

**A conceptual framework for changes in Fund Management  
and in their Accountability for ESG issues**

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### **Abstract**

In the past decade the significance of environmental, social and governance (ESG) factors in investment processes and ownership practices has become very high profile especially with regard to financial markets and investing financial institutions. This paper reveals a new conceptual framework for fund management (FM) based on field based empirical patterns and literature analysis. This is used to analyse how fund managers can adapt and change in a systematic and coherent way relative to ESG issues. Ethical problems and climate change issues will be used as the main examples of ESG issues. This change to FM is designed to enhance FM accountability to clients (pension funds, other savers) and other stakeholders concerning ESG issues.

### **Introduction**

The paper begins with a brief summary of literature. This is followed by a section on the FM field research methods and a summary of the empirical patterns found in the FM cases. In **section 1**, the paper reveals new empirical patterns from field research concerning fund manager (FM) **firm** context, organisation, investment decision processes and behaviour, and their properties and relative strengths. These all purposefully interacted as a collective and integrated FM **organisational** means to help FM **individuals** and **teams** to reduce the complexity of new information flows, to produce new information, to make sense of this information, to avoid (own) negative behaviour, to exploit the behaviour of others, and to take investment decisions. These patterns are outlined as a grounded theory of FM.

**Section 2** discusses these empirical results within relevant theory and literature. The empirical patterns in FMs were interpreted as evolutionary (Nelson and Winter 1982) responses to uncertainty developed in *a common institutional setting* (Scott and Meyer, 1994; Scott, 2001). FM investment decision making process in the FMs was explored as both a goal seeking structured task sequence (Cyert and March, 1963) and as a process of sense making (Weick, 1979). These occurred together as one process which was both mediated and moderated in a common informed context. They revealed different but related insights into the same phenomena of the inductive, iterative, pattern seeking cycle evident in actual FM decision making. Both were means to cope and reduce the uncertainty associated with equity investments (Hellman, p236, 2000) and to find new information and investments of value. Active FMs also developed *creative* dimensions to their decision processes and contexts (Nonaka & Toyama, (2005), Ford and Gioia (2000)). Behaviour was a major factor in the FM cases. Simon's (1957) ideas and developments in '*behavioral finance*' (Shefrin and Statman, (1985), Tversky and Kahneman (1992)) were used to explore opportunistic FM behaviour.

**In section 3**, the new conceptual framework, based on the empirical patterns and literature analysis, is used as the focus of the analysis to explore environmental, social and governance (ESG) issues concerning the future investment decision role of FMs. Ethical and climate change issues are located within FM context, process and properties. This provide a coherent conceptual frame to analyse how FMs can adapt to these issues in a systematic way, and how changes in these FM areas can lead to new adaptive FM behaviour and outcomes consistent with emerging concerns on ethical and climate change issues.

In the absence of a coherent theory of FM and of measures of the invisible world of FM, fund managers can 'manage' these environmental, social and governance (ESG) issues in the public and 'visible' domain only. Thus they can demonstrate their apparent commitment to this wider set of issues through use of visible inputs such as (company and sector level ) research in these (ESG issue) areas, and by visible outputs such as stock selection and asset allocation decisions that reflect the issues. However, 'under the surface', within the FM, between reporting periods, such matters can be ignored in the core investment process and its organisational context.

The conceptual framework for FM (Grounded theory of FM and literature analysis) FM,) especially its strategic and operational context, process elements and knowledge properties, provides a much clearer target for reasoning from ethical, sustainability, and socially responsible finance perspectives. More specifically, the conceptual frame is used in section 3 to analyse in a systematic and coherent way ESG issues, barriers to ESG change in FM, and a systematic strategy for new actions concerning ESG change in FM. Ethical problems and climate change will be used as the main examples of ESG issues.

### **Literature – introductory**

Field research and analysis on the nature of FM has been limited since Clarkson (1963). However, research by Holland and Doran (1998), Hellman (1996, 2000), Arsnwald (2001), Holland ( 1995, 2001, 2003, 2004, 2006), and Holland and Johanson (2003) have generated many new insights into FM behaviour and actions, and provide an important starting point for this research.

Field research by Holland and Doran (1998) in 1993-94, revealed how UK fund managers acquired a private information and influence advantage from their investee companies. The immediate target for information acquisition and influence was a set of intermediate corporate variables and states such as management quality, and the coherence of plans for succession and for corporate strategy. This was also expected to give them the means to develop superior valuation models and to combine these with a continuous flow of new information to identify 'cheap' and 'expensive' shares. They also used this private information to control risk in the wider portfolio. The resulting fund performance was the means for the FMs to satisfy a fiduciary duty to supply their clients with their preferred mix of return, diversification and liquidity

Hellman (2000) used field interviews and documents to investigate the reasons for institutional investors' investment actions on the Swedish stock market. Investor action, based on fundamental opinions about investments in company stocks, was restricted or reinforced by investor contexts and market premises, the role of valuation models and quantitative analysis in comparison with qualitative judgements. Arsnwald (2001) conducted a broadly based questionnaire in which he asked German fund managers for their basic views and practices. The fund managers primarily recognised underlying economic information as a source of superior value. However, destabilising behavioural factors arose from the choice of information sources and investment strategies and styles. Company news, and analysts' earnings revisions were thought to impart as strong a market impulse as the perceived mispricing of stocks relative to the market or sector

Further field research by Holland (2006) in 1997-2000 probed these areas further and developed embryonic versions of a grounded theory of fund management. The resulting case themes included the nature of the private information agenda including intellectual capital; the corporate value creation process; dynamic links between intellectual capital variables; role of

private information on intellectual capital in stock valuation; and the role of private information on intellectual capital in risk control and asset allocation decisions. The themes linked the FM case data in a coherent form and provided a simplified overview of much detailed and complex case data.

## **Research methods**

Field research in 20 large active international fund managers (FMs) in 2004-09 was designed to probe investment decision making behaviour in more detail, to expand on previous work, and to develop a coherent model of FM. The 2004-09 field research involved interviews with managers in large active international fund manager. These FMs operated in Edinburgh, London, Frankfurt, Tokyo and other world financial centres. New fund manager behaviour and action concepts (at open, axial and selective coding levels) arose from the additional 3<sup>rd</sup> stage processing (during 2004-2009) of the new case data. In addition, new literature and theory of significance to the phenomena was also identified. The paper, therefore, constitutes an exercise in ‘theoretical sensitivity’ whereby new work allows the author to return to the original data with a new perspective (Strauss and Corbin, 1998). Additional open, axial and selective codes were generated concerning FM context, process, behaviour, as well as advantage and weaknesses. Sub categories such as properties and strengths of context and process were also developed. These new and refined axial codes were then used to develop theoretical constructs (selective coding) and associated ‘maps of causal elements’ that were constructed into a more developed grounded theory of ‘fund management action’ (Strauss and Corbin, 1998). This expanded, developed and provided new detailed insights into the original FM ‘action and behaviour’ grounded theory models (Holland and Doran (1998), Holland (2006) by showing how they involved more elaborate structures, function, content, elements and processes. It provided more clearer concepts of FM structure, process, of their properties and strengths, their weaknesses, and their dynamic interactions. These resulting codes were then checked to demonstrate that they were connected to original quotations in the source material and, thus, provided traceability or grounding.

## **1. EMPIRICAL PATTERNS IN THE FM GROUNDED THEORY**

The FM case data revealed that the active Fund managers (FMs) (across a range of FM style or peer groups) faced major problems of informational search and estimation when making investment decisions such as stock selection and asset allocation under uncertainty. Active FMs shared fundamental **beliefs** about imperfections in markets and believed that their superior skills were the means to succeed in investment decisions. The FM field research revealed that the active FMs sought structured, adaptive and creative decision responses to their problems of economic and financial uncertainty. These purposeful decision processes were conducted within knowledge intensive, internal and external contexts, in part ‘owned’ as intangible assets by FMs as individuals, teams and firms. The connections identified between FM context and process elements to investment decision making are illustrated in Figure 1.

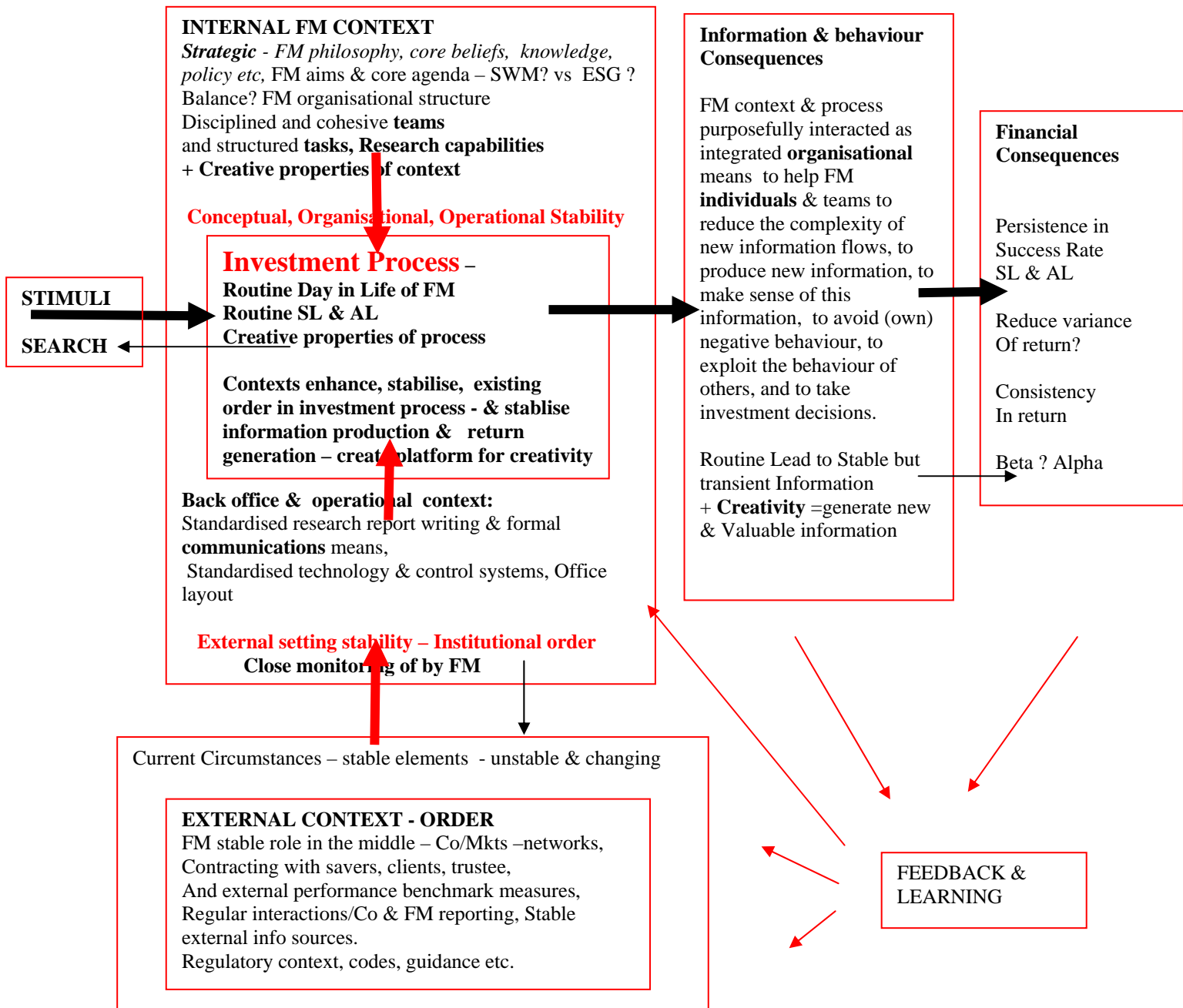
Empirical patterns from field research revealed that FM context and investment processes **elements**; each with their **properties** of shared purpose, order, creativity, knowledge, coherence and matching; and the relative peer group **strengths** of properties – all purposefully **interacted** as collective and integrated FM organisational means (or dynamic system) to help FM individuals and teams to reduce the complexity of new information flows, to make sense of this information, to avoid own negative behaviour, to exploit the behaviour of others, and to take investment decisions and to create portfolios. These connected causal patterns constituted a grounded theory (Strauss and Corbin 1998) of fund management, and were used to structure the theoretical analysis.

**The properties** of context and process included order, creativity, knowledge, coherence and matching; and the relative peer group **strengths** or **weaknesses** of properties. These were central to the quality of FM decisions and to FM performance. Common internal FM order present in the internal FM strategic context was manifest, inter alia, as stable FM philosophy and beliefs. The common internal FM order present in the FMs (across peer groups) was also manifest within the operational context. This consisted inter alia, as FM firm objectives, internal organizational structure, support functions, control and communication systems, and standard risk control technology. Internal order also included 'front office' layout, structured and highly disciplined 'back office' functions. These supported and enhanced decision processes. Coherence factors were key properties of internal context by linking strategic context to operational context. Coherence or integration factors in FM firms included categories such as the degree of co-ordination between key strategic intangibles such FM philosophy and knowledge, culture (as core beliefs, shared values) and shared aims. Matching factors were key properties of internal and external context linking strategic context to external context. They involved the perceived match of key elements (such as FM philosophy, structure and process, as key intangibles), and their properties (such knowledge, order, coherence, and creativity) to FM risks taken (and chosen information niche, investment universe and landscape) and to a wide range of potential circumstances for the present and long term. These coherence and matching properties of context, process and expected investment outcomes focussed FM attention on key aims, means and activities in difficult investing situations and decisions, and gave FMs stable 'shape' when involved in competitive 'games' with other FMs in a volatile market environment.

FM knowledge was a **property** of context and process. Much knowledge, inter alia, of the environment, investment society, markets, corporate value creation, and of investment process, was employed by FMs during their investment decisions. This knowledge was developed in the case FMs during the investment decision making (routine and creative) process and longer term learning (Holland, 2009). Such knowledge existed as cognitive states in individuals, as a property of FM context and process, and as formal FM firm knowledge about such knowledge and how to use it. The knowledge existed formally in the case FM firms' training manuals and information systems and informally in the experience and cognitive skills of FMs and external parties.

These empirical patterns are used to structure the theoretical analysis in the following sections of the paper. These sections reveal more on the details of the empirical patterns as well as using relevant literature to develop a comprehensive explanatory framework for FM

**Figure 1 Empirical patterns in FM context and process elements**



## 2. THEORETICAL DISCUSSION AND ANALYSIS

The investment decision making process in the case FMs is described in two related ways. Firstly as goal seeking, routine investment decision process with a **structured task sequence** (employing fundamental analysis) set in an organisational context (Cyert and March, 1963). Secondly as a process of **sense making** (Weick, 1979) and interpretation. These occurred together as one process as FMs (individuals and teams) exploited and were influenced by a common organisational context and its properties of knowledge, order, matching, and coherence and their relative strengths.

### **Action, behaviour and process as a structured task sequence**

*Stock selection decisions* (daily) involved tasks such as screening of companies followed, for example, by qualitative information production. This could be followed by quantitative analysis involving earnings adjustment and estimation, choice of valuation model(s) (market relative and absolute), and stock valuation. FMs also assessed whether they had an information and understanding advantage (via their mosaic and 'nuggets') over the market concerning their company valuation. They analysed the information in current market expectations, and assessed how the market would react to FM specific information. These judgements were collectively used in stock buy, hold, or sell decisions. Practical concepts of individual stock (selection) risk management (and uncertainty reduction and avoidance) such as screening and regular monitoring were also employed in this sequence.

The set of tasks for decisions about equity portfolio composition (and broader *asset allocation*) were conducted in cycles of say a month or six weeks periods. They began by assessing investors needs for return, risk and liquidity (relative to agreed benchmarks), and this was followed by macro analysis, prior risk screening of companies and sectors, assessment of sector and portfolio exposures and risk, and judgements about how best to gain the required portfolio risk diversification and return benefits. Practical concepts of portfolio risk diversification (across stocks, sectors, portfolio and economic cycles) and hence value enhancement were employed in these tasks. FMs also assessed whether they had an information and understanding advantage over the market concerning their portfolio decisions and valuation and whether the portfolio was expected to perform robustly over a range of circumstances.

Both stock and portfolio decisions were conducted by FMs in a co-ordinated and linked manner to produce the portfolio return, risk, and liquidity relative to benchmark performance desired by their investors. High order and routine were expected to produce persistence in terms of FM performance close to expected **Beta** returns.

Cyert and March's (1963) behavioural theory of the firm focused on the more routine and ordered aspects (dimensions, properties) of firm decision processes and context. This theory is relevant to explaining goal seeking behaviour of the case FMs. The FMs, individuals and teams, during their routine SL and AL, acted in accordance with a fixed set of operating procedures and programs. They made their choices in terms of FM investment goals (concerning risk, return, and liquidity of portfolio of funds invested) and on the basis of expectations of value created by companies and of value recognised by stock markets. They conducted routine investment decisions within FM order manifest as stable internal and external organisational contexts. This 'routine in order' was also reflected, inter alia, in the regular and predictable use of external networks, FM-Company interactions, use of company intellectual capital (IC) information in FM routines, and regular internal FM interactions (Holland, 2006). FM stock selection decision processes had similar structural features to those

found by Bouwman, Frishkoff, and Frishkoff, P (1987, 1995) for financial analysts, and those found by Holland and Doran (1998) and Holland (2006) for FMs.

### **Investment decision making and action - *and sense making***

Processes of **sense making** and interpretation (Weick, 1979, 1995) were present throughout all phases of investment decisions from search, external stimuli, analysis, valuation, and choice, both at stock selection and at asset allocation levels. According to Weick (1995), 'Sense making is the search for contexts within (which) small details fit together and make sense... It is a continuous alteration between particulars and explanations, with each cycle giving added form and substance to the other. It is about building confidence as the particulars begin to cohere and as the explanation allows increasingly accurate deductions. (Weick, 1995, p. 133)

The role of FM **firm aims and core agenda** were essential in **organising** *sense making* and meaning. Shareholder wealth maximising aims dominated the thinking of the case FM in areas such as information search and the FM investment decision making agenda. Little attention was paid to environmental, social responsibility aims, but attention was paid to governance aims and agenda.

The role of FM **firm** properties (such as knowledge, order, coherence, and matching) plus the role of **individual** (psychological and information processing) characteristics were also essential in **organising** *sense making* and meaning (Silverman, (1970) Taylor-Gooby et al (2006)). More specifically the properties and their relative strengths, were central, inter alia, to sense making and interpretation by FM individuals and teams during routine *and* creative investment decision making, to exploiting tendencies, errors and mistakes in other investors, and to the control their own behaviour and impulses leading to ill considered actions. For example, prior FM knowledge of company value creation helped FMs **organise** sense making during their search for *novel* information concerning investee companies. Prior FM knowledge; of how other investors behaved, how markets behaved, and how the FM behaved; helped organise sense making by FMs during the assessment of whether the novel information was of *significant value* in markets. A small number of insights from such processes were expected to give FMs an information and valuation advantage over markets. The resulting meaningful information was the basis for investment **decision action** (Silverman, 1970).

### **Creativity in FM routines and in use of context - a source of Alpha?**

Cyert and March's (1963) behavioural theory of the firm is relevant to explaining routine. FM routine and order could discourage individuals to move to another more creative mode in the investment decision process because such evolutionary developed patterns are often hard to change. According to Nonaka & Toyama, (2005) there is a need to develop a continuous self-renewal and creative process (*kata*) in decision making. By necessity, active FMs also had to have a strong **creative** dimension to their decision processes and contexts.

**Creative characteristics of FM individuals** (such as open mindedness, challenge outlook, imaginative, high curiosity and motivation to find new ideas, sensitivity, adaptiveness, independence, enjoyment of problems, and perseverance (Guilford, 1970)) were expected to be enhanced by a FM support **context and process with strong creative properties**. As Heuer (p75, 1999) noted 'new but appropriate ideas are most likely to arise in an organisational climate that nurtures their development and communication'. Ford C M and Gioia D A (2000) found both context and decision process influenced the creativity of managers' decisions and especially the novelty and value dimensions of creativity. Similar contextual and decision process factors and combinations of these factors were at work in



enhancing FM individual and team creativity. These were manifest as creative dimensions to the properties of FM firm context and process, which had been learnt, chosen and evolved over time.

The creative dimensions to **internal FM firm context** (additional to those for order dimension) involved shared beliefs and conceptual elements such as FM philosophy and knowledge that had a strong creativity ethos and purpose. They included considerable knowledge about these contexts and how to exploit them for creative purpose. They involved the shared belief and intention to tailor prior knowledge to each new situation. They involved flexible internal organisation design which could be adapted to new circumstances. They included FM discretionary controls over investment decision constraints imposed by clients and by short term quarterly performance pressures. They involved encouragement of a high level of discretion and control at FM team and individual level.

The creative dimensions to **external context** involved FMs **adopting a very active** role 'in the middle' between companies and markets, and the active exploitation of external behavioural and knowledge advantages in investee companies and markets. In addition, external creative means such as flexible access to adaptive information sources, and sceptical views of prior FM knowledge about the behaviour of others, added other creative dimensions to FM investment decisions.

**Creative** dimensions to ongoing or operational investment **decision processes** (additional to order and routine etc) involved, inter alia, use of, and knowledge of how to use; flexible routines, active conversations and of 'positive' behaviour, 'brainstorming', intense probing of investee companies, pressurizing problem companies and noting response, probing external research capability, and when the FMs were receiving urgent and often stock value significant feedback from stock markets. Stock selection or asset allocation routines could be adapted from a linear sequence of tasks in stable circumstances to a contingent performance of tasks to match decision urgency and information supply conditions. This flexible use of routines has been described by Feldman (2000) as a key source of change and innovation in organisations.

Important creative processes (Nonaka and Toyama, 2005) arose when FMs received high quality feedback from the stock market and from analysts and others. This timely, often urgent and significant feedback helped them to continuously check the differences between their predicted company valuation outcomes and the stock price reality, and to check differences between their information set and that of the market. Novel insights associated with significant losses for the FM were avoided. This reflected the differential importance of novelty and value dimensions of creativity as noted by Ford and Gioia (2000).

**Creativity** was perceived to arise in investment decisions when the above creative means in context and process were collectively used in the investment process to break up old ideas and form new associations in a way that was more radical, novel and arose with higher frequency than in the world of order and routine. Significant value implications were means to screen merely novel ideas from actionable ideas.

### **Interpreting individual and team behaviour**

The FM cases revealed much insight into a variety of FM *behaviour* in investment decision making. Simon's (1957) ideas of bounded rationality and 'satisficing', are relevant to explaining some aspects of FM investment decision behaviour within the FM firm at stock selection and asset allocation levels (both routine and creative forms). FMs face bounded rationality when screening out companies for further detailed investment analysis and when

screening huge amounts of information supply into usable and comprehensible amounts of information. Simon, also argued that individuals (and teams) with bounded rationality will 'satisfice'. FMs sought 'just enough' information to act on in their immediate investment decision. They chose the first hypothesis that appeared 'good enough' rather than exploring all potential hypotheses. When time pressures and information limits were reduced, a limited number (often just two) of hypotheses and counter hypotheses were generated and assessed against 'just enough' information (see Bolton, 2008). In the longer term, the case FMs learnt 'just enough' in the form of their own theory, heuristics, categories or themes etc to guide the selection of thesis-counter thesis.

The properties of FM context and process (knowledge, order, coherence, matching, creativity) and the **chosen** psychological characteristics of individuals and teams, all matched to FM investment aims and risk universe, were collective means to overcome bounded rationality limitations in information processing and sense making capabilities of individuals and teams. In behavioural finance terms they were means to overcome hindsight bias and overconfidence at the level of individuals. They were also the means to enhance FM sense making and information processing capabilities and reduce bounded rationality.

The above suggests that aspects of FM investment decision behaviour can be explained, in part, by '**behavioural finance**' theory (Shefrin and Statman, 1985; Tversky and Kahneman, 1992). This body of thought can be used to explain how FMs thought about the behaviour of other investors and how this FM analysis then drove new kinds of FMs actions. As noted above, the case FMs had their own theories of behaviour in markets and used these to explain aggregate market behaviour and price behaviour. Such theories were based on ideas similar to behavioural finance. They were used by FMs as a tools to think about and debate how some groups of investors were behaving differently to each other, but in ways common within their own market 'behaviour' segment.

Typically, this could include say, five behavioural segments such as sophisticated 'lead' FM, follower FM, quasi indexer FMs, formal indexers, and naïve investors. Formal indexers had to behave in predetermined way when a large company entered or left their stock market index. Naïve, small investors could share the same broad assumptions and views of markets (the market is going up and we will all get rich) and behave in ways common within their 'behaviour' group. Quasi indexer FMs, could all assume that the optimum behaviour for them would construct portfolios 'close to' a stock market index. Tuckett (2009) refers to this as 'groupthink' or a feature of a *basic assumption group*. Hence naïve investors and quasi indexers could both exhibit groupthink but differ in their specific groupthink and subsequent behaviour.

Sophisticated, large active FMs (the main case FMs) took the view that they had the research resources, knowledge, and trading capabilities to understand these other groups and could exploit their behaviour. 'Follower' active FMs, with less resources, knew that the larger sophisticated FMs had a competitive edge on them, and so devoted much effort to monitoring their actions and copying them.

The FM own theory of, market use of information, of pricing, and of behaviour were the means to place the company value creation mosaic within a market context (market mosaic) to isolate the few fragments of information unknown by the market. The FM hope was these would **also** be significant value relevant pieces information or '**nuggets**' when eventually known by markets.

The case FMs also used their own ideas of behavioural errors by other investors, and their own organisation behaviour to gain special behavioural advantages. They sought to control their own behaviour and impulses leading to ill considered actions. Thus strengths were sought in the properties of context and process, say in areas such as internal risk control systems and in staff recruitment and training. These were used exercise some control over FM own behavioural weaknesses such as mismatched attitudes to risk, high levels of overconfidence, hubris, and bias etc. relative to the chosen information niche, investment universe and risk universe. They were also used to exploit similar perceived behavioural weaknesses in other investors.

### **3. USING THE CONCEPTUAL FRAMEWORK TO EXPLORE ISSUES FROM ETHICAL, ENVIRONMENTAL, SOCIAL & GOVERNANCE (ESG) PERSPECTIVES**

It is difficult to conceive of how to secure change in FM firms relative to ESG issues by using conventional finance theory or the prevailing literature on ESG or on SRI investing. However, the conceptual framework for FM, especially its strategic and operational context, process elements and knowledge properties, provides a much clearer target for reasoning from ethical, environmental, social and governance (ESG) perspectives. The conceptual frame for FM developed in this paper, will be used in a systematic and coherent way in this section to analyse ESG issues and barriers to ESG change in FM. Ethical problems and climate change issues will be used as the main examples of ESG issues. The conceptual frame is also used to propose **new actions** concerning ESG change in FM and develops an explicit and systematic strategy to change FM relative to ESG issues. This change strategy involves enhanced monitoring of the external context, change in the internal strategic context, changes in properties of context and process, followed by changes in the operational context, decision processes, and in the monitoring of portfolio decision outputs. The conceptual frame is also used to analyse how such systematic ESG based changes in FM can combine and permeate all aspects in the dynamic production of information and FM decision making over time. This systematic use of the FM conceptual frame in this way forms a new strategic analytical tool for FMs, for client and savers, for regulators, and governments concerned about ESG issues.

Illustrative examples are taken from the case FMs and from the wider literature emerging on how FMs should change their practices. The latter included 'Fair Pensions' (October, 2009), CERES (January, 2010 with these proposing many climate change examples for UK and US FMs. Sources such Sparkes and Cowton (2004) discussing broader changes in socially responsible investment. These sources provide evidence that some of the proposed changes are already occurring but that significant barriers exist. These current changes are fragmented and focus on the details of FM decision making. The conceptual frame provides a 'clear road map for change' and proposes integrated strategic change in FM consistent with ESG aims and agendas.

#### **ESG issues in FM - using ethical problems as examples.**

Many ESG issues were identified in the FM cases in the 2004-09 field research. They were also identified from the wider current debate and literature on FM and ESG issues. Ethical issues in FM, and climate change issues in FM investment will be used as the main examples of ESG issues. Both are becoming increasingly important and significant for FMs and their clients, and they are having to develop explicit strategies to deal with these new pressures and associated risks.(eg see Foreign and Colonial, Railpen etc)

In Tables 1 and 2 the conceptual frame for FM has been used to classify ethical issues in a systematic way. These tables show that many ethical issues are involved and exist within the FM firm, They are well distributed throughout FMs at all levels of context and process. This shows the pervasiveness and significance of ethical issues in FM.

**Table 1 FMs and Ethics - examples of key issue areas *In FM process***

**Strategic areas**

- ♦ Creative accounting for FM performance
- ♦ FM employees take bulk of investment benefits but not risks

**Operational areas**

- ♦ Fraud in back office accounting, auditing etc

**Investment decision process**

- ♦ Manipulate / bias information in stock selection
- ♦ Team members 'obey orders' of team superiors despite own doubts – and misbehave

**Market trading areas**

- ♦ Churning, Fraud
- ♦ Insider Dealing
- ♦ Trading client funds for own FM benefit – firm or individual

**Interactions with clients and investors**

- ♦ Taking risks beyond that agreed with clients
- ♦ Exaggerated Promises
- ♦ Misleading investor Prospectus

**Table 2 FMs and Ethics - examples of key issue areas *In FM context***

**Strategic areas**

- ♦ No explicit ethical policy for FM
- ♦ Top Management FM pursue 'greed is good' = weak ethical 'tone at top'

**Operational areas**

- ♦ Weak auditing and risk control systems

**Investment decision process**

- ♦ FM code of conduct not part of process

**Market trading areas**

- ♦ Codes for PSL, insider dealing not disseminated, understood etc

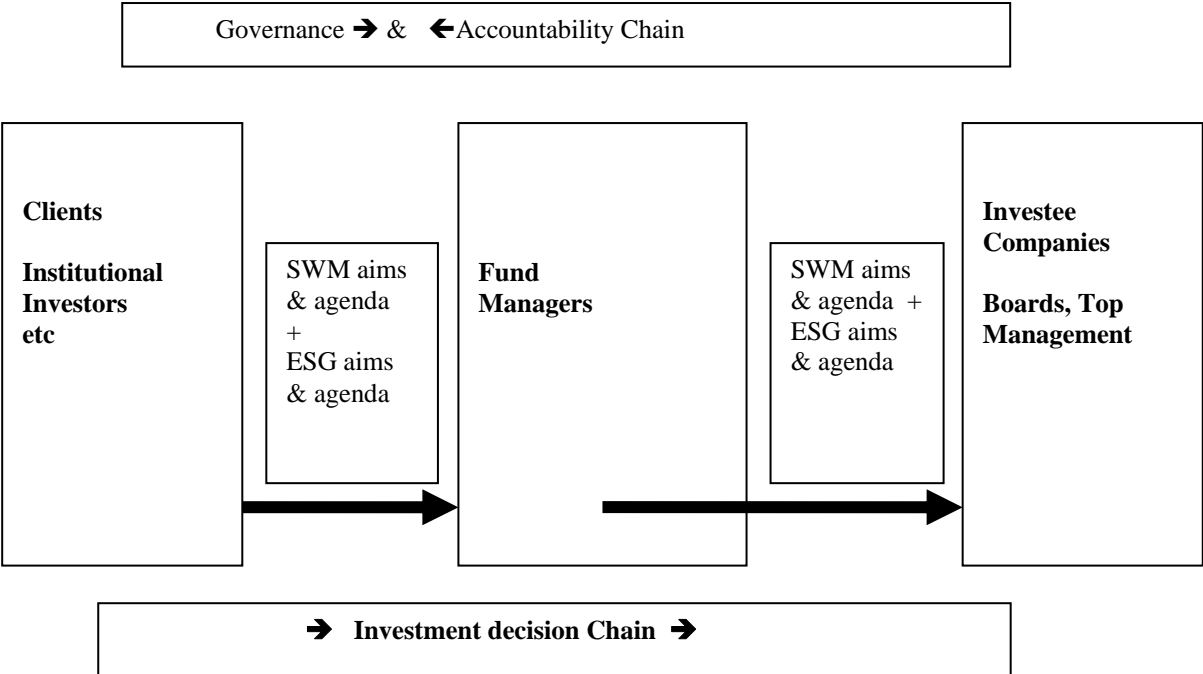
**Interactions with clients and investors**

- ♦ Main context = FM as fee maximising business
- ♦ This creates conflicts of interest (COI) with provision of investing services

**ESG issues in FM - using climate change issues as examples**

FMs are not directly effected by climate change issues at present, and these issues do not normally arise directly **within** the FM firm. This is a sharp contrast to ethical issues which do occur directly within the FM firm (endogenous) and as well as within its environment (exogenous).

However, climate change pressures exist in the immediate FM environment, in particular on both company and client sides of the ‘chain of investment decisions and accountability’. Figure 2 illustrates the ‘chain of investing and accountability’ which links clients, FMs and investee companies. Climate change signals and pressures are growing along the chain with the FM facing a ‘squeeze’ in the middle (CERES 2010, Fair Pensions 2009). These climate change signals and pressures are starting to have indirect impacts on FMs at all levels of structure, process and properties of ethics issues



The following **table 3** also shows that climate change issues on the investee company and client chain and impact on FM. Many issues are involved and their impacts are well distributed throughout FM. This shows the pervasiveness and significance of climate change issues for FM.

Thus whether climate change has a material impact on value or not, FMs still have to satisfy clients, deal with problematic investees companies, responds to the lobby, and to deal with their own conscience on these matters. Climate change issues arising in the investment and accountability chain with clients and investments creates **many risks**, perceived and actual, for the FM **firm** and for its **portfolio** of investments. Table 4 summarises many of these risks.

**Table 3**

**Investee companies directly affected by climate change**

- ♦ Investee companies increasingly face climate related pressures on
- ♦ Resources, carbon energy sources, carbon intensity of production etc
- ♦ As well as more volatile and extreme weather (Floods, freezes, droughts etc)
- ♦ As well as increasing (inter) government pressures – on carbon emission reductions and caps, and carbon emission disclosure

**Clients directly affected by climate change**

- ♦ Key Clients (pension funds, insurance companies) and consultants
- ♦ face pressures from lobbyists, from Governments, UN and & inter governmental bodies to influence FMs
- ♦ These key clients eg Pensions funds put pressure on FMs to respond
- ♦ Via surveys, direct calls for actions
- ♦ This creates further risk of losing fees business
- ♦ Majority clients (56%) still do not do this
- ♦ But of great interest to influential small % -(Fair Pensions Report, October 2009)

**Table 4**

**Climate change Risks**

**FM firm risks from climate change issues**

- ♦ FMs more concerned about investee company litigation risk or regulatory risk linked to climate change – which is then extended to clients and FMs as trustees and owners
- ♦ FMs less concerned about climate change per se when deciding whether to invest in a company. (Ceres survey Jan 2010)
- ♦ FMs concerned about own reputation risk with clients and savers etc arising from CC risks
- ♦ FMs may face regulation to disclose their plans to explain their views of climate change risks, of opportunities & their role in carbon reduction of investee companies.

**FM portfolio risks from climate change issues**

- ♦ These pressures can have more indirect impact on FM exposures to risk in key sectors, and on overall portfolio
- ♦ Increase perceived systemic risk –reduce opportunities for FM diversification
- ♦ Key Question is what is the value significance of above?
- ♦ Many FMs may perceive that only few of above have material impact on the value of company investments (Ceres survey of FM Jan2010)
- ♦ and difficult to identify key sectors at risk (Fair Pensions Report, October 2009)
- ♦ Thus FMs ignore, or down play in investment decisions?

## **Barriers to incorporating change concerning ESG issues in FM**

Adapting Holland and Johansson (2003) we can identify least three barriers to ESG related change in FMs. Firstly, capital market actors such as FMs might lack the necessary understanding of the potential of ESG issues in a specific firm which give rise to a knowledge problem. Secondly, even if capital market actors do understand the connection between ESG issues and the vision of the firm they don't know if they could rely on available ESG indicators – the uncertainty problem. Thirdly, a management problem arises if actors on the capital market do not know if the management would take necessary action on data. Furthermore, Holland and Johanson (2003) state that both FM and company management cultures are locked in to their own mentality and changing mentality is not an easy task. By definition it takes time and requires strong incentives.

Many diverse barriers have also been identified by practitioners to incorporating change concerning environmental, social and governance (ESG) aims and issues into FM investment decisions (for example, see 'Fair Pensions' (October, 2009), CERES (January, 2010), Sparkes and Cowton (2004), Goldstein and Plantan F, (2008), Vivo and Franch (2009). These have strong similarities to the Holland and Johansson (2003) barriers.

The conceptual frame for FM developed in this paper can also be used to **classify** such barriers in FM context, process and properties.

At the level of FM **philosophy and core beliefs**, barriers can arise where FMs do not believe in the ESG issues (such as ethical problems and/or climate change), or where they believe they have no material effect on investments (see 'Fair Pensions' (October, 2009). This is despite many examples of the negative impact of unethical behaviour (insider dealing, fraud etc) on firm reputation (including FMs) and of climate change issues (carbon tax, controls over emissions etc) on the value of investments. The top management of FMs may also believe that external codes concerning ESG have to be recognised but their introduction will not make a material change to FM organisation and processes.

Alternatively they may take the view that areas such as ethics or awareness of climate change issues are really the responsibility of individuals and the FM (ethical) context they operate in does not have any effect on their ESG related behaviour. These beliefs may lead FMs to drive strategic change concerning ESG solely by the recruitment of new staff with the required ethical and/or climate change skills and understanding. Many authors (eg Peterson and Ferrell, 2004) have pointed out the fallacy of not recognising the impact of established organisational context and process on individual and team behaviour, ethical or otherwise. Weick's views (1995), have highlighted how significant established context and process are in FM sense making.

Other barriers arise from FM perceptions about their external context. FMs may argue there is little or no pressure from their clients or savers on these matters (see 'Fair Pensions' (October, 2009), CERES (January, 2010). 'Star' FM performers and their performance can be rated highly and the occasional ethical problem of successful FMs easily forgiven by shareholders. Both the UK (Fair pensions) and US (CERES) surveys of FMs found that the short term pressures on FMs to perform meant they took little notice of the longer term negative effects of climate change issues or of weak moral reasoning. However, these negative effects included threats to reputation and loss of competitive edge when interacting with key clients and savers. They include major risks arising in portfolios where appropriate returns are not being generated for the risks borne.

This paper also argues that another critical barrier lies in FMs and ESG stakeholders facing a complex world of FM organisation and decision process, with little guidance from existing theory on how to think about change. The prevailing paradigm in finance theory places strong emphasis on SWM, MPT, EMH, CAPM etc as the primary conceptual frame to explain and to direct FM decisions. This frame of reference ignores the dynamics of organisations such as FMs. This paradigm is inappropriate for a changing world where the 2007-09 financial crisis has revealed major ethical issues in FMs, banks and other financial institutions. The increasing significance of climate change issues over the past decade has also combined with the financial crisis of 2007-09, to raise major questions about whether these financial institutions can deliver their core finance functions and also serve the wider public good concerning ESG issues.

In contrast, the conceptual frame for FM can be used to explore, in a **systematic way**, how FM context, process, and their properties can be adapted to reflect ESG issues. This in turn can help FMs overcome many of the above barriers to change.

Historic change in FM firms during 1990-2007 suggests that such ESG related change is possible. Major changes have arisen in FM roles in corporate governance, in the use of corporate price sensitive information (PSI), during major changes in company business models (the knowledge revolution) etc. These have stimulated organisational change in FMs and changed FM behaviour. FM have set up new rules, procedures, processes and bureaucracy to deal with these dramatic changes (see Holland, 1994, 1998, 2001, 2005 etc).

### **Changes in FM context, process, and properties to reflect ESG issues**

This section uses the conceptual model to develop a strategy to adapt context, process, and properties to ESG issues beginning with external and internal strategic context, followed by changes to properties, operational context and then decision process. This sequence ensures that ESG issues will permeate all aspects of FM and their dynamic interactions. These changes should all reflect the FM trade-off or balance sought between SWM and ESG aims and agenda.

FM top management could begin with their **external context**. They could begin to actively monitor developments in a changing public consensus on ESG issues. They could explore how their institutional setting is changing. For example they could probe how are City values and Wall St values are changing to reflect ESG issues and public sentiment. They could explore how regulation on ethical and climate change issues was being reflected in new external codes for FMs.

FM top management could then consider changes to their own **internal strategic context**. The FM top management could use existing and emerging codes of conduct for ethical behaviour and climate change as the formal means to analyse how to alter FMs aims and philosophy in way consistent with ESG issues. Thus the FMs could begin to adapt and develop own FM culture, values, norms and beliefs via leadership from the top.

In the 2004-09 case FMs, the role of FM **firm aims and core agenda** for action were essential in **organising sense making** and meaning. Shareholder wealth maximising aims dominated the thinking of the case FM in areas such as information search and the FM investment decision making agenda. This was moderated by other economic aims where the FM pursued maximisation of fee income and an active agenda of marketing and promotion to increase the size of funds under management. A trade-off between these economic aims and



their action agendas was common practice. Little attention was paid to environmental, social responsibility aims, with more formal attention being paid to governance aims.

If FMs wish to adapt to ESG issues at **at this strategic level**, they will have to clarify their unique view on their trade-off or balance sought between SWM and ESG aims. They will also have to clarify their own views on the differing and conflicting ideas of 'value' arising from SWM and ESG aims. They will have to make explicit the extent to which they intend to implement an ethical or climate change policy. Do they intend to exceed, meet, or exploit externally set codes? If they can communicate this within the FM firm, then **sense making during investment decisions can be influenced both by SWM aims and agenda and by ESG aims and agenda**.

The conceptual frame also suggests that FM elements such as **properties** such as coherence, matching or knowledge have to be adapted so that more **attention** is paid to ESG issues. Changes in properties of context and process to reflect ESG issues can create a more ESG sensitive context and process and can make sense making (Weick (1979, 1995)) in investment decisions more sensitive to these issues. High 'scores' for the strengths of these properties and hence high attention on ESG issues can provide a strong indication of future investment decisions being consistent with these issues. Such improved sensitivity to ESG issues can also help remove some of the bounded rationality constraints (Simon,1957) imposed on FM. Thus climate issues such as the impact of carbon taxes or ethical issues such the misuse of price sensitive information can become more explicit in investment decisions and in the FM formation of company value creation mosaics. Raising the profile of ESG issues can also stimulate creativity by forcing FMs to consider novel ways of creating legitimate value.

The **coherence** questions here are, how are the ESG (ethical, climate change) issues connected together through FM context and process in a coherent way? How are SWM and ESG aims and agenda balanced in a formal way during the investment process? The **matching** question is, how does the adapted internal FM context and process (with new ESG dimensions) match the external demands of ESG oriented stakeholders as well as to the conventional investment universe and investing aims of the FM. Posing these questions is the first step to creating positive ESG change here.

In terms of **knowledge**, FMs can, over time, adapt their own theory of markets and behaviour to incorporate new views of how the market (for information, for stock pricing) includes, or does not include, such ethical, sustainability, and socially responsible issues in understanding companies (and sectors and whole economies) and in their valuation.

They could also develop FM wide knowledge and skills of, ethical behaviour in investee companies, in the FM, in markets climate change issues, carbon tax and value, litigation risk They could identify key companies and sectors with big ESG change effects (finance? Banks?). They could develop FM process/context knowledge (as SC & RC ) by periodic reviews. The FM could exploit codes and other external source to create in-house knowledge on ESG issues and use these to boost the education and training of staff on these matters.

A critical area of FM knowledge and skills to develop concerns how to change the FM process, organisation, context, to reduce ESG (ethical, climate change) problems and associated risk in investments. This will involve much of the human and structural intellectual capital identified above. The FM must also address how this knowledge can be integrated with prior FM knowledge based on SWM aims.

In this new ESG sensitive context, individuals have to learn how develop and defend own ethical stance, and exploit ESG (ethical and climate change ) knowledge of their team, of their FM firm, to accelerate their own development. This will requires active discussions of ESG issues in formal and informal meetings in all teams and throughout the FM hierarchy.

If the above **strategic change** can be established, then FM top and middle management could consider changes to their own **internal operational context**.

These operational changes could be manifest as further changes in FMs research focus, use of ESG research in decision process, and decision criteria, etc to reflect key social, environmental and ethical issues. Thus the FM firm and teams and individuals could make much higher use of their own or external research on sustainability, or social responsibility in company and sector wide business models. Changes could be made in FM incentives schemes to reflect FM balance sought between SWM and ESG aims. This will involve changes in FM incentives at firm, team and individual levels to reflect ESG (ethical and climate change) issues and risks. Controls could be established on known areas of unethical behaviour as illustrated in table 1.

The next step in the strategy for change, would be FM management and front line FMs to consider changes to their internal **investment decision processes** such as stock selection (SL) and asset allocation (AL). FMs managers and front line FM staff could begin by adapting decision criteria and other aspects of investment decisions to reflect the FM trade-off or balance sought between SWM and ESG aims. For example, they could take ESG issues directly into account in their decisions but this change in practice could also be constrained if the actions and outcomes led to increasing risk, lower return and value. They could build ESG rules and codes into key investment steps such as screening, analysis, and valuation in stock selection.

In addition, use could be made of new decision criteria that stop FM investment in those firms that 'score' very badly on ESG issues. Examples in stock selection include,

- Companies that make promises they never deliver
- Tobacco companies, nuclear power, or 'defence' industries.

More positive examples in asset allocation include,

- The fund must invest at least 20% of its capital in companies that are providing new solutions to climate change (new wind farms, energy conservation, energy efficiency etc).
- At least 30% in assets have to be in the top 25% of 'carbon light' companies in their sector, and the rest (50% or less) in companies that have shown 'significant' improvement in their carbon footprint over the past two years.

Finally, FM top management have to consider how such ESG changes impact on **decision outputs at portfolio levels**. This would involve changes in portfolio monitoring and risk management to answer the following questions

- Where are key ethical behaviour risks (in FM, in companies, in markets) and where are key exposures and risks? In the portfolio?
- Do they provide appropriate return for this level of risk and exposure?
- Are these risks offset or diversified in other parts of the portfolio?
- How do the new risk and returns contribute to overall performance?

The conceptual frame indicates that the proposed changes above to key areas of structure, process, and properties of FM, will also have a major impact on the **collective dynamics of**

**FM.** The intention of the above changes is to ensure that FMs (individuals, teams, management) become more sensitive to and more aware of ESG issues and risks in the FM external context, internal context and process. This is likely to increase the FM understanding, at all levels, of the significance of the ESG. FMs with strong ESG (ethical and climate change) purpose / aims, with higher ESG (ethical and or climate change) properties to context, and to properties such as knowledge (of issues, of behaviour), coherence and matching, can interact with investment decision process in more forceful way. This can heighten the ESG (ethical or climate change) dimension to the dynamics in FM structure and process, and ensures that ESG issues permeate the **whole FM system and all of its interactions.**

### **Other changes possible**

FMs can also use the conceptual frame to target positive changes in governance and accountability processes along the investment and accountability chain in Figure 2.

Disclosure is a key area for improving governance and accountability processes. Increased FM transparency of ESG (ethical and climate change) related changes and of major issues during investment decisions, is likely to reduce the likelihood that ESG problems will occur. This can reduce the chances of FM misbehaviour, and of FMs experiencing major ESG related risks and the subsequent negative reputation impact. As a result FMs have to improve their communications to **own clients of FM** policy of how the FM perceives and exploit (avoid) ESG (ethical and climate change) issues and associated risks in investing

FMs can use the conceptual frame to structure new formal reports to disclose the change they have made. These changes could be internally audited and verified by rating agencies or consultants and disclosed in their public ratings and advice. Trustees and regulators will have actively demand such information before these agencies and FMs deliver through much improved disclosure practices.

FM rating agencies could use the conceptual framework to conduct their analysis of FM from the conventional shareholder wealth perspective. They could also do this from ethical, sustainability, and socially responsible finance perspectives. Qualitative ratings based on the the elements identified in the conceptual frame for FM could reflect specific issues (say ethics) or all of these ESG issues, and well as the conventional ratings for SWM directed process and structure.

FMs could also use the ideas in the conceptual frame to improve their own governance of companies concerning ESG issues. They can make use of close relations with their **investee companies** to probe and understand ESG issues arising their business models. This extends the approach discussed in Holland (2001, 2002). FMs can now explore how investee companies respond to ESG issues at Board and top management levels via strategy and asset changes, and how they disclose these changes. They can also engage with companies to actively promote positive ESG (say ethical) behaviour, and they can alter their AGM voting to reflect above issues. These range of actions, if co-ordinated within a coherent strategy (based on the conceptual frame for FM) can be more effective than sporadic, uncoordinated change and action.

### **Summary and Conclusions**

This paper has described a coherent model of FM and discussed this within relevant theory. This confirms and extends prior research by Holland and Doran (1998), Hellman (2001 ),

Arsnwald (2001), Holland (2001, 2002, 2003, 2006), and Holland and Johanson (2003). These empirical findings and integrated theoretical concepts provide a novel conceptual frame for thinking about the behaviour of FMs. This can help FMs (and others such as regulators, FM rating agencies, and academic researchers) to think about how to create robust forms of FM organisation, decision processes, and behaviour and thus how to improve FM performance..

The conceptual frame developed in this paper is one means to think about how to deliver an effective equity savings function. This can be interpreted as one dimension to 'socially responsible' investment where less resources are wasted by a smaller number of lower cost FMs delivering the expected return for their level of risk. However the paper argues that more radical change in FM relative to environmental, social and governance (ESG) issues is possible. The conceptual frame for FM developed in this paper, has been used in a systematic and coherent way to analyse ESG issues and barriers to ESG change in FM. Ethical problems and climate change issues were used as the main examples of ESG issues. The conceptual frame was also used to propose **new actions** concerning ESG change in FM and developed an explicit and systematic strategy to change FM relative to ESG issues. This systematic use of the FM conceptual frame in this way forms a new strategic analytical tool for FMs, for client and savers, for regulators, and governments concerned about ESG issues

The conceptual frame and analysis cannot, by themselves, guarantee that beneficial change will occur and the desired ESG outcomes will happen. However the conceptual framework for FM is a key means for change. It exposes the hidden nature of FM and encourages this direct focus on change **within** the FM, its elements, and its subsequent impact on investment decisions, rather just focussing on visible inputs and outputs. It makes it possible to understand what FM factors have to be changed, and how they have to be changed. It helps identify the broad direction of change and the road to take. This can help exponents of such change to focus and energise their efforts on the targets identified in a rational way consistent with the framework. The conceptual frame for FM can also help improve FM disclosure on the 'invisibles' of FM and how they relate to ESG issues. Enhanced disclosure based on a coherent conceptual framework can help the diverse stakeholders to connect their values and concerns about ESG issues to desired changes in FM. This can help them exert pressures for change in a more rational and coherent way.

This paper offers operational means for trustees of ethical or socially responsible funds, consultants and others to argue for variation in the aims, structure, process, actions and behaviour of FMs towards wider social and ethical viewpoints as well as SWM aims.

Clients and trustees of say a pension fund, can use the new conceptual framework to enhance trustee governance of FMs holding their funds, and to encourage the same FMs in turn to enhance their governance or stewardship role with investee firms. Clients and trustees can use the conceptual framework to pose coherent and connected questions about FM context and process elements, their properties and strengths, and how FMs have delivered financial performance and satisfied the conventional wealth creation agenda. The trustee mandate or contract with FMs can also be adapted (by using the conceptual framework) to include institutional shareholders codes for 'good' corporate governance by FMs. (eg The Institutional Shareholder Committee UK, 16<sup>th</sup> Nov 2009)

Many interested parties such as regulators, trustees, consultants, rating agencies and those interested in specific issues such as 'ethical investing' and 'socially responsible finance' can also use the conceptual frame for FM and its theoretical interpretation to pursue their ESG aims and agendas with FMs in a more coherent way and that these be balanced in some way

with SWM aims. The conceptual frame for FM, especially its strategic and operational context, process elements and knowledge properties, provides a much clearer target for reasoning from ethical, sustainability, and socially responsible finance perspectives. Regulators could demand that that clients, trustee and clients employ a clear conceptual framework when governing or challenging FMs, and may also use the framework to inform their own regulations

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