

Why poor moral ethics prove costly

By Rob Arnott

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A successful economy hinges on trust. Trade must be mutually advantageous the vast majority of the time, with buyer and seller both content. If we are cheated 1 per cent of the time, we are dismayed, but we write it off. If we are cheated 10 per cent of the time, we practise “defensive trade.” We draft contracts carefully, seeking to anticipate every possible abuse.

In 2004, I wrote a piece in the Financial Analysts Journal on the distinction between moral ethics (doing only what is right) versus legal ethics (doing only what is allowed). In a very real sense, the credit bubble and its aftermath hinges on this conflict. Worse, we are going further down this path, at a prodigious pace.

In effect, we have collectively abandoned the moral principle of a determined intent to repay when we borrow. This holds true all over the world, though the US has arguably advanced situational ethics to high art. The consequences can be severe. The expedient of borrowing in order to consume is becoming endemic, at the corporate, household and public level.

Is it legal for a bank to incentivise a broker to sell mortgages that the borrowers cannot afford? Yes. Is it legal for investment banks to package and sell these mortgages en masse to investors, with the issuer having no residual incentive – no “skin in the game” – to assess the ongoing creditworthiness of the borrowers? Of course. Is it legal to buy a credit default swap (CDS), a bet on a company’s failure, and to then take actions to facilitate the company’s demise? Yes. But, in a surprisingly direct analogy, it is illegal for you to buy life insurance on me without my permission.

Is it legal for a homebuyer or credit card borrower to borrow sums that he has no reasonable expectation to repay? Yes. Is it legal for a homeowner to walk away from debt that she can afford to pay? Often yes. Is it legal for an individual to shun self-reliance, and look to others – typically through the government, which is us – to bear the consequences of errors in judgment? Often, yes. Is it legal for us to fail to save for our own needs, looking to the next generation to cover our retirement costs? Absolutely.

Is it legal for a nation to incur large debts or commit to future entitlement programmes, off balance sheet, if the nation has no realistic prospects of honouring these obligations? Is it legal for a nation to carry expenses off-balance-sheet, as we do with pre-funding of Social Security and Medicare, when off-balance-sheet accounting has put company executives in jail? Is it legal for a nation to back the debts of government sponsored enterprises (such as Fannie Mae and Freddie Mac) with full faith and credit of the government, and carry those obligations off-balance sheet? Yes, all of these are legal.

All of these are legal choices. Are any of them ethical? I think not.

What does any of this have to do with investing? Plenty. Many articles in finance journals have demonstrated that companies with aggressive accounting (reported operating earnings routinely well in excess of cash flow), usually underperform; other studies demonstrate the same for companies with governance focused more on management interests than shareholder interests.

When companies put their ethical mission ahead of short-term profits, as with Johnson and Johnson (Tylenol recall) or Google (China) examples, how often do we find that their long-term interests are hurt? Are the companies that we admire most less financially successful as a result?

The same holds true for individuals and governments. Individuals who are self-reliant are generally more successful and happier than those who rely on others' resources. As for countries, deteriorating rule of law and increasing corruption generally hurt long-term capital markets performance.

As we have already seen, if we do not police the behaviour of our own community, if moral ethics does not govern business behaviour, society will seek to raise legal ethics, through more laws and regulation, in a doomed effort to force the missing moral choices.

If we do not invest in businesses that condone unethical conduct, countries that are increasingly reckless in their governance, or individuals who seek to profit from others rather than with others, we not only earn outside profits, but also we reduce the rewards for unethical practices.

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