Boston that same week, there was standing room only at a tech conference.) I said to our little group that “the more frequent and reprehensible the conduct is in the industry, the more likely that the government will step in and impose regulations. Wise investment professionals, for the sake of the industry, will support CFA Institute [then AIMR] in its goal of ‘setting a higher standard’ and enforcing it.”

I think I got that one pretty much right. Investment firms all around the world are dealing with more compliance and legal regulations than ever before. At one large firm, the constant complaint from investment staff is “legal runs this place now.”

How things have changed. Only a few years ago, the public relations firm Edelman Group released its annual “Trust Barometer” report under the headline “Business more trusted than government and media.” In two short years, Edelman changed that headline to “Business must partner with government to regain trust.”

As a practical matter, that is why all of us in the investment world should take ethics seriously. To the degree that we ignore ethics, we leave the door open for government to come in and do the job for us, and we all know how that works. When asked to choose between government regulations for the investment business and self-policing, CFA Institute members overwhelmingly choose the latter.

Setting aside for a moment the whole moral issue of being a good person, CFA charterholders understand the business case for ethics. I know because they told me. When I asked a representative sample “Is there a business case to be made for investment firms to behave ethically?” more than 90 percent of those I surveyed said yes. It’s a stretch to be successful as a fiduciary if people don’t trust you.

Their intuition is confirmed by Edelman’s “U.S. Financial Services Trust Barometer” for 2010, which now features a U.S. financial services breakout. Clients surveyed by Edelman identified the top three factors in a firm’s reputation: (1) has transparent and honest business practices—82 percent of survey respondents, (2) a company I can trust—80 percent, and (3) offers high quality products and services—79 percent. So, for the investment industry, honesty is the best policy. Edelman even has data to show that financial service customers will pay a premium for the same products to firms they trust.

But do we investment professionals really get it? The answer is a resounding no! There is a huge disconnect between what investment professionals know is right—and makes good business sense—and what they actually do. Using real-time survey technology, I have studied this disconnect.

In February 2010, I made presentations on ethics to the CFA Society of Melbourne and the CFA Society of Sydney. The audiences were a reasonable proxy for the global investment profession—in other words, my findings are not evidence of an exclusively Australian phenomenon.

As part of those presentations, I posed a series of questions about professional ethics to those in attendance (a total of 52 investment professionals in Melbourne and 56 in Sydney). First, I showed them examples of nine common ethical violations that our firm, Focus Consulting Group, has identified as common industry problems based on conversations with clients. The violations fall into the following categories: (1) selective presentation of performance numbers, (2) spinning personnel changes, (3) hiding salient performance-record features, (4) misrepresenting the PM, (5) high-load funds, (6) use of pitch books, (7) use of sponsored conferences, (8) capacity versus alpha, and (9) claims that performance “will soon return to normal.”

Performance presentation and personnel changes are the two dominant categories. First, with regard to performance, a fund’s worst period of performance is omitted from presentations in favor of the time period over which its performance looks the strongest (usually three, five years, or the last quarter). The manager does this to prevent the client from seeing all the facts. Virtually every manager has a graph or table in which its fund’s performance looks muscular and robust. Second, with regard to personnel changes, employees “no longer with the company” are often portrayed as “non-team players” instead of...
the key contributors they actually were. This is also true when a manager describes personnel changes that have occurred over time, especially when competitors acquire his top performers.

I then asked the participants, “Do you agree that the prior lists [the information I presented to them] contain examples of ethical breaches?” And 100 percent of the attendees in Melbourne and Sydney said yes. When asked, “Do you believe that investment firms routinely commit these breaches?” 93 percent and 81 percent responded in the affirmative.

Finally, “Do you believe that your firm committed any of these breaches in 2009?” In conversation, people will say to me, “I’ll bet they all said, ‘No, it doesn’t happen at our firm!’” That would be a classic case of denial—it is going on all through the industry but not at any of the firms represented in this audience. But the actual response is even more shocking.

The professionals I surveyed were not in denial. Two-thirds of them said, “Yes, those breaches occur at our firm.” Thank goodness for anonymous polling technology—you can get some fascinating answers!

I even went further and asked them which of the nine violations occur most frequently at their firm. Figure 1 shows the results from one of the presentations.

When I shared these results with Marianne Jennings, professor of legal and ethical studies at Arizona State University’s W.P. Carey School of Business, she was astounded by the fact that two-thirds of the participants acknowledged their firms were committing the breaches.

“Somehow we do disconnect from understanding to action,” she wrote to me via e-mail. “There is a whole psychology going on here that somehow gets us comfortable. In the laboratory of ethical dilemma resolution, we are 100 percent ethical. In the workplace, well, it depends. I suspect we are back to working on culture and interaction.”

A similar reaction came from Tamar Frankel, professor of law and ethics at Boston University. “I am flabbergasted at the finding but suspected most of it,” she said.2

What is going on here? These investment professionals acknowledge ethics as good business practice (especially for fiduciaries!) and yet run off the ethical rails in everyday practice. So why not be ethical? In my view, game theory explains a lot of unethical behavior.

The most important of all the game-theory models is quite likely the Prisoner’s Dilemma, according to Scott Stevens, professor of computer information systems and management science at James Madison University.3 In the Prisoner’s Dilemma, if we take the high road and the other party takes the low road (betrays us), we will lose, and they will win. In investments, most of the nine categories of ethical violations named above lend themselves to this analysis. For example, if I play it straight with explaining my weak performance (i.e., “I have no idea when performance

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<td>Hiding salient features</td>
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<td>Performance will “soon return to normal”</td>
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Note: Responses to question posed to an audience of more than 50 investment professionals in February 2010. Participants had the option of selecting up to three categories.

Source: Focus Consulting Group.
will turn”), I will stand to lose the account to someone who reassures the client that “we have changed our model and are confident that a turn is right around the corner.” The groups I surveyed clearly believe that most industry participants are taking the low road. The smart response, according to game theory, is to do likewise. This strategy of “tit for tat” is widely recognized as the best one for winning the Prisoner’s Dilemma.

If you don’t believe that investment leaders reason this way, consider this e-mail I received from a client:

“My new boss actually comes from my biggest competitor— [name of company given] —where he was passed over for the top. Our leader believed that we didn’t know how to play the game the way our competitors appeared to be playing it—down and dirty. (As a good Bostonian, I tend to belong to the “if you build it, they will come” school of marketing—probably not a massive money-spining strategy.) As such, he felt it was time we learned some new tricks. So if our competitors are getting ruthless—so should we, was the logic. Not always good news for a values-based business like ourselves.

Game theory in action! They take the low road, we take the low road.

Behavioral finance also explains some of the ethical violations. Robert Prentice, associate professor at the McCombs School of Business, argues that the very same decision biases that disrupt our rational investing also derail our ethical thinking.

For example, when asked whether they are more ethical than the average person, more than 90 percent of the investment professionals said yes. Their response indicates a classic case of overconfidence bias at work.

Conformity bias is another huge factor in ethical failures. If I worked in a firm where my colleagues were routinely committing ethical violations, I would be naive to think that I will spot the unethical behaviors and call them out. Our need to fit in and be liked seems to be far greater than our need to do the right thing.

What’s to Be Done?

Leadership and culture are at the heart of solving the dilemma. The results of the surveys I conducted indicate that leaders must be vigilant. Your firm is likely to be committing these breaches. Practicing good ethics requires a savvy awareness of the “enemy” and a conscious strategy to confront it. Again, most leaders are overconfident, believing that their firm is fine. For this reason, in an earlier paper I co-authored with Jim Dethmer, we argued that leaders must take a hard look at themselves and their organizations rather than point the finger at Bernie Madoff and others. One of our suggestions was keeping a diary or journal and discussing the entries. Jennings agrees that this exercise in self-awareness is important. She later told me that she has asked her students and ethics course participants to name one thing they did in the past year at work or in their personal lives “that troubled them.” The results have been “amazing” and “astonishing” to her. “They can spew it right out as a problem,” she said, “but they did not stop themselves.” In other words, the famous line from the comic strip Pogo had it right: “We have seen the enemy, and the enemy is us!”

Frankel agrees that the necessary ingredients for changing the culture lie with leadership. The three keys are (1) leadership must want its company to be honest and ethical, (2) leadership must convince other leaders to do the same, (3) honesty and ethics must be enforced. Leaders must realize their importance in providing a solution to the ethical dilemma. Each year, our firm hosts a retreat with our advisory board, which includes investment leaders from around the world. At our last retreat, we all agreed that investment leaders are far too modest about their ability to make a difference in the ethical arena. One of the attendees, Jeff Diermeier, CFA, former president and CEO of CFA Institute, made a forceful point that exemplary investment leaders who are well known to us in the profession (“household names,” if you will) are largely unknown in Washington, DC. We seem

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to suffer from the handicap of being “activist challenged.” In this regard, we applaud Jack Bogle and others who have made it their business to speak powerfully on the subject. And Vanguard certainly has benefited from its squeaky-clean image.

**Calling Out Colleagues**

In a *Harvard Business Review* article called “How to Challenge Unethical Behavior at Work—and Prevail,” author Mary Gentile recommends two steps for leaders and team members who witness unethical behavior. First, in agreement with Jennings and Francel, she writes that “all managers should know how to respond constructively (indeed, learning to do so is a key piece of their professional development), and senior managers must be able to change the cultural norms that gave rise to bad judgment in the first place.”

Second, managers and staff must recognize the classic attitudes that accompany unethical behavior: (1) “It’s a standard practice in the industry, everyone does it.” (2) “It’s not a big deal, it doesn’t hurt anyone.” (3) “It’s not my responsibility; I’m not the one doing something wrong.” (4) “I want to be a good team player, I want to be loyal.”

All of the above must be recognized for what they are—rationalizations. And then they must be confronted. Gentile recommends these approaches:

- **Treat the conflict as a business matter.** The same standards of communication, persuasion, and factual detail apply as in other business discussions.
- **Recognize that this is part of your job.** “People tend to view ethical conflicts as aberrations—distractions from ‘real’ work. That’s just not true.” This point seems particularly apt in a fiduciary business!
- **Challenge the rationalizations.** When colleagues claim that a certain behavior is standard practice, you can simply respond, “If this is standard, why is there a policy against it?” or “If it is expected, are we comfortable being public about it?” (the classic “Newspaper Test” made famous by Warren Buffett after he stepped in to save Salomon Brothers). When someone argues, “It’s not a big deal, no one gets hurt,” you might respond, “Yes, but if everyone everywhere takes that approach, it will matter.” This is precisely what Jennings was referring to when she coined the classic phrase “ethics creep.” All of us keep moving the ethical line over a few inches until we are way into unethical territory!
- **Turn junior status into an asset.** People often feel that they are too new or too junior and thus can’t address an ethical conflict. But that argument can be flipped. You can say, “I may have misunderstood something since I’m new, but I think we may be creating a problem by misrepresenting why our portfolio manager left the firm. Aren’t we in danger of being caught in a lie?”
- **Expose faulty either/or thinking.** Replace it with both/and thinking. A manager may say, “We have to put our best foot forward in these short-list presentations or we’ll be at a disadvantage.” (Translation: We have to fudge the truth.) Instead, managers can acknowledge what other firms are doing—fudging—and say, “we are going to be honest, transparent, and win the business.” Indeed, when I have discussed the material in Gentile’s paper with investment leaders, they often say just that—we will still take the high road and still win!
- **Make long-term risks more concrete.** Research on decision biases shows that long-term costs and benefits feel less tangible than short-term ones. Indeed, this asymmetry is the power behind the Prisoner’s Dilemma: I don’t know if I can trust you to do the right thing longer term, so I’d better betray you now and take a short-term gain. Most investment professionals are savvy about both behavioral finance and game theory, so the tools and language are in place to have the rational conversation about short term versus long term.

Gentile closes her article with a quote that fits for investment people: “Business people tend to be pragmatists. If they don’t believe it’s possible to voice their values effectively, they probably won’t bother trying. For this reason, leaders at all levels of the organization need not only to demonstrate their own commitment to ethical behavior but also to provide opportunities for employees to witness and practice such behavior. They can set the right tone by telling stories.”

Our work with firms on culture involves story telling—not marketing or public relations but real moments of truth when a person made a choice for integrity, especially when it took courage. Sharing these stories with colleagues helps people get the feeling that they can make a stand. If we investment professionals awake from our trances and remind ourselves constantly that the majority of us need to take the ethical high road (and if we punish smartly those who don’t), we can preserve the integrity of the financial markets.

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