

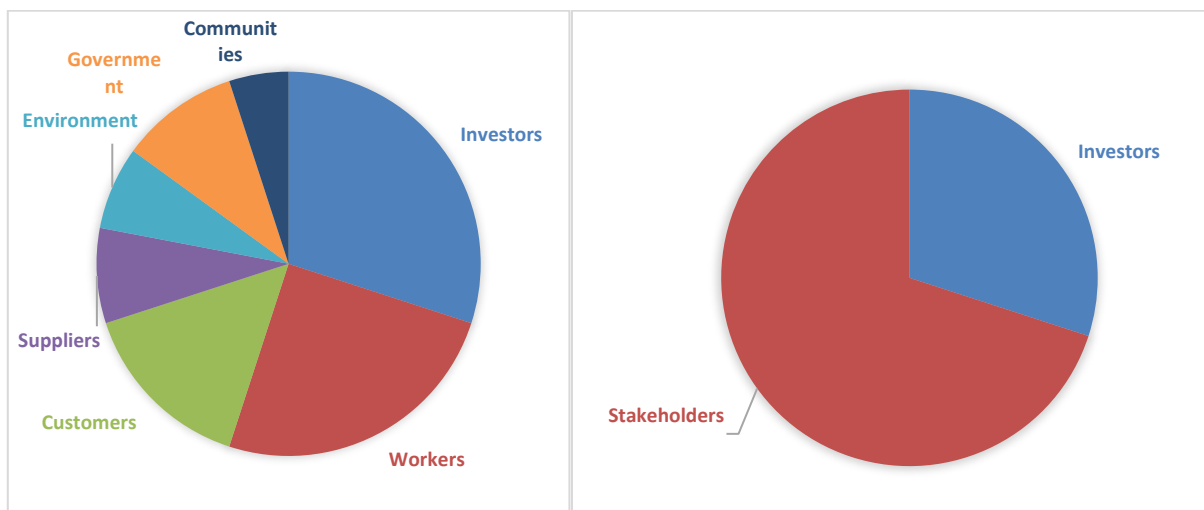
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PURPOSEFUL BUSINESS: THE EVIDENCE AND THE IMPLEMENTATION

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The Pie-Growing Mentality

The value that a company creates for society can be represented by a pie. It includes not only the profits to *investors*, but the value it delivers to *workers*, *customers*, *suppliers*, the *environment*, the *government* and *taxes*. Collectively, these other constituencies are known as *stakeholders*.



Some executives believe that their only goal is to maximise profits for investors. The *pie-splitting mentality* assumes that the size of the pie is fixed (at least in the short-term). Thus, the only way to increase profits – the slice taken by investors – is to reduce the slices taken by other stakeholders. They can do so by price-gouging customers, reducing worker wages, or polluting the environment. Unfortunately, some companies have the pie-splitting mentality, and undertake these actions, which is why there's a serious crisis of public trust in business. (A notable example is Turing Pharmaceuticals, which increased the price of a drug by 5500% overnight.)

The *pie-growing mentality*, in contrast, views the pie as not fixed. Companies can grow the pie by investing in stakeholders – improving working conditions, pioneering new products for customers, or reducing their environmental footprint. Profits then rise as a by-product of growing the pie. Actions primarily to benefit stakeholders may yet ultimately benefit investors – even if higher profits were never the primary objective of these actions. A company may improve working conditions out of genuine concern for its employees, yet these employees ultimately 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 ultimately be able to commercialise it or benefit from an enhanced reputation. (A notable example is Merck, which developed a drug (ivermectin) to cure river blindness and then donated it for free.) A company may reduce its emissions far beyond



the level that would lead to a fine, due to its sense of responsibility to the environment, yet ultimately benefit because customers, employees, and investors are attracted to a firm with such values.

In a pie-splitting company, profits are the end goal, and actions should only be taken if they generate profit. In a pie-growing company, creating value for society is the end goal. It will take many actions even though the link to higher profits is unclear, but higher profits may manifest anyway as a by-product.

What Is A Responsible Business?

A responsible business is one that creates value for wider society, not just for investors.

While this statement may seem uncontroversial, it suggests that many common views on what constitutes responsible or irresponsible business may actually be incorrect. Often, companies are labelled as “irresponsible” if they generate high profits or their CEO earns millions. However, these high profits or earnings may be a result of growing the pie – of creating substantial value for society and transforming many citizens’ lives. Google shareholders and executives have become wealthy, but through creating many products that ordinary citizens benefit substantially (nearly always for free) – where would we be without Google Search, Google Maps, Google Docs, or Gmail? Of course, profits and salaries can also be generated through pie-splitting. Thus, it’s critical to first analyse the source of high profits and salaries rather than automatically viewing them as irresponsible.

Note, also, that investors are not nameless, faceless capitalists, but parents saving for their children’s education, a pension scheme investing for its retirees, or an insurance company laying aside to fund future claims. Profits are a critical source of value to society – although, as the pie shows, not the only important source of value. Without the prospect of profits, a company would not be funded to begin with; without having generated profits, investors could not meet their obligations.

Instead, the most irresponsible behaviour that a company can undertake is to fail to grow the pie, by coasting and preserving the status quo rather than innovating and taking risks. The failure to take a pie-growing action is an *error of omission*. Yet critics of business typically focus on *errors of commission* – taking an action perceived as pie-splitting, such as paying a CEO handsomely or engaging in a share buyback. Had Merck decided not to develop ivermectin, then millions more citizens would have gone blind, but the company would never have received the media criticism currently meted out to highly-paid CEOs or companies that undertake share buybacks. Kodak is still viewed by many as an innocent victim of digital camera technology rather than a complacent company that failed to innovate – a failure that cost employees thousands of jobs and investors billions of value. Thus, the pie-splitting mentality is possessed not only by executives, but critics of business.

In contrast, the most responsible actions that a company can take are not to split the pie in favour of stakeholders - to reduce CEO pay, or sacrifice profits to cut its carbon emissions¹ - but to actively create value. Simply being excellent at one’s core business is a major way in which companies create value for society.

The Case For Responsible Business

Assuming that companies’ fiduciary duty is to investors², why should they focus on growing the pie rather than growing profits? There are two reasons.

¹ Previously, we discussed how cutting carbon emissions may grow the pie. This arises if £1 of profits spent on reducing emissions generates more than £1 of value to the environment. If it generates £1 of value to the environment, then it splits the pie differently – the environment’s gain equals investor’s losses, and total value to society is unchanged.

² Although investor primacy has been questioned on legal grounds, this legal discussion is a large topic itself and beyond the scope of this lecture. Instead, we argue here that even if investors have primacy, companies should still pursue social value.



The first is that pursuing social value creation may ultimately lead to more profits than pursuing profits directly. A company focused on profits will indeed invest in stakeholders – but only if it calculates that such an investment will increase profits by more than the cost of the investment. Indeed, comparing costs and benefits is how finance textbooks argue companies should decide whether or not to take an investment.

But real life isn't a finance textbook. In practice, it's very difficult to calculate the future payoff of an investment. In the past, this was easier when investments were in *tangible assets* – if you build a new factory, you can estimate how many new widgets the factory will produce and how much you can sell them for. Most of the value of a 21st century firm comes from *intangible assets*, such as brand and corporate culture. If a company improves working conditions, it's impossible to estimate how much more productive workers will be, and how much higher profit this greater productivity will translate into. The same is true for the reputational benefits of a superior environmental record. A company that's free from the shackles of having to justify every investment by a calculation will invest more and may ultimately become more profitable.

The second is that investors typically care about more than just profits. Investors are almost never just investors. They are (or they manage money on behalf of) workers and customers, they're members of communities, they're affected by the environment, and they pay taxes. A major reason why parents invest is to pass on their wealth to their children. However, if they generate investment returns through supporting companies that contribute to water shortages or global warming, their investment will make their children worse off.

The Evidence for Responsible Business

The idea that companies that serve society ultimately become profitable sounds attractive, but almost too good to be true. Is this actually the case in the real world, or just wishful thinking?

Supporters of responsible business typically cite stories or anecdotes of responsible companies that ultimately ended up profitable, or irresponsible companies that ultimately get their comeuppance. Indeed, Merck is currently one of the largest pharmaceuticals companies in the world, and former Turing CEO Martin Shkreli is currently in prison.³ Indeed, we live in a world where stories are very powerful. They're used successfully in TED talks, books, and business school case studies. However, you can always hand-pick a story to illustrate whatever point you'd like to make. A believer that responsible business doesn't pay off could point to tobacco companies' outsized profits. Moreover, commentators sometimes overextrapolate from a single story and make it appear much more general than it is. So we must be extremely careful of opinions, or calls for reform, based on stories. A key hallmark of all of my Gresham lectures is that they will be based on large-scale evidence, studying hundreds or thousands of companies, published in the most rigorous peer-reviewed journals.

To study the performance of companies that create value for society, we need a measure of societal value creation. Edmans (2011, 2012) studies employee satisfaction – how well a firm treats its workers – as measured by the list of the “100 Best Companies to Work For in America.” This list was available since 1984, providing a long time-series of data. It's also particularly thorough, studying not only quantitative factors such as pay and benefits, but also qualitative factors such as trust in management, pride in your job, and camaraderie with your colleagues.

To isolate the effect of employee satisfaction, the studies compare firms in the Best Companies list to those in similar industries, or those with similar size, recent performance, and growth opportunities. They find that the Best Companies deliver stock returns that beat their peers by 2.3-3.8% per year over a 28-year period – 89-184% compounded. Further tests suggest that it's employee satisfaction that leads to good performance, rather than good performance leading to employee satisfaction.

³ Note that he is in prison for securities fraud rather than price-gouging at Turing.



Fornell et al. (2006) analyse customer satisfaction. They find that companies in the top 20% of the American Customer Satisfaction Index earned just under double the returns of the Dow Jones Industrial Average over 1997-2003. Derwall et al. (2005) investigate the environment, using a measure of “eco-efficiency” that gauges the value of an enterprise’s goods and services relative to the waste that it generates. Highly-ranked firms beat lowly-ranked ones by 5% per year between 1995 and 2003.

Instead of studying the value delivered to one particular stakeholder, an alternative approach is to examine the extent to which companies adopt sustainability policies, such as to improve water efficiency. Eccles, Ioannou, and Serafeim (2014) find that high-sustainability firms beat their low-sustainability peers by 2.2-4.5% over 1993 to 2010.

Defining Purpose

The above arguments and evidence highlight the merits of the pie-growing mentality. How do companies actually put it into practice?

The important first step is for a company to think hard about what “growing the pie” and “creating value for society” – general concepts – mean in its particular circumstance. This is the role of *purpose*. A company’s purpose is its reason for being – the role it plays in the world and the way it contributes to human betterment – in other words, how it aims to create value for society.

A purpose consists of two dimensions: *who* a company exists for and *why* it exists. The *who* is the stakeholders that a company aims to prioritise, and the *why* is how it aims to serve them. Importantly, a purpose is valuable as much for what it leaves out as for what it includes. Virtually all major decisions a company makes involve trade-offs. One of the main benefits of having a strong purpose is to guide these trade-offs, but this isn’t possible if a purpose aims to be all things to all people. All stakeholders are important to a company to some degree, but defining the *who* as “to serve customers, colleagues, suppliers, the environment, and communities while generating a returns to investors” would be meaningless. Instead, the agri-business Olam prioritises the environment, and the retail store John Lewis prioritises its employees.

Turning to the *why*, it is only meaningful if the converse would also be reasonable. Costco’s purpose, to provide “quality goods and services at the lowest possible prices” (i.e. prioritise price, subject to attaining a minimum level of quality), is meaningful as the converse (to prioritise quality, subject to attaining a minimum level of affordability) would also be a reasonable purpose.

Prioritisation is particularly important because, while a pie-growing company aims to serve society rather than just investors, investors still remain an important member of society. A company that creates value for stakeholders at the expense of investors simply splits the pie differently; creating value for both stakeholders and investors grows the pie. While pie-growing involves making many investments without a calculation, the other extreme of cheerfully ignoring profits and investing in stakeholders in a carefree manner is pie-splitting or pie-shrinking. A clearly defined purpose will highlight the stakeholders that are particularly *material* to a company. Investing in material stakeholders is particularly likely to improve long-run profits – even if you can’t predict or calculate the source of the higher profits. Indeed, Khan, Serafeim, and Yoon (2016) find that companies with good stakeholder performance across all dimensions – i.e. indiscriminately – don’t actually beat the market, but those that rank highly on only material stakeholders do.

Implementing Purpose

Purpose is far more than a mission statement – it must be implemented. Two steps are key for purpose to “live” in an organisation. The first is to *communicate it externally* – as the adage goes, “what gets measured gets done”. This involves defining metrics, both quantitative and qualitative, of the extent to which a company is fulfilling its



purpose, and reporting them so that investors can hold it accountable. Without such metrics, investors will evaluate companies according to short-term earnings, and so executives will prioritise earnings over purpose.

The second is to *embed it internally*. This in turn involves many steps. One is to evaluate managers and employees on the above metrics, rather than the financial “key performance indicators” traditionally focused on. Another is to reform executive pay – move away from the target-driven bonuses that are common nowadays, and move towards giving executives stock with they must hold onto for several years. Since growing the pie typically takes several years before it ends up manifesting in higher profits, long horizons are critical to encouraging investors to adopt the pie-growing mentality. These reforms will be covered in more detail in my second lecture, [Executive Pay: What’s Right, What’s Wrong, and What Could Be Fixed](#).

Another dimension to reform is corporate governance, which extends beyond pay to other ways in which executives are held to account. At present, boards have committees focused on audit, pay, risk, and new appointments, but committees for human capital and innovation may be particularly valuable to encourage pie-growing. In addition, while a company typically gives investors a “say on pay” (sometimes mandated by law), giving them a “say on purpose” will ensure that they have buy-in to its mission and are also able to hold it accountable for delivering on it. These reforms will be covered in more detail in my third lecture, [Reforming Corporate Governance](#).

Finally, it’s important to move beyond companies and recognise that they’re only one part of the ecosystem. Making capitalism fairer, and ensuring that it serves society better, requires system-wide change. In particular, companies are accountable to investors – it’s investors who vote for or against directors or policies, engage with management to agitate for change, and buy or sell shares, driving the stock price up or down. Thus, reform must involve ensuring that investors play an effective role in stewarding the companies they own. This will be covered in more detail in my fourth lecture, [The Stewardship Role of Investors](#).

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