

White Paper

Ethical Investing (EI): Invest With The Values You Use In Raising Your Children

A human being is part of a whole, called by us the Universe, a part limited in time and space. He experiences himself, his thoughts and feelings, as something separated from the rest--a kind of optical delusion of his consciousness. This delusion is a kind of prison for us, restricting us to our personal desires and to affection for a few persons nearest us. Our task must be to free ourselves from this prison by widening our circles of compassion to embrace all living creatures and the whole of nature in its beauty.

Albert Einstein

Ethical Investing

A White Paper by Integrity Mutual Funds

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Integrating Ethics & Investment

Integrating our ethical values into our investing lives is admirable, but it will fail more traditional financial performance metrics unless it is accompanied by a disciplined equity analysis and risk management methodology. Integrity's three step methodology has been successful in addressing the dual needs of ethical investors to obtain good returns without violating their ethical principles.

Step 1: Integrity first screens only for companies that consistently generate high levels of free cash flow and high returns on invested capital (ROIC), and that we believe are selling at a significant discount to fair value, estimated using discounted cash flows.

Step 2: For companies that meet these criteria, before a full analysis is performed Integrity first conducts an investigation into ethical factors relevant to that particular company.

Step 3: Only when we are satisfied the company is acceptable on balance after an investigation of all ESG (environment, social & governance) and animal rights criteria do we then proceed with a full analysis, so this approach satisfies our dual financial and ethical criteria.

The purpose of this white paper is to address why we believe Step 2 is important for so many investors. First, though, it helps to define what we mean by Ethical Investment (EI).

What Is Ethical Investing (EI)?

EI means investing with the same set of values we use in all other aspects of our lives. Unlike narrower approaches that focus only on one or two issues like "green," "social responsibility," "animal cruelty," "family values" or "corporate governance," EI encompasses all of them. *EI employs the same broad set of moral principles we use in raising our children – thrift, honesty, charity, modesty, conservation, kindness towards all creatures, and living by the Golden Rule.*

Truly ethical investment means addressing all ethical aspects of a company's behavior and management, not one narrow issue. No company, though, is a saint. Even the best ones fall short on some ethical issues. *The overriding reality of a broadly ethical approach to investing is that black and white conclusions are no longer possible in most cases.* Our judgements become various shades of gray.

It's easy, for example, to simply screen out companies that treat their employees badly, or that experiment on animals. But what if they have exceptional corporate governance and use 100% clean energy? What if they experiment on animals, but are trying to change the FDA's rules to allow more alternatives to animal testing?

Ethical Investing is, in the end, about making a difference ethically, about creating positive change both in our personal lives and in the world, in whatever small way we can.

Why Does EI Matter?

Our culture and most others is founded on a basic set of moral principles that vary little from one culture to another, that form the very basis of their societies. They are the rules and principles we teach our children to live by. They are expressed in the Boy Scout Oath. They constitute the Golden Rule, unselfish behavior, fair play.

It is the moral fabric of our society that provides its cohesion and its stability, not laws and guns. When we step outside that moral fabric that gives our lives meaning, we tear it in some small degree each time. If enough of us do it often enough, we overwhelm our society's ability to heal itself.

The US is a young country, fully settled only within the memory of those still living today. We have become accustomed to limitless resources, and that expectation has been bred into our culture and made a part of our lives and institutions. Waste didn't seem to matter on a vast, empty continent with a small population surrounded by huge, empty oceans.

Not even clean air and water are any longer abundant or to be taken for granted, though. We can no longer live the way we have for the last half century and expect to leave our grandchildren anything other than a wasteland. Most of us grew up with air and water far cleaner than what we breathe and drink today. The costs to us in poorer health, and the costs of making our air and water clean enough for use, have soared in recent decades.

Western society has also gradually begun to eliminate and make illegal cruel practices in our past such as bear baiting, dog and cock fighting and bull fighting. We are maturing as a society, and have come to a widespread recognition over the last century that such practices are barbaric, because they impose immense suffering on sentient animals that are given no choice, merely for human amusement or benefit.

One of the places most of us, however unintentionally, step outside our moral universe is in our investing lives. We all worry about some things, of course. Most of us are concerned with the ethics and behavior of a company's (or a mutual fund's)

management, as well as corporate governance. Some of us also are concerned about how a company treats its employees and the community that sustains it. These purely human issues have become known as *“Socially Responsible Investing (SRI).”*

Others of us worry about the impact we as individuals and our companies have on our environment, and what management is doing not only to minimize their adverse impact on our world, but to clean it up. This is widely termed *“Green Investing.”*

Many take as their primary moral concern in investing certain religious values, such as *“Christian Values”* investing, or investing by Sharia principles for the Muslim community.

Like Mohandas Gandhi and Albert Einstein, some of us feel that we have a responsibility to act to minimize the suffering not only of humans, but of all creatures, especially sentient ones. These investors are known as *“Animal Rights Investors.”*

These are all admirable, moral positions, but individually and alone, they don't form a complete moral universe. Our goal at Integrity Mutual Funds is to unite all these concerns under one broadly inclusive term – **Ethical Investing (EI)**. And to recognize the unique investment opportunities made possible by expanding our concern for the health of our world to our investment decisions.

What Our Children Can Teach Us About Ethical Investment

Not one of us would fail to carefully consider how to best approach the moral development of our children. So why should we not take the same ethical approach in every other aspect of our lives?

We don't teach our children only about environmental issues, yet ignore the rest of their moral development. What responsible parent teaches their children only to recycle, and to turn off the water while they brush their teeth, but that it's okay to torture animals, take advantage of the helpless, and not give to charitable causes?

We try to teach them moral behavior in every aspect of their lives. Raising children isn't an exception in our moral universe – it's the rule and it should become the model for every part of our lives. The best guide to **EI** is to ask ourselves, What would we teach our children to do?

In our investing lives there is no single, defining event like the birth of our first child that makes us sit down in wonder and awe at the responsibility we now bear for a new life, and ask ourselves, What now? No one asks us to defend the moral basis of our investment choices. But if we don't raise our children morally, we'll hear about it from everyone from the in-laws to the school principal and maybe even the police.

We teach our children that thrift is virtue and greed is vice because we're worried about how they'll turn out when they are grown. Then we go and buy stock in a company run by a CEO with inflated bonuses and a golden parachute without any further thought. We'll cut our kids' allowance if we catch them throwing trash out the window, and we teach them to clean up their campsite and pack their trash out. Then we'll turn around and invest in a mutual fund that owns notorious, uncaring polluters.

Most of us simply haven't considered investing from a broadly moral perspective before. It requires some digestion. Including money and investment within our moral universe is a big step for most people. For one thing, although EI is growing faster than any other investment group, few do it, and for reasons that defy rational or moral examination, regard those who do as kooks and tree-huggers. Selective morality is the norm.

There is one universal, unifying force for making better, more moral investors of all of us, though – our children. It would be a better world if we simply applied the same values to our investing activities that we applied in raising our children.

Are Returns Affected by Ethical Investment Strategies?

Investors have often avoided ethical issues, believing that they are inappropriate in the world of business and will, in the end, cost them money. Moral behavior and financial success are widely presumed to be mutually exclusive.

Recent research in respected financial journals, however, shows that when the ethical dimension is included, investors' returns increase. Research indicates it's because EI tends to steer investors away from potential damage resulting from major corporate scandals and financial and environmental crimes, and toward companies that are less wasteful and more transparent in their operations and reporting.

Financial Analysts Journal published a major study in 2005 (Vol. 61, Number 2: *The Eco-Efficiency Premium Puzzle*, Jeroen Derwall, Nadja Guenster, Rob Bauer, and Kees Koedijk). The research addressed differences in returns histories for various ethical investment alternatives and the overall stock market. Their conclusion was that there is a strong positive bias to returns from EI that cannot be explained by any other factors.

In April of 2006 the United Nations launched their Principles for Responsible Investing (PRI) initiative. It has now attracted \$10 trillion in assets, and more than 200 major investment organizations from 25 countries, including Goldman Sachs, JP Morgan, Merrill Lynch, Morgan Stanley, UBS & Deutsche Bank, according to a recent UNEP (United Nations Environment Programme) Finance Initiative report.

CRA RogersCasey, a global financial consulting group, performed an extensive [recent review](#) of reports evaluating the effectiveness of so-called ESG (Environmental, Social & Governance) factors in influencing investment returns. They admit to initially being skeptical of the value of ESG factors in investment returns. Their report stated:

“However, we were impressed by the quantity of reports that showed a strong link between ESG issues, profits, business activities and, ultimately, stock prices. We find that a clear case is emerging for the investment community to consider including ESG issues in investment decision-making processes.”

Other reviews of research on ethical investment criteria have reached essentially similar conclusions. Many earlier studies show no returns effects either way, while a large minority show positive effects. Studies showing negative correlations are rare, with the statistics borderline in significance. The consistent conclusion from reviews of multiple studies tends to strongly support a positive correlation between returns and the inclusion of ESG factors in investment methodologies.

It shouldn't matter, though. Even if a broadly ethical approach to investing did produce lower or neutral effects on our returns, do we want to allow our state of moral development to be determined by our investment returns?

Few of us actually believe that the level of one's moral development should be a function of profit. Put that way, virtually every one of us would respond with an emphatic disagreement that money and morality are equivalent. It should be the other way around, in fact.

All acts create consequences. Most of us would prefer that the consequences follow from doing the right thing, not from chasing money. Good investors concentrate on their methodology and accept their returns. That goes for ethical investors just as it does for ethical employees, ethical sports conduct or ethical parents.

Another rationale often heard with regard to the returns issue that has the ring of superficial plausibility is that restricting our choices to only good companies makes it harder to earn a good return than no restrictions at all. However, the same investors will buy a large cap growth fund that automatically eliminates more than 90% of all publicly-traded companies!

Growth investors eliminate far more than half of all companies. So do dividend and small cap value investors. Clearly, any active management methodology narrows the selection of available choices dramatically. *The whole point of active management is to narrow our choices*, so the argument above is specious. Nevertheless, even avoiding all developers, agribusiness, pharmaceuticals, ethically challenged CEOs and mountain top-destroying coal companies, there are thousands of stocks remaining.

We are likely to perform better buying good companies because they are less likely to blow up in our faces due to scandal. We are likely to perform better buying companies with highly ethical management, because if a company's senior management and CEO are conservative in the way they apply accounting principles, they are probably conservative in other areas as well. If they cut corners on the production line or in employee benefits, or are lax in their corporate governance, they likely do the same thing in other areas, to the detriment of value creation and shareholders profits.

Even without those considerations, in the short run we are likely to do just as well buying a good company using a particular set of criteria as we will a bad one, so why buy stock in a company that does something we wouldn't tolerate in our own family, neighborhood, city or country?

However, if there is an investment case (as opposed to a moral one) to be made for preferring one over the other longer term, it is that companies are less likely to run into trouble with investors or regulators that might adversely affect their stock's value, when their management is more concerned with ESG (Environmental, Social and Governance) issues, or with the higher rate of death and serious side effects that follow from generalizing the results of animal tests to humans.

We've all seen investors lose money in unethically run companies from **Tyco** (senior management greed and hubris) to **Enron** (outright fraud and lying). Moral behavior by senior management sets the tone for the entire company. It is also addictive. Once management starts applying moral thinking in a specific instance, it tends to spread to other issues, and it can only benefit investors longer term.

As one example, consider the action of **Johnson & Johnson**, when it immediately recalled and destroyed all 31 million bottles of its best-selling and hugely profitable Tylenol pain killer in 1982. It did so immediately and without prompting after 7 people around Chicago died as a result of cyanide-laced tablets.

It wasn't even J&J's fault, yet it was widely regarded as a worst-case catastrophe for any consumer products company. Only 2 months later, though, Tylenol was back in more expensive, tamper proof bottles. A year later they had recaptured most of their lost market share. A generation later they are still admired for that one single, unselfish act.

Why did Johnson & Johnson recover so quickly from such a disaster? *Because the company acted from moral principles, not from a concern for profit.* Their action made the company a hero and an example of moral investment behavior to an entire generation of consumers. Shoppers responded with loyalty, appreciation and increased trust in the company, which benefitted J & J's bottom line in ways they could not possibly have predicted at the time.

Ethical Investing As a Lifestyle

For those of us who believe in a higher power, how are we as individuals, and as a species, ultimately to be judged? According to the teachings of those such as Gandhi and Jesus, or according to how much money we make on our stocks and mutual funds? Should it be the degree of our destruction of Nature's bounty to meet our own desires for personal status, or according to how we value truth and morality?

Most of us as mature individuals possess a personal morality that's as singular as we are. Should we decide to pursue this broader scope for moral behavior, we must always remember that none of us is perfect. We aren't going to find a fund managed exactly according to our own personal moral commandments down to the last detail unless we manage it ourselves.

Americans are coming to understand this as a culture, and are looking for ways to do something about it. St. Francis of Assisi wrote: *"If you have men who will exclude any of God's Creatures from the Shelter of Compassion and Pity, then you have men who will deal likewise with their fellow men."*

The choice to live within our moral universe is the primary driver of all our other decisions, such as how we invest, what we do for a living, how we play, vote, serve our community and raise our children. Our behavior is conditioned by our level of moral development. Morality and investment success cannot be mutually exclusive, *because the way we invest is a direct consequence of our moral state.*

We do the best we can as imperfect people and investors, we learn as we go, usually the hard way, and we should presume a willingness to behave ethically for corporate senior management. It's rarely a black or white issue, and corporations are often willing to change for the better. If we as investors believe this to be the case for a particular company, isn't it better to own their shares, rather than simply avoid them and feel pure?

Let us be very clear about this: We cannot be moral without *acting* moral. Morality isn't a state of mind, it's a manner of behaving, of living. We cannot escape moral responsibility for our actions by assigning the agency of our hypocrisy to a more remote person – say, the CEO of a company, our broker, or the manager of a mutual fund.

Our personal morality is unique. We cannot violate someone else's morality, only our own. When we believe smoking is harmful, yet buy tobacco stocks (or mutual funds that buy them), we are committing hypocrisy. If we recycle yet buy companies that do not do all they can to minimize pollution, we are hypocrites, or to employ a more charitable phrase, internally inconsistent in our moral behavior.

We can only change ourselves. We can be an example to others also, but that should not be the reason for change. We change because we admire others who inspire us to do better. We change because it will create a better world for our children. We change to deal with cognitive dissonance, which makes us happier living in our own skins.

Einstein believed that we should extend our personal moral universe to include all of creation. Why not begin today, with our investments?

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Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

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