Shareholders or Stakeholders? Yes

By Rick Frazier and Peter Derby

"Without exception, all the countries self-described as socialist know varying degrees of economic backwardness." —Carlos Rangel

The recent revival of socialism as a potentially viable economic doctrine worthy of adoption in the U.S. is disheartening. Just a cursory investigation of socialism's track record when implemented at various times and in various places and forms, should be sufficient to expose it as economically ineffectual at best and humanitarian nightmare at worst.

By contrast, even during its earliest, harshest beginnings, capitalism did more to save people from starvation and death than any other social system or religious organization in the world. As it matured, capitalism has helped to greatly reduce extreme poverty and improve living standards wherever it was allowed to take firm root. Today, we believe capitalism needs to be practiced in ways that make it more highly regarded as a system worthy of encouragement and preservation because it's the system that best allows personal freedom, progress and opportunities to coexist.

The first step requires acknowledgement that capitalism's critics have some legitimate complaints about the way capitalism has evolved in the U.S. over the last forty years. Many of these complaints are grounded in a perceived lack of caring on the part of corporate executives. Raw, oppressive forms of capitalism are rare in the U.S., but people can still find themselves working within stressful, psychologically unhealthy corporate cultures, or losing their jobs while watching executives benefit from layoffs. Nineteen and twenty-year-old army corporals implicitly understand no one will respect them unless they lead by sharing in the hardship. Why is this simple truth so difficult to understand for a 50-year-old executive with a couple degrees and years of experience? In a 2014 interview with *Forbes*, Jim Goodnight, CEO of SAS Institute said, "It makes me really mad when a CEO lays off thousands of workers and is rewarded with the stock increasing."

Other examples of the perceived soullessness of corporations will no doubt come to mind for readers and be added to the thicket of criticisms. More systemic critiques about cronyism, rent-seeking, corporate welfare, surveillance capitalism, regulatory capture, share buybacks, or short-termism are often included in overarching disparagements of today's capitalism.

The next step requires widespread adoption of a multi-stakeholder mindset by U.S. businesses. This won't fix all the perceived problems laid at capitalism's doorstep, or ever satisfy those who are dogmatically anti-capitalist. It will however, push capitalism in a direction that makes it far more defendable. When corporate leaders genuinely adopt a multi-stakeholder mindset, it breeds an attitude of caring throughout the firm—about providing optimal long-term returns for investors; about being a good neighbor in the

communities where it operates; about creating a work environment or culture that inspires people to give their best efforts; about maintaining mutually beneficial and trusting relationships with suppliers; about minimizing negative social and environmental impacts resulting from operations; and especially about providing quality and value to customers. This is what a well-executed multi-stakeholder operating system is meant to accomplish.

Upon hearing this description, most people, especially young adults, consider this to be the behavior of a well-managed company that practices capitalism in a way they can get behind. The late Milton Friedman probably would have agreed as well. In a debate with Whole Foods founder John Mackey, published by *Reason* magazine in 2005, Friedman pointed out that his oft-quoted statement, "the social responsibility of business is to increase its profits" refers to *social* responsibility, not legal or financial. He went on to explain why his view was equivalent to Mackey's view that a "corporation should try to create value for all of its constituencies."

A response we often hear from people when describing the principles of a multi-stakeholder operating system is that all of it just makes managerial common sense. They have a point. The intangible elements within our description really matter to a company's capacity to create future cash flow and speak to the day-to-day obligations of managers. So why would anyone argue against something that apparently makes so much sense?

The "common sense" reaction is also often accompanied by a sort of hand-wave dismissal, intimating that it's also easy to do. It's not. Managing ongoing tensions among stakeholders and between cultural values in our society is no walk in the park. And even maintaining a high-quality relationship with a single stakeholder can require heavy lifting. For example, despite a bounty of customer data available to corporations today, many still struggle to develop emotional connections with customers, or to strengthen customer loyalty. As a newly appointed president of a large financial services company once told us, "Everyone keeps telling me how great things are around here. But if that's the case, why am I getting about a thousand 'Dear Stupid' messages from customers every month?"

A multi-stakeholder operating system is built on basic and timeless principles which every organization can and should adopt. But every organization will also express these principles in their own unique voice. This is why it should remain a voluntary act that avoids a one-size-fits-all, politically driven "accountability" reporting mandate which would stand about as much chance of being useful as mandating how jazz should be played.

Additionally, there is no shortage of guidelines available to firms since a good deal of time and effort has already been devoted to the development of multiple reporting frameworks. Some of these include, the Inclusive Capitalism long term value framework, the International Integrated Reporting Council framework, the World Intellectual Capital Initiative intangibles reporting framework, the Sustainability Accounting Standards Board principles-based framework, the Global Reporting Initiative Sustainability Reporting Standards, the Enhanced Business Reporting Consortium framework, and the

Business for Social Responsibility triangular framework. More specialized frameworks are also available such as the International Organization for Standardization's human capital reporting framework, the Climate Disclosures Standards Board and the Human Rights Reporting and Assurance Frameworks Initiative. Most politicians clamoring for a government-induced reporting mandate are probably unaware of these developments.

Supporters of a stakeholder accountability mandate often extol the virtue of forcing companies to operate in such ways that all stakeholders are treated equally at all times. This is a moral objective that lacks practicality because stakeholders' contributions to a company's success are wide-ranging variables that resist the neat equalization implicit in the idea of balancing interests. The multi-stakeholder model should be viewed as a pragmatic operating system that ultimately *reflects moral sensibilities* by avoiding an overemphasis on one stakeholder to the neglect of other stakeholder groups. In this view, moral results become side effect outcomes, not mandated objectives derived from subjective moral or political beliefs.

The subjective nature of moral beliefs creates conflicting opinions about right and wrong in corporate behavior. What one person might feel is unfit corporate behavior, another might justify as a fully legal, ethical and practical response to real-world conditions. This is why it can be such a challenge to analyze company performance based on the tenets of corporate social responsibility (CSR).

Management consultant and author Peter Drucker separated social responsibilities into social impacts, or what business does to society and social problems, or what business can do for society. It's quite easy to reach consensus that all businesses should try to minimize or eliminate negative social impacts resulting from operations. That all businesses should also address social problems provokes controversy. For example, in response to the recent Business Roundtable statement on corporate purpose, the Council of Institutional Investors (CII) stated, "It is government, not companies, that should shoulder the responsibility of defining and addressing societal objectives with limited or no connection to long-term shareholder value."

Edward Freeman, Darden Business School professor of ethics at the University of Virginia, who can be rightly called the U.S. intellectual father of the multi-stakeholder operating system, has called for the immediate demise of corporate social responsibility and recommended replacing it with corporate *stakeholder* responsibility. Freeman was previously the academic director of the Business Roundtable Institute for Corporate Ethics and is currently an academic director for the Institute for Business in Society at UVA. His award-winning book, *Strategic Management: A Stakeholder Approach* was published in 1984. Thirty-five years later, perhaps the 181 members of the Business Roundtable who recently became signatories to the organization's stakeholder proclamation now think he might be on to something. We do too. A company with a sterling social responsibility record doesn't necessarily mean it's also a great place to work, loved by customers, or a good investment.

Anecdotal evidence indicates the multi-stakeholder operating approach has reached a tipping point, ahead of any universal demand from investors. Instead, marketplace expectations about the companies we work for, buy from, and allow to operate in our communities are making a multi-stakeholder operating system less optional. This is probably why a growing number of public companies now make claims of stakeholder attentiveness on their websites. As far back as 2008, an article in *Business Ethics Quarterly* cited a random sample of websites of 100 companies from the *FORTUNE 500* that revealed 64 out of 100 claimed to embrace approaches to "maximize the well-being of all stakeholders." As we know well, determining which companies have actually made a bona fide commitment requires some work.

The signatories to the Business Roundtable's recent stakeholder proclamation will also demonstrate varied degrees of commitment. Some have been on the multi-stakeholder path for quite some time, others will be playing a lengthy game of catch-up and some might simply use it as a new form of "greenwashing."

Those companies that started early have a refined network of stakeholder listening posts, giving them advanced notice of potential and emerging problems, as well as new business opportunities. At its most mature expression, a multi-stakeholder operating system consists of internal indices such as a culture index, employee engagement index, or customer perception of value index whereby the link between the performance of those indices and their effects on financial performance is tracked. Advancements in modeling tools that quantify such relationships make this type of causal analysis very doable today.

While marketplace realities act as a forcing mechanism, the degree to which investors expect companies to adhere to a multi-stakeholder operating system as a foundation for value creation is more difficult to gauge. One investor demand proxy to consider is the UN Principles of Responsible Investing (PRI). The UN PRI has 2500 signatories, mostly investment managers and asset owners that commit to incorporating ESG (environmental, social, governance) criteria in their investment analysis and decision-making processes. Signatories pay a fee and provide the PRI Association with information. But as the PRI Association is careful to point out, "All information is provided 'as-is' with no guarantee of completeness, accuracy, timeliness…" Such guarantee would require significant audit work to verify signatories are really putting a shoulder behind their commitment. As one portfolio manager for a multibillion dollar fund told us, "We pay the fee, overlay ratings from one of the ESG data firms, call it a day and everybody's happy."

Socially conscious investors might also serve as a proxy for measuring investor demand for companies to demonstrate their stakeholder-centric bona fides. It's difficult to imagine how any company can meet the expectations embedded in the various definitions we come across for social responsibility or sustainability without being guided by a multi-stakeholder operating system. This claim is supported by research conducted in 2018 by Vukic et al., indicating a positive link between the level of corporate stakeholder orientation and the quality of CSR reporting.

Morningstar classifies a total of 288 mutual funds and ETFs as socially responsible with a total inflow of $5.5 billion in 2018 and about $20 billion in 2019. The numbers clearly show an increasing interest in these investment strategies by investors. However, current total asset calculations for capital allocated to socially responsible-type investments are murky. In his book, *The Enlightened Capitalist*, author James O'Toole states, "The first so-called social investment fund was launched as early as 1971; by 2017, there were over 200 such funds active in the United States, with collective assets of $77 billion." At the other end of the spectrum is a trends report from the US SIF Foundation which states, "Total US-domiciled assets under management (AUM) using SRI [socially responsible investing] strategies grew from $8.7 trillion at the start of 2016 to $12.0 trillion at the start of 2018."

We attempted our own calculation using Bloomberg's fund screening function. Screening for general attributes associated with any and all types of U.S. domiciled ESG funds, we derived a total of about $230 billion. Since Bloomberg doesn't track every public fund, we estimate another $50 to $70 billion could be added to this total. Using $300 billion seems to be a credible estimate, representing a little over 1% of total U.S. market assets based on the Wilshire 5000 full market cap of $33.8 trillion as of 12/31/19.

The surge of investor interest in ETFs overall has been remarkable, racking up a little over $4 trillion. Bloomberg Intelligence issued a report in August 2019 that put the number of assets in socially responsible ETFs at $60 billion. Issuance of socially responsible ETFs has lagged behind the general trend, which means the bulk of these social ETFs are relatively young. Nonetheless, given the topical nature of socially responsible investing we expected the total to be higher.

One reason commonly cited for investor hesitation about socially responsible funds is a perception that subpar return performance is the norm. In fact, it's not unusual for financial advisors to warn clients about this possibility. According to the ETF.com data screener, out of 30 ETFs categorized as ESG, socially responsible or sustainable funds, five have performed better than the S&P 500 over a 3-year period ending in 2019 and none has performed better over a 5-year period. However, over the past couple years socially responsible funds—many of which have a decidedly environmental bent—have enjoyed a performance uptick due to their natural avoidance of large swaths of the underperforming energy sector. This might largely explain the recent asset-inflow swell reported by Morningstar.

Given 2500 UN PRI signatories, the US SIF asset numbers previously noted, and more than 12,000 signatories to the UN Global Compact committing to responsible business behavior, a person could justifiably conclude the era of socially responsible business and investing has arrived in full force. It's certainly been top of mind in financial markets the past few years. "This topic has evolved massively," said Geraldine Matchett, the CFO and incoming co-CEO of DSM, the Dutch nutrition and materials company. "For a long time it was a minor, niche, 'impact investing' topic largely ignored by investors. Suddenly, we are having a conversation instead of a monologue."

Yet the percentage of total assets flowing into socially responsible funds, while growing, is still quite small. And ongoing discussions persist about changing the face of capitalism under banners such as conscious capitalism, inclusive capitalism, moral capitalism, virtuous capitalism, creative capitalism and several more. A common thread running through most, if not all of those discussions, is the multi-stakeholder operating system. This is where we need to go if we really want to move the needle.

The U.S. is viewed as a latecomer to the ESG/CSR movement compared with other parts of the world, especially Europe. Widespread adoption of the multi-stakeholder operating system would afford us a leapfrogging opportunity. The ESG lens isn't wide enough or deep enough to capture all of what needs to be done and reported by companies, or assessed by investors from a multi-stakeholder perspective. It doesn't tell us enough about upstream intangible assets that produce very tangible downstream financial consequences.

Among the reporting frameworks listed earlier, several attempt to fill the gap by using a more holistic lens to assess corporate performance. As an example, the fairly new Inclusive Capitalism Long Term Value Framework puts a stronger emphasis on corporate culture. State Street Global Advisors has also started asking companies to provide insights about corporate culture. This often overlooked, upstream intangible indicator, not typically captured by ESG, probably gives investors a better handle on organizational risk than just about any other information companies currently report. It's no coincidence that corporate culture takes center stage during postmortem analysis whenever companies fall off the beam.

The link between culture, performance and risk has been well established for decades. Culture also plays a significant role in talent recruitment and retention. Prospective employees rarely, if ever, conduct research about a company's governance mechanics, but they do want to know about culture. When did you ever hear someone mention governance when describing why they love their workplace, or why they love doing business with a firm?
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Granted, one might argue certain aspects of ESG/CSR address issues customers are starting to care more about as well. And of course the link between customers' willingness to keep buying and a company's capacity to create future cash flow is obvious. But ESG and CSR don't provide any real insight about customer perceptions. The customer portion of ESG analysis available to investors, when it exists at all, typically contains negative information such as product safety-related legal cases, charges of false advertising, product recalls, predatory lending criticisms, etc. While this information might be useful for determining which companies to potentially avoid, it provides little insight about which companies are doing a great job meeting or exceeding customer expectations. Likewise, a "human capital" pillar is included in some ESG assessments and can include upwards of a hundred different criteria, often assessing just about everything except the one thing that matters most to productivity and performance, namely employee engagement levels.

The World Economic Forum, which takes place in Davos, Switzerland every year, and its founder, Professor Klaus Schwab, has been encouraging businesses to adopt a multi-stakeholder operating system for the past fifty years. According to an article in FORTUNE, the Business Roundtable's decision last August to revise its statement on corporate purpose had given the issue new life at the 2020 meeting, with countless panels and conversations on the topic being held. "CEOs that participated agreed they face growing demands to look after stakeholders—customers, employees, their communities, and the environment. But all insisted that doing so was in the long-run interest of shareholders."

At a Forum meeting several years ago, former CEO of PepsiCo Indra Nooyi was a panel participant when she suggested analysts be sent back to school to learn how businesses actually create value. Most of the value creation elements she described were part and parcel of a multi-stakeholder operating system. The problem with her suggestion at the time, and largely today still, is that those retrained analysts will have learned to evaluate intangible asset information that mostly remains locked inside companies, or has yet to be measured and monitored by companies.

While corporate financial performance and economic prosperity increasingly come from intangible assets, investors are largely left guessing about how well companies are managing, safeguarding and leveraging those assets. In a 2001 speech sponsored by the Practicing Law Institute, Robert Bayless, former SEC Chief Accountant, Division of Corporation Finance said, "Intangible assets are very important in this economy. If intangible assets are important to the business, registrants should identify them and explain what management does to develop, protect and exploit them. Operational, non-financial measures can be very effective in explaining to investors the value of a company's intangibles." Two decades later investors are still mostly groping in the dark when it comes to intangible asset analysis.

More than a decade ago, we did a couple years of groping ourselves when we first set out to develop an investment research process that would allow us to identify companies that seemed committed to a multi-stakeholder operating system. We knew what to look for based on our previous modeling work inside companies, but we weren't sure where to find what we needed for our assessments as analysts on the outside. We felt blind and ill-equipped at first since the whole accounting and reporting apparatus was designed to provide information about *tangible* assets.

Since the multi-stakeholder operating system is comprised of intangible assets, we were forced to cobble an information system together from scratch. Fortunately we discovered a pool of specialists outside the typical vendor pool serving the investment community who were able to provide the insights we were looking for. Let's look at some examples.

Labor & Human Rights Risk: Most companies with a large number of suppliers and contractors in their supply chain have a forced labor policy, or some form of labor and human rights policy in place. Uncovering labor and human rights risks in supply chains is

a huge challenge in social auditing, particularly when a firm has thousands of suppliers. Most analytics providers relied on for such due diligence are also evaluating many other issues and striving to offer coverage for as many companies as possible. In short, they're spread too thin to offer quality assessments in this area. We turned to organizations that were solely focused on conducting on-the-ground audits of factories for many years within their clients' supply chains. We tapped into their network of auditors around the world and asked them to rate U.S. companies based on a jointly developed grading scale. No other investment or research firm had ever approached these organizations for such an assessment.

Intangible Asset Management Index: Another specialist had created an algorithmically generated index for offering reputation insurance that goes beyond typical forms of business insurance such as D&O coverage. When we reviewed what they were insuring against, it was losses resulting from many parts of a multi-stakeholder operating system—metrics that were linked to stakeholder expectations in six areas of business performance: ethics, innovation, quality, safety, sustainability and security. We were the first investment firm to request access to these ratings.

Su*pplier Relationship Quality:* Professor Rob Handfield at North Carolina State University devised a way to asses the quality of a firm's relationship with suppliers to determine whether suppliers were being treated in a way that would create a mutually beneficial and trusting relationship. Most firms rarely capture the full benefits available to them from their supplier relationships, including innovations, due to low quality relationships. Again, we were the first investment firm to ask Professor Handfield to evaluate companies as part of our research process.

Culture: Culture can be measured, but it's practically impossible to do as an outside analyst. As a result, proxies need to be used. Openness and honesty are certainly components of a healthy culture. We became the first user of an algorithmic process designed to evaluate the openness and honesty of executive communications. In addition, we also use a series of Human Equity Value Metrics that correlate with the characteristics of high performing cultures and employee engagement levels. These metrics were developed by a consulting firm that has been conducting culture assessments for companies for several decades. Here again, we were the first investment firm to request access to the formulas underlying these metrics.

Customer Perception of Value: Proxies are not required to assess the quality of customer relationships. What *is* required is a way to figure out what customers really think about a company, brand, or product as opposed to what they say they think. Our prior consulting experience served us well in this regard. We knew exactly who to turn to for this type of in-depth analysis. Conducting customer research on a large number of companies is expensive, but nothing is more fundamental to a company's capacity to create future cash flow than loyal, economically profitable customers.

By no means do we claim to have completely cracked the code for intangible asset analysis. We can probably claim we've been at it for as long or longer than anyone else

and feel we've built a system that allows us to assess companies with some measure of confidence. But the search for new or better sources of information that can potentially provide additional insights never really ends. It requires continuous tinkering and more tinkerers are arriving on the scene. As previously noted, more analysts are beginning to appreciate the need to get a better handle on how well companies are safeguarding and leveraging some of the intangible assets that comprise a multi-stakeholder operating system.

We've been sloshing through the beachhead of an incubation period with ESG and CSR. The multi-stakeholder operating system can take capitalism to higher ground and bring more investors on board because of its pragmatism and its ability to demonstrate a stronger link between intangibles and corporate performance. The Council of Institutional Investors has expressed concerns about businesses acting as social instruments, but it also stated, "CII supports putting capital to its best use for long-term performance, which includes addressing stakeholder contributions to that objective." This statement betrays a certain coherence, but it opens the door to the possibility the CII will support our call to action. The long-term view is difficult to marshal when the pressure to play the quarterly earnings game remains a stubborn reality. This makes managing the short-term versus long-term polarity, while consistently growing the economic pie, a formidable task. And investors justifiably become skeptical when they are asked to focus on the long-term, only when short-term performance is lousy. The multi-stakeholder operating system allows companies to demonstrate an authentic commitment to long-term value creation.

Institutional investors have more capacity to influence widespread adoption of a multi-stakeholder operating system than any other stakeholder. They would be well served to insist on it and hold companies accountable for reporting on progress. Analysts should welcome such reporting as a way to better understand what's really happening inside companies and how the underlying health of the company is being safeguarded. It would also provide analysts with new insights beyond the tangible asset grist mill where everyone is pretty much grinding the same financial ratios in search of alpha. Socially conscious investors should welcome an operating system whereby companies add value for all stakeholders as a matter of course, lessening the need for businesses to give something back because they don't take something in the first place. We often refer to well-managed companies as "running like clockwork." It's a mechanistic metaphor. Analyzing companies through a multi-stakeholder lens defines well-managed companies in more humanistic terms.

If we get this right, the need for separate, bolted-on social responsibility reports and the need to apply softening modifiers to capitalism will fade away. We'll simply call it capitalism again without apology or guilt. There will be fewer social problems for either business or government to address if we practice capitalism in a way that improves its attractiveness and its effectiveness. It's even possible institutional investors will eventually come to realize their "long-term" best interests will be better served by a changed incentive system—one that rewards executives for implementing an operating system that requires paying steadfast attention to upstream intangibles that have a significant effect on downstream financial performance.

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The fear that shareholders will suffer if companies adopt a multi-stakeholder operating system seems misplaced. After all, shareholders are stakeholders within the multi-stakeholder operating system and in addition the U.S. central bank has been providing an unprecedented level of downside risk protection for shareholders. A world where shareholders are protected against macro risk by the central bank and can be protected against micro risk by well-managed companies seems like a pretty good deal overall. Absent a central bank equivalent for other stakeholders, companies operating with a more holistic view of the enterprise and its place in society are filling the void. These companies are best positioned to align themselves with marketplace and societal forces that are becoming too powerful to ignore. The SARS-CoV-2 pandemic could contribute even more steam.

A number of recent articles claim leaders who embrace the idea of caring for stakeholders as a core value will be well-positioned to succeed in a post-COVID world of business. Bloomberg Intelligence recently issued its proprietary Covid-19 Corporate Pandemic Response Tracker to "identify companies harnessing resources, capital and innovation while acting in the interest of their employees and society." Bloomberg Intelligence believes companies will be rewarded for the type of caring behavior associated with a multi-stakeholder mindset. They might be right, but history is not on their side. When Southwest Airlines was the only airline that decided against layoffs after 9-11, investors did not rush in to support that decision. In fact, the company was criticized by analysts. In the end it turned out to be the right decision on multiple fronts. But it would have been nice to see more institutional investors put their money where they often put their mouths on the topics of short-termism or employee welfare.

We've always maintained that companies guided by a multi-stakeholder operating system can create wealth for shareholders without neglecting other stakeholders. We envisioned the possibility of a virtuous cycle whereby companies would realize lower capital costs as more investors reward them for operating this way. And we always imagined institutional investors would lead the way if we could show them no return trade off would be required. We began to question this assumption several years ago and decided to license one of our indexes for a retail investment product. Our current thinking is that individual investors might be more willing to lead the way. If they do, the bedrock upon which living standards have always been improved can be protected. And it doesn't get more socially responsible than that.

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