GOVERNANCE

September 2020 Issue 313

The human factor

'I commonly find that managers are convinced that corporate scandals are something they read about, but are not intrinsically their problem. They are convinced that they would never behave like that and that it could not happen in their own organisations. This attitude is risky because the whole point about ethical blindness is that it emerges from stressful situations in which sound judgement no longer prevails.'

Professor Guido Palazzo

Should businesses serve wider society?

'Investors are not "them"; they are "us". … Policies that suppress investors will not only make companies less purposeful and less productive, but also harm citizens. Investors aren't the enemy, but allies in growing the pie. Any serious proposal to reform business should place investor engagement front and centre.'

Professor Alex Edmans

Content

Feature

Should businesses serve wider society?

Professor Alex Edmans argues that creating social value is neither defensive nor simply ‘worthy’ – it’s good business.

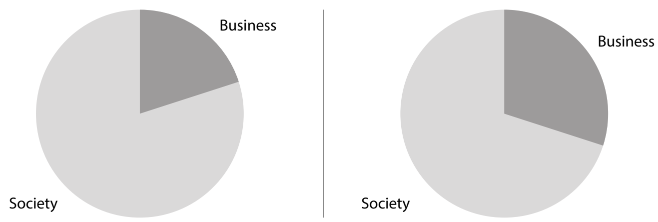
Even before Covid-19 devastated the world, capitalism was already in crisis. The 2007 financial meltdown cost nine million Americans their jobs and 10 million their homes. Although the economy has recovered since then, the gains have largely gone to bosses and shareholders, while ordinary incomes have stagnated. Corporations affect not only people, but also the planet. The environmental costs created by business are estimated at $4.7trn per year. Notable examples are the Deepwater Horizon disaster which spilled five million barrels of oil into the sea, and Volkswagen’s dodging of emissions tests which caused an estimated 1,200 deaths in Europe alone.

Citizens, and the politicians that represent them, are fighting back. The precise reaction varies – Occupy movements, Brexit, electing populist leaders, restricting trade and immigration, and revolting against CEO pay. But the sentiment’s the same. ‘They’ are benefiting at the expense of ‘us’.

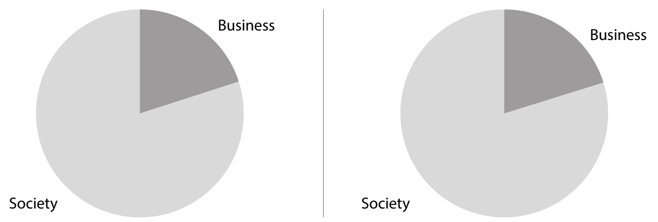
In turn, companies were responding – or at least appearing to. Sustainability became the corporate buzzword of the day. It was the theme of this year’s World Economic Forum in Davos. Last August, the US Business Roundtable radically redefined its statement of the ‘purpose of a corporation’ to include stakeholders – customers, employees, suppliers, the environment, and communities – rather than just shareholders. BlackRock chief Larry Fink, in his annual letter to CEOs the last few Januarys, has stressed that their companies must serve wider society.

But it wasn’t clear whether these leaders genuinely meant what they said. Critics argue that Davos is more about appearing to do good than actually doing good. Sceptics speculate that the Business Roundtable made that statement to pre-empt anti-corporate regulation, particularly if a Democrat wins this year’s election. Cynics claim that Fink’s letters are a response to accusations that index funds are excessively passive and don’t hold companies to account.

Why is it that some leaders may not do as they say? Because many fear that sustainability is at the expense of profits. Traditional management thinking is that the value created by a company is represented by a pie, which is fixed in size. So any slice of the pie given to society means a smaller slice for shareholders. A CEO’s goal, therefore, is to squeeze as much as possible out of others, by holding down wages, price-gouging customers, and paying scant attention to the environment. This *pie-splitting mentality* would argue that you should practice sustainability to the minimum possible, and reduce it to PR initiatives that cost little but create much fanfare.



But the *pie-growing mentality* stresses that the pie is not fixed. By investing in stakeholders, a company doesn’t reduce investors’ slice of the pie, as assumed by some CEOs – it grows the pie, ultimately benefiting investors. A company may improve working conditions out of genuine concern for its employees, yet these employees become more motivated and productive. A company may develop a new drug to solve a public health crisis, without considering whether those affected are able to pay for it, yet end up successfully commercialising it.



It might seem too good to be true that serving society might ultimately boost profits, so we need large-scale, rigorous evidence. That’s what I gather in a new book, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*. One study shows that companies that treat their employees fairly – as human, rather than resources – outperformed their peers by 2.3–3.8% per year over a 28-year period. That’s 89–184% compounded. It does further tests to suggest that it’s employee satisfaction that leads to good performance, rather than the reverse. Other studies find that customer satisfaction, environmental stewardship, and sustainability policies are also associated with higher stock returns.

A shift in thinking

The pie-growing mentality shifts our thinking on some of the most controversial aspects of business. First, it transforms what leaders’ and enterprises’ responsibilities are, and how and what society should hold them accountable for. We often ‘name and shame’ companies who engage in *errors of commission* – actions seen as pie-splitting, such as making what we see as too much profit. But high profits may be a by-product of serving society. Instead, we should hold businesses accountable for *errors of omission* – spurning opportunities

Feature

to grow the pie through inaction. For example, Kodak failed to invest in digital cameras and ultimately went bankrupt. Yet it's rarely seen as a corporate governance failure because investors didn't profit – but that's of no consolation to the 150,000 workers who were made redundant. An irresponsible company is one that shrinks the pie or fails to grow it, harming everyone.

Secondly, the pie-growing mentality changes our view on how to reform executive pay. The level of CEO pay is perhaps the single most-cited piece of evidence that business is out of touch with society. Median FTSE 100 pay is £3.6m, 120 times the average employee. The idea is that, if the CEO wasn't so greedy, her pay could be redistributed to her colleagues or invested. But that's the pie-splitting mentality. The amount that can be reallocated through redistributing the pie is tiny. The median equity value in the FTSE 100 is £7bn. £3.6m is only 0.05% of the pie – far smaller than the 2.3–3.8% that can be created by growing the pie through improving employee satisfaction.

Moreover, just like high profits, high pay could be a by-product of creating value. It's fair for CEOs to be paid like owners – to own a long-term share in her business, so that she's on the hook if it underperforms. But the flipside is that, if she grows the long-term stock price, she'll automatically be rewarded as her shares will be worth more. For example, Disney's Bob Iger was criticised for earning $66m, but the market value of Disney had risen by 578% in his four years at the helm, and 70,000 jobs had been created. So we shouldn't criticise high CEO pay without first asking whether it results from pie-growing or pie-splitting.

And that's where there is indeed major room for reform. Some CEOs aren't paid like long-term owners. They're instead given bonuses based on short-term targets – and so it's indeed possible for them to earn millions by exploiting workers and customers. So the solution isn't so much to change the *level* of pay, even though this might win the most headlines, but its *structure* – to move away from short-term targets and pay the CEO with shares that she can't sell for (say) five–seven years. Giving her long-term incentives rewards her for pie-growing and discourages pie-splitting. Importantly, she should continue to hold her shares after retirement, to ensure that her horizon extends beyond her tenure. And shares should be awarded to all employees, to ensure that everyone benefits from pie-growth. If the company does well, it's not just due to the CEO.

Thirdly, the pie-growing mentality shifts our thinking on investors. Investors are often viewed as nameless, faceless capitalists who extract profits at the expense of society. But such views aren't backed up by the evidence. Rigorous studies show that, while shareholder activism does indeed increase profits, this doesn't arise from pie-splitting but pie-growing – improved productivity and innovation, which in turn benefits society.

Investors are not 'them'; they are 'us'. They include ordinary citizens saving for retirement, or mutual funds or pension funds investing on their behalf. Policies that suppress investors will not only make companies less purposeful and less productive, but also harm citizens. Investors aren't the enemy, but allies in growing the pie. Any serious proposal to reform business should place investor engagement front and centre.

Putting it into practice

So how does a company actually 'grow the pie'? The starting point is to define its purpose – why it exists, its reason for being, and the role that it plays in the world. A purpose might be to develop medicines that transform citizens' health; to provide an efficient rail network that connects people with their jobs, family and friends; or to manufacture toys that entertain and educate children.

Importantly, a company's purpose cannot be to earn profits – instead, profits are a by-product of serving a purpose. This is similar to how a citizen's vocation is not to earn a salary; instead, he earns a salary by choosing a career he enjoys and thus flourishes in. Equally importantly, a purpose should be focused. Many companies have broad purpose statements, such as 'to serve customers, colleagues, suppliers, the environment, and communities while generating returns to investors' because they sound aspirational. But a purpose that tries to be all things to all people offers little practical guidance because it sweeps the harsh reality of trade-offs under the carpet. Leaders need to make tough decisions that benefit some stakeholders at the expense of others. For example, closing a polluting plant helps the environment but hurts employees. A focused purpose statement highlights which stakeholders are first among equals to guide such a trade-off.

And evidence highlights the criticality of focus. Companies that do well on ESG dimensions across the board don't beat the market. But those that do well on only dimensions material to their business – and scale back on others – do significantly outperform. The book introduces three principles (the principle of multiplication, the principle of comparative advantage, and the principle of materiality) to provide practical guidance on which investments in stakeholders a company should make, and when it should show restraint. This balance is critical. Some leaders misinterpret the call to 'serve society' as an imperative to invest as much as possible, and many politicians advocate such behaviour. But there are many cautionary tales of companies imploding through overinvestment, Daewoo being a particularly prominent one.

A collaborative effort

So it's not business or society – it's *and*. This observation gives us great hope, but also great responsibility. Not only can all stakeholders benefit from a growing pie, but it's also their duty

continued on page 12

GOVERNANCE

www.governance.co.uk

Subscription form

Please complete this form and send by mail to:

**Subscriptions Department Governance Publishing and Information Services Ltd
The Old Stables, Market Street,
Highbridge, Somerset, TA9 3BP, UK**

**Tel: +44 (0) 1278 793300
Email: info@governance.co.uk
Website: www.governance.co.uk**

(Please tick one)

- ☐ Yes! I would like to subscribe to Governance for one year
- ☐ Or save with a 2 year subscription

Governance international subscription costs:

	£UK	Euro	US$
1Yr	325	450	490
2Yr	585	790	855

Governance can accept cheques in other currencies but an administration fee of £15 will be charged.

☐ I enclose a cheque/bankers draft for	
Currency	Value
☐ Please invoice me	
Specify currency:	
Order reference:	
Title:	
First name:	
Surname:	
Position:	
Company/Organisation:	
Address:	
Postcode:	
Email:	
Tel:	
Fax:	

continued from page 11

to work together to grow the pie. When they do so, bound by a common purpose and focused on the long-term, they create shared value in a way that enlarges the slices of everyone – shareholders, workers, customers, suppliers, the environment, communities, and taxpayers.

Importantly, an approach to business driven by purpose typically ends up more profitable in the long-term than an attempt to maximise shareholder value. So it's one that leaders should voluntarily embrace, even in the absence of public mistrust or threats of regulation. Creating social value is neither defensive nor simply 'worthy' – it's good business. The highest-quality evidence, not wishful thinking, reaches this conclusion: To reach the land of profit, follow the road of purpose.

Alex Edmans is Professor of Finance at London Business School and author of 'Grow The Pie: How Great Companies Deliver Both Purpose and Profit'. His book can be purchased through Amazon here: https://amzn.to/2RzUhSZ

What our subscribers say

'*Governance* is a useful means of keeping up to date on developments in a field which is assuming greater importance by the day.'

Index

Designed and printed by WithPrint
Riverside Studio, Gills Lane, Rooksbridge, Somerset, BS26 2TY
www.with-print.co.uk

ISSN 1358-5142

Governance Publishing and Information Services Ltd
The Old Stables, Market Street, Highbridge, Somerset TA9 3BP, UK
Tel: +44 (0) 1278 793300
Email: info@governance.co.uk Website: www.governance.co.uk