

Why do they care? The market for corporate global responsibility and the role of institutional investors

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Abstract. Institutional investors, primarily pension funds, drive global financial markets. The result is investors vulnerable to the risks companies face in global consumer and capital markets. While some market risks are inevitable, others such as reputation risk can be mitigated through increased corporate social and environmental standards and the increased transparency that such higher standards demand. The transparency necessitated by reputation management has a dual role in monitoring corporate behaviour and providing all stakeholders (internal and external) with the information to evaluate corporate behaviour. Driving this process is the belief that higher standards of corporate responsibility pay off for investors over the long-term through both potential equity premia and risk reduction. This paper presents a model for understanding how and why institutional investors may encourage firms to adopt higher standards. To illustrate our argument, we rely upon the experience of two large pension funds: the UK Universities' Superannuation Scheme's strategy of corporate engagement and its attempts to encourage firms to raise their environmental standards by focusing on the climate change impacts of USS investments, and CalPERS' policy of company-screening in emerging markets using both the CERES and Sullivan Principles to monitor corporate behaviour. Investor engagement in corporate responsibility offers an insight into investors' role in global standard-setting and global citizenship.

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1. Introduction

Global corporations are closely scrutinized for their policies and practices across the world. How they treat workers in Indonesia, for example, can have significant repercussions for their reputations in “home” markets of North America and Western Europe—witness the public debate over global standards that has enveloped companies such as Nike and Shell over the past decade. Levitt (1983) once suggested that the true global corporation is one that leads consumer preferences, crossing-over cultural differences in tastes and preferences with well-defined branded products. His manifesto for corporate strategy was at once enormously ambitious for management (given the decentralized character of the multinational corporation) and remarkably far-sighted about the emerging significance of brand image and identity (given the prevailing view about the functional value of products). If contested by management theorists and disputed by critics, it is an essential component of modern corporate strategy (Aaker 1996; Schmitt and Simonson 1997).

There has long been academic interest in multinationals—their reach and responsibilities (see Dicken 2001 and Dunning 2003 at the intersection of economics and geography). Indeed, the development of multinational trading institutions like the East India Company and the Hudson Bay Company is a staple of economic history. What seems to be increasingly important is the accountability of global corporations to “home” markets even if nation-state regulation of their policies and practices across the world seems weak and inconsistent within and between the jurisdictions in which they operate. One of the stories told about global corporations is of their insulation from regulation (Subramani 1998). On the one hand, as long as they respect “local” laws and regulations few governments are willing to challenge corporate policies and practices in far-off places. On the other hand, recognizing the dependence of less developed countries on foreign direct investment, “local” regulatory regimes are often lax and poorly policed. Even so, notwithstanding the public furore over third-world conditions, many global corporations appear to operate at higher standards than those required by local regulation (Angel and Rock 2004).

In this paper, we suggest that corporate accountability may be less an issue of government policy and regulation (assuming laws and regulations are properly observed) and more an issue of consumer market and financial market pressure. Our

goal is to indicate how market position and expectations can affect corporate policies and practices driving higher standards in remote jurisdictions or at least deliberate management of those standards in ways consistent with “home” expectations. In doing so, we do not mean to suggest that accountability is an enlightened process of corporate beneficence. In point of fact, we identify “agents” in both kinds of markets who have an interest in promoting and sustaining accountability. Most important in this regard are institutional investors and especially pension funds; we show that their interests straddle both markets being factored into the metrics used to assess corporate performance. Our paper develops an argument begun elsewhere about the pivotal role of pension funds in Anglo-American societies and beyond (Blackburn 2002, Clark 2000, and Clark and Hebb 2004).

The paper is largely conceptual and illustrative rather than a detailed report of empirical research. We rely upon a set of analytical tools developed in economics and finance about Anglo-American and Western European firms that are light on tangible assets (like plant and equipment) but heavy on intangible assets (like brand image and corporate reputation) (Teece 2002). As well, we assume incumbent managers are compensated, in part, by share-options and performance-related bonuses and that shareholders are many but dispersed (one way of distinguishing between Anglo-American firms and their continental cousins; see Roe 1994 but compare with Clark and Wójcik 2003). Part of the argument relies on an assumption that a crucial measure of corporate value is its price-earnings (P/E) ratio. Consistent with Lowenstein (1996), it is assumed that managers manage what is measured; that is, the objective function of the firm combines a concern for both variables. To sustain a targeted P/E ratio requires many activities, not least of which is the deliberate management of market sensitive information.¹ Most importantly, it requires corporate transparency in that financial investors prefer to be confident about forecast earnings and consequent stock market pricing. These assumptions and logical connections are the building blocks of our framework.

1/. While not discussed in any detail in this paper, we assume that financial markets rely upon information to assess corporate value. Whatever the connection between market pricing and real commodity exchange, in the first instance stock markets economize on information collection and processing using summary statistics and metrics to indicate value (see Wilhelm and Downing 2001).

The paper proceeds in the following manner. In the next section, we set out the core components of our argument concentrating on the status of Anglo-American firms as “fictive persons” and the scope of their responsibilities as private economic agents. In this regard, we distinguish between Anglo-American firms and their continental European counterparts suggesting that the latter may have very different mandates than the former. Thereafter, we deal with the significance of brand image and corporate reputation for firms that rely upon intangible assets (section 3), the increasing importance of transparency for financial markets and institutional investors (section 4), and instances where corporate reputation has been significant for institutional investors (section 5). In conclusion (section 6), we draw implications from our framework for understanding the behaviour of global corporations, emphasising the importance of third-party activists.

2. Theory of the firm

By convention, we begin by setting out the conceptual framework for subsequent analysis. Here, we explain our perspective on the global corporation paying particular attention to its objectives and the criteria by which decisions are made. In doing so, the firm is treated as an organization characterised by a hierarchical structure of authority and a set of compensation practices reinforcing that hierarchy; senior executives control the manner in which tasks are defined and executed down through the corporate hierarchy and across its units. We do not mean to suggest that senior managers are the super-rational input-output processing machines of conventional economic theory. Quite the contrary. The related literature in economic geography and management recognises that corporations are, more often than not, beset by internal conflict and rivalry (Schoenberger 1997). This issue is left for another time.

Most importantly, we treat the corporation as a private economic agent. This can be justified in a number of ways, including reference to the relevant literature in economics (Jensen 2000). However, there is a more important point to our perspective than just theory. Historically, English common law assigned firms involving more than owner-managers a distinctive legal status—that is, the status of a “fictive person”. In effect, this enabled corporations to own property, undertake contractual relationships, transact with others whether individuals or other entities, and generally behave as if they were unitary agents with the same economic rights as

anybody else.² Consistent with the common law institution, this approach evolved over time and with regard to changing economic circumstances. For those interested in comparative economic development, F. W. Maitland argued that this approach to the corporation encouraged higher rates of economic growth and institutional innovation (being especially important in facilitating the transfer of wealth between the agrarian aristocracy and the emerging urban industrial elites). This is a crucial reference point for the evolution of financial markets, represented in contemporary maps of law and finance (see La Porta et al. 1997, 1998).

Not only is the Anglo-American corporation treated as a fictive person, it is also sometimes treated as a private person with related rights and responsibilities. Unlike many of its continental European cousins, the Anglo-American corporation is empowered to maximise shareholder value (amongst other goals). It is not required to balance stakeholder interests, community sentiments, or moral imperatives. The Anglo-American corporation claims the right to act, just as any other person claims the right to act, according to its best interests. This does not mean, of course, that the Anglo-American corporation can ignore properly established laws and regulations. But it does mean that the corporation need only respect those minimum standards imposed by the law even if the public at large might expect more of such institutions than they would expect of themselves. The combination of private status and wide-ranging discretion provides a normative claim as to how the firm should be treated and a positive reference point for analysing firm decision-making. It also provides a rationale for understanding the significance of often-stated arguments to the effect that “the business of business is business” (Friedman 1962).

Let us be clear, however, about our own opinion on these issues. First, whatever the status of legal doctrine, public expectations are not limited to doctrine (and properly so) (Williams 2002). As recent events and legal proceedings have shown, the corporation as a fictive person may be treated as an economic agent but this need not translate into the same status as “real” individuals in public debate about moral

². See the work of F.W. Maitland, one of the leading nineteenth and early twentieth century legal historians. Runciman and Ryan’s (2003) have edited a collection of Maitland’s papers on the corporation and the trust. Compare with Hansmann and Kraakman (2002, 62-63).

issues.³ Second, in any event much of the debate about the global corporation and its treatment of people around the world rarely considers legal doctrine; shareholder resolutions at annual general meetings argue for greater accountability and transparency for a variety of economic, environmental and social reasons. Third, even so, one should not underestimate the interest of senior executives in the fictive person doctrine. For those at the top of the corporate hierarchy, the doctrine represents both an arena for action and a means of legitimating decision-making. Moral claims are one thing. Understanding the motives of global corporations in relation to global standards also requires understanding economic incentives (see Smith 1990 and Smith 2003).

In what follows, we assume that senior managers manage and that owners are shareholders in the sense that they buy and sell common stock. The ownership of such companies is dispersed—few institutional shareholders devote more than a fraction of one per cent of their assets to particular firms and most own stock as part of an investment strategy designed to diversify portfolio risk. At the limit, the majority of institutional shareholders are shareholders because companies are included in an index product representing some portion of the entire stock market.⁴ In this respect, recognising that the publicly-listed corporation has an obligation to shareholder value, the principal-agent problem looms large (Williamson 1996). Absent adequate incentives linking manager compensation with corporate stock market performance, managers' interests in their own welfare may dominate corporate strategy. As we know, of course, over the 1990s concerted efforts were made to align manager incentives with stockholder value. Codes of corporate governance have been introduced so as to encourage the efficient third-party pricing

³/ Witness the judgement of the California Supreme Court in *Kasky v. Nike Corporation* 27 Cal 4th 939 (2002). Therein the CSC was asked to rule on the status of Nike – whether its private interests as an economic agent could be extended into the public area, allowing Nike to engage in public debate about global standards unencumbered by tests of veracity associated with state law (re. competition and advertising). The CSC decided that the corporation did not have the same “rights of free speech” of an ordinary citizen. The US Supreme Court declined to review this decision.

⁴/ We do not have the space to develop this point in any detail except to note that institutional investors typically hold both passive index-linked stock portfolios and active stock-selection portfolios based upon relative stock prices and market capitalization. This type of investor is described in detail in Clark and Hebb (2004) and Davis and Steil (2001). Below, we explore the implications of this institutional structure.

of corporate value. We acknowledge that these types of instruments may not be consistent with social welfare nor need they be entirely effective as illustrated by recent scandals of corporate governance (Coffee 2003).

The analysis in subsequent sections of the paper focuses more upon corporations that are light on tangible assets (and liabilities) rather than corporations that are heavy on tangible assets (and liabilities). Much has been written about the latter type of corporation in economic geography and elsewhere. Re-reading the economic geography of the corporation over the past 20 years one is struck by the fact that, until recently, the literature was obsessed with manufacturing corporations with extensive networks of production, suppliers, and distributors (but compare with Zingales (2000) for a theory of the firm light on tangible assets). This is a world familiar to many. It is also a world that demands a distinctive analytical framework and conceptual tools. For example, it is amenable to institutional approaches emphasizing entrenched interests and the division of power between management and labour (Dore 2000, ch. 9). As shown elsewhere, it is also amenable to the use of concepts such as embeddedness, sunk costs, and the spatial fix (Clark and Wrigley 1997). In this paper, we focus on firms that are light on tangible assets although examples used to illustrate the logic of the argument duly recognise other types of firms.

Characteristically, corporations that depend upon intangible assets such as reputation and brand image and its management for value discount heavily the inherited configuration of production. While these kinds of firms may sell enormous numbers of units into global consumer markets, their sites of production are, more often than not, relatively small recognising the low threshold for reaping economies of scale. Furthermore, with control over the technology of production it is easy enough to out-source production, subject to the costs of maintaining standards of quality consistent with the brand image of products. While price competition is important in developed markets, brand image and its management is a refuge from head-to-head price competition. In this respect, the functional value of a product may be less important than the value attributed to consumer lifestyle, tastes and preferences (Lury 1996). These arguments are developed in subsequent sections of the paper. At this point we emphasize the profound nature of this shift in the derivation of corporate value: from managing the efficiency of productive assets including the relationship between

capital and labour, to managing the “reception” of product brands and corporate reputation. This is the world aptly described by Wrigley and Lowe (2002).

3. Valuing the firm

There are many different ways of valuing the firm (see Ho and Lee 2004). For example, we could focus upon firms’ reported assets and liabilities. Furthermore, firm valuation often depends upon perspective and interest. For example, there is a vibrant market in the financial services industry for expert opinion on these issues, driven in part by the lucrative mergers and acquisitions (M&A) market. For our purposes, the most relevant perspective is that of an institutional investor—an investor that holds a broad portfolio of market stocks, bonds, and other financial instruments being less concerned with the intrinsic value of an individual firm than the market value of firms as expressed in stock prices. In what follows, we provide a reference point for valuing the firm, its stock price and its reported earnings.

3.1 The price-earnings ratio

Fund managers and investment companies distinguish themselves in relation to the market for financial services by particular theories of market value including reference to issues such as "growth" (expected short-term stock price appreciation) and "value" (expected long-term stock price appreciation) (see Graham and Dodd’s 2003 republished classic). Some advocate a trading strategy that takes advantage of short-term mis-pricing of stocks and the supposed irrationality of others. Some argue that we should be concerned with fundamentals, particularly the long-term prospects for industrial sectors as well as the economic prospects of whole markets and economies. More theoretically, there are those who have argued that stock markets are efficient in the sense that all available information is factored into current and expected prices and that it is impossible to systematically beat the market (Fama 1970). In this paper, we assume that stock markets are not so strongly efficient. At the same time, some markets are more efficient than others and efficiency can vary over time (Clark and Wójcik 2003).⁵

⁵/. We follow the lead provided by Shleifer (2000) and Shiller (2000) who suggest that financial markets are subject to all kinds of human behaviour some of which is rational and much of which is not so rational. Over the mid to late 1990s, of course, P/E ratios were often ignored—side-lined by the momentum induced by herd behaviour (speculation). Recently, P/E ratios have returned as a useful metric by which institutional investors judge relative value (see Alford et al. 2004).

One important reference point for valuing individual stocks, sectors, and markets is the price-earnings (P/E) ratio. By convention, the P/E ratio divides the market price of a firm (P) with the reported net earnings of the firm (E) (Fabozzi and Peterson 2003, 792). Textbook treatments of such concepts often invite the reader to imagine that there are two firms A and B where the former trades at \$10 per share and reports earnings of \$1 per share and the latter trades at \$80 per share and reports earnings of \$2 per share. Their respective P/E ratios are 10 times earnings and 20 times earnings. More interesting examples can be concocted. The obvious question is which firm is more valuable? Considering that the S&P 500 long-term P/E ratio is about 15 times earnings, it would seem that firm A is under-valued and firm B is over-valued (Shiller 2002). This may be justified if A and B come from industries with very different “legacy” costs. For example, A may come from automobile manufacturing and B may come from computer software. Implied, therefore, are two time horizons over which valuation occurs: with the quarterly report of corporate earnings against current prices, and with respect to the future noting the trend in reported earnings and market prices. If reported earnings continue to disappoint investors, we would expect share market prices to fall to match revenue expectations. On the other side of the process, if a firm’s reported earnings exceed expectations over successive time periods, the firm’s share price may increase over time in anticipation of higher earnings.⁶ As a result of this series of positive quarterly reports, the latter firm develops a good reputation in the capital market, while the former under-performing firm develops a poor reputation based on its series of below-expected quarterly earnings reports (this point is taken up in more detail later in the paper).⁷

⁶/. This scenario is premised upon market arbitrage around an accepted reference point used by market agents to judge relative value. We suggest this kind of logic for its utility in understanding how market agents evaluate value. But we should also acknowledge that some analysts dispute the implied historical significance of the “reversion to the mean” thesis underpinning claims that market agents systematically value companies against a benchmark P/E ratio (see Dimson *et al.* 2002).

⁷/. Notice that the P/E ratio is very crude. More complex calculations about the return on capital invested may be factored into share price such that being “under-valued” is an expression of a variety of issues recognised by analysts but not directly included in the equation (see Madden 1999).

3.2 Earnings, brand image and management

Given the significance we attribute to the price/earnings ratio, managing the flow of corporate income is a crucial decision-making variable for corporate executives and shareholders. For companies reliant upon their place in consumer markets for the flow of earnings, managers are very sensitive to the "reception" of their products in home markets and other markets across the world. Many corporations have followed Levitt (1983) who argued that global corporations should use their proprietary interest in branded products to dominate not only their home markets but to extend their reach to other markets in the north and in the south. By Levitt's account, and in comparison to multinational corporations, the global corporation uses branded products to fashion local tastes and preferences taking advantage of low-cost sites of production to reap economies of scale in the drive for market share in each and every market. Over the past 20 years, Levitt's recipe for global strategy has become a point of reference for many dismayed about the cultural consequences of globalization.

Notice, however, that brand image and its management rely upon the integrity and authenticity of brand image itself. There is an extensive literature on this topic, not easily summarised considering the intersection between brand image, aesthetics, and the semiotics of meaning (Schmitt and Simonson 1997). At this point, we would suggest that brand image and its management depend on three principles. First, brand image is designed, more often than not, to be univocal in the sense that it relates to commonly-recognised aspirations while being local in the sense that it seeks a connection with market-specific tastes and preferences. Second, brand image and its management seeks to exclude competing images and counter-interpretations of the image. Third, brand image is necessarily compact, squeezing into a distinctive symbol of desirable conceptions of quality and relative price. For many corporate managers, the best brand image is one that can be exported around the world and sold at a price that denotes quality. Price competition on the functional value of a product is anathema to brand image and management.

By this account, reported earnings are the result of deliberately fostering product brand image and managing its reception in home and global markets. To do so requires intellectual capital, taste-conscious image consultants, and high-cost representatives of the brand (such as David Beckham and Michael Jordan). Not

surprisingly, once brand image has been created and deployed across markets, corporate executives have a huge interest in protecting and enhancing its value. At the same time, of course, competitors have an interest in aligning their own products with the dominant industry-related brand image while those appalled at the dominance of brand image may deliberately seek to undercut its integrity and claims of authenticity (Klein 2000). In the best scenario, a successful brand image generates higher levels of earnings across geographically dispersed markets—earnings returned to the parent corporation in the West. Higher earnings and the perception of market dominance may convince financial analysts to place such firms on their “buy” lists prompting further increases in company stock prices.

3.3 Reputation and the stock market

In the previous section, we argued that brand image and its management are essential components in driving reported earnings. This does not necessarily mean that there is a one-to-one correspondence between derived revenue and distributed profit; there remains a crucial and most contentious issue having to do with the scope and significance of managers' power in relation to stockholder interests. Nevertheless, the link between brand image and its management and reported earnings is a vital element in understanding the sensitivity of global corporations to their reception in consumer markets.

At the same time, we should also recognise that senior executives have a significant interest in the reputation of their firms in global stock markets. Stock options, performance bonuses, and related forms of incentive-based compensation packages are linked, in various ways, to corporate stock market performance. During the 1990s, of course, this link became quite notorious in that the promise of great wealth from exercising under-priced stock options encouraged some senior executives to deliberately “manipulate” the nature and quality of information released to global stock markets.⁸ The indictment of senior executives for fraud and the violation of

⁸/ In the 1990s, pressure groups representing Silicon Valley stymied attempts in the US to “expense” the cost of stock options against corporate earnings. In effect, current compensation commitments have been steeply discounted by shifting into the future their cost accounting—the true costs of stock

SEC regulations in firms such as Enron and WorldCom are indicative of gross failures of corporate governance and market scrutiny (see Coffee 2003 and Gordon 2002). In this regard, public sector pension funds have made transparency an important goal in their campaigns for improved standards of corporate governance (Hebb 2004). Whatever the significance of these failures of corporate governance, performance-based incentives remain a staple component of many senior executives' compensation packages. They have a direct interest in the stock prices of their firms.

As we know, however, the stock price of a firm combines an assessment of the current value of the firm relative to reported earnings plus expectations of increased or decreased "value" over the short and medium terms. Indeed, in the relatively efficient markets of the Anglo-American world where there is a great deal of information about the current circumstances of large-cap firms, expectations may be the single most important element in determining stock market prices. Those prices are themselves the product of past expectations—whether those expectations were realised or were dominated by surprising news good and bad. At the limit, the temporal path of stock market prices could be characterised by what Maikel (2003) refers to as a "random walk" process. We also know that financial analysts seek cost-effective ways of summarising the vast amount of data available on listed firms. "Reputation" is used throughout the industry to represent expectations about future market prices.

A good reputation signals to the financial market and analysts in particular that corporate "value" is likely to be preserved and enhanced over the future. A good reputation is also a way of minimising the intrusion of financial analysts and corporate governance specialists into matters of manager discretion while suggesting to the public at large that there is a consistent and mutually beneficial relationship between corporate managers' interests and shareholder value. By contrast, a poor reputation is almost always associated with a sequence of "surprising" news of less than expected reported earnings, problems of business strategy, and perhaps poor

options have been ignored. However, the Financial Accounting Standards Board (FASB) has indicated that it will once again introduce rules requiring the current expensing of stock options consistent with international standards and similar rules about to be introduced in the European Union. If adopted, this may substantially alter the availability of stock options down through the corporate hierarchy and the

corporate governance. Once established, a poor reputation invites greater scrutiny of managers' performance. As recent events have shown, it also invites institutional investors to actively campaign in favour of internal "reforms" aimed at managers' compensation packages, and their roles and responsibilities (compare with Faccio and Lasfer 2002). A poor reputation may also signal vulnerability in the market for corporate control.⁹

There is obviously a close connection between corporate reputation and the brand image and management of products. But that relationship is not entirely symmetrical. Some corporations like Unilever are large bundles of branded products each with distinctive labels and markets spread across the world. In effect, these firms may be relatively anonymous being enormous portfolios of differentiated products and markets such that their reliance on any one branded product is trivial in relation to the revenue streams associated with products in other markets. On the other hand, there are corporations whose reported earnings rely upon the performance of a small group of related branded products in overlapping consumer markets. In many cases, an extended range of related products is only as good as the market reception of their flagship products. In these cases, stock market reputation and brand image and management may be intimately related. In other cases, however, financial analysts may be content with using corporate reputation as the summary indicator for assessing expected value, recognising that the portfolio of products and markets is such that knowledge about any individual branded product is largely irrelevant. Even so, there are significant coordination costs and transaction costs involved in managing corporations with diversified portfolios of branded products. There is clearly a limit to this kind of business strategy widely acknowledged in the investment industry and the management literature.¹⁰

liberal use of these compensation instruments as incentives tying corporate executives' interests to those of current shareholders (Zion 2004).

⁹/. A recent example is, of course, the drama associated with the Disney Corporation, the role of its chief executive, and the hostile takeover offer from Comcast (itself a company with a relatively poor reputation for corporate governance). More often than not, M&As are "governance" measures of the last resort—after all other options have failed. Too often, M&As are pursued by incumbent managers for their own interests led by the financial services industry for the fees generated for advice etc. (see for an extensive review Maher and Anderson 2002).

¹⁰/. See the pessimistic assessment of Unilever's earnings and competitive strategy published in The New York Times 29 April 2004 under the heading "Prof it falls nearly 20% at Unilever". Available online at <http://query.nytimes.com>

4. Transparency and market value

The linkage between brand image and corporate reputation is illustrated in Figure 1. Brand management and reported corporate earnings are directly linked through consumer sales. Such sales are dependant on the reception of the product in consumer markets. Perceived value, local tastes and preferences play a direct role in product reception, and as a result management spends considerable resources on managing the flow of information that informs such consumer preferences (see for example Lowenstein 1996). In any given time period the revenue that drives reported earnings is derived from both the revenue generated in the consumer market in the previous time period plus an error term that captures both positive and negative surprises in the market.

$$\text{Reported Earnings} = \text{Revenue (R)} = R_{ft} = R_{ft-1} + E_t$$

When corporate behaviour anywhere along the supply chain runs counter to its compressed brand signal, the resulting loss of revenue is captured through changes in E_t in any given time period. Continuous quarterly surprises creates a sequence of disruptions that over time disturbs even flows of expected revenue. Within the capital market, falls in expected earnings drive the decline in share price. As a result, management seeks to control unanticipated surprises (or variance) that might create volatility in reported earnings. While a company's reputation can survive a single drop in reported earnings in time t , it cannot maintain a good capital market reputation in the face of significant volatility in reported earnings over a two to three year time period.

In the upper left hand half of the matrix (see Figure 1) we find firms with strong reputations. Here reported earnings match expected earnings, with little volatility in this space. Positive reputation is measured in the positive flow of expected quarterly earnings over time. As described above, some firms sell in overlapping consumer markets with a small group of related branded products. For these firms it is particularly important that product and company reputation reinforce the compressed messages such firms deliver into the marketplace. Some global firms are situated in

the upper right hand half of the matrix with large bundles of branded products each with distinctive labels and markets spread across the world; again, they seek external confirmation of value in these far-flung markets that a strong reputation provides. One advantage of being “located” in this space is that if and when subsidiary firms come under attack in consumer markets, the parent corporation can jettison them without damage to its own reputation or that of the other firms in its massive holdings. As a result, these often faceless global corporations are less vulnerable to unexpected drops in earnings should their brand images fail.

However, most firms prefer to be located in the upper left hand box, where strong brand recognition compresses multiple positive messages that reinforce their positive capital market reputations. We would place a global confectionary or apparel company, for example, in this space. Their strategy of acquiring selected high-quality branded products is a good example of the intersection between brand management and positive corporate reputation so important to these companies. In this space, however, the enormous value placed on individual brand leaves these firms hostage to counter-claims that cut across the brand images and acquired reputations these companies would wish to sustain. Nowhere was the clash of claims over brand and reputation more evident than the 1999 Seattle anti-globalisation riots where McDonald’s Golden Arches, Nike’s “swoosh” and Starbucks’ logo all came under fire. The lower left hand of the box captures the space where strong brand message is countered by direct assaults on corporate reputation in financial markets. The impact of such reputational damage may be felt by senior managers and may also flow back to consumer markets as measured in shocks to expected revenue.

Outside agents, usually NGOs and other committed parties, use the media as a form of involuntary corporate disclosure, releasing negative information designed to disrupt the desired brand images and corporate reputations companies wish to sustain. Such media campaigns often include direct attacks on the motives of senior company executives who can have a visceral reaction to seeing their names associated with corporate misdeeds and splashed across national newspapers (Fama and Jensen 1983). Attacks on brand image combined with name and shame campaigns have proven effective in delivering messages designed to disturb consumer loyalty and change

corporate behaviour.¹¹ Outside agents attempt to provoke savvy consumers into avoiding branded products made under substandard conditions with an aim of punishing corporate behaviour in financial markets.

Most important to corporations is the actual or expected impact of media attacks and consumer boycotts on companies' quarterly earnings statements. Here we find (as shown above) that damage to brand image can leap across consumer markets and into capital markets, influencing investor decisions and lowering share prices. It must be remembered that senior corporate managers are not only motivated by personal status and reputation halos that result from consistently high stock prices. In most cases their compensation packages are directly affected by the value of their stock-options measured in current share prices. Even slight changes in consumer demand captured by earning declines and signalled to capital markets can affect investor and analyst expectations. Share prices measure expectations of future returns based on all available information—attacks on brand image and reputation bring new information to capital markets that may dampen future expectations.

Such changes in expectations are further amplified through the price/earning ratio or the amount an investor is willing to pay for each dollar earned by the company. This number measures changes in corporate value both directly and indirectly and is carefully scrutinized by investors. As noted above, reported declines in quarterly earnings directly affect both the numerator (price) and the denominator (earnings) in this ratio and simultaneously reduce the overall P/E multiple an investor is willing to pay for the stock when future expectations are dampened. Figure 2 demonstrates the major P/E ratio shifts prompted by changes in quarterly earnings. Corporations seldom worry when earnings and price are positive, a region found in the upper left hand of the matrix. Here we usually find stocks sought by 'growth' investors where good corporate news is followed by increases in stock price, maintaining equilibrium in the P/E ratio. In the lower left hand quadrant we find positive earnings with stable

¹¹/. A good example of such a successful campaign was the Greenpeace attack on Shell Oil's reputation following the planned disposal of the Brent Spar oil platform in the North Sea. Under threat of reputational damage, Shell Oil agreed to dismantle the platform on land despite the considerable additional costs involved and legitimate claims that such a disposal strategy would actually be more harmful to the environment.

or declining stock price. These companies tend to be in sectors with declining future prospects, where current earnings are discounted against future expectations. This quadrant tends to attract 'value' investors seeking solid underlying fundamentals in firms that may be 'mis-priced' by the market. With positive earnings and low prices, this quadrant attracts value investors who seek low P/E ratios with underlying strong fundamentals.

It is the two boxes in the right half of the matrix with declining earnings that are of concern to corporations and investors alike. Even if share prices increase or remain the same as we find in the upper right hand box, the decline in earnings is amplified in the capital market through a direct increase in P/E ratio. Such a signal prompts investors to sell and the result is the decline in both price and earnings found in the lower right hand box.

In light of the importance of P/E ratios to companies and investors alike and the vulnerability of corporate earnings and by extension share prices to reputational attack, investors increasingly demand levels of transparency in corporate behaviour and greater financial and non-financial disclosure. Once transparency is in place investors use their ownership position to demand higher firm-level standards of behaviour as a means of protecting their investment from the negative impact of reputational attack (Clark and Hebb 2004, Hebb and Wójcik 2004, and Hebb 2004). We contend that increased corporate transparency is inextricably linked to value in both consumer and capital markets with direct consequences for the actors that dominate each domain (see Figure 3).

For pension fund investors, the liabilities that come from providing retirement benefits over long stretches of time, combined with their enormous asset size, mean they face portfolio risks when substandard firm-level behaviour leaves corporations open to reputational attack. Vulnerability is no longer restricted to just the financial aspects of firms' behaviour; it now also includes social and environmental standards of behaviour. The world of pension fund investing is one of constant calculation of risk and return. In order to adequately judge the risk from investment, institutional investors increasingly demand greater financial and non-financial disclosure from firms in their portfolios. Given the linkage between brand value and share price, such

firm-level transparency provides institutional investors with the information necessary to make judgements about future corporate performance.

It could be argued that within capital and consumer markets, investors' legitimacy as the ultimate owners of firms makes their demands for increased transparency and greater corporate social responsibility more pressing than claims of outside agents within consumer markets. Institutional investors, as indicated earlier in this paper, seek increased transparency without regard to the broader social obligations of the firm but rather as a means of protecting their investment over time. Just as the effects of attacks on brand image may leap across to capital markets, the reverse is also true in that the increased transparency and raised standards of corporate behaviour demanded by investors can have positive effects in consumer markets with a resulting increase in firm earnings over time (see Dowell *et al.* 2000, EPA 2000, Porter and van der Linde 1995).

The opposite also holds for firms with poor corporate social and environmental standards. Transparency in capital markets can make information on "poor" corporate behaviour available to consumers. Increased information about the firm enables those inside and outside of the firm to be more effective monitors of corporate behaviour. In these cases, transparency can be a catalyst for attacks on brand image and may even prompt local regulatory changes by those seeking to hold firms accountable to higher social and environmental standards.

5. Institutional investor strategies

To illustrate the significance of reputational issues in capital markets, we draw upon the experience of two large pension funds: the Universities Superannuation Scheme (USS) (one of the largest in the UK) and the California Public Employees Retirement System (CalPERS) (one of the largest in the world). Both funds actively engage companies in their investment portfolios in order to raise corporate, social and environmental standards of behaviour. We draw on a series of semi-structured interviews over the last two years with senior managers and trustees in each of these organizations combined with extensive internal and external document reviews (part of Tessa Hebb's DPhil research). We use our own research to develop a deeper understanding of the intersection between engagement and corporate reputation, and

its results in terms of changing corporate behaviour (see Clark and Hebb 2004, and Hebb and Wójcik 2004).

USS is a multi-employer defined benefit plan providing retirement benefits for nearly two hundred thousand current and retired UK university staff. It is considered to be a young plan with current active and contributing members far outweighing plan beneficiaries. USS faces long-term risk rather than short-term risk; it must be able to provide for its current members in the distant future. Consequently, the temporal structure of USS liabilities makes the plan sensitive to the long-term value of its holdings. With as much as 56% of assets in domestic equity markets and 23% of assets in international stocks, the precipitous decline of global financial markets in the aftermath of the TMT bubble hit the pension fund hard with its annual performance slipping below benchmark three years running. In 2002 the fund returned -16.7% with its asset base falling from £22 billion (2000) to £15.5 billion by late 2003 before recovering during the stock market rally of 2004.

USS began its ambitious program of responsible investment in 2000 after considerable internal lobbying from a group of USS members under the banner of “Ethics for USS”.¹² A letter writing campaign resulted in four thousand cards requesting ethical screening of investments delivered to the USS senior managers and Board members. The lobby group sought the outright removal of firms judged to be unethical from the USS investment portfolio on the assumption that this would, in some way, penalize firms by restricting access to capital.¹³ USS senior management resisted the use of negative screens and instead opted for more positive engagement with companies in their portfolio. They took the unusual step of identifying climate

¹²/. In our research on pension fund corporate engagement, this is one of just a few instances where plan members were the catalyst for such intervention. In the vast majority of cases, plan members have little power. Exit, voice and loyalty are not options for plan members; their participation is taken for granted by plan administrators (Clark 2004).

¹³/. There is no evidence that screening-out makes any difference to firms' access to or price of capital. Stock sold through such a strategy are bought by other investors without regard to the intentions of the seller. Portfolio investors rarely hold more than 30 basis points of any individual stock; only in a few instances is ownership so concentrated in the hands of a few investors that a concerted selling strategy adversely affect stock prices (something possible in the recent AFL-CIO campaign against Safeway stores in the US).

change as the topic through which they would engage firms.¹⁴ Broad as this agenda might appear, the number one and number five holdings in the USS investment portfolio were British Petroleum (BP) and Shell Oil, in sum accounting for £1 billion of their £15 billion portfolio (representing their significance in the FTSE100). When considered in light of the impending impact of the Kyoto Protocol on the entire sector, it is not surprising that these companies should be the target of USS engagement.

In 2001, USS released the report Climate Change: A Risk Management Challenge for Institutional Investors opening with the following statement from the author s Mansley and Dlugolecki (2001):

“Climate change is a major emerging risk management challenge for institutional investors. Institutional investors, and pension funds in particular, aim to provide pensions and other benefits through long-term investment. They can also be seen as ‘universal investors’ in that, due to their size, they commonly invest across the whole economy. If climate change threatens economic development, and especially if there are many or significant impacts, it will also therefore be likely to undermine the ability of pension funds and other institutional investors to fulfil their aims, so it is in their interests to see that risks associated with climate change are minimised. Whilst this responsibility is widely shared, institutional investors are uniquely suited to take particular actions.”

Having identified climate change as its central focus, USS opted for positive engagement with companies rather than the perceived negative strategies of proxy voting battles, minority shareholder resolutions at annual general meetings, and media-driven attacks on corporate reputations.¹⁵ Because pension fund investors are driven by share price concerns, they use their ownership position to reduce the risk of adverse unexpected share price movements rather than as an instrument of social change. This kind of risk is increasingly understood in terms of the social and

¹⁴/. Most pension funds that use their ownership position to raise firm-level standards first identify corporate governance (reputation) concerns with which to engage companies. Once active in the process of engagement, their focus extends to broader social and environmental (earnings-related) aspects of firm behaviour. Otherwise, headline news of corporate environmental and social problems become the cue for institutional investors to look more closely at their holdings in a particular firm.

¹⁵/. In this paper, given its over-arching argument and focus upon corporate engagement, we do not consider the nature and scope of proxy votes in advancing social and environmental issues. Even so, there is increasing evidence to the effect that high-profile shareholder resolutions can have significant impacts on corporate managers’ behaviour over a wide variety of issues. For useful overviews of the theory and practice of proxy voting, see Maug (1999) and Romano (2003). On the institutional basis of proxy voting, see the web sites <http://www.corpgov.net/forums> and <http://www.issproxy>.

environmental performance of the firm, particularly when substandard performance in the third world sends reputation signals into the marketplace.

Despite USS's use of terms such as socially responsible investing (SRI) and responsible investing (RI) to describe their investment policy, this pension fund does not consider its actions to be part of the SRI movement. For the vast majority of pension funds, the SRI movement is considered to be outside the mainstream of investment management. Nor does it align its corporate engagement approach with 'noisy' pension fund activists such as CalPERS. While USS votes its proxies, it does not publicise lists of companies it plans to target for improvement, nor has it ever submitted a minority shareholder resolution calling attention to firms' risky behaviour. In fact USS, believes that these types of approaches are blunt tools that often fail to achieve the changes they seek in corporate behaviour. From their point of view, the senior management of such targeted firms does not always understand the message that is being delivered by disgruntled shareholders in such forums. Basically, USS approaches its engagement with corporations as primarily a risk reduction strategy. By demanding more information and higher firm level standards of behaviour, Peter Moon (2003), USS senior investment officer, suggested "we are making capitalism more efficient".

As a result of USS's "behind the scenes approach", it is hard to identify precisely where there has been influence. In effect, USS seeks to pre-empt reputational damage before it occurs either in the consumer or capital markets, acting before rather than after a decline in earnings, share prices, and the P/E ratio. In this way, positive corporate engagement is like an insurance policy taken out on something that subsequently does not occur. The results are difficult to measure either directly through share prices changes or indirectly through corporate behavioural changes because we are not told where such engagement has occurred in order to maintain the positive reputation of the firm. While we are able to assume given the size of USS holdings in BP and Shell, that such positive engagement has occurred, in light of the magnitude of issues to be tackled under climate change the impacts are hard to quantify. However BP's recent pledge to move 'beyond petroleum' may speak to the power of such institutional investors' corporate engagement, and certainly speaks to

the positive reputational impacts of corporate social responsibility that more and more firms wish to associate with their brand.

USS has quantified some impacts of their engagements with firms before rather than after reputational damage and declining share price have eroded shareholder value. Two examples are their intervention with the UK construction company Balfour Beatty and with pharmaceutical giant GlaxoSmithKline (GSK). In the case of Balfour Beatty, USS was one of many voices pressing the company to withdraw from the Turkish Ilisu Dam project. Late in 2001, Balfour Beatty reversed its position on this project and withdrew. Nowhere in the company's official press release is there mention of institutional owners' intervention on this topic. But from anecdotal evidence, we know there was considerable behind-the-scenes pressure on the firm given the negative reputation effects such an environmentally damaging project could inflict on the firm's share prices.

A second example of USS direct engagement with companies in their investment portfolio was their intervention with GSK the second largest holding (valued at £550 million). USS sought to avoid reputational damage and the resulting decline in long-term share value by urging GSK to withdraw from the court case against the South African Government for the manufacture of generic AIDS drugs. In April of 2001, GSK and other global drug manufacturers agreed to drop their legal case and subsequently offered low-cost AIDS drugs to South Africa and other developing countries. In the same time period, GSK announced profits of US \$5.8 billion with only two percent of its revenue from markets in developing countries. Institutional investors believed that the potential for reputation damage from the South Africa court case far outweighed the threat posed to the pharmaceutical industries' intellectual property rights.

It is hard to quantify the effect of such leverage on share price and long-term performance. What is important is USS' pattern of positive engagement with firms that represent significant holdings in its portfolio on issues of reputational risk. Additionally two of these three firms, BP and GSK are global leaders in their sectors, with strong brand recognition easily tarnished by public dispute. Consumer boycotts

in first-world markets are a real possibility given the sensitivity of educated consumers to these issues.

In contrast to the quiet diplomacy of USS, CalPERS takes a more direct, public, and sometimes confrontational approach with companies in order to offset reputational risk in its investment portfolio. While both pension funds share a similar motivation to maintain and sustain share value and to minimize reputation risk in their portfolios, USS seeks to avoid sending adverse reputational signals into the capital market as a result of its engagement with companies. This is not surprising given that USS targets its largest holdings for engagement and would, in effect, drive share prices down on themselves should they disrupt investor expectations of future performance. In effect USS seeks changes in corporate behaviour before rather than after reputational damage has been inflicted. This tactic, however, can lack transparency, denying other stakeholders timely information on which to make decisions about the firm. CalPERS takes a very different approach to corporate engagement. It uses the threat of negative publicity to produce the desired changes in corporate behaviour. With public disclosure integral in such engagement, the result can lead to greater transparency in both capital and consumer markets.

Beginning in the late 1980s, CalPERS began to use its ownership position in firms to raise standards of corporate governance. Arguably CalPERS' motivation in seeking higher corporate governance was the link between such standards and improved financial performance (see Hebb 2004 for a detailed study of CalPERS corporate governance program). CalPERS' officials indicated that becoming active owners fulfils its fiduciary duty to its plan members and beneficiaries. CalPERS targets poorly governed, under-performing firms in an annual "name-and-shame" campaign played out through the media. Because these firms under-perform sectoral benchmarks, CalPERS assumes the negative reputational damage inflicted from inclusion in their annual Focus List will not further erode these companies' already discounted share price. Here, the institutional investor acts as an outside agent threatening reputational damage if the firm does not respond to CalPERS' demands. Unlike the early years of this campaign, CalPERS now provides for initial positive engagement with firms it targets but uses the threat of reputational damage to induce company cooperation.

Recently CalPERS extended its corporate engagement to include broader social and environmental aspects of firm behaviour. Following the 1998 Asian financial crisis, CalPERS' officials realized that their increased exposure to emerging markets left them vulnerable to higher levels of risk in their investment portfolio. Again under the rubric of fulfilling their fiduciary duties, CalPERS took the decision to screen both countries and companies in their emerging market portfolio for a variety of capital market, social and environmental risks in order to avoid investing in countries or companies prone to reputational attack. See Appendix 1 for the full list of country and company risk factors identified by CalPERS for concern.

Most of the publicity on this policy decision focused on the impact of screening entire countries out of CalPERS' portfolio (see for example Hebb and Wójcik 2004 for detailed analysis of this policy decision). However even within their permissible country list, CalPERS further screens individual companies in emerging markets on issues of broad corporate social responsibility including labour rights, human rights and environmental standards. Not only does CalPERS apply these standards to investment decision-making, it makes the result of its screening public, further increasing transparency and awareness of substandard corporate behaviour (see the CalPERS' web site for examples of company-screening in emerging markets). As with the corporate governance Focus List, CalPERS is fully prepared to inflict reputational damage on these companies. CalPERS' deliberate decision to withhold investment in these companies leaves them unaffected by the subsequent drop in share value that may result from these reputational attacks.¹⁶ Needless to say when one of the largest institutional investors in the world publicly withdraws from such investments the impact of the ensuing reputational damage is exacerbated by other investors' capital flight.¹⁷ Such leverage across capital markets can have a direct impact on corporate decision-making.

¹⁶/. In fact two of the three external money managers CalPERS uses in its emerging market screening have significantly outperformed their benchmarks since inception. Such out-performance speaks to both the value of active fund management and the value of reputation in these markets.

¹⁷/. Witness the adverse impact on FDI to the Philippines when CalPERS announced in 2002 that it would divest itself from that emerging market (Hebb and Wójcik 2004).

It must be noted, however, that unlike its corporate governance campaigns, which have both domestic and global reach, CalPERS restricts its social and environmental concerns to firms domiciled in emerging markets. These concerns do not currently extend to either multinational enterprises in CalPERS' portfolio that face similar social and environmental risks in their global supply chains, nor to CalPERS' domestic equity holdings. Given the growing threat reputational damage inflicts on share prices, we expect the social and environmental aspects of firm behaviour across all CalPERS' holdings will grow in importance. It seems likely, however, that when CalPERS holds large positions in these firms it will seek higher social and environmental standards through greater corporate transparency and disclosure rather than outright attacks on corporate reputation.

6. Implications and conclusions

In this paper, we focused on firms that are both light on tangible assets and heavy on intangible assets. Such companies tend to have global reach and are dominant in today's consumer and capital markets. Despite their prominence, these firms are relatively understudied in finance, economics and economic geography. We contend that firms with significant brand image and corporate reputation rely upon these intangible "assets" to fashion competitive advantage in global markets. Brand image is valuable to firms because of its capacity to compress into simple symbols multiple messages about products including reference to lifestyle, taste and preference. And corporate reputation in capital markets is derived from the predictability of earnings.

Three arguments are made in this paper. First, the value that these kinds of firms place on brand image leaves them vulnerable to counter-claims about the virtues or otherwise of their corporate behaviour. When corporate behaviour runs counter to the societal norms embedded in their brands, outside agents may be able to target brand image in the media in order to highlight companies' irresponsible acts. Furthermore, the global supply chains characteristic to these firms leave them vulnerable to the very different standards of production between the less developed countries and the developed consumer markets of the West where the products are sold. Such media attacks can undercut the positive images these firms want associated with their products.

The second argument of our paper posits that pension funds and institutional investors more generally who dominate global capital markets are increasingly sensitive to reputational attacks on the firms they hold in their investment portfolios. We argue their concern is not the result of an abiding interest in corporate social responsibility. Rather, there is increasing awareness of the costs of systemic attacks on brand image and corporate reputation because such attacks can have a direct impact on institutional investors' portfolio returns through adverse current and future stock price changes. The more extended the global supply chains of firms in their investment portfolios, the more reputational risk these types of investors face through their long-term investment strategies.

The third argument of the paper revolves around the response of institutional investors to these increased levels of reputation risk in their portfolios. We contend that pension funds and institutional investors are holding increasing numbers of global firms directly accountable for their governance, social, and environmental behaviour. These types of investors demand higher standards of corporate behaviour than those required of many emerging markets, particularly in those developing countries where social, labour and environmental regulations are kept deliberately low in order to attract and keep these companies. In order to hold companies to account, institutional investors require greater corporate transparency and disclosure to adequately judge the reputational risks inherent in their business strategies.

From these arguments, we draw four implications (although others are implied as we see below). In the first instance, it could be argued that we have entered a new phase in the relationship between large shareholders and their firms. Indeed, our argument is an elaboration of a previous argument to the effect that Anglo-American economies are now in what might be termed the 5th stage of capitalism (see Clark and Hebb 2004 and compare with R.C. Clark 1981). Not content with "revealed" performance through stock market prices, large public pension funds have sought to affect firms' announced results and hence future stock market prices. This is entirely consistent with the world in which large institutional investors find themselves—a world with few options for exit, and with limited power to directly influence the behaviour of corporate executives. At the limit, however, this type of policy and the use of financial leverage by "insiders" reassembles continental European systems of

corporate governance that give preference to large shareholders over small shareholders. Granted, the institutional form is very different. But there is little doubt that engagement may give those involved preferential access and claim to market-sensitive information (compare with Perotti and von Thadden 2002).

One consequence of institutional investors' interest in *ex ante* information has been a growing market for third-party quantitative and qualitative assessments of firm governance practices. These types of assessments are a way of providing institutional investors the kind of summary information necessary for judging the *ex ante* risks associated with investing in different types of companies. Ratings firms publicise their assessments thereby providing to the market and especially for those unable to claim status as preferred "insiders" systematic information on firms' governance characteristics. Most interestingly, the ratings market has a variety of clients some of which have a narrow interest in the form of corporate governance whereas others have an interest in a wide variety of social and environmental standards. Indeed, there is an active research programme amongst institutional investors seeking to evaluate the relationship between standards of corporate governance and social and environmental responsibility. If it can be shown that these two elements are related in any causal fashion then social activists may have a vital clue in their campaigns to affect the role and responsibilities of firms in global consumer markets (Bauer et al. 2002).

In our assessment of the relationship between global standards and corporate engagement little was said of any moral commitment to global justice. This issue is not on the agenda for institutional investors such as CalPERS and USS. Most importantly, this is because an explicit concern with global justice would run counter to the fiduciary responsibilities of pension fund trustees and their service providers in the investment management industry. In any event, to characterise the issue as one of global justice would be to introduce a level of dispute and contention that runs counter to the presumption in favour of collegial and consensual decision-making within these institutions (Clark 2000). To imagine that these institutions could carry a moral agenda as well as a financial agenda would be to mistake cause and effect. There seems little doubt that engagement strategies can increase global social and environmental performance but that effect is a collateral benefit rather than the explicit object of corporate engagement itself. The most important reference points

for affecting global justice remain community sentiments and the actions of social activists who can mobilise the tastes and preferences of consumers.

Fourthly, we would suggest that regulators must sustain their current initiatives in the area of corporate governance: that is, improving transparency with respect to corporate decision-making, ensuring that boards of directors have independent shareholder and stakeholders representatives, improving corporate reporting standards, and expanding reporting criteria such that the market for corporate ratings grows in ways consistent with the spread of information throughout securities markets. Most importantly, nation-states must protect the rights to free speech of third party activists and the public at large who have an interest in what happens in far-off places. In the end, the public interest in global justice is only as good as the information made available, officially or unofficially.

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Figure 1. Interaction between brand and reputation

		Brand Image	
		Concentrated single brand	Bundled diverse portfolio
Reputation	+ ve	high earnings	high earnings
	- ve	low earnings	low earnings

Figure 2. Price/Earnings ratio

Capital Market

		Earnings	
		+ ve	- ve
Price	+ ve	P+/E+	P+/E-
	- ve	P-/E+	P-/E-

Figure 3. Transparency and market value

		Capital Markets		Consumer Markets	
		Transparency		Transparency	
		high	low	high	low
Performance	+ ve				
	- ve				
		Investors Insiders/ Legitimate		Consumers Outsider/ Renegades	

Appendix 1

CalPERS' Country and Company Screens in Emerging Markets:

Agenda Item 6A Investment Committee October 14th 2003

At its April 16, 2001 meeting, the Investment Committee approved a solicitation document for the active emerging markets manager search. That document stated that CalPERS was seeking active managers whose qualifications included a transparent and well-documented process for considering strategic factors of importance to the CalPERS' Investment Committee, including geopolitical and investability factors.

These factors include:

- ?? transparency, including elements of a free press necessary for investors
- ?? political stability
- ?? progress towards the development of basic democratic institutions and principles
- ?? a strong and impartial legal system
- ?? property and shareholder rights
- ?? labor practices/harmful child labor
- ?? corporate social responsibility (including CERES Environmental Principles)
- ?? compliance with the Global Sullivan Principles of Corporate Social Responsibility
- ?? compliance with the International Labor Organization (ILO) Declaration on Fundamental Principles and Rights at Work
- ?? market regulation
- ?? market volatility
- ?? currency risk
- ?? liquidity risk
- ?? repatriation risk
- ?? market openness to foreign investors
- ?? government commitment to free market policies
- ?? legal protection for foreign investors
- ?? trading and settlement proficiency
- ?? transaction costs