

Can Investment Management Ethics Be Taught?

By *Robert Dannhauser, CFA, FRM, CAIA*
 Head, Standards of Practice and Outreach, CFA Institute



Ethics in the investment management business often straddles an uneasy contradiction: We want those whom we choose to entrust our money to be honest, ethical actors who look out for our best interests. Yet we widely acknowledge, and often celebrate, the notion that investing is a competitive, zero-sum endeavor in which self-interest dominates. As investors, we seek out managers who can be single-minded, driven, and even ruthless — on our behalf. But even the most ardent fiduciary concedes that the interests of the asset owner do not perfectly align with those of the asset manager. The best fiduciaries identify those areas where conflicts exist, do what they can to mitigate them, and offer full disclosure of what remains so that their work can be evaluated in the proper context. But failure to appropriately address the inevitable conflicts — either out of ignorance or inattention — can lead to what in hindsight are clear ethical lapses.

THE ROAD TO RUIN IS PAVED WITH GOOD INTENTIONS

No amount of ethics education and awareness will deter someone bent on committing fraud for personal enrichment. At the same time, few people enter the investment profession with the idea that someday they will front-run their clients, trade on inside information, write fraudulent research reports, or engage in other unethical practices. The crooks are, thankfully, a very small minority. Far more common — but no less impactful — are investment professionals who begin with a well established moral compass that is overwhelmed by the occasionally challenging circumstances and thorny conflicts of interest inherent in any agent

relationship. Think of these as basically good people who are led astray — usually by a cascading series of actions that confuse short-term self-interest with the longer term interests of doing right by clients. Even well-intentioned investment professionals can find themselves in circumstances that may tempt them to cut corners in their professional lives. Situational influences sometimes overpower good intentions or even basic character traits.

As Robert Prentice points out in his *Financial Analysts Journal* article¹, “Ethical Decision Making: More Needed than Good Intentions,” people faced with making a decision with ethical implications are subject to a number of biases that influence how they behave. These include: obedience to authority figures who condone unethical behavior for economic gain; a conformity bias that pushes people to conform their judgments to a potentially unethical corporate culture; a self-serving bias which inclines decision makers to gather and process information to advance their self-interest and support their pre-existing views; incrementalism, which slowly lowers the bar of acceptable conduct through small steps that eventually pave the way to behavior that initially would be unacceptable; and groupthink, overconfidence, and over-optimism.

Even if individuals want to make the right choices and follow an ethical course of conduct — and are aware of the obstacles that may trip them up — they can still be influenced to act improperly by a corporate culture that does not reward ethical behavior. An individual’s natural desire to “do the right thing” must be reinforced

by building a culture of integrity in the workplace.

ETHICS VS. COMPLIANCE

We trust that market regulation sets necessary boundaries and consequences for unacceptable conduct, but the track record of enforcement agencies in preventing unethical conduct before it happens is uneven at best. Regulation is notoriously reactive. And given the lack of sufficient resources to enforce even well conceived rules and regulations, relying on a regulatory framework to lead the charge in establishing ethical behavior is ill-advised.

From the investment manager’s perspective, focusing on regulatory requirements without having an underlying commitment to a culture of integrity misses the forest by looking at the trees. Knowing what rules or regulations apply in a particular situation is important but a “check the box” compliance mentality is not sufficient to ensure ethical behavior. Individuals must be able to both recognize areas that are prone to ethical pitfalls and to identify those circumstances and influences that can impair ethical judgment. The goal of any good ethics education program is to identify ethical traps and assist individuals who are seeking to act in good faith to neutralize harmful cognitive biases.

Regulators have tried to help increase the visibility of ethical commitments of managers. For example, investment advisers in the U.S. are required by the Investment Advisers Act of 1940 to have a code of ethics that governs the firm’s activities on behalf of clients. But ethical codes alone are insufficient, and asset owners are challenged to understand what differences there may be between one

manager's code and that of another. For firm managers and asset owners alike, it is tough to determine if the words in a document have any effect on how business is conducted.

Codes of ethics, by their nature, constrain actors. They tend to identify policies and practices that limit the self-interests of the investment managers in an attempt to address the conflicts that arise from being an agent for the asset owner. This creates an ongoing tension between what's best for the manager's client and what's best for the manager. As John Dobson put it in a 2005 *Financial Analysts Journal* article²:

"People really are homo economicus: They are personal wealth-maximizing opportunists who will lie, cheat, or steal whenever their personal calculus indicates that such behavior will maximize their own personal wealth."

But does maximizing personal wealth at the expense of clients lead to long-term success? We as investors do not want to trust our financial well being to investment professionals who don't commit to the highest standards of ethics and professional conduct. While success is certainly an important consideration in any business, achieving success at the expense of integrity, honesty, and trust is not merely improper but also counterproductive from a purely business perspective. Potential clients will question whether an unethical investment professional who is seemingly successful will cheat them to serve the professional's personal interests or the interests of bigger, "more important" clients at their expense.

Dobson argues that codes of ethics set the appropriate context to remind asset managers of what their self-interest really is: honest, empathetic behavior

that sustains relationships. He cites wide-ranging research from primate behavior to neurobiology to lend credence to the idea that ethical behavior is, in fact, natural behavior, and thus, codes of ethics don't constrain investment professionals but "nurture" our best instincts to do right by our clients and sustain our long-term credibility in the marketplace.

ETHICAL "MUSCLE MEMORY"

If Dobson is right and we're already wired to do the right thing with the benefit of the framework provided by a code of ethics, the continued incidence of ethical issues is perplexing. Perhaps a code of ethics is necessary but not sufficient, and perhaps "nurturing" an inclination to do right is no match for the multitude of daily decisions that investment managers make. We need to exercise ethical decision-making skills to develop the "muscle memory" that will make it far more likely for fundamentally ethical people to make good decisions given the reality of agent conflicts. Just as coaching and practice transforms our natural ability to run across a field to the technique and endurance to run a 5K race, teaching and practicing ethical-decision making skills prepare us to confront the hard issues effectively.

A code of ethics risks being a largely ignored, dusty compilation if it isn't truly integrated in the fabric of a firm's business, and training on ethical decision making can only be effective if it is relevant, pragmatic, and tied to the code of ethics adopted by the firm. As Thomas Oberlechner suggested in a monograph examining the psychology of ethics in the investment industry³, focusing on actual rather than highly theoretical issues helps hone training participants' sensitivity to the ethical dimensions of daily decision making. Further, Oberlechner suggests a framework be introduced that allows participants to go beyond merely

discussing the ethical dimensions of a particular situation and learn to apply analytical techniques to new situations that they may encounter. A particularly effective method of learning ethics is through case-based study. The goal is not to learn the proper course of action in a particular situation, but rather to develop a framework for ethical decision making by practicing how to make those decisions in "real-life" situations. And being able to relate the decision framework to a firm's code of ethics allows investment professionals to bring the aspirations and principles of the code of ethics to life, transforming it from a compliance exercise to something that is at the heart of a firm's culture.

A DETERRENT FOR MADOFF?

For those bent on criminal activity, no code of ethics or training will likely deter them. But the goal of effective ethics education is to provide the vast majority of investment professionals who are committed to abiding by fundamental ethical principles a framework for ethical decision making that helps them consistently act in the best interests of clients. Ethics education, in conjunction with adoption of a code of ethics, is critical to investment firms seeking to establish a strong ethical foundation and to provide an environment in which employees routinely engage in ethical conduct. Training their employees to put into practice what that code requires and making the link between ethical conduct and the long-term success of the business will signal to clients and potential clients that the firm has truly embraced ethical conduct as fundamental to the firm's culture.



Robert Dannhauser

¹ Robert A. Prentice, "Ethical Decision Making: More Needed Than Good Intentions," *Financial Analysts Journal*, vol. 63, no. 6 (November/December 2007):17-30

² John Dobson, "Monkey Business: A Neo-Darwinist Approach to Ethics Codes," *Financial Analysts Journal*, vol. 61, no. 3 (May/June 2005):59-64

³ Thomas Oberlechner, "The Psychology of Ethics in the Finance and Investment Industry," *Research Foundation of CFA Institute Monograph*, vol. 37, no. 4 (June 2007):1-92.