UPDATED AND REVISED

A FINANCIAL TIMES
BEST BOOK OF 2020

'... a tour de force.' - **Andy Haldane,**
Chief Economist, Bank of England

GROW THE PIE

HOW GREAT COMPANIES DELIVER BOTH PURPOSE AND PROFIT

ALEX EDMANS

GROW THE PIE

Should companies be run to earn a profit, or to serve a purpose? In this ground-breaking book, acclaimed finance professor and TED speaker Alex Edmans shows it's not an either-or choice. Drawing from the highest-quality evidence and real-life examples spanning industries and countries, Edmans demonstrates that businesses driven by purpose are consistently more successful in the long term.

But a purposeful company must navigate difficult trade-offs and take tough decisions. Edmans provides an actionable roadmap for company *leaders* to put purpose into practice, and overcome the hurdles that hold many back. He explains how *investors* can discern which companies are truly purposeful rather than greenwashing, and engage with them to unleash value for both shareholders and society. And he highlights the crucial role that *citizens* can play as employees, customers and investors, in reshaping business to improve our world.

This edition has been thoroughly updated to include the pandemic, the latest research, and new insights on how both companies and investors can make purpose a reality.

Alex Edmans is Professor of Finance at London Business School and a leading authority on reforming business to serve the common good. He has spoken at Davos and in the UK House of Commons, and gave the TED talk 'What to Trust in a Post-Truth World' and the TEDx talk 'The Social Responsibility of Business'.

PRAISE FOR THE HARDBACK EDITION OF *GROW THE PIE*

Financial Times Business Book of the Month (March 2020)
Financial Times Summer Books of 2020
Financial Times Best Books of 2020
Chartered Management Institute Management Books of the Year

> 'The quest to encourage companies to adopt positive values, for the benefit of all stakeholders, sometimes seems long on vision and short on firepower. Edmans, a finance professor, provides plenty of ammunition to support the idea that visionary leaders can expand the whole "pie" in pursuit of purpose and profit.'
>
> —*Financial Times*

> 'In a thoughtful new book, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*, Alex Edmans of LBS argues that the wealth accrued by a boss does not necessarily come at the expense of others . . . Mr. Edmans's view of pie-growing is nuanced. He advocates an approach to business with the primary aim of creating value for society. Profits are not the main goal but a welcome side effect.'
>
> —*Economist*

> 'In his newly published and excellent book *Grow the Pie*, Alex Edmans lands an important and fundamental message about the relationship between profit and purpose. He explains that businesses are better off if they look to "grow the pie" by serving the needs of all stakeholders rather than by pie splitting and focusing simply on shareholders and profit.'
>
> —*Management Today*

'Edmans's insights are fresh, often surprising, and always thoughtful and thought-provoking . . . One doesn't have to agree with every one of Edmans's recommendations to respond positively to the spirit that infuses his writing: Optimism, supported by copious evidence, about the potential for positive-sum outcomes to transform business performance and its contribution to society. It is a tonic for our times.'

—*National Review*

'I do not know whether capitalism is in crisis. But I do know Alex Edmans's superb book makes the case, compellingly and comprehensively, for a radical rethink of how companies operate, and indeed why they exist. It is the definitive account of the analytical case for responsible business, but is at the same time practical and grounded in real business experience. It is a *tour de force*.'

—*Andy Haldane, Chief Economist, Bank of England*

'This is an original and important book that will help transform how business sees itself – and how we see business. Alex Edmans, in his passionate advocacy of 'Pieconomics', challenges us all to adopt a mindset and unity of purpose in which all business actions contribute to pie-growing. The implications are radical and far-reaching. Read it: it will challenge how you think.'

—*Will Hutton, former editor-in-chief,* The Observer,
and author of The State We're In

'Politicians are calling for large companies to be regulated or split up. In this compelling book, Alex Edmans argues that there is indeed a problem with corporate behaviour, but that the solution may be simpler: change corporate purpose so that companies focus on growing the pie rather than grabbing more of it. Edmans's arguments are a powerful and persuasive antidote to much of the conventional wisdom about the corporate world.'

—*Oliver Hart, 2016 Nobel Laureate in Economics*

‘This is a brilliant and timely book, taking the business case for responsible capitalism to a whole new level. Edmans provides a rigorous, evidence-based approach, exploring numerous angles around how businesses can (and, as he shows, must) combine profit-seeking with purpose, as well as the role investors and other stakeholders can play in driving a genuine win-win approach. He tackles counter-arguments head on and has the courage to expose examples of virtue-signalling that falsely discredit responsible businesses. Citing case studies collated over decades, it’s a great read, too, offering fascinating examples well beyond the usual suspects. *Grow the Pie* really has the power to convince the sceptics as well as to encourage advocates to consider new ways to embed the approach further in their businesses.’

—*Dame Helena Morrissey, financier and founder of the 30% Club*

‘This is a must-read book for anyone interested in reforming capitalism – particularly in its role of serving wider society. The book is grounded in academic evidence, but the ideas are highly practical, and recognise the need for business to be profitable as well as purposeful. Most companies have inspiring mission statements; Edmans provides a concrete framework for translating them into actual practice. He does not shy away from acknowledging the challenges with running a purpose-driven company. Instead, he tackles them head-on, giving clear guidelines on how to navigate tough decisions, which he illustrates with powerful examples.’

—*Dominic Barton, former Global Managing Partner of McKinsey*

‘In *Grow the Pie*, Alex Edmans has provided us with a valuable contribution to contemporary thinking about how business can be a force for good in society. I have long advocated seeing the mutuality of interests between business, the workforce, suppliers, communities, the government and other stakeholders, and Alex employs a solid evidence base to back up this belief so many of us intuitively share: that generating social value is good business. His thought-provoking, often contrarian, ideas are rigorously logical, delving beneath the superficial analyses we often see, which assume correlation implies causation. And Alex's engaging storytelling brings the principles of "Pieconomics" to life with examples of prominent businesspeople – not just those who understand the benefits of growing the pie, but also those who don't.

I'm pleased to see this impressive piece of work come out at a time when we in the business world need to raise our game in building trust with stakeholders. This means not just arguing for the benefits of business for society, but actually delivering on those benefits. It means an underlying shift in attitude away from "us versus them", towards mutual efforts to grow and share the pie of business value.'

—Sir James G. M. Wates, Chairman of Wates Group

'Alex Edmans provides robust evidence against the claim that businesses must choose between shareholder value and social responsibility. Although there are trade-offs, there is no single trade-off. What is good for shareholders can be good for society: evidence matters.'

—Baroness Onora O'Neill, philosopher and former President of the British Academy

'Alex Edmans has done a great service to society by showing that business doesn't have to be a zero-sum game if we focus more on growing the pie rather than maximising our slice of it. This is capitalism with a human face.'

—Andrew Lo, MIT Sloan School of Management

'As someone who believes passionately in the power of business to contribute powerfully to the broader well-being of society, I'd thoroughly recommend this important, timely and evidence-rich book. For me, three things jump out from its pages: healthy businesses help to make healthy societies;

business and society should see each other as partners, not adversaries; and it is an act of enlightened self-interest for business to be driven by its long-term social purpose, not short-term profit maximisation.'

—Liv Garfield, CEO, Severn Trent

'Just as *Freakonomics* encouraged readers to look beyond the conventional wisdom that underlies many public policies, now Professor Alex Edmans introduces the concept of Pieconomics. In *Grow the Pie*, he challenges popular rhetoric that the free enterprise system is broadly detracting from society. Instead, through many and varied examples, he offers an alternate lens through which we can interpret what constitutes responsible business. In this thoroughly readable book, Edmans debunks mythologies about corporate behaviour and offers a new vocabulary by which we can have principled discussions about the role of business in society. A "must-read" for leaders in government, business and the media that reports on both.'

—Paula Rosput Reynolds, Director of GE, BP and BAE

'An important, thoughtful and timely book. The conflicts surrounding business, and its effects on society, are the subject of a heated debate. With clarity and insight, Alex Edmans makes a valuable contribution to this key debate. Anyone interested in this important subject would find much to learn from, or wrestle with, in this book.'

—Lucian Bebchuk, Harvard Law School

'Alex Edmans has produced rigorous evidence that the choice between people and profits is a false dichotomy. Now he makes his work accessible to a broader audience and explains how it's possible to overcome the trade-offs that hold so many leaders and companies back.'

—Adam Grant, author of Originals *and* Give and Take *and host of the TED podcast Work Life*

‘Contemporary discussion tends to focus on the exercise of power by investors, boards and executives, often involving confrontation and dispute. But while strong decisions will often be required and critically important to the success of a business, the overarching need is for the embedding of pervasive influence geared to the purpose of promoting long-term sustainable growth. A fundamental ingredient is the way in which shareholders discharge the obligations that inexorably go alongside their privilege and rights as owners. This book is a must-read for asset owners, fund managers and the boards and executives who lead business enterprise. It provides evidence-based analysis and guidance on how the influence of well-designed stewardship can yield benefit in terms of both financial returns for savers and investors and returns for all stakeholders in a way that benefits society as a whole.’

—Sir David Walker, former Chairman of Barclays and Morgan Stanley International, author of the Walker Review

‘This uplifting book provides powerful examples, as well as evidence, that socially responsible businesses generate even higher long-term profits than corporations focused on short-term profit maximisation. Value is created particularly in new-economy enterprises by employee purpose, creation of brand and reputation, which drives customer preference. The findings reflect my own real-world experiences of striving for business excellence across the global Life Sciences industry.’

—David Pyott, former Chairman and CEO of Allergan

‘Finance Professor Alex Edmans defines his purpose in life as “to use rigorous research to influence the practice of business”. This book, *Grow the Pie*, demonstrates his manifest success in fulfilling that purpose. Edmans mobilises evidence – not anecdotes – to make a case, both accessible and compelling, for policies and practices that increase the value available for all stakeholders, versus simply and simplistically maximising profit. Edmans's critical contribution is to reframe arguments about business and capitalism from an all too prevalent short-term zero-sum game to collaborative games where, over time, all can benefit.'

—*Bill Janeway, Warburg Pincus*

'*Grow the Pie* has some excellent messages for managers . . . Edmans urges firms to focus on what is closest and most important to them. He presents evidence that counterintuitive business strategies, consistent with increased worker welfare, can deliver market-beating returns for innovative firms. He also presents compelling arguments from the other side of the debate, justifying some of the most maligned business strategies in the corporate world, such as high CEO salaries and stock buybacks, as potentially legitimate and beneficial.'

—*Law & Liberty*

'There have been a number of articles on the challenges faced by capitalism and everyone has asked for a rethink. Everyone laments the growing inequality, the dominance of a few companies in a few sectors, etc. Most people offer glib solutions like break up the company, add more taxes. Edmans, through pragmatic research done over years, points out that social value or delivery to society need not be in conflict with shareholder value.'

—*Founding Fuel*

'*Grow the Pie* sets out a pioneering new approach to how companies can create both profit and social value, based on rigorous evidence and real-life examples spanning industries and countries. It provides an actionable framework to guide which investments to take and which to turn down, and shows how to navigate difficult trade-offs. By applying it, companies can create both profit for investors and value for society – which is more important now than ever.'

—*CEO Today*

‘*Grow the Pie* reveals a pioneering approach to solve the crisis in capitalism: moving away from a “pie-splitting” mentality and advocating a new “pie-growing” mentality. It lays out an actionable framework explaining how managers, investors, and policymakers can reform business to serve society, and also how citizens can play their part. The book presents quality evidence on controversial topics such as executive pay, shareholder activism, and share buybacks, uncovering many surprising results and showing that they can in fact be used for social good.’

—*The European*

‘Ultimately, if we are going to make progress on social and environmental issues, we need to make progress on what happens within companies. This book is very much grounded in the real world, but shows how companies can become more successful by embracing purpose. Lots of new examples.’

—*ESG Clarity*

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How Great Companies Deliver Both Purpose and Profit

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CONTENTS

PREFACE TO THE REVISED EDITION

By the time *Grow the Pie* was released on 26 March 2020, COVID-19 had already started to devastate the world. 24,000 citizens had lost their lives, 520,000 had tested positive and millions more were estimated to have been infected, but had not yet been tested.[1] Fifty-six countries including the UK, France, Germany, Italy, India and Mexico, plus several US states, had already gone into lockdown.

The impact on business would be catastrophic. Thousands of companies were forced to close, sparking mass redundancies. Among those that survived, there were serious concerns that responsible business would be a relic of the past – a luxury in a time of crisis – as companies needed to watch every penny.

Yet many enterprises took extraordinary actions to serve society. Some ensured a fair split of the pie, by continuing to pay furloughed workers, offering loans to customers and suppliers, and donating products to communities. Not every company had pie to share – some didn't have relevant products to give; others were strapped for cash as their business had been badly hit. So they instead played their part by growing the pie through innovation and excellence. Mercedes' precision engineers teamed up with University College London to reverse-engineer a breathing aid and improve its design so that it could be manufactured at scale. Perfume companies used their expertise in alcohol-based products to make sanitiser, and clothing companies pivoted to masks and hospital gowns. And citizens played their part too, buying groceries for their vulnerable neighbours or advance-purchasing products from local businesses.

Most of these leaders and citizens won't have read the book, so I can't claim they were intentionally implementing the principles of Pieconomics. But the pandemic highlights the power of viewing responsibility as growing the pie and actively doing good, rather than only splitting the pie and doing no harm. It showed how serving society needn't involve substantial financial expenditure and is thus feasible even in a crisis. I recognise it's rare to update a book so soon after its release, and a paperback edition is usually the same as the hardback but a year later. But I wanted to update it to give aspirational examples of how enterprises and citizens are growing the pie even under the most difficult circumstances. Creating value for society isn't just an ancillary activity to pursue when times are good, but both realistic and urgent in a downturn.

And many other events took place since I completed the hardback, so this isn't just a 'pandemic edition'. In August 2019, two months after handing in the final manuscript to my publisher, the Business Roundtable redefined its statement of the Purpose of the Corporation away from just shareholders to include stakeholders. This sparked a vigorous debate on whether shareholder or stakeholder capitalism was the appropriate model, and scrutiny on whether the signatories were actually putting it into practice. New, high-quality research on responsible business has since come out, and readers alerted me to previously published papers of which I was unaware beforehand. Exciting developments have occurred in the practitioner as well as academic world, such as new ways to measure the societal impact of investments.

While all the physical launch events were cancelled, I'm deeply grateful to the companies, investors and universities who extended invitations to give webinars on the book, as well as to the podcast hosts and journalists who interviewed me. Through the Q&A, I received challenges and pushbacks to my ideas, and learned which of the arguments and evidence I gave in response most resonated. Audiences asked about topics they were interested in but weren't in the hardback, or I did cover but they wanted more. In particular, while large-scale evidence – the backbone of this book – focuses on mature public companies, many were interested in how Pieconomics applies to start-ups and private firms. Some companies and investors invited me to work with them on putting the principles of the book into practice. These practitioners taught me some great ideas for Part III of the book on 'How to Grow the Pie'. Universities gave the opportunity to participate in debates on responsible business, since 2020 marked the 50th anniversary of Milton Friedman's claim that 'The Social Responsibility of Business is to Increase Its Profits'. Through these interactions, I learned from the differing perspectives of others.

So rather than tacking on an epilogue chapter about the pandemic, this revised edition contains changes throughout. The core principles remain the same, but several of the examples and applications are new. There are major enhancements to the middle third of Chapter 1 (contrasting Pieconomics with other modern approaches to business, such as Corporate Social Responsibility and Stakeholder Capitalism), the final third of Chapter 1 (applying Pieconomics to the pandemic, and dealing with a shrinking pie), the first half of Chapter 2 (contrasting Pieconomics with the Friedman viewpoint), and the first half of Chapter 3 (on the danger of viewing responsibility as a public relations exercise). The amendments to the evidence-rich Chapters 4–7 mainly involve adding new research, with Chapter 4 covering whether social performance pays off in a downturn and how it affects debtholders, not just shareholders, and Chapter 6 containing a new section on investors in private companies. In addition to new research, Chapter 5 discusses how executive pay should be modified in a pandemic, and Chapter 7 tackles how responsible companies should approach dividend policy, to supplement the material on repurchases. Chapter 4 gives the reader a fly-on-the-wall peek into the peer-review process – taking one paper and walking through all the hurdles it had to overcome to be published – to underscore the book's focus on research from the most stringent journals.

The most substantial changes are to Chapters 8 and 9, on how enterprises and investors can put Pieconomics into practice. Chapter 8 contains new material on how companies can define, embed and communicate their purpose, as well as on the power of purpose in start-ups. Chapter 9 goes into much more depth on how an investor can assess whether a company is responsible, discussing the various data sources and their limitations. It features a revised set of questions that asset managers can ask companies to evaluate whether they're truly growing the pie, shaped by numerous conversations with investors since the hardback version – as well as questions for savers, such as pension funds, to ask asset managers to scrutinise whether they're actually practising responsible investment. It also draws a parallel between responsible investing and responsible procurement that's often overlooked, emphasising the power of corporate customers to hold their suppliers to account and use the frameworks established in responsible investing to do so. Chapters 10 and 11, which are focused on citizens, have minor enhancements on how we can play our part in a crisis. Since an overwhelming array of studies are now coming out on responsible business, given its popularity, Chapter 10 provides significantly more detail on how to assess which ones are reliable. And over and above the content, there are several changes to the structure throughout the book. In particular, long sections have been broken up into bite-sized chunks with sub-headings to bring out the key takeaways most clearly.

I thank student researchers Nicholas Britz, Hortense Morillion, Adama Sarr and Alvaro Sebastian Cotera Solano, plus Rose Beale, Dave Brealey, Øyvind Bøhren, Eric Daniels, Tom Gosling, Clare Hayes Guymer, Andrew Parry, Erica Serpico and Ben Yeoh, for input into this revised version. Most transformative was the work of Andrew Tickell, who closely read every word, researched several new examples and

provided constructive criticism on my edits. I'm grateful to everyone who showed interest in the hardback edition – for reading it, spreading the word, giving opportunities to present and discuss it, providing feedback and offering critiques. I learned a substantial amount from these interactions and insights and I hope the revised version does them justice.

INTRODUCTION

There is one and only one social responsibility of business – to . . . increase its profits.

Milton Friedman, Nobel Laureate in Economics

We share a fundamental commitment to *all* of our stakeholders. We commit to delivering value to our customers . . . investing in our employees . . . dealing fairly and ethically with our suppliers . . . [and] supporting the communities in which we work.

Business Roundtable Statement on the Purpose of a Corporation

The most effective way to improve board performance is to increase the power of shareholders.

Lucian Bebchuk, Harvard Law School

Shareholder primacy was ill-conceived in the first place and has utterly failed to provide for the needs of all stakeholders.

Martin Lipton, Founding Partner of Wachtell, Lipton, Rosen & Katz

Since 1978, CEO compensation has risen 940%, while the average American has seen a raise of just 12%. It's wrong . . . It's time we reward work, not just wealth.

Joe Biden, 46th President of the USA

Air France will disappear if it does not make the necessary efforts to be competitive . . . I call on everyone to be responsible: crew, ground staff, and pilots who are asking for unjustified pay hikes.

Bruno Le Maire, French Economy Minister

Capitalism is in crisis.

The consensus among politicians, citizens and even executives themselves – on both sides of the political spectrum and throughout the world – is that business just isn't working for ordinary people.

The 2007 financial crisis cost 9 million Americans their jobs and 10 million their homes.[1] Although the economy recovered, the gains largely went to bosses and shareholders, while worker wages stagnated. In 2019, the world's 22 richest men enjoyed more wealth than all the women in Africa.[2] This inequality will only increase due to the coronavirus pandemic. While 100 million people are being plunged into extreme poverty, the wealth of tech billionaires is skyrocketing.[3]

Corporations aren't just passive beneficiaries from global trends – they actively contribute to them. To squeeze out every last dollar of profit, many pay their employees as little as possible and work them to the bone, flouting health and safety regulations. Every day, 7,500 citizens around the world die from work-related diseases and accidents.[4] A company's impact is so far-reaching that it can harm people who aren't even its customers or employees. In June 2020, US power supplier PG&E pled guilty to 84 manslaughter charges stemming from California wildfires caused by its faulty equipment.

The damage isn't just to people, but to the planet too. In 2010, the explosion of BP's Deepwater Horizon drilling rig saw 4.9 million barrels of oil spill into the sea, threatening eight US national parks, endangering 400 species and spoiling 1,000 miles of coastline. Five years later, Volkswagen admitted installing a 'defeat device' in its cars, which cheated emissions tests and contributed to 1,200 deaths in Europe alone.[5] In May 2020, mining company Rio Tinto detonated Juukan Gorge in Australia, a sacred site for the indigenous Puutu Kunti Kurrama and Pinikura people, which had been continuously occupied by humans for 46,000 years. Over and above these individual cases, the environmental costs created by business are estimated at $4.7 trillion per year.[6]

Citizens are fighting back. On 15 April 2019, the activist group Extinction Rebellion organised demonstrations in 80 cities across 33 countries, blockading roads, bridges and buildings in protest at climate change. Myriad other responses include Occupy movements, Brexit, the election of populist leaders, restrictions on trade and immigration and revolts on CEO pay. But while the precise reaction varies, the sentiment's the same. 'They' are benefiting at the expense of 'us'.

In turn, companies are responding – or at least are appearing to. Stakeholder capitalism – the idea that business should serve wider society – has become the corporate buzzword of the day. It was the theme of the 2020 World Economic Forum in Davos. In August 2019, the Business Roundtable, a group of influential US CEOs, radically redefined its statement of the 'purpose of a corporation' to include stakeholders, rather than just shareholders.

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 claim that the Business Roundtable statement was a public relations exercise to stave off regulation. Indeed, several signatories shed thousands of workers in the coronavirus pandemic, at the same time as paying huge dividends to investors.

So we have companies exploiting society, citizens fighting back and companies responding with alleged publicity stunts that dupe regulators, but allow the exploitation to continue. And this cycle has been going on for centuries. In the mid-19th century, Karl Marx wrote about the struggle between capital and labour. Since then, we've seen a pendulum swing back and forth between executives and shareholders on the one hand, and workers and customers on the other. Think of the late-19th-century robber barons who created giant monopolies such as Standard Oil; policymakers responded by breaking some up. Or the peak of trade unions in the 1970s, followed by legislation that caused their decline. Or the rise of big banks in the early 20th century, which culminated in the

1929 financial crisis and their regulation by the Glass-Steagall Act – itself partially reversed since the 1980s, contributing to another crisis in 2007. Unless we can come up with another way, this movie will keep on being replayed.

But the good news is that there is another way.

By applying a radically different approach to business, enterprises can create *both* profit for investors and value for society. So in the face of all these conflicts, this is a fundamentally optimistic book. Yet this optimism is not based on blind hope, but on rigorous evidence that this approach to business works – across industries and for all stakeholders – and an actionable framework to turn it into reality.

The heart of this new approach is a shift in thinking. Conflict arises from what this book calls the *pie-splitting mentality*. The value that a company creates is seen as a fixed pie. Then, the only way to get a larger slice of the pie for 'us' is to reduce the slice given to 'them': business is a zero-sum game. To maximise profits, a CEO takes from society by hiking prices or cutting wages. Conversely, to ensure that business works for society, we must crack down on profits.

While a fair split of the pie is important, reforming business can't just be about redistributing the pie, because doing so reduces profits. This leads to two problems. First, if reform makes their company less profitable, many CEOs won't pursue it voluntarily – they might sign statements, but not put them into practice. Pie-splitting then has to be forced on businesses through regulation, but regulation only leads to compliance, not commitment. A company can meet minimum wage laws without providing meaningful work or skills development.

Second, reducing profits is bad for shareholders. Many business critics don't care – investors are often portrayed as nameless, faceless capitalists. But investors are not 'them'; they are 'us'. They include parents saving for their children's education, pension schemes investing for their retirees and insurance companies funding future claims. And investors are needed to finance companies in the first place, which they'll only do if there's the prospect of a return. So any reform of business must deliver profits as well as social value.

That's what this book is about. 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 – 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 alleviate a pandemic, without considering whether those affected are able to pay for it, yet end up successfully commercialising it. 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 benefit because customers, employees and investors are attracted to a firm with such values.

Crucially, the pie represents social value, not profits – profits are only one slice of the pie. A pie-growing company's primary objective is social value, and it views profits as a by-product. Surprisingly, this approach typically ends up *more* profitable than if profits were the end goal. That's because it enables many investments to be made that end up delivering substantial long-term pay-offs. But since these pay-offs couldn't have been forecast from the outset, the projects would have never been approved if profits were the only criterion. A 'maximise shareholder value' rule is theoretically appealing, but practically unworkable, because it's very difficult to calculate – even roughly – how many important decisions will affect long-term profits. The power of the pie-growing mentality is that it replaces *calculations* with *principles*, providing practical guidance for decision-making under uncertainty.

Summing up, a responsible business *creates profits only through creating value for society*. This positive effect on profits addresses both of the above problems. It means that investors benefit as well as stakeholders. And it means that it's in a company's own interest to transform the way they do business and take very seriously their impact on society. In fact, it's urgent that they do. Serving society isn't a luxury or optional extra, but fundamental to an enterprise's long-term success.

That the pie can be grown means not only that purpose isn't at the expense of profit, as some executives and investors believe, but also that profit needn't be at the expense of purpose, as some business critics argue. The implications are profound. High profits – and even high CEO pay – aren't automatically a reason to 'name and shame' a company, if earned in the right way. Profits are often the by-product of taking some things and making them better, the root of human progress across the ages. Investors shouldn't always be suppressed; they're allies in reforming capitalism to a more purposeful and more sustainable form. Business and society aren't adversaries, but play for the same team. When all members of an organisation work together, 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. So it needn't be a question of either-or – serving either investors or stakeholders. It's both-and.

This win-win thinking is the heart of this book. We'll start in Part I with the *why* – why businesses exist and why they should focus on creating social value, not just profit. It explains the pie-growing mentality and how it differs from not only pie-splitting, but also broader views of business such as 'enlightened shareholder value'. Part I also addresses potential objections to the pie-growing mentality and nuances in its implementation. Growing the pie doesn't mean ignoring profits, nor carefree investment with scant attention to the cost – it's focused and disciplined. Indeed, I'll provide a set of principles to guide whether to turn down a project and how to deal with uncomfortable trade-offs, which can be applied even in the face of uncertainty. Importantly, investors can assess whether a leader is following these principles, alleviating concerns that departing from shareholder value calculations makes her unaccountable. Principles combine the practicality of judgment with the accountability of calculation.

I then present evidence that generating profit as a result of serving society is not a too-good-to-be-true pipedream, but realistic and achievable. It *is* possible for investors and society to simultaneously benefit. So creating value for stakeholders isn't just a worthy ideal – it's good business sense. When I speak to practitioners on the importance of purpose, I'm introduced as a Professor of Finance and the audience thinks they've misheard. Finance folks are often the enemy of mission-led initiatives, believing they're simply a distraction from creating profits. This might be true in the short term, where trade-offs particularly bite. But the long-term evidence shows that any finance department with this mindset is failing at its job.

Part II discusses *what* grows the pie. It shows that many common reform proposals don't actually work, because they're based on splitting a fixed pie. We'll turn conventional views on some of the most controversial aspects of business on their head, by looking at them through a pie-growing rather than a pie-splitting lens. We'll see that executive pay, shareholder activism and share repurchases – often thought to serve CEOs and investors at the expense of stakeholders – can grow the pie for all. But the important word is 'can'. As currently practised, they're often failing to do so, and I'll discuss how to improve them.

Part III turns to the practical question of *how* to grow the pie. It highlights the power of purpose – an enterprise's reason for being and the role it plays in the world. Purpose answers the question 'How is the world a better place by your company being here?' But when the rubber hits the road and a CEO faces short-term profit targets, how can she put purpose into practice? This part highlights the ability and responsibility of companies, investors, regulators and citizens – individually and working together – to achieve this.

The pie-splitting mentality is widespread, and doesn't just apply to the relationship between business and society. The tale of Robin Hood, who robbed from the rich to give to the poor, is much more celebrated than the Elves and the Shoemaker, where the elves help the cobbler make shoes without taking from anyone else. We'll end in Part IV by discussing how the idea of pie-growing can be applied to wider contexts, such as interpersonal dynamics, serving others and personal leadership.

What underpins this shift in mentality? It's a careful study of the *evidence* for what drives long-term value creation within enterprise. This evidence-based approach contradicts common views on business. Some views are based on case studies or stories. Stories are vivid, bring a topic to life and get retold. So they've been used successfully in business schools, books and TED talks. But as explained in my own TED talk, 'What to Trust in a Post-Truth World', stories tell you little, because you can always hand-pick a story to support any viewpoint – and have the incentive to choose the most extreme one that makes the point most starkly. Supporters of an exclusive focus on profit might use the story of GE under Jack Welch to show it can succeed. Opponents might use the story of Enron to show it can fail. Indeed, both GE and Enron are major business school case studies, but neither story tells us whether running a company for profit works in general.

When I started my academic career as a green PhD student at MIT Sloan, the world was grey to me. I was lucky to attend a private school in London on financial aid, yet some of my comments were so left wing that my Economics teacher, the wonderfully named Mr Toy, would sing the Labour Party anthem 'The Red Flag' after I expressed them. Outside of school, I was First Division Young Football Journalist of the Year and wrote forcefully against the commercialisation of football and players' excessive wages, yet ended up working for investment bank Morgan Stanley after university. But the silver lining to my confusion was that I formed my views based on the strength of the evidence, rather than whether it supported a preconceived opinion. Doing so taught me that there are two sides to almost any debate and highlighted the importance of considering the whole pie together, not just one slice. It was through exploring the evidence that the idea of this book – growing the pie – was born.

In contrast to stories, evidence draws insights from thousands of companies, across dozens of industries, over decades. It tries to distinguish correlation from causation and address alternative explanations. Just as diagnosis precedes treatment in medicine, it's critical to accurately assess the problems with capitalism before proposing reform.

But there's substantial variation in the quality of evidence. One of the most dangerous phrases is 'research shows that . . .', because research can be hand-picked to show nearly anything you'd like it to show. In the UK House of Commons' 2016 inquiry into corporate governance, the witness before me quoted evidence which 'found that firm productivity is negatively correlated with pay disparity between top executive and lower level employees', referencing a January 2010 work-in-progress draft. The finished version had actually been published three years prior to the inquiry. Having gone through peer review and tightened its methodology, it found the opposite result:

- 'We do not find a negative relation between relative pay and employee productivity.'
- 'We find that firm value and operating performance both increase with relative pay.'

The danger of hand-picking studies is especially severe given confirmation bias – the temptation to accept any evidence that supports your pre-existing view on business, regardless of its quality. So an evidence-based view gleans particularly from studies published in the most stringent peer-reviewed journals. These journals reject up to 95% of papers, such is the toughness of their standards. The above example shows that the rigour of a study isn't just an 'academic' issue, but can fully reverse its implications for real-world practice.

The evidence in this book will uncover many surprising results which contradict common myths about business, and suggest different solutions from those frequently advocated. We'll see how reducing the jaw-dropping levels of CEO salaries isn't actually the most effective way to reform pay to benefit society. We'll understand how an investor selling his shares in the short term can encourage businesses to act more long term. We'll learn how a company using cash to buy back shares rather than investing it may create long-run value, not just for its shareholders, but also the economy as a whole.

Now an evidence-based approach doesn't mean that there's only one right answer. Even if we agree on the facts, different people might have different opinions on those facts. Even if high pay ratios are linked to better productivity, some citizens may view them as undesirable because they see inequality as more important than productivity. The role of evidence is to put the facts on the table so that policymakers, practitioners and voters can make informed decisions, fully aware of any trade-offs. So I expect you to disagree with some of my stances. In fact, I hope you'll disagree, because I'd like this book to provide fresh – and potentially controversial – perspectives, rather than being an echo chamber that simply reinforces what you already think.

Critically, I'll present evidence *against* the book's key propositions – thus exploring the interesting, complex and nuanced shades of grey in issues often portrayed as black and white. I'll acknowledge that the average responsible investing fund underperforms, and how 'sin' industries such as tobacco and alcohol have been highly profitable. I'll take seriously common concerns about responsible business and arguments for shareholder value maximisation, and recognise that the latter is far more nuanced than commonly caricatured. I'll stress that, even in the long run, there are externalities that affect society, but don't feed back into a company's profits.

This balance is critical. The World Economic Forum's 2020 report on 'Measuring Stakeholder Capitalism' claimed that 'purpose-led firms outperform their peers in shareholder value[32]'. The referenced footnote 32 takes you to an article whose first sentence is 'Despite countless studies, there has never been conclusive evidence that socially responsible screens deliver alpha' – the opposite of the claim. Advocates of responsible business can't misquote evidence to suit the story we'd like to tell. Doing so backfires as it may mislead CEOs into thinking that every socially responsible action pays off. This isn't the case, and evidence can guide a purposeful CEO in discerning which actions truly grow the pie and which don't.

The academic studies we'll cover will span disciplines – not only economics and finance, but also organisational behaviour, strategy, marketing and accounting. The insights from economics will draw from behavioural economics rather than only assuming rationality, and take into account uncertainty and other reasons why standard models fail. Moreover, the academic research will be complemented by practical examples from forward-thinking companies and investors, across different industries and countries, to bring the evidence to life. And we'll learn from failures as well as successes.

I'll also glean from my experience working with and learning from directors, executives, investors, policymakers and stakeholders on embedding purpose into business – including the many practical obstacles in doing so. Indeed, the combination of academic and practitioner insights aims to make the book not only rigorous, but also implementable. Many great academic ideas are truly 'academic' and difficult to put into practice. Serving society might seem a nice ideal, but too nebulous to implement compared to the frameworks currently used to maximise profits. This book shows that a pie-growing approach to business can be just as actionable, operational and concrete as one based on maximising profits – and ultimately lead to more profit in the long run.

Before we start, a brief discussion on terminology. The words that are used to describe businesses can already convey a preconception that they don't or don't need to contribute to society.

- A writer suggesting that companies are exploitative monopolies may use the word *corporation*. We sometimes use the word *enterprise* to highlight how companies, both old and young, can grow the pie by being enterprising – come up with new products, services and ways to engage their employees.
- A company's managers are often labelled *executives* who passively execute routine activities. It's little wonder that the public objects to CEO pay if millions are given to managers who simply execute. We sometimes use the word *leaders* to highlight how they can pursue new strategic directions and inspire their workforce.
- Executives receive *compensation*. They're assumed to have no intrinsic motivation to serve society; instead, they demand to be compensated for doing so. You get compensation for an injury, for something unpleasant. Leaders receive *reward*. Reward is earned for something intrinsically desirable, like finding a missing person.
- *Employees* suggest that workers are at the behest of the employer, employed as factors of production on a contractual basis. *Colleagues* are partners in the enterprise, contributing to its growth and sharing in its success.
- *Consumers* imply a one-time transaction: once you've consumed a good, it disappears. *Customers* provide an enterprise with their custom over the long term.
- *Shareholders* imply passive holding of an enterprise's stock. *Investors* highlight their responsibility to invest in the long-term success of a firm through active monitoring or engagement.

Enterprise, leaders, reward, colleagues, customers and investors. These words all emphasise the humanity of business and the relationships that underpin it, which we'll see are crucial in growing the pie to benefit all of society.

HOW TO READ THIS BOOK

By presenting this case for both purpose and profit, the intended audience is varied. It includes readers who view profit as important even if not the only goal, such as investors and executives, as well as those who emphasise the need to serve society, such as trade unions or stakeholder representatives. The ideas can be put into practice not only by senior executives, but also middle managers who can instill a social orientation into their teams, and employees who can spark ideas and manage upwards. It's also intended for readers outside business, who wish to learn both sides of the controversy surrounding capitalism – the good and the bad – in a debate which has become increasingly polarised.

Given the broad intended audience, this book contains a variety of material, some of which will be of most interest to particular types of readers. As a result, there are different paths through this book. The best approach, naturally, is to read all chapters in order. They're designed to be an integrated whole – each chapter builds on the next, there are multiple cross-references between chapters and some examples run throughout the book. However, readers short on time may choose to focus on particular chapters, depending on their objectives.

Chapter 1, which introduces the pie-growing mentality, and Chapter 4, which presents the evidence that growing the pie creates value for both investors and society, should be of interest to all readers. In addition to those chapters:

- The general interest reader, which includes those outside business wanting an introduction to how capitalism works and its role in society, as well as business sceptics, will likely find Chapters 3, 8, 10 and 11 of value.

- Leaders of businesses, who seek a framework to put these ideas into practice, and navigate difficult issues such as which projects to turn down and how to resolve trade-offs, should also read Chapters 2, 3 and 8.
- Investors or boards, interested in how shareholders should engage with companies and how to design governance structures to lay the grounds for long-term thinking, should find value in Chapters 5, 6, 7 and 9. Chapter 9 is especially useful for those interested in responsible investing.
- Policymakers, business leaders, academics and others interested in the highest-quality research on what creates long-term value, and how to apply this research to practice, should pay particular attention to Chapters 5, 6, 7 and the 'Policymakers' section of Chapter 10.
- Readers interested in real-world case studies, such as business students, professors or speakers seeking anecdotes for talks, and practitioners wanting examples to follow, should read Chapters 2, 3 and 8, as well as the opening examples of Chapters 5, 6 and 7.

Part I

Why Grow the Pie? Introducing the Idea

1 THE PIE-GROWING MENTALITY

A New Approach to Business that Works for Both Investors and Society

Judith Aberg stepped out of the subway and looked ahead to an ordinary day at work. Her office building stretched across six blocks of Fifth Avenue in New York City and overlooked Central Park. But her employer wasn't the white-shoe investment bank that you'd expect to occupy such coveted real estate. It was Mount Sinai, one of the largest teaching hospitals in the US.

Judith's job was tough. She not only treated patients herself, but also served as Chief of the Division of Infectious Diseases, leading hundreds of researchers, clinicians and staff. Yet her job was also rewarding. In 2014, she oversaw the opening of the Institute for Advanced Medicine, which united physicians across multiple disciplines to provide care to over 10,000 HIV patients in New York City.

But 25 August 2015 was no ordinary day. A patient in Mount Sinai was being given Daraprim to treat toxoplasmosis, a parasitic infection that leads to fever, aching muscles and fatigue. Supplies of Daraprim were running low, so the Mount Sinai pharmacy tried to order some more. This reorder should have been routine. But the pharmacy staff were told that Mount Sinai's credit limit wasn't high enough, and brought this to Judith's attention.

'There must be some mistake!' she thought. Mount Sinai's credit limit was $40,000, surely enough to buy a single bottle of 100 pills. But when she called up Daraprim's supplier, Turing Pharmaceuticals, she was shocked to learn that the price had just been hiked from $13.50 to $750 per pill – a 5,500% increase. So a 100-pill bottle cost $75,000, nearly double the limit.

Turing had been founded in February 2015 and named after Alan Turing, who famously broke the code of the Enigma machines used by Germany in the Second World War. But while Turing the scientist was driven to innovate and break new ground, Turing the company wasn't driven by innovation at all. Rather than developing new drugs, its strategy was to buy existing drugs and hike their prices.

Such a strategy might seem like outrageous greed, but it was second nature to Martin Shkreli, Turing's 32-year-old CEO. Shkreli, the son of immigrant janitors, caught a break aged 17 when he landed an internship at Cramer, Berkowitz & Co., the hedge fund founded by CNBC's Mad Money host Jim Cramer. Shkreli started in the post room, but quickly made a name for himself when, in early 2003, he spotted a stock he thought was over-hyped – Regeneron, a biotech company developing a weight-loss drug. He advised his bosses to short-sell it – bet that its price would drop. On 31 March, Regeneron conceded that the drug failed a clinical trial. That day, its stock halved in value, making millions for Cramer, Berkowitz & Co.

But making millions for others wasn't enough for Shkreli. He wanted to make millions for himself. So in 2006, aged just 23, he started his own hedge fund, Elea Capital Management, which also bet on stock prices collapsing. After one of these bets went wrong and Elea itself collapsed, Shkreli was undeterred. He simply started afresh in 2009 by setting up another hedge fund with childhood friend Marek Biestek, named MSMB Capital Management after their initials.

MSMB was as much of a failure as Elea, despite Shkreli's attempts to cover it up. In December 2010, he claimed that MSMB was worth $35 million, when it didn't even have $1,000.[1] So under the guise that 'there wasn't enough money in hedge funds',[2] he ironically transformed himself from an anti-biotech speculator into a biotech CEO. He first founded Retrophin in March 2011 and then Turing.

Shkreli's money-making strategy was to forget about investing in new medicines, and instead to buy existing ones on the cheap, hike their prices and restrict their supply. Turing started out with three drugs – ketamine for depression, oxytocin to induce labour and a ganglionic blocker for hypertension – all acquired from Retrophin. On 10 August 2015, Turing bought Daraprim for $55 million. The very next day, it executed the 5,500% price increase.

This was a boon for profits, but a disaster for society. Toxoplasmosis is a dangerous disease, particularly for pregnant women, the elderly and AIDS patients. Left untreated, it can lead to seizures, paralysis, blindness, birth defects and even death. It was so serious that the World Health Organization (WHO) included pyrimethamine (the chemical name for Daraprim) on its 'List of Essential Medicines'. But the price hikes meant that this essential medicine was no longer affordable. Judith had to cut its usage from five times a month to a maximum of one and, as she told the *New York Times*, switch to 'alternative therapies that may not have the same efficacy'.[3] These substitutes were less tested, with unknown side effects. 'That doesn't make patients feel confident. It doesn't make us feel confident,' she said to CNN.[4]

Just as damaging as the extortionate prices was the restricted access. Despite Daraprim being an essential medicine, Turing sold it through only one pharmacy, Walgreens, and only then in its 'specialty' rather than regular stores. This stopped competitors getting their hands on it to develop cheaper alternatives. Obtaining it was so difficult that the HIV Medicine Association set up a web page where doctors could share their experience. One reported that it took four and a half days to get hold of a medicine that, before Turing bought Daraprim, had been available immediately.

The Pie: The Value Created for Society

We can illustrate Shkreli's strategy using a pie. The pie represents the value an enterprise creates for society – for Turing, this value comes from its drugs. *Society* contains many different members, as shown in Figure 1.1. These members may capture

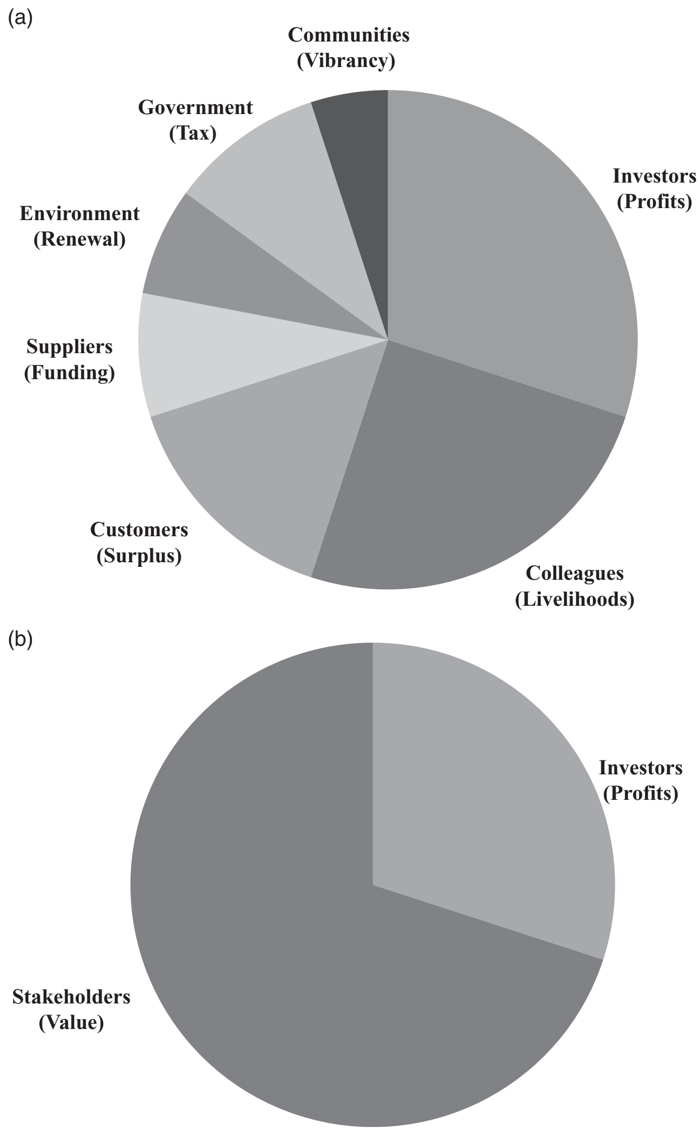

(a)
Communities
(Vibrancy)
Government
(Tax)
Investors
(Profits)
Environment
(Renewal)
Suppliers
(Funding)
Customers
(Surplus)
Colleagues
(Livelihoods)
(b)
Investors
(Profits)
Stakeholders
(Value)

Figure 1.1

very different slices of the pie, depending on what strategy Shkreli chooses to adopt.

The member Shkreli focused on was *investors*, who enjoy *profits*. As highlighted in the introduction, shareholders are not 'them'; they are 'us'. The failure to serve investors can ripple through society. A reported £17.5 billion funding deficit led to the Universities Superannuation Scheme (the UK university pension scheme) announcing cuts to pension benefits in 2018. This caused 42,000 staff to strike[5] and 126,000 students to demand tuition fee refunds[6] because of missed lectures. Some universities had to remove the skipped content from their exams. So profits are important, and investors are an important member of society. But they're not the only member.

Because the pie includes more than just profits.

The pie includes the value an enterprise gives to its *colleagues*. This comprises their pay, but also training, advancement opportunities, work-life balance, and the ability to pursue a vocation and make a profound impact on the world. We'll call this value *livelihoods*, to reflect both the workplace environment and the company's impact on employees' home life.

The pie includes the long-term value *customers* enjoy over and above the price they pay, which we'll call *surplus*. An enterprise creates surplus by inventing a product that materially improves their lives, providing free after-sales service or not using misleading marketing tactics.

The pie includes the value to *suppliers* from a stable source of revenue. We'll call this value *funding*, because what matters is not only how much they receive, but how promptly they're paid.

The pie includes the value provided to the *environment*, by a company reducing its resource consumption and carbon emissions, and undertaking positive actions like planting new trees and encouraging recycling. We'll call this value *renewal*.*

* A common term is environmental 'conservation' or 'preservation'. We use 'renewal' to highlight that maintaining the status quo, for example not increasing pollution levels, isn't sufficient.

The pie includes the value enjoyed by *communities*, by an enterprise providing employment opportunities, improving access to water and sanitation, and donating its knowledge or products to local initiatives. We'll call this value *vibrancy*.

Finally, the pie includes the value given to the *government* through *tax* revenues.

A company thus serves not only investors, but also colleagues, customers, suppliers, the environment, communities and the government. Together, these other parties are known as an enterprise's *stakeholders* who, collectively, enjoy *value*. *Members* refer to either investors or stakeholders, and *citizens* are the people who live in society.*

The Pie-Splitting Mentality

Shkreli was a pie-splitter: he had the *pie-splitting mentality*. This mentality views the pie as being fixed in size. Then, the only way to increase one member's share of the pie is to split it differently, by reducing the shares of others. These other members are your rivals, whom you fight to grab as much of the pie as possible.

The member whose slice Shkreli wanted to increase was investors. He was a substantial shareholder in Turing himself, and he might come under pressure from other investors if he didn't generate enough earnings. He saw his objective as single-minded – 'My investors expect me to maximise profits'[7] – and pursued this objective by taking from stakeholders, as shown in Figure 1.2.

By far the main stakeholder Shkreli took from was customers – patients and health insurance companies. But Shkreli also

* Some writers include 'investors' within 'stakeholders'. For clarity, we use 'stakeholders' to include only non-investor members, and 'society' to refer to investors and stakeholders combined. We don't have leaders as a separate category, since they're also colleagues and (often) investors. Sometimes 'members' refer only to investors, such as in the UK Companies Act. We use a broader definition, since it's unclear why, say, a colleague is any less a member than an investor.

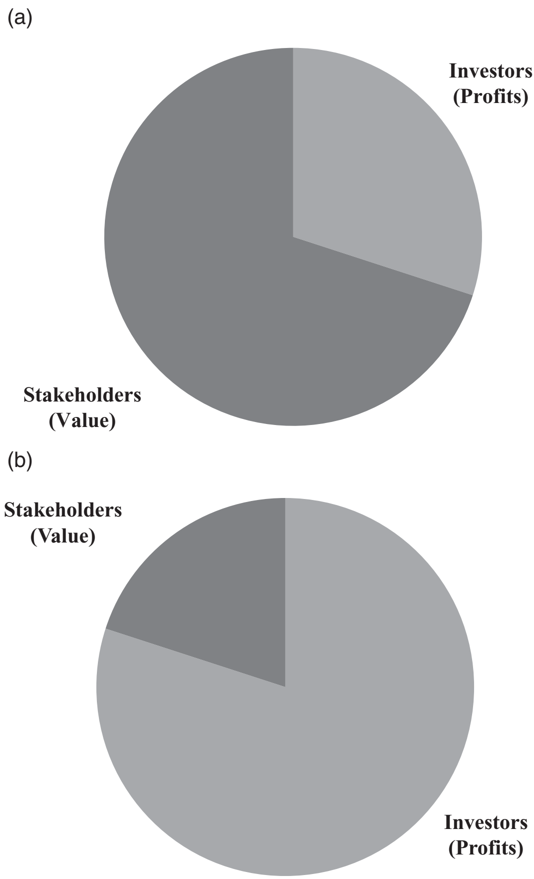


Figure 1.2

took from his colleagues, who may have joined a biotech start-up excited about inventing new drugs, but instead spent their days ordered to squeeze higher profits from existing drugs. He took from suppliers, because the restricted sale and thus production of Daraprim slashed the demand for its inputs. And he took from communities, because reduced access to Daraprim hurt patients, their families and their friends.

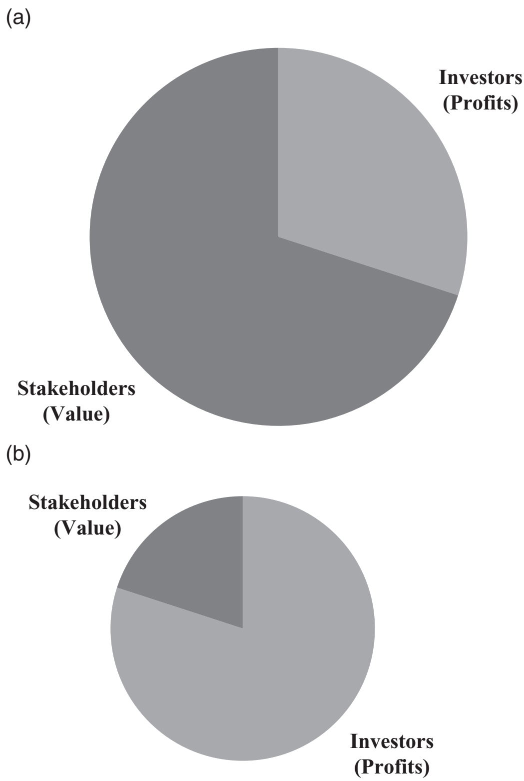


Figure 1.3

In Shkreli's relentless pursuit of profit, he paid little heed to growing the pie by developing new drugs. Worse still, his actions shrunk the pie. By restricting access to Daraprim, there was less around to benefit society. But if investors' share of the pie increases enough, their slice rises even if the pie shrinks, as shown in Figure 1.3.*

* *Share* refers to relative value, the percentage of the pie that a member receives, and *slice* to absolute value, the share multiplied by the overall size of the pie.

The pie-splitting mentality is attractive. Pie-splitting can be done almost immediately and at zero cost. At the flick of a switch, Shkreli increased the price of Daraprim by 5,500% without spending a dollar. Pie-splitting didn't require the substantial expense, time and risk of developing a new medicine, getting approval from the US Food and Drug Administration and marketing it. And it was entirely lawful. As Shkreli brazenly declared, 'Everything we've done is legal' and 'I liken myself to the robber barons'[8] – late-19th-century American businessmen who used similarly unscrupulous, yet legal, strategies to get rich. Even though Shkreli was later sentenced to seven years in prison, this was for securities fraud at his hedge funds and unrelated to price-gouging at Turing.

In the Introduction, we discussed how you can always find a story to illustrate a point. Sadly, Turing appears to be far from an outlier. Companies can take surplus from customers not only by price-gouging, but also by pushing products that customers don't need or don't understand. From 1990 until the mid-2010s, UK banks sold payment protection insurance to customers who took out mortgages, loans and credit cards. This insurance promised to repay customers' debts if they lost their jobs or became ill. But it was fraudulently sold – 1.3 million customers were falsely told they'd only be approved for a loan if they bought the insurance, and 2 million were sold a policy they'd never be able to claim on (for example, because they were self-employed[9]). The price of the insurance was rarely disclosed, even though it typically added 20% to the cost of a loan, and sometimes as much as 50%.[10]

Companies can also exploit workers. UK retailer Sports Direct allegedly paid workers below the minimum wage, fired them if they took sick leave and gave them 'zero-hours' contracts with no guarantee of employment. It forced zero-hours employees to work overtime for free by threatening them with no work the next day.[11] When the coronavirus crisis unfolded, the UK government ordered citizens not to go to work unless it was essential. Sports Direct audaciously claimed that sporting equipment was essential in a pandemic and tried to force its employees to still come in – risking them becoming sick and then infecting others. In June 2020, over 1,500 employees at a factory owned by the German meat producer Tönnies caught coronavirus, due to being made to work and sleep in cramped and unsafe conditions. This sparked an outbreak in the region and forced two nearby districts to go into lockdown.

And companies can squeeze suppliers by paying them as late as possible, using their sheer size to demand rock-bottom prices or walk away from contracts without fear of reprisals. UK clothing retail group Arcadia, owned by flamboyant billionaire Sir Philip Green, cancelled £100 million of orders in the pandemic, even though some of the goods had already been manufactured.[12] £9 million of these orders were from Bangladesh, a country particularly reliant on the garment industry. One supplier, who lost £2 million of promised sales, reported that Arcadia's U-turn put his business on the brink of collapse and his 2,000 employees facing destitution. By the end of May 2020, global fashion brands had cancelled orders, demanded price reductions and delayed payments, causing Bangladeshi garment factories to lose $3.7 billion of sales and garment workers worldwide to suffer $5.8 billion of unpaid wages.[13]

In all these cases, companies see society as a sitting duck, there for the taking. Even if they don't actively exploit stakeholders, they may simply ignore them and focus on maximising profits, not caring whether stakeholders benefit as well. As mentioned in the Introduction, Jack Welch of GE is one of the most revered CEOs in history for his successful, and relentless, pursuit of profits. Welch had a single goal – to make GE the world's largest company by shareholder value. He viewed serving stakeholders as a distraction that leads to inefficiency.

When businesses exploit society, citizens pressure policymakers to protect their share of the pie with regulation. Companies respond by trying to bypass the laws. And the conflict continues.

But there is another way.

Roy Vagelos urgently needed money.

In 1978, William Campbell, a research scientist at Merck, had made a potentially breakthrough observation. Ivermectin, a drug Merck had developed to treat parasitic infections in livestock, might also cure onchocerciasis in humans.

Onchocerciasis was a cruel disease. It was transmitted by blackflies which bred along river banks – banks where citizens lived, played and worked because the soil was fertile and water was plentiful. A blackfly's bite injected the *onchocerca volvulus* larva, which matured into worms that lived under the skin and grew up to two feet long. Their larva caused itching so severe that it drove some sufferers to suicide. Once the larva invaded the eyes, it frequently caused blindness – hence the common name for onchocerciasis, river blindness.

River blindness was a serious epidemic. 18 million people were already infected with *onchocerca volvulus*, with over 100 million more at risk.[14] It would soon become endemic in 34 developing countries, mainly in West Africa, but also in Latin America.[15] In the most affected villages, the entire population was infected by age 15 and went blind by age 30. Once blind, adults would need to be led by their kids – who, as a result, believed blindness was just a part of growing up. Families who reduced their infection risk by moving away from the fertile river banks instead couldn't grow enough food. Having to choose between blindness and starvation reduced communities to empty shells, devoid of any real economic development.

William's hypothesis, therefore, was momentous, and would later see him jointly awarded the 2015 Nobel Prize in Medicine. But in 1978, it was still only an idea; it needed to be rigorously tested. Anti-parasitic drugs didn't usually succeed across species. Following William's lab work, another Merck researcher, Mohammed Aziz, launched the first human clinical trial of ivermectin, in Senegal in 1981. It proved so successful –

a single tablet completely cured the disease, without any of the side effects common in anti-parasitic drugs – that the WHO thought the data must have been recorded incorrectly. But Merck conducted trials in other African countries over the next few years, which found similar success. In 1987, ivermectin was approved for human use under the brand name Mectizan.

But there was one final challenge – money. It would cost Merck $2 million to set up a distribution channel to West Africa and an extra $20 million per year to produce it, even ignoring the millions that Merck had already spent on development. The West Africans suffering from river blindness were some of the poorest people in the world. They lived in huts caked in mud and wore skirts woven from grass. They couldn't afford to pay for Mectizan, nor could their debt-ridden governments. Roy Vagelos, Merck's CEO at the time, asked the WHO to fund Mectizan, but the answer was no. He pleaded with the US Agency for International Development and the US Department of State. Still no. That's why Roy urgently needed money.

Roy then went to one final, and radical, source of funding – Merck itself. On 21 October 1987, Roy announced that Merck would give Mectizan away for free, 'as much as needed, for as long as needed', to anyone anywhere in the world who needed it. Merck established the Mectizan Donation Program (MDP), which brought together the WHO, the World Bank, UNICEF, dozens of Ministries of Health and over 30 non-governmental organisations to oversee and fund the distribution of Mectizan.

On the face of it, donating a drug was a crazy idea. The MDP would cost millions to Merck's investors, mostly institutions with responsibilities to their clients – savers. These investors might sell their stock and drive down the stock price, or pressure Merck's board to fire its CEO.

But this seemingly difficult decision was easy for Roy. He was driven not by profits, but by the desire to use science to serve society. The son of Greek immigrants, Roy grew up peeling potatoes, cleaning tables and washing dishes at

Estelle's Luncheonette, his family's diner. Estelle's main customers were scientists and engineers from the nearby Merck laboratories, and Roy heard them talk excitedly about the drugs they were developing to improve people's health. As he recounted:

'They had great ideas and loved what they were doing. They were passionate about their work, and that infected me[16] . . . they encouraged me to pursue chemistry.'[17] Roy's primary concern wasn't the millions of dollars the MDP would cost, but the millions of lives it would transform.

The MDP proved wildly successful. It's currently the longest-running disease-specific drug donation programme of its kind. It's delivered 3.4 billion treatments to 29 African countries, 6 Latin American countries and Yemen in the Middle East, and now reaches 300 million people per year. Thanks to the MDP, the WHO has certified four Latin American countries (Colombia, Ecuador, Mexico and Guatemala) as having eliminated river blindness. It's no longer a major public health issue in the savannah areas of West Africa.

The decision to donate Mectizan grew the pie. Initially, most of the increase went to West African and Latin American countries, communities and citizens. But Merck subsequently benefited as well, even though such benefits weren't the primary reason for Merck's decision. The MDP boosted Merck's reputation as a highly responsible enterprise. In January 1988, *Business Week* described Merck as one of 'the best in public service' and called the MDP 'an unusual humanitarian gesture'. *Fortune* named Merck America's most admired company for seven years in a row between 1987 and 1993, a record never equalled before or since.

This reputation for serving society in turn attracted both investors and stakeholders. Even though investors bear the financial costs of the MDP, many investors care about social as well as financial returns, as I'll discuss in Chapter 2. Ten years after launching the MDP, Roy reported that he hadn't heard any complaints from shareholders[18] – but he did receive numerous letters from colleagues saying they'd joined Merck because of the MDP. They were excited by the potential to solve the world's most serious health problems through a career at Merck.[19] Today, thanks in part to this reputation, Merck is one of the largest pharmaceuticals companies in the world, worth over $200 billion. It remains an extremely sought-after employer, and it's still on *Fortune*'s list of most admired companies. Investors have benefited too. Since 1978, they've enjoyed an average annual return of 13%, nearly one and a half times the 9% delivered by the S&P 500.

The Pie-Growing Mentality

Roy was a pie-grower: he had the *pie-growing mentality*. This mentality views the pie as expandable. It aspires to grow the pie – to create value for society – because doing so benefits both investors and stakeholders alike. Profits are no longer the end goal, but instead arise as a by-product of creating value, as shown in Figure 1.4. Since business is a positive-sum game, investors aren't trying to take from stakeholders, and

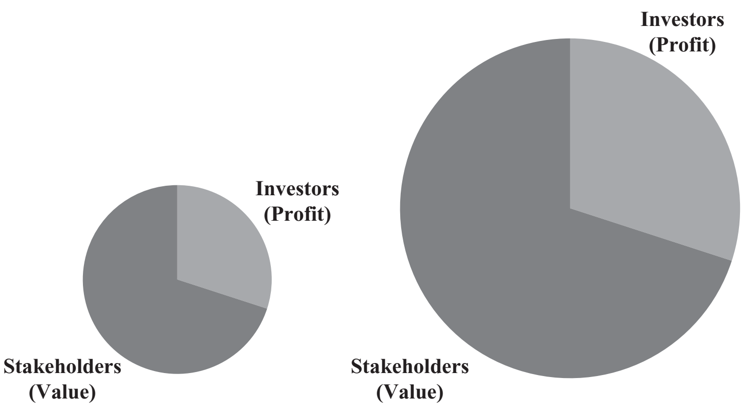


Figure 1.4

stakeholders don't need to defend themselves from investors. They're on the same team.

We'll use the term *Pieconomics* ('pike-onomics') to capture the pie-growing behaviour that this book is about. Pieconomics is an approach to business that seeks to *create profits only through creating value for society*. Pieconomics most definitely sees investors as important. But an enterprise serves them not by giving them a larger slice of what already exists, but through growing the pie. Under Pieconomics, a leader constantly asks herself whether she's increasing profits through creating value or redistributing it from stakeholders. Do new products genuinely improve customer welfare or cause addiction? Are higher prices due to superior product quality or market power? Is the company committed to providing a healthy workplace, even if there are inevitably job losses in certain areas as technology evolves? Are profits being enhanced through ignoring the company's impact on the environment?

Other approaches to business, such as Corporate Social Responsibility ('CSR'), also recognise the need for enterprises to serve society. But Pieconomics goes beyond CSR and implies a shift in thinking on what companies' responsibilities are, how leaders should run their businesses, and how both companies and leaders should be held accountable. There are four key shifts.

From Ancillary to Core

In the early Catholic Church, the wealthy could commit any number of sins and buy an 'indulgence', or earn one through good works, that absolved them from punishment. That's similar to how CSR is often practised. A company can undertake CSR without changing its core business; instead, it involves activities siloed in a CSR department – such as charitable contributions – done to offset the harm created by its core business. But as Matt Peacock, Vodafone's former Group Director of Corporate Affairs, told my class, CSR is like a company saying to the people of a village: 'Yes, we chopped down your ancient forest full of cultural significance and religious meaning. But don't worry, we used some of the logs to build you a youth club.'

In contrast, Pieconomics is embedded into the core business and ensures that its primary mission is to serve society. Under Pieconomics, it doesn't matter how many charitable acts you do if your core business creates social harm – a tobacco company that makes donations is undertaking CSR, but not growing the pie. Similarly, as we'll stress in Chapter 8, the main ways in which companies serve society are through a ruthless dedication to excellence in their core business, or creatively applying their core competencies to new challenges, such as Mercedes using its precision engineering expertise for breathing machines. It's not by engaging in ancillary activities unrelated to their comparative advantage.

The power of this insight is that Pieconomics can be practised by all businesses at all times, not just large companies flush with cash in an economic upswing. Pieconomics is also relevant for small enterprises and, as we'll discuss at the end of this chapter, in crises. It costs money to split the pie differently or to undertake eye-catching CSR initiatives. But excellence in your core business, or using your comparative advantage to solve social problems, typically doesn't involve major financial expenditure. It only needs an attitudinal shift – to be driven by the hunger to create value for society even if the immediate benefit to profit is unclear.

From Errors of Commission to Errors of Omission

A common dictum of CSR is 'do no harm'[20] – not to take from other stakeholders by splitting the pie unfairly – for example, through extortionate prices. But Pieconomics stresses that it's even more important for a company to 'actively do good' by growing the pie – like Merck developing ivermectin for human use. Conversely, the main way that companies act irresponsibly is not by *errors of commission* (giving too large a slice to leaders or investors), but by *errors of omission* (failing to grow the pie by coasting).

In 1981, Sony released the Sony Mavica, a prototype of the electronic camera.[21] Kodak had every ability to respond – after all, it had invented the digital camera in 1975 and held patents for it. But it was too tempting to stick with the status quo, film. Kodak was the clear market leader and its sales crossed $10 billion that year, nearly all from film. Why change? A study by Kodak's head of market intelligence, Vince Barabba, predicted that digital would replace film. But this displacement would take ten years, far too long to bother doing anything about. Kodak took no action, unlike its rival Agfa, which sold its film business, and Fuji, which made digital a strategic priority.

Kodak's inertia was an error of omission that led to its bankruptcy in 2012 – a huge fall from grace, as Kodak had been worth $31 billion at its peak and employed 150,000 people at one point. Yet Kodak was never subjected to the media backlash that high CEO pay or share repurchases, supposed errors of commission, currently receive. Most people don't view Kodak as an example of corporate irresponsibility, because neither executives nor shareholders benefited. Yet the fact that investors also lost is of no comfort to the workers made redundant. Kodak's executives were pie-shrinkers who harmed everyone. Their complacency and inaction saw a once-great company fail.

This distinction between errors of omission and commission also suggests we should redefine the concept of trust in business, which is now under scrutiny. Trust is often defined as 'doing what you say you'll do' – fulfilling contractual obligations and keeping implicit promises. But that's only about avoiding errors of commission. Under this definition, a payday lender is trustworthy. It says it provides emergency funds at high interest rates and it does. Similarly, a company that sticks to its current product offering, and doesn't launch any innovations that risk failure, will be considered trustworthy. But not breaking promises shouldn't be enough to earn the public's trust. A trustworthy business is one that *uses its expertise and resources to address society's challenges*.

From Value Extraction to Value Creation

While Pieconomics views coasting as destroying value for society, it also stresses that high profits needn't be at society's expense. Headlines highlight how much profit an enterprise makes in a single day – even a single minute – as if this requires an apology. *Time* magazine ran an op-ed entitled 'Every 60 Seconds, Apple Makes More Money than You Do in a Year'.[22]

That's the pie-splitting mentality. Crucially, this mentality is practised by not only executives who exploit stakeholders, but also citizens and policymakers who judge companies. High profits might indeed be the result of value extraction. But before we criticise high profits, we have to first investigate where they came from. Particularly in the long term, they're much more likely to result from making products that transform customers' lives for the better, providing employees with a healthy and enriching place to work, and renewing the environment for future generations. If society has the pie-splitting mentality, then a leader's prime goal is no longer to be excellent at her business. Indeed, success is a liability if profits become large enough to be deemed excessive.[23] Yet delivering high profits need not be shameful. Failing to create profits by creating social value is.

Similarly, with the pie-splitting mentality, a policymaker's goal is to ensure that companies don't make what could be seen as too high profits. In February 2019, Amazon reversed its decision to build half of its second North American headquarters in Queens, New York City. This new headquarters would have created between 25,000 and 40,000 jobs, with an average salary of $150,000, and provided $27.5 billion of tax revenues. It would also have boosted local companies, generating 100,000 more jobs, and economic development with knock-on benefits such as reduced crime. But Amazon pulled out due to strong opposition from some local politicians and residents, based on the pie-splitting mentality. They objected to Amazon being offered $3 billion of tax breaks to come to Queens, thinking this came at the expense of the community. Congresswoman Alexandria Ocasio-Cortez celebrated Amazon's withdrawal, saying the $3 billion could now be used for subway repairs and teacher salaries.

This simply wasn't true. The tax breaks weren't an upfront donation that would have taken funds away from other uses. They were reductions from future taxes that Amazon would have had to pay only if it had grown the pie. Queens would still have enjoyed a vastly increased slice, including taxes of over nine times the foregone revenue. Ocasio-Cortez tweeted: 'Anything is possible: today was the day a group of dedicated, everyday New Yorkers & their neighbors defeated Amazon's corporate greed.' But defeating Amazon didn't mean that Queens won. Everyone lost because the pie shrank.

The division of the pie is certainly important, and we'll turn to this shortly, but the spoils can be shared only if there are spoils to begin with. A well-paid leader is sometimes accused of stealing from the enterprise, but a leader steals more by coasting. High pay is sometimes referred to as value extraction, but value destruction is a far worse problem. Average CEO pay in an S&P 500 firm was $14.8 million in 2019. That's substantial compared to average wages, but tiny compared to the median firm size of $24 billion. Even if an executive is overpaid by 100%, that's only $14.8 million. If she fails to create just 1% of firm value, that's $240 million lost to society.

This positive view of profits suggests that we should rethink the concept of 'stakeholder capitalism'. It's become an extremely popular term, yet has no official definition[24] in any dictionary or Wikipedia. It's commonly interpreted as giving stakeholders equal priority to shareholders so that they get more of the pie at the expense of profits – akin to 'antishareholder capitalism'. But again that's based on the pie-splitting mentality. A responsible business absolutely needs to ensure that value is fairly shared, but it's even more important to create value in the first place. What we need is neither shareholder capitalism nor the common interpretation of stakeholder capitalism, but an approach to business that works for both investors and society. Thus, we won't use the term 'stakeholder capitalism' in this book. But if it's used in practice, we propose defining it as 'creating profits only through creating value for society' – the same definition we've given to Pieconomics.

Similarly, that profits are only one slice of the pie is an important contrast to 'de-growth economics'. Advocates of this view argue that economies shouldn't grow too fast or create too much value, otherwise we'll exceed planetary boundaries such as resource constraints or temperature thresholds. But this narrowly views growth and value as being in purely financial terms. Instead, growing the pie involves creating social value – treating employees with respect, developing their skills, addressing global health problems, pioneering solutions to climate change or inventing production techniques to get more from less. To such growth, there is no limit.

From Ex Ante to Ex Post

The importance of the size of the pie, rather than just its division, is linked to another important distinction – between ex ante (before the event) incentives and ex post (after the event) outcomes. Merck's anti-cancer drug Keytruda generates value for patients who take it, colleagues who produce and market it, and suppliers who provide the inputs. Yet Merck's investors also benefit significantly – Keytruda generated $11.1 billion of sales in 2019. That's because a patent prevents other companies from making similar drugs until 2028. Perhaps ex post, after Keytruda was invented, any company should be allowed to make it to ensure a more equal distribution of the gains – other companies' investors, employees and suppliers would share in the pie, and patients and insurance companies would enjoy lower prices. But doing so would erode ex ante incentives to develop the drugs in the first place. Developing and gaining approval for a new drug costs an average of $3 billion,[25] and the vast majority of drug ideas fail. Without the prospect of profits in the rare case of success, companies could never justify exploring a new idea. As Merck's current CEO, Kenneth Frazier, points out: 'The price of [a] successful drug is paying for the 90%-plus projects that fail. We can't have winners if we can't pay for losers.'[26]

The contrast between ex ante and ex post applies far beyond patents. Providing ex ante incentives to grow the pie may require giving ex post rewards to those who do so. Perhaps a disproportionate share is necessary if growing the pie is uncertain and risks huge losses. As I'll stress in Chapter 5, this share should go to all members responsible for pie growth – colleagues as well as leaders. But without the prospect of rewards upon success to balance the risk of failure, leaders may coast and settle for the status quo – an error of omission. An unequal distribution of something is almost always better than an equal distribution of nothing.

The table below highlights some of the key differences between Pieconomics and CSR:

	Pieconomics	**CSR**
Leader's Mindset	Grow the Pie Actively Do Good	Split the Pie Do No Harm
Activities Affected	Core	Ancillary
Critical to Avoid	Errors of Omission	Errors of Commission
Profits Viewed As	Value Creation	Value Extraction
Perspective	Ex Ante	Ex Post

Dealing with Trade-Offs and a Shrinking Pie

A key attraction of Pieconomics is that growing the pie can increase every member's slice. But the important word is 'can'. One member's slice might shrink even if the pie grows, because value creation often involves trade-offs. New technology might lead to better products for customers, higher profits for investors and easier jobs for colleagues that remain – but other workers being made redundant.

The famous Coase theorem,[27] thanks to the Nobel Prize-winning economist Ronald Coase, shows that when the pie grows, it's always possible to find a way of compensating those whose slices would otherwise fall, so that no member loses and at least one benefits. This harmonious outcome is known as a Pareto improvement, after Italian economist and political scientist Vilfredo Pareto.[28]

Pareto improvements won't happen automatically, so leaders must take active steps to ensure that a theorem becomes reality. A pie-growing enterprise *first* grows the pie and *second* tries to ensure that no member's slice shrinks. A company that implements new technology may invest in outplacement and retraining to reduce the impact of layoffs, even if doing so lowers the profit boost from the technology. A business that builds a new factory may spend money on reducing emissions and noise pollution. Importantly, the members whose slice shouldn't shrink include investors. If a company delivers value to stakeholders entirely by sacrificing profits, this splits the pie differently rather than growing it.

Now a company may not be able to fulfil the second criterion, despite its best efforts. Even with outplacing and retraining, some displaced workers may be unable to find other jobs. Many trade-offs are real and can't be managed around. While CSR instructs a company to 'do no harm', many pie-growing actions hurt at least one stakeholder.

How do leaders know whether to take actions that grow the pie, but reduce some members' slices? Chapter 3 will introduce three principles to help a leader navigate trade-offs between investors and stakeholders. Chapter 8 will emphasise how an enterprise's *purpose* – its reason for being and the members it particularly aspires to serve – can guide trade-offs between different stakeholders.

Just as a pie-growing enterprise shares the gains from pie growth, it also shares the losses from pie shrinkage. In early 2009, in the aftermath of the financial crisis, manufacturer Barry-Wehmiller lost 40% of its orders in a few days. To avoid bankruptcy, the board concluded it needed to save $10 million and started to discuss layoffs. Typically, employees bear the pain and executives get off unscathed. But CEO Bob Chapman had something else in mind – to split the burden. Every colleague, from secretary to CEO, was required to take four weeks of unpaid vacation. Leaders took an extra hit as bonuses were suspended. As Bob said: 'It's better that we should all suffer a little than any of us should have to suffer a lot.'

By the next year, Barry-Wehmiller still hadn't laid off a single colleague. Not only did it safeguard its workers' jobs, but it also ensured their free time was used productively by putting on classes at its corporate university. Others did volunteer work or spent more time with their kids over the summer. Barry-Wehmiller ended up saving $20 million, double its original target, and morale soared.

The financial crisis was a serious shock – but the economy bounced back, which is why Barry-Wehmiller was able to ride it out. In contrast, the coronavirus pandemic has permanently damaged entire industries. For example, the travel sector is unlikely to fully recover even though vaccines are now available – people have become used to remote meetings and virtual conferences. Thus, in May 2020, Airbnb took the tough decision to shed a quarter of its workforce. As we'll stress in Chapter 3, Pieconomics isn't an excuse to shy away from tough decisions. Safeguarding all jobs would have been irresponsible as it would have endangered Airbnb's long-term survival and the livelihoods of all colleagues. However, Airbnb ensured it took this commercially necessary decision in a humane way. It gave at least 14 weeks' severance pay to all displaced workers even though none is required in the US, guaranteed them a year's health insurance given the pandemic, let them keep company laptops to help them find a new job and reassigned part of its recruitment department to outplacement.

In contrast, the consequences from not sharing the losses can be severe, as Sandra Sucher and Shalene Gupta describe in the case of Finnish telecoms firm Nokia.[29] In 2008, Nokia faced stiff competition from low-cost Asian rivals, which had driven prices down by 35% in a few years. Over the same period, labour costs in Nokia's plant in Bochum, Germany, had risen by 20%. Nokia decided to close Bochum. The closure may well have grown the pie – without it, Nokia's long-term viability may have been jeopardised. But 2,300 workers lost their jobs. Nokia did little to soften the blow, and this failure ultimately hurt the company. A week after the shut-down was announced, 15,000 citizens protested at Bochum, German politicians demanded that Nokia repay the subsidies it had received for the plant and unions called for a boycott of Nokia phones. Photos of crying employees and protesters crushing Nokia phones spread through the news and social media. The negative publicity cost Nokia an estimated €700 million of sales and €100 million in profits over 2008 to 2010. And even these figures may understate the long-term consequences. While most firms track their customer Net Promoter Score (how many customers will recommend its products), employees are often the biggest net promoters of an enterprise – to both future customers and colleagues. Unceremoniously dumping workers can hinder recruitment for many years to come.

So in 2011, when Nokia needed to lay off 18,000 employees due to difficulties in its mobile phone business, it had learned its lesson. It launched the Bridge programme, giving these workers five potential paths forward: finding another job within Nokia, finding another job outside Nokia through outplacement, starting a new business, taking business or trade courses, or building a new path such as volunteering – the last three funded by grants from Nokia. Bridge cost €50 million, a drop in the ocean compared to its €1.35 billion restructuring budget from 2011 to 2013. As a result, 60% of the 18,000 workers knew their next step the day their jobs ended, and there were no protests in any of the 13 countries where the layoffs occurred.

Collective Responsibility

We've talked about *enterprises* with pie-growing and pie-splitting mentalities. But an enterprise isn't a disembodied unit. It's the collection of investors, leaders and stakeholders. Pie-growing isn't the responsibility of only leaders – crucially, *every stakeholder can help grow the pie.* Sure, Roy Vagelos had the power to give ivermectin away for free. But employees have the power to go the extra mile even if not explicitly required or rewarded by their contract. When Barry-Wehmiller announced its furlough, some employees took a double load in place of a colleague who couldn't afford to lose four weeks' pay. Customers have the power to risk buying from a new entrant rather than the safety of the market leader, provide feedback to improve a company's products or contribute to review sites to help other customers. Communities have the power to constructively express their concerns to a company looking to enter the area, rather than engage in a 'not-in-my-back-yard' protest.

And pie-splitting is committed not only by investors and leaders. Colleagues may resist a change in working practices that would safeguard the firm's long-term viability. Customers may boycott a firm if the CEO is being paid well, even if it's the result of creating value, or not bother to participate in recycling schemes. Growing the pie may primarily be the responsibility of leaders, but it can't be done without all citizens playing their part. We'll come back to this in Chapter 10.

Why Is Pieconomics So Urgent Now?

The urgency of business recognising its responsibility to society is arguably greater today than ever before. The sheer size of firms, the vast workforces they employ and the billions of dollars that flow through them give companies the power to solve social problems, provide fulfilling careers to colleagues and generate returns for citizens. But there are serious concerns that they're instead using this power to exacerbate social problems, exploit colleagues and generate returns only for the elites – the 2020 Edelman Trust Barometer found that 56% of respondents believe that capitalism does more harm than good in the world.[30] Rapidly increasing sections of the population feel cut out of the benefits of economic growth. Incomes of ordinary people have stagnated, while profits and executive pay have soared.

Not only has business's power to affect social problems grown, but so have the problems themselves. As a society, we're facing challenges of a scale and complexity that capitalism as we know it is struggling to address. Some of these problems are partly or predominantly caused by business – income inequality, resource usage, climate change and the replacement of workers with machines. The consequences that enterprises exert on society, but don't feed back into profits, are known as *externalities*. If companies don't drastically reduce their negative externalities, they'll lose their social licence to operate – as the increasing populism shows they are already doing. This may lead to anti-business regulation that will damage their long-term productivity.

That businesses should 'do no harm' – curb their negative externalities – has long been recognised. This is how CSR has typically been practised. But Pieconomics stresses that companies should actively do good. Other global problems are not the fault of business, such as a growing and ageing population and the coronavirus pandemic. A company that focuses on profit with little regard for these challenges is doing no harm. But it's not enough to do no harm. Ignoring social problems, when an enterprise has great power to solve them, is not acceptable. In contrast, by committing to create profits only through creating value for society, pie-growing firms help rebuild trust in capitalism – recall a trustworthy enterprise is one that uses its expertise and resources to address society's challenges.

A second reason why Pieconomics, rather than CSR, is so urgent today is that many companies can't afford to practise CSR. CSR is often viewed as throwing money at a problem – for example, India has a law requiring large companies to spend 2% of their profits on CSR initiatives. Likewise, many great responses to the pandemic involved splitting the pie more fairly. Some CEOs accepted a zero salary; Unilever donated €100 million of food and sanitiser to local communities and safeguarded the jobs of its 155,000 workers – including contractors, such as cleaners and catering staff.

These actions are highly laudable and should never be downplayed. But the problem with viewing responsibility as only about splitting the pie is that many companies don't have pie to share, particularly in a pandemic. What if you're not in the food and sanitiser industry and don't have relevant products to donate? What if you're a small enterprise that doesn't have millions lying around, or a big business whose revenues have plummeted, such as an airline? You know that keeping all workers on full pay would be the 'right thing to do' – but it would be commercial suicide.

The value of thinking about responsibility as pie-growing is that it unlocks the potential for *all* companies to play their part. A responsible leader asks herself 'What's in my hand?' What resources and expertise does my company have, and how can I deploy them innovatively to serve society?

Such a mindset can inspire some great ideas – just like Merck adapting ivermectin from livestock to humans. Chelsea Football Club doesn't have anything obviously relevant in a crisis. Football tickets and replica merchandise are of little value. But what's in its hand is its hotel, where it allowed doctors and nurses to stay for free, saving them a long commute after a day of fighting on the front line. LVMH's luxury perfumes were indeed a luxury in a pandemic. But what's in its hand is a production facility that uses alcohol, which it redeployed to manufacture hand sanitiser. Many of JetBlue's planes were grounded as passenger numbers plummeted. So it partnered with charities such as the Red Cross and Médecins Sans Frontières to use these planes to transport medical professionals, devices and supplies to where they're most needed. This mindset applies to non-profits as well – the English National Opera launched a programme to teach breathing techniques to citizens recovering from long COVID.

Sometimes, what's in a company's hand is its relationships with other organisations. Qantas Airways couldn't afford to keep paying its furloughed staff, since its business was badly hit. But it had a relationship with Woolworths grocery store, where customers could earn Qantas miles for shopping in Woolworths. It leveraged this relationship to redeploy its staff to Woolworths – not only safeguarding their incomes, but also helping meet the spike in customer demand for groceries. Mercedes had a partnership with University College London (UCL) through projects such as Formula 1 in Schools. It combined its engineering expertise with UCL's, plus the medical knowledge of UCL Hospitals, to reverse-engineer continuous positive airway pressure (CPAP) breathing aids – a less invasive alternative to ventilators.* Mercedes then mass-produced them by repurposing the machines that typically made pistons and turbochargers for Formula 1 engines. This initiative used not only Mercedes'

* Another problem with ventilators was that they required highly trained staff to operate, which the UK had a shortage of. Towards the start of the pandemic, UCL consultant anaesthesiologist Dr. Dave Brealey found an old CPAP breathing machine in a museum cabinet in the UCL anaesthetic department called a WhisperFlow. He recalled that they were used in the 1990s and didn't require highly trained staff to operate, and so he took it to the UCL Mechanical Engineering workshop to see if they might be able to reverse-engineer it. There, UCL Professor Tim Baker called his long-standing collaborators at Mercedes. Since Formula 1 was on hold, they were able to get into their cars immediately and drive down with their computer-aided design

relationships, but also its skills. The same precision engineering needed in elite motorsport, where there's very little margin for error, is similarly essential for a medical device. UCL and Mercedes also shared their designs for free to 1,300 teams in 25 countries within a week.

And thinking of responsibility as growing the pie is particularly relevant for small businesses, who don't have pie to give. Take Barry's, the boutique fitness studio. What's in its hand is fitness expertise, which it used to offer free livestreamed workouts – particularly valuable when citizens are locked down at home. Now it might seem not particularly innovative for a fitness studio to provide fitness classes, albeit online. The real creativity was in how it redeployed its office and desk workers. Some of them also had jobs as actors; since acting can be volatile, they also worked for Barry's to provide a stable income. If you're an actor, what's in your hand is that you're entertaining. How does that help in a crisis? Barry's launched a 'Barry's Cares' programme, which included their staff reading stories and providing entertainment to children over Zoom – taking the load off working parents whose kids were at home due to school closures.

These inspiring examples give us hope even in bleak times. If there's any silver lining to the crisis, it's that it will permanently lead to a shift in thinking about what responsible business entails – from splitting the pie by spending money to growing the pie by innovatively using what's in our hand. The latter can be practised by companies both large and small, and in bad times as well as good. And as we'll stress in Chapters 10 and 11, citizens and junior employees can grow the pie, whereas only senior

equipment. Within 100 hours of their first meeting, the combined team – from Mercedes, UCL Mechanical Engineering and UCL Healthcare Engineering – made its first prototype. An added benefit of reverse-engineering a previously used device was that regulatory approval was very quick.

management controls the purse strings and can decide where to spend a company's cash.

Moreover, the urgency of Pieconomics isn't just due to the pandemic, and won't dissipate once the pandemic is over. In particular, newer generations view serving society as particularly important. A survey by Kantar and American Express, just before the pandemic, found that 62% of millennials (born between 1980 and 1996) agreed that 'it is important for me to be known for making a positive difference in the world', versus 52% of Generation X (born between 1965 and 1979).[31] Yet millennials also recognise the importance of profits – 58% agree that 'the successful business of the future will maximise shareholder value/profits', versus 51% of Generation X. Similarly, a joint study by PwC and the international student organisation AIESEC combined the responses of a PwC survey of CEOs with an AIESEC study of young leaders.[32] Only 32% of CEOs view shareholders as more important than stakeholders, while 67% believe the opposite. In contrast, the responses were almost identical for young leaders (46% and 48%, respectively). Thus, to inspire a new generation of workers and provide them with vocations rather than just jobs, it's important for the business of the future to create value for society – but in a pie-growing way that also delivers profit.

Even if we accept that growing the pie is important, and that all members of an enterprise have a responsibility to help it create value, the idea seems general and vague. How do we know if an action grows the pie? What does it actually mean for a particular company to create value for society? A retailer does so in a different way from a pharmaceuticals firm. We'll come to these questions in Chapter 3 and reprise them in Chapter 8. But first, in Chapter 2, we'll discuss how Pieconomics differs from other approaches to business that emphasise the need to serve stakeholders.

In a Nutshell

- The pie represents the value an enterprise creates for society. Society includes not only investors, but also colleagues, customers, suppliers, the environment, the government and communities. If companies consider only investors and ignore stakeholders, they'll lose their social licence to operate – as they may already be doing.
- *Pie-splitting* increases one member's slice by reducing others'. Most commonly, companies may increase profits by price-gouging customers or exploiting workers. But the pie-splitting mentality may also be held by stakeholders, who think cutting profits is the best way to increase their own slice.
- *Pie-growing* increases the value an enterprise creates for society – by inventing new and better products, developing and nurturing its workforce or renewing the environment.
- *Pieconomics* seeks to create profits only through creating value for society. Doing so may generate more profits than pursuing profits directly, and more value for stakeholders than sacrificing profits would.
- Pieconomics differs from CSR in the following ways:
    - ✳ It is embedded in the core business and ensures that its primary mission is to serve society, rather than representing ancillary activities to offset the harm caused by the core business.
    - ✳ It recognises that *errors of omission* (failing to create value by coasting rather than innovating) are even more serious than *errors of commission*.
    - ✳ It acknowledges that profits need not be a sign of value extraction, but instead may be a by-product of value creation.
    - ✳ It argues that ex ante incentives to grow the pie are even more important than the ex post redistribution of the pie.

- Growing the pie involves trade-offs. A pie-growing company first aims to increase the size of the pie and second tries to ensure that, to the extent possible, no member's slice shrinks. The second goal may not always be possible, and a leader's judgment and an enterprise's purpose are important to navigate such trade-offs.
- Pieconomics is urgent given the scale of social problems and the power of business to alleviate or exacerbate them. Innovation and excellence to solve these problems often involves an attitudinal shift rather than a major financial outlay, and can be practised by all firms – even small enterprises or those who are financially constrained.

2 GROWING THE PIE DOESN'T AIM TO MAXIMISE PROFITS – BUT OFTEN DOES

Freeing a Company to Take More Investments, Ultimately Driving Its Success

The idea that businesses should be driven by social value first and profits second sounds attractive. But it's also controversial. Milton Friedman is arguably the second most influential economist of all time, after John Maynard Keynes, and he advised the likes of Richard Nixon, Ronald Reagan and Margaret Thatcher. He won the Nobel Prize in Economics in 1976, mainly for his contributions to monetary policy, which form the bedrock of central banks' thinking worldwide.

Yet Friedman's most cited article isn't on monetary policy, nor even a research-based study, but a 1970 *New York Times Magazine* opinion piece entitled 'The Social Responsibility of Business Is to Increase Its Profits'.[1] It's been quoted 23,000 times, five times as often as any of his research articles. But most of these citations are with scorn and ridicule, to highlight how capitalism is in the dark ages and urgently needs to be overthrown. To declare that you reject Friedman has become almost a requirement for acceptance into polite society.

But many people have cited Friedman's article without reading further than the title. They think they don't need to, since the title already makes his stance clear: companies should maximize profits by extorting customers, overworking employees and polluting the environment. 2020, the fiftieth anniversary of Friedman's article, saw many critics proclaiming how Friedmanism is 'dead' – yet many of their writings showed a deep misunderstanding of what Friedman actually said. Even though I don't agree with it, it's critical to acknowledge that Friedman's argument is far more nuanced than it sounds – and as it's frequently quoted for being – for three reasons.

First, it doesn't assume that investors only care about profits. Let Andrea and Miguel both be investors in Apple. Andrea cares about racial equality, Miguel about environmental renewal. If Apple gave a large donation to Black Lives Matter, this would please Andrea, but not Miguel. Instead, Apple should make as high profits as possible, allowing it to pay as high dividends as possible. Then, Andrea can donate some of her dividends to Black Lives Matter, and Miguel his to Greenpeace. Or, Andrea and Miguel may have other socially beneficial uses for their dividends, such as funding their children's education.*

So Friedman does recognise that *individuals* have social responsibilities beyond profits. He argued that the social responsibility of *business* is to increase profits because doing so gives individuals – Andrea and Miguel – maximum flexibility to choose which social responsibilities they wish to fulfil. It's not the CEO's prerogative to take this decision away from them. As Friedman writes: 'if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other'. Warren Buffett uses a similar argument to explain why Berkshire Hathaway has a policy against charitable donations: 'This is the shareholders' money. Many corporate managers deplore governmental allocation of the taxpayer's dollar, but embrace enthusiastically their own allocation of the shareholder's dollar.'

* Friedman argues that the same logic holds if Andrea and Miguel are colleagues, suppliers or customers. If Apple donates to charity, this reduces the wages or prices it can pay, or increases the prices it must charge, leaving less for Andrea and Miguel to donate.

But Friedman's argument is founded on pie-splitting. It assumes a dollar that Apple takes from investors creates only a dollar of value to society. That may be true for charitable donations. A dollar is worth the same to Black Lives Matter regardless of whether it's given by Apple or Andrea (ignoring taxes), and so Apple doesn't have a *comparative advantage* in donating to charity. However, the assumption isn't true for most actions that directly affect society, which are pie-enlarging. If Apple invests a dollar in reducing its plastic packaging, it helps the environment much more than if it paid out that dollar as dividends and Miguel donated it to Greenpeace to lobby for a tax on plastic bags.

So Friedman's claim that companies serve society by maximising profits isn't always true, because his assumption that they have no comparative advantage in serving society is sometimes invalid. But the value of Friedman's framework is to emphasise that they should deviate from profit maximisation *only if* his assumptions don't hold – and they sometimes do. Many companies donate to charity; India goes further and requires large companies to spend 2% of their profits on CSR, which donations count towards. But Apple's expertise is making iPhones, not choosing which charitable causes are most worthy. Companies giving to Black Lives Matter in the light of George Floyd's tragic death would have been wise to heed Friedman's advice. They should have instead invested their money in recruiting under-represented minorities at all levels, stamping out discrimination in their promotion and evaluation processes, and ensuring that their culture encourages a diversity of thinking – actions that only they can control, which means they have a comparative advantage in doing so. So instead of ridiculing Friedman's article, advocates of responsible business can use it to guide us on what socially responsible actions companies should and shouldn't undertake.

A second reason why Friedman's argument is nuanced is that he does recognise that individuals can't solve all social problems – leaders must take action. But these should be leaders of countries – politicians who pass laws and set taxes – not businesses. That's because politicians are elected by the public and thus accountable to them. If citizens are concerned with climate change, they can vote for parties that pledge to curb it. If the government doesn't reflect the electorate's preferences, it will be voted out. In contrast, a CEO isn't elected by a country's citizens, and thus isn't accountable to them. If she's allowed to deviate from profit maximisation, she may support her own pet social causes rather than those of most concern to the nation.

But there are several problems with entrusting everything to regulation, as we'll discuss in Chapter 10. We'll highlight three here. First, companies may distort regulation by lobbying. In 2017, 69 of the world's richest entities by revenue were corporations, not governments.[2] This gives companies substantial power to influence regulation through political donations.

Second, regulation is most effective at addressing measurable issues. Minimum wage legislation has bite as it's easy to check if a company is complying. It's much harder to regulate qualitative issues such as creating a collegial and vibrant corporate culture, and giving meaningful work and skills training to colleagues.

Third, regulation is slow. Elections typically happen only every four or five years. In contrast, CEOs *are* accountable to citizens, and on a much more timely basis. They're appointed by the board of directors, which investors vote on – often every year. A counterargument is that only the wealthy are investors. In fact, most citizens are investors through their pension plan, and Chapter 10 will stress how pension plans should seek the input of their beneficiaries.

Even though Friedman's assumption of effective regulation doesn't always hold, his framework is again valuable because there are cases where it's satisfied. As discussed, regulation is effective for enforcing a minimum wage. So if a company wishes to pay above the minimum wage, even if market forces don't dictate this and there aren't the productivity benefits we'll discuss in Chapter 4, it needs to have good arguments why the government has set the minimum wage wrongly. A company should depart from shareholder value and play the role of government *only if* there are reasons to believe that regulation isn't correctly reflecting citizens' preferences.

The third, and most powerful, defence of Friedman is that the only way an enterprise can make profits – at least in the long term – is if it serves society. So profit maximisation is socially desirable as it leads companies to invest in their stakeholders. In contrast to the common misinterpretation, Friedman gives a big green light to such investments. He stressed that 'it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees.'

Why is Apple one of the most valuable companies in the world, breaking the $2 trillion mark in August 2020? Because it serves *customers* by offering the highest-quality products. The iPhone X's Face ID and camera are the culmination of Apple spending over $400 million acquiring PrimeSense (3D sensors), LinX (multi-aperture camera models), Faceshift (facial motion capture software), Emotient (facial expression recognition) and RealFace (facial recognition technology). Apple's after-sales service is renowned – a customer can make a free appointment at an Apple store's Genius bar to fix a problem.

Apple nurtures its *colleagues*, who report numerous attractions of Apple as an employer on Glassdoor, a workplace review website. They can make a positive impact on the world, learn from and be inspired by smart colleagues, and enjoy a start-up culture despite Apple's size. Now, as with any large enterprise, Apple isn't perfect across every dimension, and we'll return to criticisms of its working practices in Chapter 4. Taking into account both the good and the bad, a 2021 LinkedIn survey ranked Apple the eighth-most sought-after employer in the US. It's one of only three US companies that have made Glassdoor's list of top-100 employers for all thirteen years since it started. This allows Apple to attract the employees who provide the innovation, strategic thinking and customer focus that drive its success.

Apple invests in long-term *supplier* relationships. It has a $5 billion Advanced Manufacturing Fund to support innovation in its suppliers. The Fund invested $200 million in the glass supplier Corning to keep its glass processing technologies state-of-the-art, and $390 million in Finisar to help it develop Face ID's lasers.

Apple has a strong *environmental* record, with 100% renewable energy in offices, stores and data centres and 100% of its paper packaging coming from sustainable sources. Its new robot, Daisy, can disassemble nine versions of the iPhone and sort their components for recycling. It has committed to be 100% carbon neutral across its entire business – including its manufacturing supply chain and product life cycle – by 2030.

Apple contributes to local *communities* by running the Global Volunteer Program to equip colleagues in organising volunteer events, and partnering with (RED) to launch (RED) products, whose sales support HIV/AIDS programmes.

As a result of being profitable, Apple was the largest taxpayer in the world before the December 2017 Tax Cuts and Jobs Act, remitting over $35 billion to *governments* between 2015 and 2017. Its effective tax rate was 25% in 2017 and 26% in the previous four years.*

It's true that the fastest way to increase profits is to split the pie differently. Shkreli did so overnight by hiking the price of Daraprim. But there's a limit to how much profit pie-splitting can generate in the long term. Even if Turing could hypothetically take the entire slice from stakeholders, it could never increase its profits higher than the size of the original pie.

* As with most global companies, some critics argue that Apple locates activities in certain countries to reduce its tax burden. For Apple's response, see 'The Facts about Apple's Tax Payments' on its website. We don't take a stance on what the 'fair' tax rate is. Instead, our point is that, for any given tax rate, higher profits increase the tax payment.

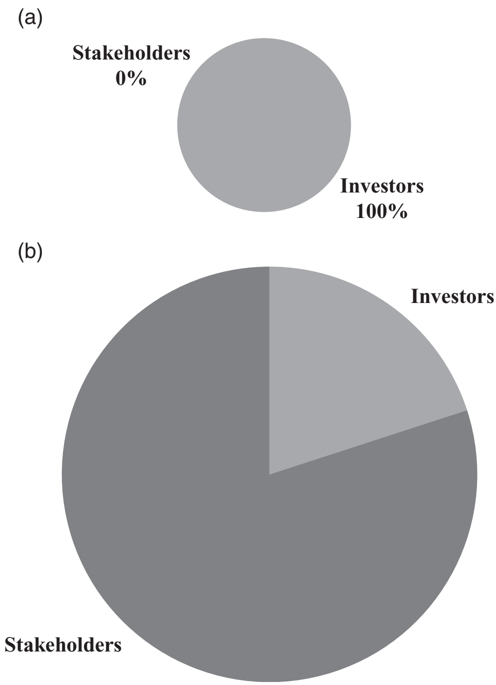


Figure 2.1

But if it grows the pie by investing in stakeholders, the potential profits are much higher, as shown in Figure 2.1.

Friedman's third argument, that a focus on profits forces a company to invest in stakeholders, is the foundation for a broader approach to profit maximisation called *enlightened shareholder value* (ESV). ESV agrees with the pie-splitting mentality that a company's goal is to maximise profits. But it's enlightened because it recognises that doing so in the long run requires it to invest in stakeholders. Critics argue that shareholder value maximisation is short-termist, but *shareholder value is an inherently long-term concept* – it includes all the profits that a company generates for its shareholders, both now and in the future. While the Business Roundtable's new statement on the Purpose of a Corporation was heralded as revolutionary, 'delivering value to our customers . . . investing in our employees . . . dealing fairly and ethically with our suppliers . . . [and] supporting the communities in which we work' is simply good business – it's not the exclusive territory of purposeful business. Any company maximising shareholder value should undertake these actions. Failing to do so isn't due to an excessive focus on shareholder value, but insufficient focus – due to an excessive focus on short-term profit instead.

Maximising shareholder value does not mean maximising short-term profit. Indeed, a stakeholder-focused company is often described as 'sustainable', but 'sustainable' simply means 'long-term'. ESV could be called 'sustainable' as it also takes a long-term approach, albeit to maximise profits rather than social value. We'll thus not use 'sustainable' in this book to describe a pie-growing enterprise, but 'purposeful' or 'responsible'.*

Some critics of shareholder value present it as a caricature – one that advocates exploiting stakeholders in the greedy pursuit of short-term profit – and then easily destroy the caricature. They then push their own theory of how a company should operate, and it's not difficult to argue that theirs is superior when the alternative has been presented as a straw man. By claiming that the status quo is stuck in the dark ages, critics can propose extreme measures such as throwing out the idea that companies should be accountable to shareholders – and thus be seen as radical reformers, drumming up popular support. This one-sided presentation of shareholder value is not only inaccurate, but also destructive, as it fuels the pie-splitting mentality. It views investors as enemies of society, leading to proposals to restrain them. Instead, they're partners in growing the pie – the evidence of Chapter 6 will show that shareholder engagement creates value for stakeholders, rather than extracting value from them.

* We'll only use 'sustainable' in Chapter 5 when referring to reward schemes, where long term is indeed the dimension that matters.

So Pieconomics actually has many similarities with ESV. Both highlight the criticality of companies investing in their stakeholders. Both stress the importance of profits. And both argue that shareholder value and stakeholder value are highly correlated in the long run, as the evidence in Chapter 4 will show.

But there's a key difference. ESV argues that an enterprise's ultimate goal is to increase long-term profits – and by doing so, it will create value for society as a by-product. Pieconomics argues that an enterprise's ultimate goal is to create value for society – and by doing so, it will increase profits as a by-product. *Profits are an outcome, not a goal.*

This difference is fundamental. It's not just about switching around words in a sentence. It's about why the enterprise exists, what drives its daily decisions and what it should be held accountable for. ESV advocates also acknowledge that there's a difference. Indeed, they'd argue that it's why ESV is better than Pieconomics. ESV has a single, measurable objective – long-term profit. Pieconomics seems to have a pretty fundamental problem – you can't measure the pie. It consists of several different slices, many of which, such as community vibrancy and environmental renewal, can't be quantified. Even if they could be, there's no clear formula to weight them. Pieconomics has multiple, unmeasurable objectives. This means that, at least in theory, ESV has two key advantages.

First, ESV is *concrete*. Because there's a single, clear objective, there's a single, clear way to take a decision – will it increase long-term profit? With multiple objectives, there's no unambiguous way to take a decision. If an action improves vibrancy and reduces renewal, does it help or hurt society?

Second, ESV is *focused*. A company practising ESV will only take an action if it boosts profits. It won't spend millions on reducing emissions if they're already below the level that would lead to a fine. But a pie-growing enterprise might do so, simply to help the environment – thus harming profits.

I agree with both objections. But I'd argue that the same reasons are why the pie-growing mentality is fundamentally superior – not only for society, but also, surprisingly, for investors. I'd turn both reasons on their head. The pie-growing mentality may be less *concrete*, but it's *intrinsic* rather than *instrumental*. The pie-growing mentality may be less *focused*, but it considers *externalities* rather than just *profits*.

Being intrinsic is desirable because pursuing social value is often more profitable in the long term than pursuing profits directly. Considering externalities is desirable because investor welfare is affected not only by profits, but also by a company's social impact.

	Enlightened Shareholder Value	**Pieconomics**
Motivation	Instrumental	Intrinsic
Objective	Profits	Social value

Let's discuss each difference in turn.

Instrumental vs Intrinsic

Enlightened shareholder value believes an enterprise should be *instrumentally* motivated to create profits, whereas Pieconomics believes it should be *intrinsically* motivated to create social value.

Under ESV, a company should only invest in stakeholders if the benefit of doing so exceeds the cost. Every action is a means to an end. Renowned economist and leading ESV advocate Michael Jensen states this motivation clearly: 'change efforts should be guided by the sole purpose of increasing shareholder value'.[3]

Under this view, Apple leaders and employees should be driven each day to think about how to make Apple's profits as high as possible. The lure of riches is what spurs its designers to innovate, its retail staff to provide excellent customer service and its leaders to develop new strategic partnerships. While this view may seem narrow, it has a key attraction. It provides a concrete way to evaluate the trade-offs that exist in nearly every decision. Attracting the best employees, giving free consultations at a Genius bar and developing the Daisy robot are all costly.

How does Apple evaluate each decision? Through *calculation*. It sets up an Excel spreadsheet to calculate all the effects on current and future profits. The spreadsheet then converts each future profit to an equivalent profit today, using a *discount rate* that takes into account the fact that $1 in the future is worth less than $1 today. Summing up all current and future profits, the spreadsheet spits out a final answer, known as the 'Net Present Value' (NPV) of the decision. If, and only if, the NPV is positive should Apple go ahead.

The idea of instrumental profit maximisation sounds sensible in theory. And it often works in practice, particularly for tangible investments whose costs and benefits can roughly be estimated. If Apple is considering a new factory, it can forecast how many iPhones the factory will produce and how much it can sell them for. While the real world is risky, NPV is able to handle risk. You can do a 'sensitivity analysis' where you plug in different assumptions for the sale price of iPhones, and see how the conclusion changes.

But NPV is far less useful in practice for intangible investments, because it's much harder to estimate their costs and benefits. As Jonathan Haskel and Stian Westlake explain in their book *Capitalism without Capital: The Rise of the Intangible Economy*, a company's most important assets have shifted from tangible to intangible capital: non-physical assets such as patents, brand and knowledge. Intangible assets accounted for 90% of the value of the S&P 500 in 2020, compared to 17% in 1975.[4] One of the most important intangibles is *stakeholder capital*, the strength of an enterprise's relationships with its stakeholders. This includes the trust customers place in a company's brand, the reputation it has with regulators and the commitment of colleagues to its mission.

ESV has trouble even with tangible investments that have intangible benefits. Consider Apple's decision whether to provide employees with a free gym. The first step is to calculate the cost of the gym. The cost of building the gym, installing equipment and hiring instructors (or outsourcing this) is relatively simple to quantify. But the benefits are much harder, because they're intangible. Will the gym attract and retain workers, and what's their value to Apple? How many lost days due to sickness will the gym avoid, and how much would they have cost Apple? How many interactions between colleagues in different departments will the gym foster? These questions are extremely difficult to answer. So you can't calculate the NPV of the gym, and without it, you can't justify the gym under ESV.

The problem with intangible outcomes is not *risk*, but *uncertainty*. A risky problem can be analysed as you have a rough idea of its parameters. Drawing another card in blackjack is risky as you don't know what it will be, but you can calculate the probability it will be favourable as you know what's in a 52-card deck. Even if some of the deck has already been drawn, you can do a sensitivity analysis with different assumptions. With uncertainty, you don't even know the parameters of the problem. You have no idea what interactions the gym will foster – there's not even a baseline around which to conduct a sensitivity analysis. To use terminology popularised by former US Defense Secretary Donald Rumsfeld, risk concerns known unknowns, but uncertainty comprises unknown unknowns.

And the returns to intangibles aren't only *uncertain*, but also *distant* – even if they do arise, they'll be far into the future. A machine churns out widgets almost immediately, but if the gym prevents a colleague from developing diabetes in ten years' time, the financial benefit to Apple doesn't manifest for a decade. Evidence shows that leaders use a much higher *discount rate* for long-term benefits than they should.[5] So NPV calculations are driven by short-term effects.

When decisions are instrumental – driven by the desire to achieve outcomes – they'll only be based on outcomes that can be quantified with some degree of accuracy. But most important outcomes can't be quantified. This highlights the flaw in the argument that ESV is concrete because there's a single criterion – profits – which can be measured. Profits can only be measured looking backwards; it's very hard to estimate them looking forwards. The fact that you can measure profits years after taking a decision doesn't help you predict profits at the time you take it. 'Maximise shareholder value' is theoretically appealing, but practically unworkable.

ESV would have led Apple to forsake many investments in its employees. Not only larger investments such as building the gym, but also – and especially – smaller investments, such as granting workers days off for volunteering or extended parental leave. Each of these actions alone is likely to have little effect on a worker's productivity. But the collective effect of taking none of them will be to significantly reduce productivity. Profits come from unpredictable sources, and so a mindset of maximising profits will rarely maximise profits.

That's where Pieconomics comes in. A pie-growing enterprise makes decisions for *intrinsic* reasons – to create value for society – rather than to instrumentally increase profits. Stakeholders are the end itself, rather than a means to an end. This leads it to make many investments that are ultimately profitable, but couldn't be justified by a calculation. Apple invests in the gym simply because it cares about employee health. By doing so, it will recruit, retain and motivate great workers, increasing profits as a by-product, even if this increase couldn't be quantified at the outset. More broadly, Apple never set out to be worth $2 trillion, but to push the boundaries in innovation and design – and doing so led to its substantial value.[6]

Profits are important, but *profits are an outcome, not a goal* – pursuing them directly may backfire. By analogy, one reason to get a job is to make money. But choosing a career based on purpose might actually lead to greater financial security since, if a citizen does a job he loves, he'll become successful and command a comfortable salary. Aristotle wrote that 'happiness is the meaning and the purpose of life', but pursuing happiness directly can lead to self-indulgent behaviour that ultimately worsens long-run happiness. Instead, a different purpose, such as to serve others, or to seek out challenges, may spark decisions that are stretching in the short term, but ultimately increase happiness in the long term.

The principle of growing the pie provides clearer practical guidance than the rule of growing profits because it's much easier to see how an investment will affect stakeholders than profits. Using the gym as an example, the effect on colleagues is less *uncertain* – they clearly benefit from superior health, while the profit impact is harder to calculate. And it's less *distant* – the health benefits arise within a few months, while the impact of health on future sick leave and productivity may not manifest for several years.

Because of the pie-growing mentality, Apple decided not only to build a gym in its head office, but to build a top-quality one. It's 100,000 square feet in size, with exercise physiologists monitoring data and three climate-controlled temperature chambers to mimic Arctic and Saharan conditions. Did it justify such a substantial investment on NPV grounds? No. As Apple's current CEO, Tim Cook, said: 'I'm a big believer in people staying active. It's something that makes them feel better and more energetic. It's all about the fixation on the customer, and the customers here are our people, our employees.'[7] (Of course, a company shouldn't undertake *any* investment that benefits stakeholders, regardless of the cost. Chapter 3 will provide a set of principles to guide a leader on which investments to take and which to turn down.)

The gym is a deliberately simple example because it's well known that gyms improve employee health. But sometimes the best way to create value for society is unknown, and so an added advantage of the pie-growing mentality is to spur innovation. Even if these innovations were primarily undertaken to benefit stakeholders, the benefits may spill over unexpectedly to investors.

Walkers Crisps wanted to reduce its carbon footprint out of environmental concerns. In 2007, it partnered with the Carbon Trust to study the carbon footprint of a packet of crisps across its life cycle, from the planting of a potato tuber to the disposal of a bag. The investigation found that much of the footprint came from drying the potatoes. Digging deeper, Walkers learned that the drying cost was so high because it bought potatoes by gross weight, incentivising farmers to keep potatoes humidified to increase their water content. So Walkers switched to purchasing by dry weight, not only lowering their own drying costs, but also discouraging farmers from using energy to humidify potatoes. In two years, Walkers reduced the carbon footprint of a packet of crisps by 7%, saving 4,800 tonnes of carbon emissions and cutting Walkers' energy bill by £400,000 per year. An exploration undertaken to benefit the environment ultimately helped investors.

Indeed, some of the greatest innovations in history have arisen despite dizzying odds. Even after William Campbell's hypothesis regarding ivermectin, it was highly unlikely that it would ever become effective and safe for humans. Only 1 in 1,000 compounds tested in a preclinical setting makes it to human trials, and only one in five of these ends up being approved.[8] Reducing decisions to a profit forecast will stifle risk-taking, because the benefits are so uncertain that the decision can't be justified on paper. But when social value is the objective, the prize from successful innovation is much higher, which motivates exploration even if the odds are stacked against you. The effect ivermectin could have on citizens' lives, if developed successfully for human use, vastly outstripped its potential impact on profits, and so spurred Merck to invest in researching it. The financial benefits of finding a coronavirus vaccine are limited because successful developers are expected to make the vaccine affordable –

indeed, AstraZeneca and Johnson & Johnson have pledged to sell theirs at cost. But companies around the world made substantial efforts to develop one, for the sake of humanity rather than profit.

Thus far, we've discussed how pie-growing actions often ultimately increase profits. On the flipside, actions that boost short-term profits often shrink the pie and reduce long-term returns. In the 1970s, Nestlé aggressively marketed breast milk substitutes to pregnant women and mothers of babies and young children, particularly in developing countries. It used sales reps dressed as nurses to convince new mothers to use infant formula and gave free samples to hospitals and maternity wards. This caused mothers to stop lactating, so they were locked into buying the formula.

Nestlé also failed to warn that powdered formula isn't sterile and may contain harmful bacteria. This, combined with the lack of clean water to mix the formula with, meant that strict sanitation methods were needed to make it safe for infants. However, many mothers in developing countries couldn't read the language in which the sterilisation instructions were written – and even if they could, they didn't have the facilities to perform them, such as fuel to boil water. Nor did Nestlé stress the criticality of following the instructions to the letter. Mothers over-diluted the formula to make it last longer, which led to malnutrition.

None of this activity was illegal at the time, but it was certainly immoral and destroyed rather than created social value. And it ended up destroying value for Nestlé itself. In 1977, the Infant Formula Action Coalition launched a boycott against Nestlé in America, which quickly spread to Australia, Canada, Europe and New Zealand. The boycott was suspended in 1984, by which time it had already cost Nestlé around $1 billion in sales,[9] and resurfaced in the late 1980s when Ireland, Australia, Mexico, Sweden, and the UK adopted it. Even to this day, some customers still don't trust Nestlé – in 2015, readers of Ethical Consumer voted Nestlé the 'least ethical company of the last 25 years'.

Summing up, if a company only takes actions to get something in return, it won't take actions where it expects nothing in return, even if these actions unexpectedly lead to profits down the line. To create value that none of its competitors creates, a company must make investments that none of its competitors is making. In a world where investment decisions are frequently reduced to a mathematical calculation, these are investments that can't be reduced to a mathematical calculation.

Profits vs Externalities

Enlightened shareholder value believes an enterprise should be instrumentally motivated to create *profits*, whereas Pieconomics believes it should be intrinsically motivated to create *social value*.

We've just argued that many actions that enhance social value also improve long-term profit as a by-product. But it would be too naïve and unrealistic to assume that every single action that grows the pie also increases investors' slice. Many pie-growing actions don't enhance profits, even in the very long term. Some are invisible, and so are unlikely to increase customer demand, such as the nutritional content of a restaurant's food. Even for visible actions, many have a much smaller profit impact than their cost. The Mectizan Donation Program certainly improved Merck's reputation, but there's no way to calculate if this boost exceeded the expense.

Similarly, many pie-shrinking actions don't reduce profits, even in the very long term. The Daraprim price hike worsened Turing's reputation, but when a physician prescribes a medicine, or a patient buys one over the counter, their primary concern is the medicine's effectiveness – not the ethicality of the manufacturer. Or market power and lobbying may allow profits to be earned despite pie-shrinking behaviour. Even though the first evidence linking smoking to cancer was published in 1950, tobacco companies have continued to earn outsized profits. Margins rose 77% between 2007 and 2016,[10] and the five largest firms made a combined $35 billion in profit in 2016.[11]

While ESV considers only profits, Pieconomics also takes externalities into account. A pie-growing enterprise focuses on creating social value with the assurance that most value-creating actions will, sometimes unexpectedly, increase long-run profits – but also with the recognition that a few won't. Consider the trade-off illustrated in Figure 2.2. The pie at the top represents the status quo. The firm has the choice between two strategies. Strategy A grows the pie moderately and investors capture the entire gain. Stakeholders' slice is unchanged – they capture a smaller share of a larger pie. Strategy B grows the pie significantly, while keeping the shares unchanged, so both investors and stakeholders gain. However, investors gain less than under Strategy A.

As the evidence of Chapter 4 will show, in the long run these trade-offs are the exception rather than the rule. However, it's important for Pieconomics to acknowledge the exceptions and address how to deal with them.

Which strategy should leaders choose? At first glance, it seems to depend on who the law says they should run the company for. The most common view is that directors' primary responsibility is to investors, with a secondary responsibility to stakeholders, and so they should choose Strategy A. This is embedded in the UK Companies Act and is a common interpretation of US corporate law. Moreover, moving from the status quo to Strategy A is a Pareto improvement, because one member gains and no one loses.

Even though a Pareto improvement seems the ideal outcome, Pieconomics argues that leaders should go further. Pieconomics isn't about win-not lose, it's about win-win. Importantly, this approach isn't driven by the law. It's true that directors' duties in some countries, particularly in Europe, are towards the company as a whole; even in the US,

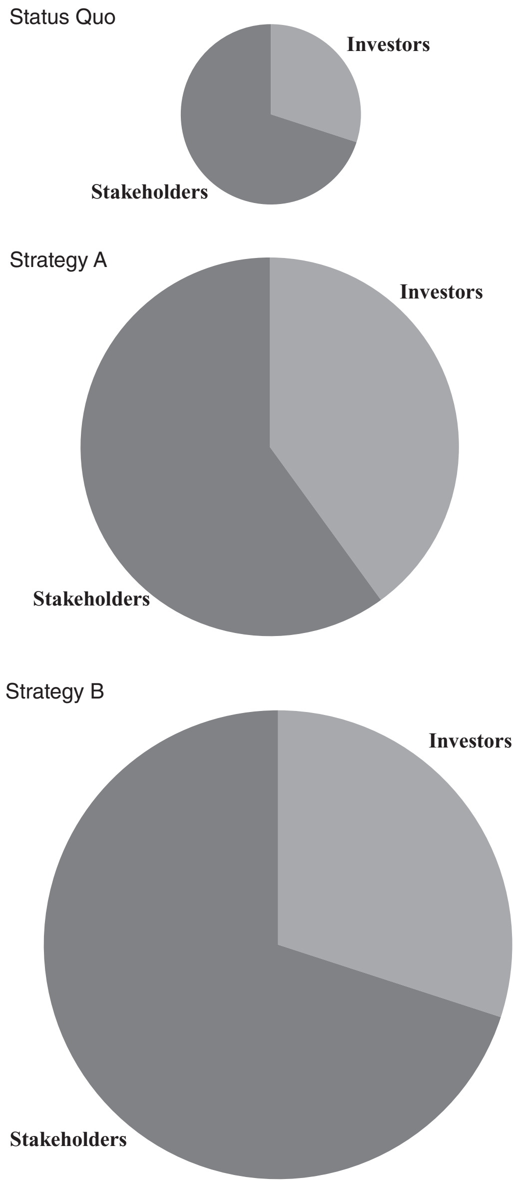

Status Quo
Investors
Stakeholders
Strategy A
Investors
Stakeholders
Strategy B
Investors
Stakeholders

Figure 2.2

shareholder primacy has been successfully challenged in court.* But this stresses the futility of an approach based on the legal regime – it varies across countries, making general guidelines impossible, and is ever-changing and open to interpretation.

Pieconomics isn't about simply complying with the law – it's about creating social value. It stresses that the legal regime doesn't matter for the trade-off in Figure 2.2. *Even if* investors have legal primacy, an enterprise should still care about externalities and may choose Strategy B, despite the lower profits.

Because investors are never just investors. They're often colleagues, customers and community members. They're affected by the environment, they pay taxes and they may own stakes in suppliers.[12] So investors care about the livelihoods, stewardship, funding, vibrancy, renewal and taxes that a firm provides – not just profits.

Why do people invest in a company? To provide for their own or their children's future. A basic finance principle is that people care about the real value of money (what they can buy with their dollars), not the nominal value (how many dollars). They might prefer a lower salary in Montana to a higher salary in New York because the cost of living is lower. Similarly, people invest to provide a higher quality of life, rather than just a higher bank balance, for themselves in old age or for their children. If a company increases profits but also pollution, investors' monetary returns may be higher but their

* Thirty-five US states have 'constituency statutes' which allow directors to consider the interests of stakeholders as well as shareholders. However, in nearly all cases, constituency statutes are permissive rather than mandatory – directors may consider stakeholder interests, but don't have to, offering limited guidance. Moreover, even in states without constituency statutes, shareholder primacy has been successfully challenged. In Shlensky vs Wrigley, the Illinois Court of Appeal upheld a decision that took stakeholder interests into account, even though Illinois didn't have a constituency statute at the time. The Chicago Cubs baseball team decided not to install lights at Wrigley Field and play night games, despite the potential higher revenues, due to the negative impact on the local community.

standard of living lower. Externalities may even have a financial effect on investors. If a company farms unsustainably and raises food prices, investors lose financially in the long run because they're also customers.

And investors may care about externalities even if they're not the stakeholders affected by them – they may be concerned for those that are. Investors may care about noise and local air pollution from a factory, even if they don't live in the vicinity; how a company treats its workforce, even if they don't work for that firm; and how global warming devastates coral reefs, even if they don't intend to visit these reefs. As economists Oliver Hart and Luigi Zingales stress, shareholder welfare includes not only shareholder value but also externalities, and so even if shareholders have primacy, companies should consider both.[13]

These externalities are becoming increasingly important to investors. In 2020, $1 in every $3 under professional management in the US ($17.1 trillion) was invested in Responsible Investing (RI) strategies, which choose stocks on social rather than purely financial criteria. That's 42% higher than in 2018, and 25 times as high as in 1995.[14] This isn't just a US phenomenon. When adding in Europe, Japan, Canada and Australasia, the 2020 figure becomes $35.3 trillion, up 55% from 2016, with Japan growing by 500%.[15] For example, in 2018, Japan's Government Pension Investment Fund, the world's largest pension fund, increased its RI investments from 3% to 10% of its equity portfolio – a rise of $9 billion. Moreover, many mainstream investors, who aren't classified as 'responsible', take externalities very seriously. Across all investors, 3,038, representing $103.4 trillion of assets, had signed the UN Principles for Responsible Investment – a commitment to incorporate environmental, social and governance (ESG) issues into investment decisions – by March 2020. That's substantially higher than the 63 investors and $6.5 trillion of assets when the principles were founded in 2006.

You might not be convinced by the above statistics. Perhaps the growth of RI funds is due to their financial rather than social performance – so it's not definitive proof that it's driven by investor concern for externalities. Sam Hartzmark and Abby Sussman were able to isolate how saver demand is affected by social performance alone, by cleverly exploiting a change to information on funds' social performance that didn't affect information on their financial returns.[16] In March 2016, Morningstar unexpectedly published social performance rankings on more than 20,000 mutual funds, based on Sustainalytics's ESG ratings of the underlying stocks that each fund held. The impact is shown in Figure 2.3.

Before March 2016, there was only a weak relationship between social performance and fund flows. But over the next 11 months, the differences were substantial – top-ranked funds enjoyed inflows of 4% of fund size ($24 to $32 billion) and bottom-ranked funds suffered outflows of 6% ($12 to $15 billion). Strikingly, the vast majority of the 20,000 funds weren't marketed as sustainable funds – yet savers still cared about their social performance.

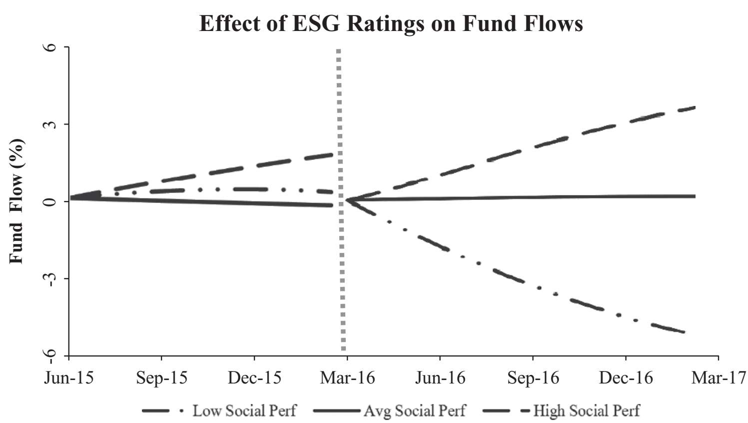


Figure 2.3

Moreover, even if a firm thinks that its decisions create 'externalities' that don't feed back into profits, they may eventually do so in unexpected ways. The 'Instrumental vs Intrinsic' section discussed actions whose consequences are difficult to predict but are internal to the firm undertaking them, such as investing in employee health. The effects are even harder to forecast – and so a leader may be even more tempted to think of them as externalities – if they affect society in general, such as climate change. But while the consequences are widely shared, the impact on an individual firm can still be significant. Chevron lost $1.4 billion in the second half of 2006 partly because Hurricanes Katrina and Rita reduced oil and gas production. Rio Tinto's Australian operations were hit by cyclones, floods and heavy rain, reducing profits in the first half of 2011 by $245 million. Floods in Thailand submerged Honda's assembly plants in late 2011, costing it over $250 million.[17] More broadly, a survey by the Carbon Disclosure Project found that 215 of the world's largest companies estimated a total potential value loss from climate change of $1 trillion.[18]

Now you might think it's rational for an enterprise to ignore externalities. An individual firm is only one of thousands, so it has little effect on the environment – an example of the free-rider problem. But individual cases can have widespread effects, like the Deepwater Horizon disaster discussed in the Introduction. Companies may ultimately pay for the damage they individually cause – BP paid $65 billion in clean-up costs and legal fees from Deepwater Horizon, and US power supplier PG&E filed for bankruptcy due to liabilities stemming from the California wildfires. Moreover, most customers and colleagues believe that a company has a responsibility to address externalities, as shown by the Nokia and Nestlé boycotts. They're unlikely to be persuaded by a cost-benefit analysis arguing that the impact of the firm in isolation is insufficient to justify action. Indeed, citizens' buying behaviour depends on how much they believe a company contributes to society. A review of multiple academic studies found that 60% of customers are willing to pay a premium for socially responsible products and the average customer will pay 17% more.[19] What leaders sometimes dismiss as 'externalities' often bounce back and ultimately affect the company.

A second feedback channel is that, if citizens don't view businesses as serving society, they may pressure policymakers to pass regulations to constrain them, or be less supportive of business subsidies such as R&D credits. Again, an individual firm may be tempted to adopt the free-rider mentality, but that's not how things work in practice. As discussed in the Introduction, public perceptions are affected by individual anecdotes, not by the average firm. A single company's actions can have a substantial effect on the public perception of business.

Shortly after the Daraprim price hike, 2016 US Presidential Candidate Hillary Clinton tweeted that 'price gouging like this in the specialty drug market is outrageous' and proposed a $250 monthly cap on prescription drug costs if elected. This Tweet wiped $15 billion off the Nasdaq biotech index overnight. The damage from the Volkswagen emissions scandal, mentioned in the Introduction, spilled over to the entire German auto industry, harming its international reputation. The US sales of BMW, Mercedes-Benz and Smart fell by $3.7 billion in the following year.[20] The European Union implemented several new regulations on vehicle approvals and emissions testing that may lower the profitability of the whole industry.[21]

The effect of externalities on public perception is crucial. In many countries, investors call the shots – directors are elected by them and directors' legal responsibilities are primarily to them. Investors might object to Pieconomics because it's upfront that it doesn't always maximise profits. But if they don't urgently embrace a form of business that works for all of society, citizens will push for regulatory change and investors will no longer be calling the shots.*

Note that the significance of externalities doesn't mean that they have equal importance to profits, so that leaders can focus entirely on the size of the pie and ignore its division. An enterprise that generates a large pie, but gives investors a tiny slice, would be unlikely to be funded in the first place. Chapter 3 will provide three principles to guide CEOs through difficult trade-offs between investors and stakeholders. These principles will show that, in some cases, leaders should indeed sacrifice profits to create a bigger pie – choose Strategy B in Figure 2.2. But in other cases, the stakeholder gains aren't sufficient to outweigh the investor losses, and so the trade-off shouldn't be made.

Triple Bottom Line

While this chapter has contrasted Pieconomics with ESV, we close by briefly comparing it to the Triple Bottom Line framework (TBL). Unlike ESV, which assumes that a company has a single financial 'bottom line' or objective, TBL argues that it also has social and environmental bottom lines. These three goals are often referred to as people, planet and profit.

To compare Pieconomics with TBL, let's use the same two dimensions we used to contrast Pieconomics and ESV – objective and motivation. The objective is where there's greatest similarity. Both Pieconomics and TBL target social value, unlike ESV which focuses on profits. Indeed, since the term was first coined by John Elkington in 1994, TBL has been successful in encouraging companies to think seriously about, and measure, their

* Since policymakers' responses to trust-eroding actions may ultimately reduce profits, you might wonder if these actions indeed create 'externalities' because they're eventually internalised. But that's more a semantic distinction. Regardless of whether we label trust-eroding actions as externalities, companies should be very serious about earning the public's trust. Even if externalities are eventually internalised, this internalisation is very difficult to predict, and so ESV will ignore them. And it remains the case that there are true externalities unlikely to affect future regulation, which Pieconomics will consider, but ESV won't.

contribution to society. The motivation is where they differ. While Pieconomics' motivation is intrinsic, TBL – at least as commonly practised – is instrumental.

In 2018, Elkington proposed a recall of the TBL concept. He argued that it's mainly been used as an accounting framework to measure a company's social and environmental contribution, rather than to engineer a mindset change as originally intended.[22] This leads to an instrumental motivation. A leader takes actions if they have a quantifiable impact on the social or environmental bottom line. This may skew investments to ones with a short-term or quantitative pay-off as it can be immediately reported. A company might create more jobs, rather than improving the quality of existing jobs, as the former is more measurable. Investing in stakeholders remains a means to an end – a non-financial end, but a short-term and quantitative one nonetheless. Pieconomics frees a leader to create value for stakeholders without being constrained by whether or how fast the outcomes can be accounted for. It's a mindset and an approach to business, rather than an accounting framework.

Now in Chapter 8 I'll stress how it's critical for companies to report on the value that they create for society. But improved stakeholder metrics, like improved profits, are a by-product rather than the end goal. An enterprise should invest in stakeholders and report on any outcomes after the fact, rather than make investments based on whether they'll improve metrics that can be reported.

The biggest difference between Pieconomics and TBL is the pie-growing mentality that's at the heart of Pieconomics. It stresses the importance of the size of the pie, and avoiding errors of omission from missed opportunities to grow the pie. In contrast, Elkington points out that 'many early adopters [of TBL] understood the concept as a balancing act, adopting a trade-off mentality'. TBL is often used to ensure a balance between purpose, planet and profit, consistent with the pie being fixed. It might view a high financial score, but modest social and environmental scores, as an error of commission – as if profits were achieved at the expense of planet and people. In contrast, Pieconomics stresses that the size of the pie is not fixed, and prioritises growth over balance. While it's important to ensure that, to the extent possible, no one's slice shrinks as the pie grows, growth that's unevenly distributed is better than no growth at all.

In a Nutshell

- Milton Friedman's argument, that the social responsibility of business is to increase its profits, is much more nuanced than commonly portrayed. It argues that businesses should focus on profits since doing so requires them to invest in stakeholders, and increasing profits gives shareholders maximum flexibility to support their preferred social causes. However, it makes three critical assumptions:
    - ✳ That a company has no comparative advantage in solving social problems. This may be true for some activities, such as charitable donations, but not others.
    - ✳ That politicians reflect citizens' preferences in the laws they pass. However, regulation is ineffective at addressing qualitative issues, and the political process is slow and imperfect.
    - ✳ That leaders can forecast how an investment in stakeholders affects profits. However, such forecasting is difficult in a world of uncertainty.
- *Enlightened shareholder value* argues that businesses should invest in stakeholders because they can't be profitable in the long run without doing so. It agrees with Pieconomics that profits and social value are linked, but stresses that companies should put profits first and society second. Pieconomics argues the reverse. This leads to two key differences.
    - ✳ ESV believes that an enterprise should be *instrumental* – only create value for society if doing so will ultimately

increase profits. Stakeholders are a means to an end. Pieconomics believes that an enterprise should serve society for *intrinsic* reasons, even if it can't calculate the profit increase from doing so. This approach often generates more profit in the long run by freeing up a company to make investments, particularly intangible ones, that it otherwise wouldn't. This is because the effect of investments on stakeholders is typically less *uncertain* and *distant* than the effect on profits.

  * ESV focuses on *profits*. Pieconomics focuses on *social value*, which includes externalities. Even if investors have primacy, they're never just investors – they're often colleagues, customers and community members, and thus affected by externalities. In addition, if companies persistently generate negative externalities, they'll be regulated or lose customer trust.

- Profits and externalities are much more aligned than commonly believed – actions to create value for society often ultimately increase profits through unexpected ways. But true externalities still exist. Even if increasing stakeholder value reduces profits, investors may be willing to make the trade-off.
- The Triple Bottom Line framework agrees with Pieconomics that a company's primary goal should be social value. However, it's mainly an accounting framework and its motivation is more instrumental – encouraging activities where the social benefit can be reported – than intrinsic. It also stresses balance, whereas Pieconomics emphasises value creation.

3 GROWING THE PIE DOESN'T MEAN GROWING THE ENTERPRISE

Three Principles to Guide Trade-Offs and Which Projects to Turn Down

Pieconomics is about creating value for society. While investors are far from the only member of society, they're still an important member. This chapter thus discusses two important caveats that must be heeded when practising Pieconomics – growing the pie doesn't mean ignoring profits, and growing the pie doesn't mean growing the enterprise. We then provide three principles to guide leaders in navigating these caveats.

Growing the Pie Does Not Mean Ignoring Profits

Investors are often seen as the least deserving members of an enterprise, particularly compared to employees, customers or the environment. But just as Chapter 2 stressed that investors are never just investors, stakeholders are rarely just stakeholders – many are investors themselves. Colleagues and customers hold shares either directly, or indirectly through mutual funds or pension funds. Even hedge funds, often maligned as greedy capitalists, are often held by pension funds or university endowments.

Profits are a key element of a well-functioning society. Without profits, citizens can't fund their retirement, insurance companies can't pay out claims, and endowments and pension funds can't provide for their beneficiaries. Even though many investors are willing to sacrifice some returns to achieve social objectives, there's still a limit. In October 2018, policeman Jason Perez ousted Priya Mathur, the president of the board of the California Public Employees' Retirement System (CalPERS). He argued that Mathur focused too much on ESG at the expense of investment returns, jeopardising the financial security of thousands of employees to boost her own public image. At the time, CalPERS was only 71% funded, and colleagues were facing the prospect of significant increases in their pension contributions. As a result, they voted for Perez – highlighting how responsibility can't mean ignoring profits.

And profits are important not only for investors, but also for stakeholders. Without profits, an enterprise can't fund product innovation for customers or training for workers. As Merck's Kenneth Frazier argues: 'We try to balance [affordable prices for customers] with the goal of ultimately providing a good return to our shareholders – because they keep financing the research that will produce tomorrow's drugs.'[1] If Merck didn't earn profits from its other drugs, including ivermectin for animal use, it would have been unable to launch the Mectizan Donation Program. And without profits, a company will eventually go out of business and create zero value for society. In a pandemic, a responsible company takes tough decisions – such as Airbnb's layoffs – to safeguard its profits and thus its long-term survival.

Not only is generating profits important after a company has already been established (ex post), but also the prospect of generating profits is important to get a company established in the first place (ex ante). Profits are what shareholders receive for risking their money in the firm, which they could have otherwise spent or invested elsewhere – just as wages are paid to employees for their effort, and revenues to suppliers for their inputs. If investors feared that a company would subsequently ignore them, they wouldn't fund it in the first place.

Then, an idea could never attract start-up capital and become a reality; an established firm could never attract additional funding to grow and move from good to great.

And taking profits into account helps ensure that companies are attentive to stakeholders' needs – profits are valuable *signals* for what society wants.* Customers increasingly value the convenience and safety of online shopping, and so retail websites are more profitable than physical stores. This encourages retailers to invest in e-commerce, exactly as many customers desire. In turn, since the offerings of generic high-street stores are largely covered by e-commerce, retailers can now repurpose them to provide personalised shopping experiences such as Nike Live, which uses data science to ensure its product offerings cater to the exact needs of local customers. Or, they may sell these stores, allowing prime locations to be reallocated to other personalised uses, such as restaurants, coffee shops and health clubs, where there should be high demand once the pandemic subsides.

The importance of profits is why we defined Pieconomics as '*create profits only through* creating value for society'. Creating value for society is the primary goal and so Pieconomics still represents a significant departure from ESV. But creating profits remains an important secondary goal.

A definition that omits profits, such as 'creating value for society', would be even more radical and get much greater support from some quarters. But to ignore profits would be unrealistic and undisciplined. It's unrealistic because companies wouldn't be financed by most investors. It's undisciplined because it provides little guidance to leaders and prevents society from holding them accountable. Since almost every decision will benefit at least one stakeholder, a leader can argue

* However, they're not perfect signals. As discussed in Chapter 2, a pie-growing enterprise should also take externalities into account, as these are benefits or costs to society that aren't captured in profits.

that this stakeholder is the most important one and so the decision has grown the pie. Anything goes.

As we've stressed, an enterprise can't achieve the secondary goal of profits through calculation. Indeed, Pieconomics justifies many investments where there's no clear benefit to profits, such as the Mectizan Donation Program. Sometimes higher profits will manifest as an unexpected by-product, but other times they won't – that's the definition of profits being unexpected. A pie-growing company needs to be comfortable that not every single decision it takes will increase profits, even in the long term. But applying the pie-growing mentality across all its decisions should, in aggregate, lead to more profits than ESV. The three principles later in this chapter will guide whether an action is likely to ultimately increase profits, even if the source of the increase can't be predicted.

Growing the Pie Does Not Mean Growing the Enterprise

Pieconomics is about creating value for society. So it's tempting to think that the more an enterprise grows, the more value it creates. If Merck developed a new drug for hypertension, it would create value for customers (sufferers of hypertension), suppliers (of the inputs to the new drug), employees (through providing new jobs) and so on. Indeed, many policymakers argue that firms should invest as much as possible. Massachusetts Senator Elizabeth Warren proclaimed that 'the real way to boost the value of a corporation is to invest in the future'.[2]

This argument isn't actually correct. Pieconomics is about *creating* value. Value is only created if the benefit of an investment exceeds its cost. The cost of investing resources is the next-best opportunity to which the resources could be deployed, known as the *opportunity cost.* Under ESV, a firm cares about its own alternative uses for the resources within the firm – private opportunity costs. Under Pieconomics, the lens isn't the firm, but society, and so the relevant opportunity costs are the alternative uses for the resources within society – social opportunity costs. If Merck built a new factory for the hypertension drug, it would use raw materials and workers, both of which could instead be deployed to build a school. Not investing could allow another firm within society to achieve more with the same resources.

Pieconomics stresses that *value is created when a company uses resources to deliver more value than they could elsewhere* – the social benefits exceed the social opportunity costs.* Simply investing resources may not create value. A baker can use a lot of flour, but if it falls on the floor rather than in the baking tray, it won't grow the pie.

This observation means that, contrary to common belief, an enterprise's responsibility isn't to provide jobs. It's to allow citizens to be assigned to careers where they can use their talents to serve society and flourish as humans. These careers may be outside the firm and require it to let certain workers go. In Japan, mass redundancies are a social taboo. So rather than laying off colleagues whose positions have been eliminated – for example, those who used to produce magnetic tape for videos and cassettes – companies like Hitachi, Sony, Toshiba and Panasonic reportedly send them to 'banishment rooms'. There, they're made to do worthless tasks such as reviewing security footage or reading their undergraduate textbooks, and to file a daily report of what they've done.[3]

Such jobs provide employees with neither meaningful work nor human dignity. Nor do they create value for society. The private opportunity cost of detaining employees in banishment rooms is low if there aren't other jobs within the firm, but the

* This observation doesn't require a company to calculate how much value other companies could create with the same resources. In a competitive market, the price of the resources would reflect the value that other companies could create with them. Chapter 10 discusses the role of competition in helping the price system function effectively.

social cost is high since their talents could be used elsewhere. Job cuts can grow the pie by allowing citizens to flourish outside the firm. But as stressed in Chapter 1, firms can't rely on market forces to do this reallocation, but should invest in outplacement and retraining – even at the expense of profits – to catalyse it, and provide them with a safety net through severance pay.

The resources that a company uses when it invests aren't just limited to real resources, such as raw materials and labour. It also uses financial resources – money – which could instead fund other firms. Let's now fill in the missing dots from Senator Warren's quote earlier. Her full argument was that 'stock buybacks create a sugar high for the corporations. It boosts prices in the short run, but the real way to boost the value of a corporation is to invest in the future, and they are not doing that'. Stock buybacks, where a company returns profits to its investors in exchange for them returning their shares, will be covered in more detail in Chapter 7. For now, we note that, by choosing not to grow and instead paying out funds to investors, an enterprise can allow another company to get funding and grow.

Importantly, leaders have self-interested reasons to grow the firm, even if such growth creates value for neither shareholders nor society. There are three types of value-destructive growth.

Excessive Growth in Core Business

A CEO has incentives to grow her core business excessively because CEO pay is strongly linked to firm size. In addition, bosses of larger firms enjoy prestige and status – the CEO of the market leader is most likely to keynote at industry conferences or speak at Davos. This prestige may even outlast the CEO's tenure. Inside almost any large enterprise, legendary stories circulate about past leaders. Outside, the public knows about past CEOs of firms that are dominant today much more than CEOs of firms that have since been taken over. A leader may thus grow the firm to preserve her legacy.

CEO Angelo Mozilo was determined to make Countrywide Financial the market leader in US mortgages. He frequently referred to the company as his 'baby'[4] – not investors' or society's. Aiming to become the market leader as a by-product of creating value is a worthy goal. But just like profit, market leadership shouldn't be the goal in itself.

Yet it was for Mozilo. In 2002, Countrywide was third with a 10% market share, with Wells Fargo number one at 13%.[5] Getting Countrywide to 14% wouldn't be enough; he craved it to be so far ahead that it would remain the market leader for decades, guaranteeing his name in the history books. So Mozilo publicly announced that he'd triple Countrywide's market share to 30%, far higher than anyone in the industry had ever achieved. Nowhere did he stress that this growth had to create value for society (offering mortgages that customers could afford) or even investors (offering mortgages that would be repaid). Countrywide thus plunged recklessly into subprime mortgages, making it particularly vulnerable to the financial crisis. In January 2008, it was on the verge of bankruptcy and had to be bought out by Bank of America.

Unrelated Expansion into Non-Core Businesses

A CEO may expand into unrelated new markets to build an empire for herself. A prime example of such empire-building is Daewoo, founded by former shipyard worker Woo Choong Kim in March 1967. Daewoo initially focused on labour-intensive clothing and textiles – a smart move given South Korea's large and affordable workforce. Before 1972, it bought only three businesses, two textile producers and one leather processor, which were related to its core business and helped cement its strengths.

But Kim soon wanted new toys to play with. In just one year, 1973, he bought eight companies in industries unrelated to textiles – machinery, shipbuilding and cars. It wasn't clear how Daewoo would create value compared to these firms remaining independent. By 1978, Kim had 41 businesses;

20 years later he'd added 589 international subsidiaries. Kim was an empire-grower, but a pie-shrinker – size was the only dimension in which Daewoo outperformed its peers. It lagged in product quality, technology, productivity and profitability, and was bottom of the table in valuation because the market realised that Daewoo had no business in owning many of its businesses.

In 1993, Daewoo entered the Vietnamese car market. Ten competitors entered soon after and the Asian financial crisis hit in 1997, so Daewoo could only sell 423 cars in the whole of 1998. But having invested $33 million in this venture, Daewoo refused to cut its losses.[6] This attitude was replicated throughout the company. While other Korean conglomerates were scaling back after the financial crisis, Daewoo bought 14 new businesses in 1998, despite losing $458 million that year.

The following year, with debts of $50 billion, Daewoo was about to go bankrupt and had to be broken up. This cost billions of dollars to the South Korean banks and government which had lent to it. Seven thousand colleagues lost their jobs,[7] and only five companies with the Daewoo brand name remain today.

In addition to empire-building, unrelated expansion can also be motivated by escapism – exploring a new industry to avoid dealing with the problems in the core business. Rather than taking on the challenge to develop digital cameras, Kodak escaped into pharmaceuticals by paying $5.1 billion to buy Sterling Drug in 1988. But using chemicals to coat photo paper is very different from using them to make aspirin and Milk of Magnesia, Sterling's flagship products. A photography company has no comparative advantage in pharmaceuticals.

Countrywide, Daewoo and Kodak are far from isolated examples of how empire-building and escapism can destroy social value. A study by Sara Moeller, Frederik Schlingemann and René Stulz found that over just four years – between 1998 and 2001 – US firms lost their investors $240 billion through acquisitions.[8] Buying those companies allowed CEOs to build their empires, but the opportunity cost was the substantial value that the purchased businesses were generating on their own beforehand.[9]

Excessive Pursuit of Social Causes

A final source of wasteful investment is supporting social causes that either are unrelated to a company's comparative advantage or create distraction from the core business. In *The Enlightened Capitalists: Cautionary Tales of Business Pioneers Who Tried to Do Well by Doing Good*, James O'Toole describes several enterprises that went astray[10] through an excessive focus on social performance. For example, Control Data Corporation CEO William Norris was so focused on serving society – and trying to persuade other business leaders to follow him – that he didn't pay enough attention to changes in technology and competition from Japan and Silicon Valley. The company eventually had to be broken up.

In a more recent example, Emmanuel Faber, CEO of food and drinks company Danone, repeatedly advertised his enterprise's social purpose and drummed up support for a French law allowing companies to write their mission into their corporate by-laws. To much fanfare, it became the first French company to do so, claiming that it had 'toppled the statue of Milton Friedman' (even though, as we've seen, Friedmanism is much more nuanced than its caricature). Such actions are laudable if Danone's own long-term performance were strong, giving him leeway to turn his attention to other issues – and indeed we'll discuss Danone's social initiatives later in this book. But Danone's stock price was flat during his 6.5-year tenure, compared to a nearly 50% rise for its close competitor Nestlé and around the same for the French market index. This poor performance led to it having to cut 2,000 jobs at the end of 2020, and Faber was subsequently ousted in March 2021 – with Danone's stock price rising by 4% on the announcement. As one advisor to the company told the *Financial Times*: 'It is all well and good to topple the statue of Milton Friedman. You can do that when your financial performance is better than competitors and your governance is above reproach, but if they aren't, then it is going to be a problem.'[11]

CEOs have substantial private incentives to social causes, even if doing so hurts shareholders directly through wasting money or indirectly through being distracted from the core business. They can give speeches or write memoirs on how they're saving capitalism, be heralded by the media for revolutionising business, or receive awards such as Knighthoods or Damehoods in the UK. The same goes for investors who may pursue social causes to boost their own image, even if these aren't the social causes that matter to their beneficiaries or are at substantial detriment to financial returns. As Perez wrote in the CalPERS voter booklet: 'Mathur is out of touch, believing her role is to fly around the world, ringing the bell of the London Stock Exchange and hobnobbing with United Nations officials.'

A CEO or investor should absolutely serve society, and praise for those who do so is often richly deserved. But the motivation should be intrinsic, rather than instrumental to boost her public image. This requires a leader to discern which social problems her firm is particularly well placed to solve, rather than jumping on whatever social issue happens to be the order of the day and is thus most likely to improve her reputation. Such discernment is the purpose of this chapter.

Decision-Making under Pieconomics

Putting both caveats together, an enterprise should consider investors and six different stakeholders when making decisions. This seems an extremely tricky balancing act. It's difficult not only to forecast the effects on each stakeholder, but also to know how to weight the different stakeholders. So you can't measure overall social value and thus estimate how a decision will affect it.*

* Advocates of ESV argue that a single objective (profits) removes the need for weighting which arises with multiple objectives. As argued in Chapter 2, this is a poor argument for ESV. ESV would have to include the effects of, for

Yet nearly every real-life decision involves multiple criteria that can't be weighted. When a homeowner chooses which house to buy, she doesn't just maximise resale value. She also considers whether the house fits her family's needs, how close it is to her job and her kids' schools, and whether she likes the neighbourhood. When a worker chooses a job, he doesn't just maximise his income. He also considers his passion for the work, the amount and flexibility of the hours, and the camaraderie with his colleagues.

There's no spreadsheet calculating how a decision will affect each criterion, nor a formula telling people how to weight each one. Yet this doesn't matter. Citizens comfortably make decisions with multiple objectives every day, using not *calculation*, but *judgment* – their own internal assessment of the importance of each criterion.

But it seems a cop-out to sweep complex trade-offs under the carpet by saying that they're dealt with by a leader's judgment. Even though judgment *is* used in nearly every daily decision, it's an unsatisfactory solution for companies. When a citizen chooses a job, he applies his own weighting criteria depending on how much he personally values salary, passion for the work, hours, flexibility and camaraderie. But leaders should serve society, not their own personal preferences on which stakeholders they favour. Appealing to judgment gives the leader freedom to do whatever she pleases. If she shuts down a polluting plant, she can argue that the environment is most important; if she keeps it open, she can claim that employment is most critical. The leader can justify almost any decision as being based on her judgment, and because her judgment is a black box, she can't be held accountable.

example, employee health on profits – which effectively requires it to weight the importance of health for profits. But since ESV only considers what can be predicted, it simply ignores these effects, effectively assuming the weighting problem away.

The rest of this chapter provides three interrelated principles to guide a leader's judgment in these complex situations. The *principle of multiplication* ensures that the social benefits of an activity exceed its private costs, so that the activity delivers value to society. The *principle of comparative advantage*, combined with the principle of multiplication, ensures that the social benefits of an activity exceed its social costs, so that the activity creates value for society. The *principle of materiality*, combined with the first two principles, makes it likely that the social value created will ultimately increase profit. Then, the activity creates profits through creating value for society – the definition of Pieconomics.

Principle	**Satisfied**	**If Consequence**
Multiplication	Social Benefit > Private Cost	Activity Delivers Value
+ Comparative Advantage	Social Benefit > Social Cost	Activity Creates Value
+ Materiality	Social Benefit > Social Cost and Activity Benefits Material Stakeholders	Activity Creates Profits through Creating Value

Let's consider each principle in turn.

The Principle of Multiplication

The *principle of multiplication* asks the following: *If I spend $1 on a stakeholder, does it generate more than $1 of benefit to the stakeholder?* In other words, does the activity multiply the money I spend on it? If not, the social benefit of the activity is less than the cost – the social NPV is negative – and so the activity doesn't deliver value. The enterprise could instead pay the dollar to the stakeholder (for example, higher wages to colleagues or lower prices to customers), who can then use it more effectively.

Let's apply this principle to Apple's gym decision. How do we estimate the benefit to the relevant stakeholders (colleagues, in this example)? We could look at prices of local gyms and estimate how many workers would use the Apple one. Multiplying the two gives a lower bound to how much the gym benefits the Apple workforce, to be compared to the cost. It's only a lower bound because employees will value an in-house gym more highly, due to the convenience and ability to socialise with co-workers. So there's a limit to what can be quantified. But the calculation is still useful because it shows how big the non-quantifiable benefits must be to flip the decision. Say the cost of the Apple gym is $500 per employee per month, and the highest-quality local gym costs $100. It's unlikely that the non-quantifiable benefits will be as much as $400, and so the principle of multiplication is violated. Rather than building the gym, Apple could pay higher wages, which some colleagues could spend on external gym memberships.

But haven't we just gone back to calculation? Yes and no. The principle of multiplication does provide a framework, so Pieconomics isn't nebulous. But the calculation is crucially different from ESV. ESV would ask: *If I spend $1 on a stakeholder, does it generate more than $1 of profit?* – not $1 of benefit to the stakeholder. It captures the private NPV of an investment, rather than the social NPV. This calculation is much harder due to the difficulty in estimating how the gym affects Apple's profits – we have no idea how many sickness days the gym will avoid, and how much they would have cost Apple. But we can estimate the benefit of the gym to employees by looking at the cost of other gyms. Revisiting terminology introduced in Chapter 2, the cost of going to another gym is less *uncertain* (we can get data on it) and less *distant* (employees would pay it today if Apple didn't have a gym, so we don't need to come up with a discount rate).

The gym is a simple example, because we can estimate its social benefits by looking at prices of local gyms. But social NPV calculations are feasible in far more complex cases. In Appendix A, we calculate social NPV for two hypothetical alcohol abuse and sexual assault programmes, using a framework developed by the social impact advisory firm Bridgespan and the impact investor The Rise Fund. The Impact Weighted Accounts initiative is similarly building a framework to estimate the dollar value of a company's externalities.

Still, such calculations aren't possible for all investments. If a company grants an employee a day off for volunteering, it's difficult to calculate the value to either the colleague or the charity in financial terms. Again, the principle of multiplication offers a framework, not a calculation. The manager should think about whether the (non-financial) benefits to the employee and charity exceed the cost to the company of the day off. Such non-financial decisions are made all the time. The manager might contemplate spending a volunteer day herself, and weigh up similar benefits and costs. Even though the gains are non-financial, they're still less uncertain and distant than the effect on long-term profits. The employee immediately benefits from the day off, plus the fulfilment from contributing to a cause he cares about; the charity gains from his volunteering. On the other hand, it's very difficult to estimate how the volunteering day affects the worker's productivity and likelihood of quitting.

Importantly, the principle of multiplication applies not only to undertaking activities that create social value, but also to reducing those that create social harm. As a particularly stark acknowledgement of multiplication, the Energy section of the New Belgium Brewing Company's website is entitled 'We're New Belgium and We Pollute'. It goes on to say: 'We make beer. And that means that we use energy and create greenhouse gas emissions.' Since New Belgium's core business has a multiplicative impact on the environment, investing $1 on reducing pollution likely generates far more than $1 of benefit to the environment. So New Belgium built 1,235 solar panels on the roof of the packaging hall in its Fort Collins, Colorado site, and provides its colleagues with bikes rather than cars to travel around the 50-acre site. It also took the radical step of introducing an energy tax on itself. For every kilowatt hour of energy it buys externally, it sets aside money to fund energy efficiency improvements and renewable energy projects – all of which have multiplicative effects, given how much energy New Belgium uses.

The Principle of Comparative Advantage

While the principle of multiplication helps a leader turn down some activities, it alone is rather weak and easy to satisfy. Donating to charity often satisfies that principle. If Greenpeace were cash-strapped and had an important campaign to fund, then $1 is worth more to Greenpeace than Apple. Thus, under the principle of multiplication alone, Apple should donate a substantial chunk of its profits to Greenpeace. Similarly, it should allow the homeless to eat in its staff canteen for free (outside of main meal times), since food benefits them more than it costs Apple. So leaders need additional principles to guide their decisions.

The *principle of comparative advantage*, which we've touched on before, asks the following: *Does my company deliver more value through this activity than other companies?* If so, and only if so, undertaking the activity inside the firm grows the pie. It's tighter than the principle of multiplication because it requires the benefit to stakeholders to exceed not $1 (the private cost of $1 of investment), but the value that others could deliver with $1 (the social cost). In other words, the enterprise needs to satisfy the principle of multiplication more than other enterprises. Only then does it create rather than merely deliver value.

Although charitable donations may satisfy the principle of multiplication, they fail the principle of comparative advantage. Even if a $1 donation is worth $2 to Greenpeace, it's also worth $2 if given by investors or colleagues, so they can donate just as effectively. In fact, as discussed in Chapter 2, individual donations would be more effective as they can support the charities of their choice.[12]

What about Apple allowing the homeless to eat in its canteen? Food that costs Apple $1 might provide $1.50 of benefit to the homeless because they're hungry. But a soup kitchen might turn $1 into $3 of benefit because it has a comparative advantage in feeding the homeless. It knows exactly what food best addresses their nutritional needs and locates its kitchens close to where they sleep. Apple doesn't have a comparative advantage in feeding the homeless, so it shouldn't do so. It could instead pay higher wages to colleagues or deliver higher profits to investors, who can then donate to soup kitchens.

But if Apple's canteen has surplus food which would otherwise be thrown out, then it does have a comparative advantage in donating that food. $1 of food now effectively costs $0 because there's no opportunity cost. If it costs Apple $0.30 to distribute it to the homeless (which gives them $1.50 of benefit), then spending $1 generates $5 of benefit, and so Apple should donate its surplus food. Indeed, the sandwich chain Pret a Manger does so at the end of each day. That companies may have a comparative advantage in serving society is what Friedman overlooked when he argued that they should focus on profits and leave it to investors to support social causes.

Applying the principle of comparative advantage doesn't require a company to *calculate* the value it would create with certain resources and compare it with the value every other company might create. Instead, it simply needs to *discern* what its comparative advantage is. There are two cases where the principle is usually satisfied. First, a company typically has a comparative advantage in any activity it controls directly. While charities can fund cancer research and feed the homeless, only Apple affects its plastic packaging – so Apple has a comparative advantage in reducing it. Panasonic has a comparative advantage in shortening its colleagues' commute, since only it can decide the location of its offices. So it's built them closer to employees' homes, helping the environment by reducing car travel, workers by cutting their commutes, and communities by allowing colleagues to live close to schools, neighbours and activities.

Second, a company may have a comparative advantage due to its expertise. Many charities are successful in getting medicines to developing country airports, but the final challenge of transporting them to the families or doctors that need them is much harder. That's where The Coca-Cola Company steps in. One of its core competencies is logistics and supply chain management, which it's developed so that it can distribute its products in virtually every region in every country in the world. Through Project Last Mile, Coca-Cola shares this expertise with ministries of health in several African countries so that they can deliver medicines most effectively – including the onerous last mile to a rural household or hospital. Why doesn't Coca-Cola use its logistics knowledge to instead distribute books to schools, another worthy cause? Because its comparative advantage is specifically in refrigerated transportation since it sells drinks, and this expertise is critical for vaccines as they must be kept cool. Project Last Mile's mission statement makes its purpose clear: 'If you can find a Coca-Cola product almost anywhere in Africa, why not life-saving medicines?'*

Let's now apply the principle of comparative advantage to identify which activities an enterprise should undertake, when several satisfy the principle of multiplication. Danone has a multiplicative effect on the environment through the waste created by its packaging. It also has a comparative advantage in improving its packaging material, since it directly controls it. Since both principles are satisfied, Danone

* In addition to distribution, Project Last Mile also leverages Coca-Cola's marketing expertise to increase demand for health-care services, such as HIV prevention, treatment and care.

has committed to make every piece of packaging reusable, recyclable or compostable by 2025.

But that's not enough for Danone to reduce its environmental impact. It has to ensure the packaging is actually recycled. This involves two steps. The first is to encourage customers to play their part, and it has a comparative advantage in doing so due to its strong brand and customer engagement. For example, Danone's mineral water brand Evian launched a 'Flip it for Good' engagement campaign in April 2019, where customers post a video of themselves on social media 'flipping' a bottle into a recycling bin. The second is to build effective recycling systems. That's something that Danone does *not* have a comparative advantage in, because recycling systems are outside its expertise and control. So it's established the Danone Ecosystem Fund, which works with local communities and governments to invest in recycling infrastructure and ensure that waste collectors work in a safe environment and are paid fairly.

The Principle of Materiality

Even the principle of comparative advantage could be too weak. As discussed, an enterprise has a comparative advantage in virtually every activity that it affects directly, so it might invest without limit in everything it controls, leaving few profits for investors. Since expertise is a source of comparative advantage, a company with a high-quality workforce will also have a comparative advantage in many external activities. Apple would create value by asking its engineers to tutor local undergraduates in design and innovation. Paraphrasing the definition of Pieconomics, it would be creating value for society, but wouldn't be creating profits as a by-product of doing so.

That's where the *principle of materiality* comes into play. It asks the following: *Are the stakeholders the activity benefits material to the company?* Materiality stems from two sources. The first, which we'll call *business materiality*, is how material a stakeholder is to the enterprise's business. Materiality was originally a legal concept which highlighted risks that a company needed to disclose. For example, the environment is material to energy companies since, if they don't reduce their carbon footprint, customers, employees and investors will walk away, and their profitability may be hit by carbon taxes. But Pieconomics highlights the importance of 'actively do good' in addition to 'do no harm', so business materiality also captures the importance of a stakeholder to a company's future value creation. Suppliers such as Corning and Finisar are particularly important to Apple since they provide high-tech, bespoke inputs – so it supports them through the Advanced Manufacturing Fund. Suppliers are less important to a plastics or paints manufacturer that uses commodity chemicals as inputs. Local communities and the environment are critical to the Singaporean-headquartered agribusiness Olam, which grows cocoa, coffee, nuts, spices and rice. Communities provide workers and customers, and land and water are vital inputs for production. So Olam's core purpose of 'Growing Responsibly' aims to preserve the environment and regenerate the communities where it operates. In contrast, communities and the environment are less material to an online services company, such as the flight aggregator Skyscanner. It can hire employees from all over the world, can sell all over the world and uses few natural resources.

Moreover, materiality can be defined not only at the level of the stakeholder, but specifically at the level of the stakeholder issue. The environment is material in both the beverage and mining industries, but water consumption is especially important in the former and particulate production in the latter. Colleagues are material to many industries, but diversity of thinking is especially valuable in innovative industries such as technology. Customers are important to any business, but data privacy is particularly material in financial services and social media.

The Sustainability Accounting Standards Board has devised a materiality map, which indicates how the (business) materiality of different stakeholders and stakeholder issues varies across industries. Figure 3.1 shows an excerpt. Of course, materiality will differ across companies even within the same industry.

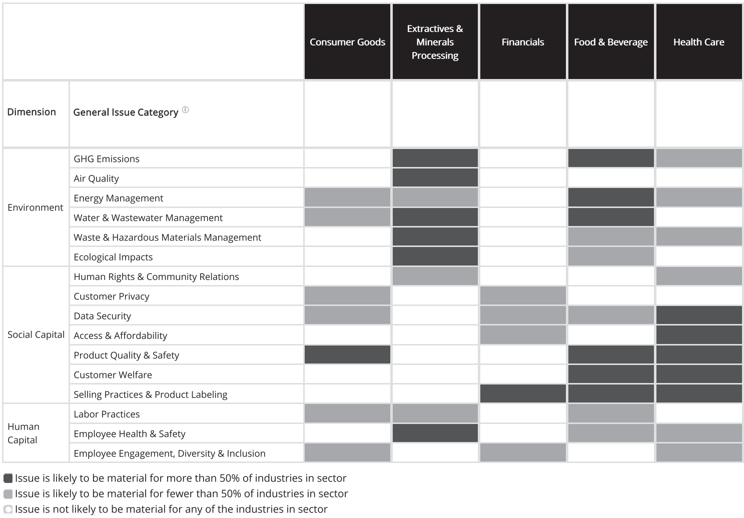


Figure 3.1 The Sustainability Accounting Standards Board Materiality Map

An individual enterprise might use the SASB materiality map as a starting point, and then refine it for its unique circumstances.

While an enterprise has a responsibility to all members, the most material ones are first among equals because investing in them is more likely to ultimately improve profits. Indeed, as we'll show in Chapter 4, the evidence indicates that only investment in material stakeholders raises long-term stock returns. Pieconomics isn't about being all things to all people and investing in every stakeholder indiscriminately, but exercising discernment and showing restraint – knowing which stakeholders are material and which aren't.

Note that business materiality is subtly different from calculation. It doesn't require the firm to calculate how much investment will boost profits by, or even identify the channels through which it will do so – only to recognise that, if a stakeholder is material, creating value for that stakeholder is likely to flow back to profits. The Apple gym may ultimately

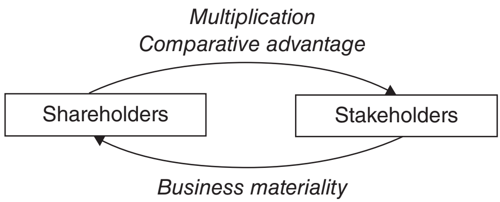


Figure 3.2

improve profits given the materiality of colleagues. Apple doesn't need to scrutinise the financial effects of each health initiative; it simply understands that health is material to workers and that workers are material to Apple, which is why it considers health initiatives a pie-growing activity.

Combining these principles, a firm should undertake an activity that benefits stakeholders if these benefits exceed the cost to the firm, it has a comparative advantage in that activity and these stakeholders have high business materiality. All three principles should be satisfied, because none of them automatically implies another. If a company creates $1.1 for every dollar spent on an activity, but another company creates $1.2, multiplication is satisfied, but comparative advantage isn't. If the numbers are $0.9 and $0.8, comparative advantage is satisfied, but multiplication isn't.* If an activity satisfies both multiplication and comparative advantage, the company should only undertake it if it benefits material stakeholders. This increases the likelihood that creating value for society will create profits as a by-product.

Figure 3.2 highlights the positive feedback loop that arises from satisfying the three principles. If multiplication and comparative advantage are followed, the enterprise creates substantial value for a stakeholder for a given dollar invested by shareholders. If business materiality is satisfied, the value

* For example, there's currently no cost-effective way to recycle polystyrene, so firms shouldn't do it.

created to that stakeholder is more likely to flow back to the firm and ultimately create profits.

In addition to guiding a company on whether to undertake an investment that costs investors but benefits stakeholders, materiality also helps navigate trade-offs *between* stakeholders. In November 2016, French electricity firm Engie announced the closure of its Hazelwood power station in the Latrobe Valley of Victoria, Australia. This decision caused 450 Engie employees and 300 contractors to lose their jobs. Customers also suffered – since Hazelwood provided a fifth of Victoria's electricity-generation capacity, average household bills rose by 16% over the next year.[13] But Engie took the decision because, earlier that year, it had announced a transformation plan to prioritise the environment. As then-CEO Isabelle Kocher said: 'We want to focus our investments solely on generating low carbon energy … we are redesigning our entire portfolio.' Hazelwood was the most polluting plant in Australia, responsible for 3% of its greenhouse gas emissions, and one of the most polluting plants in the world. In 2005, the World Wide Fund for Nature had named it the least carbon-efficient power station in the OECD.

Recall from Chapter 1 that Pieconomics involves compensating those who lose from an action. Thus, after using the principle of materiality to make the closure decision, Engie set aside 150 million Australian dollars in severance payments, an average of $330,000 per colleague – nearly double the median house price in the nearest town. It also participated in the Victorian Government's Latrobe Valley Worker Transfer Scheme, which helped 150 workers find jobs at other power generators in the Latrobe Valley.

The second dimension of materiality is *intrinsic materiality*. Stakeholders could be material to an enterprise simply because it cares about them, even if they don't contribute to its profits. For example, the homeless have low business materiality to Pret a Manger, but high intrinsic materiality, which is why Pret a Manger delivers surplus food to them. Separately, companies often perceive a responsibility towards a stakeholder harmed by their core business. Coca-Cola recognises that its substantial water consumption adversely affects the environment. Thus, in addition to lowering its water usage, it actively supports water projects. In 2009, it launched the Replenish Africa Initiative (RAIN), investing $30 million to improve access to safe drinking water for 2 million Africans by 2015.

The role of intrinsic materiality in Pieconomics is subtly different from business materiality. Business materiality, when combined with multiplication and comparative advantage, helps ensure that actions to create social value also increase long-term profit. We thus obtain the outcome in Figure 1.4, where the pie grows and so does each member's slice. But Figure 2.2 acknowledged that there are cases in which a larger pie lowers profits, even in the long run. Intrinsic materiality helps a leader discern when to opt for lower profits where a trade-off exists. In particular, if the gains go to stakeholders that an enterprise deeply cares for, these gains may outweigh any profit fall.*

Materiality is thus a two-way street. Even if a stakeholder doesn't help you (has low business materiality), you may wish to help it. When Roy Vagelos donated ivermectin for free to West Africans, he did so out of concern for their livelihoods, even if they couldn't make a material difference to Merck's profits. Yet intrinsic materiality may unexpectedly translate into business materiality. Delivering value to intrinsically material stakeholders inspires investors, employees, customers and suppliers, as we saw with the Mectizan Donation Program. Ultimately, this may enhance

* To account for these rare cases, one could redefine Pieconomics as 'creating value for investors through creating value for society', since shareholder value is more than profits. We adopt the simpler definition throughout the book because, if shareholder value includes social value, it's tautological that the latter leads to the former, and so the alternative definition offers less practical guidance.

profits, even though profits were never the primary goal, and so we're back to Figure 1.4.

Given its different role, intrinsic materiality may sometimes be used in isolation, rather than combined with multiplication and comparative advantage. Those two principles affect how much value a company creates for a stakeholder, but intrinsic materiality gauges how much the company cares about that stakeholder. Apple engineers have a comparative advantage in teaching undergraduates compared to painting a local school or helping out with river conservation. But Apple might care more about local schools and rivers, and thus choose to launch programmes that support them. An investment bank doesn't have a comparative advantage in reducing its carbon footprint compared to energy or manufacturing firms. Perhaps its executives should fly to win multi-million-dollar contracts, and invest the proceeds in social impact bonds that reduce other companies' emissions. But the bank may have a policy to cut down on air travel simply because it cares about the environment and believes that it should play its part, no matter how small.

Who gets to choose which stakeholders are intrinsically material – investors, leaders or colleagues? Ideally, it should be all three. As we'll discuss in Chapter 8, a CEO doesn't have a monopoly on purpose, but should form it in conjunction with employees. She can then seek investors' views through in-person discussions and a 'say-on-purpose' vote. Then, only investors with buy-in to the company's purpose will end up holding its stock. By engaging with them, a company gets the investors it deserves.

Taken together, the three principles in this chapter highlight that a responsible business must be discerning and disciplined. Responsibility is not a licence that 'anything goes' or to cheerfully ignore profits. While this observation may seem challenging, it is also reassuring. Some leaders may think about pursing responsibility but fear they'll need to solve all of the world's problems, or need to relegate profits to an afterthought. But this isn't the case – a responsible business focuses on the issues where it can move the needle the most and that matter most to its long-term success.

The principles and the importance of discernment highlight that the pie is a framework, not a calculation tool. When making decisions, a leader doesn't need to draw the pie, quantify how much each slice will grow, and weight the slices to assess whether the pie expands overall. Instead, growing the pie is a mental map for CEOs – and one based on evidence, as we're about to see. Leaders should seek to create profits only through creating value for society, and the principles help them assess whether a decision is likely to do so.

The Principles and Accountability

As explained in Chapter 2, one common argument for ESV is that there's a single, clear objective for which to hold a leader accountable – shareholder value. Any departure risks managers having no clear yardstick. For example, the Council of Institutional Investors, an association of US pension funds, foundations and endowments, released a statement the same afternoon as the Business Roundtable's proclamation, saying: 'we respectfully disagree with the statement issued by the BRT earlier today . . . accountability to everyone means accountability to no one.'

Chapter 1 discussed how 'stakeholder capitalism' typically implies giving stakeholders equal priority to shareholders, as well as equal priority with each other. For example, the European Commission's 2020 study of stakeholder capitalism proposed that leaders 'properly balance' the interests of employees, customers, the environment and society with those of shareholders.[14] Equality sounds appealing, but it's unclear what it actually means in practice. Does Engie closing down Hazelwood 'properly balance' the environment with workers and customers? If both closure and non-closure can be justified, there's no accountability under stakeholder capitalism as any decision could be consistent with it. Leaving everything to the CEO's judgment leads to neither shareholder capitalism nor stakeholder capitalism, but 'managerial capitalism', where leaders make decisions for their own benefit, shrinking the pie for both shareholders and stakeholders alike.

But this chapter has shown how boards, investors and stakeholders can still hold leaders accountable under Pieconomics – but for applying principles rather than undertaking calculations. They can scrutinise whether an investment is indeed following the principles of multiplication, comparative advantage and materiality. These principles stress that leaders don't have 'accountability to everyone', but accountability to address the stakeholder issues that are most material to their company, and that they have a multiplicative impact on and a comparative advantage in solving. Boards, investors and stakeholders can also challenge a leader for errors of omission, if similar firms have launched initiatives that satisfy these principles but she hasn't. The principles of Pieconomics are a middle ground between the concrete but unworkable calculations of ESV and the flexible but arbitrary judgment of stakeholder capitalism.

Moreover, accountability might be *stronger* under Pieconomics. Shareholder value can only be measured looking backwards. It consists of all the future profits from a project, some of which may not manifest until the very long term. Thus, you might have to wait several years before evaluating a decision – in turn rendering the leader unaccountable. Also, it's difficult to separate how much future profits were driven by the new project rather than the enterprise's existing business or external factors. In theory, you could do an NPV analysis at the time the new project is launched. But Chapter 2 discussed how it's difficult for even insiders to estimate the future returns to intangible investment; doing so is even harder for outsiders. Any calculation will be highly sensitive to assumptions, and these assumptions are often shaped by executives' forecasts – allowing them to hand-pick assumptions that justify the project. When I was in investment banking, the joke was that the client would ask us to advise them how much to pay for an acquisition, and we'd respond 'well, how much do you want to pay?' – because we could always come up with an analysis to justify any purchase price. In contrast, far fewer assumptions are needed to evaluate whether an investment satisfies the three principles, giving leaders less latitude to reverse-engineer a justification.

In a Nutshell

- Growing the pie doesn't mean ignoring profits, because profits play a critical role in society. Investors include pensioners and savers (or mutual funds who invest on their behalf), insurance companies and endowments. Without the prospect of profits, an enterprise could not attract funding; without having generated profits, an enterprise could not finance future investment.
- Growing the pie doesn't mean growing the enterprise. A company only creates value if it generates more value than the opportunity cost of the resources it uses. Investment shouldn't be unfettered and involves considering its costs as well as its benefits – but its social, rather than private, impact. Under Pieconomics, the lens is society. Not investing may allow another company within society to create more value with the same resources.
- Evaluating whether creating value for society will also create profits can't be done through calculation, but through judgment. We can provide three principles to guide leaders' judgment:
    - ✳ The principle of *multiplication* asks whether an activity creates more value to stakeholders (not more profit to investors) than it costs the company.

  - ✳ The principle of *comparative advantage* asks whether the company creates more value through the activity than other companies would.
  - ✳ The principle of *materiality* asks whether stakeholders are material to a company, either through affecting its business (*business materiality*) or the company having concern for them (*intrinsic materiality*).
- These three principles also allow boards, investors and stakeholders to hold leaders accountable. Indeed, they may lead to even more accountability than enlightened shareholder value, since they're less dependent on assumptions.

4 DOES PIECONOMICS WORK?

Data – Not Wishful Thinking – Shows that Companies Can Both Do Good and Do Well

Even if Pieconomics makes sense as a concept, it sounds too good to be true in the real world. It would be convenient if firms that grew the pie became profitable as a by-product. But the fact that many companies seem to ignore stakeholders suggests that Pieconomics doesn't work in practice. Even if the pie can be grown, perhaps this requires so much investment that profits fall. Figure 2.2 could be the rule rather than the exception.

The Merck story in Chapter 1 might seem evidence in favour of Pieconomics. But it's not. I could have researched thousands of companies, and then picked out the single best example of a pie-growing enterprise that's also profitable. As pointed out in the Introduction, you can always find a story to support any viewpoint. And perhaps Merck might have become even more profitable if it hadn't launched the Mectizan Donation Program.

So – as will be an occasional mantra throughout this book – let's look at the evidence. Does growing the pie ultimately benefit investors? In other words, does stakeholder value (also known as 'social performance') increase shareholder value (also known as 'financial performance')? That's what we'll explore in this chapter, using rigorous research from many disciplines – not just finance and economics, but also strategy, marketing, organisational behaviour and accounting.

The starting point for any study is to decide how to measure social performance. Society includes many stakeholders, and so you typically choose one stakeholder to focus on, say, the environment. Then, you select either an *input* measure of performance (how much the firm spends on environmental initiatives, or whether it has an energy reduction policy) or an *output* measure (how much it's reduced energy consumption by, or an external agency's evaluation of its environmental record). The second step is to decide how to measure financial performance – market share, revenues or profits. Finally, you calculate the correlation between social and financial performance.

This correlation is of such importance that hundreds of studies have investigated it. Different researchers will find different results, so how do you figure out the overall consensus? That's what a *meta-analysis* does. It's a 'study of studies', which aggregates the findings of individual papers. Joshua Margolis and James Walsh analysed 127 studies between 1972 and 2002 and concluded: 'A clear signal emerges . . . there is a positive association, and certainly very little evidence of a negative association, between a company's social performance and its financial performance.'[1] An independent meta-analysis by Marc Orlitzky, Frank Schmidt and Sara Rynes reached the same conclusion.[2]

But the studies covered by the meta-analyses document only correlation, not causation. There could be *reverse causality* – high market share, revenues or profits could cause social performance, because they give the firm resources to invest in stakeholders. Or there could be *omitted variables* – a third factor, such as good management, jointly improves both social and financial performance. And there are many other concerns in addition to correlation vs causation:

- Some studies use questionable measures of social performance. Early research asked management how much they care about particular stakeholders, but they might say they do even if they don't. Others use a company's own disclosures, but companies can pretend to be virtuous when they actually aren't – a practice known as 'greenwashing'. Others still use input measures, such as expenditure on stakeholders, but this tells you little about the output of such expenditure. As discussed in Chapter 3, simply spending money doesn't grow the pie.

- Some studies use questionable measures of financial performance. Market share, revenues and profits all don't take risk into account. A strategy focused on stakeholder capital is risky because, if the enterprise is in financial difficulty, it can't sell its environmental record to raise money. Investors care about risk, which is why they require a higher return to invest in shares than save in the bank.
- Some studies consider short time periods and so could have got lucky – just like an advocate of bond investing could argue that bonds beat stocks over 1999 to 2009, even if stocks beat bonds normally.
- Some studies only consider a single industry, and it's unclear whether the results are generalisable to other industries.

Digging Deeper

Since the jury was still out on the effect of social performance on financial performance, I decided to study it myself. My first decision was how to measure social performance. I chose employee satisfaction – how well a firm treats its colleagues – because there's a particularly good output measure available. That's the list of the 100 Best Companies to Work for in America, produced by the Great Place to Work Institute in California and, since 1998, published every year in *Fortune* magazine. This list is extremely thorough and the ultimate in grassroots analysis. It surveys 250 employees at all levels, asking them 57 questions on credibility, fairness, respect, pride and camaraderie. The Best Companies are spread across different types of industries – in 1998, the most-represented sectors were financial services (services), consumer goods (low-tech manufacturing) and pharmaceuticals (high-tech manufacturing).

And the list is available since 1984 – it was published in a book (later updated in 1993) before it featured in *Fortune*. So my original study, which ran until 2009, had 26 years of data;[3] I later extended it to 2011.[4] This period includes two major downturns: the collapse of the internet bubble in 2001 and the financial crisis of 2007. Since ESG investing has only recently become mainstream, most other output measures of social performance have only been around in the 2010s – the longest bull market in history. Thus, showing that social performance improved financial performance in the 2010s might not be convincing, as it might suggest that Pieconomics only works in economic upswings. When times are tight, as in a pandemic, perhaps companies need to preserve every penny.

Data Mining and Spurious Correlation

There's a second reason for studying employee satisfaction – there's clear logic for why it might translate into financial performance. Employees are the most important asset in many modern firms – it's they who win client relationships and invent new products. Higher employee satisfaction allows a company to recruit and retain top-quality colleagues, and leads to them being more motivated and productive. For other dimensions of social performance, the link to financial performance is less clear, particularly if the principle of materiality isn't satisfied. For example, animal rights may not be material in many industries.

Having a logical reason for why we can expect a link is important to avoid the problem of *data mining*. There's a large pay-off to finding a study that uncovers significant results. A professor who finds a variable that predicts stock returns will have a high chance of getting the paper published. A new mutual fund that claims to have done so in its launch prospectus will attract investors. So there's an incentive to mine the data. Run hundreds of regressions, correlating stock performance with many variables, and try to find something that's significant.

Some of these variables might be sensible, such as the CEO's incentives or education. But even if you ran 100 regressions on nonsense variables, such as the CEO's shoe size, the number of letters in her last name or her favourite colour, five will be significant at the 5% level by pure chance. These chance results are known as *spurious correlations*. You might find that CEOs who like red perform better – a spurious correlation because there's no reason for why red-liking should improve performance. But *after* uncovering a relationship, you can always spin a story to explain it. You could mine the psychological literature and find a study showing that red triggers dominance and thus can enhance performance – and indeed such a study exists, by Russell Hill and Robert Barton.[5] Or if you found that CEOs who like red perform worse, you could search for a study showing that red is associated with the danger of failure and leads to fear – and indeed such a study exists, by Andrew Elliot, Markus Maier, Arlen Moller and Jorg Meinhardt.[6] Several spurious correlations have become famous, such as the Superbowl Effect. If a team from the American Football Conference wins the Superbowl, the market tends to fall subsequently; if a team from the National Football Conference wins, the market rises. Some advisors even recommend investing on this effect.[7] But there's no reason for why the Superbowl winner should affect the stock market.

The ability to mine the data is a particular concern in today's 'big-data' world, where data sources and computing power are becoming limitless. Finance professor Robert Novy-Marx parodied this ability when he was able to predict the performance of trading strategies using the weather in Manhattan, global warming, the El Niño phenomenon (the temperature in the Pacific Ocean), sunspots and the alignment of the planets.[8] He noted wryly: 'It seems likely that others could replicate my success, especially given . . . the exponential growth in easily obtainable, machine readable data on candidate explanatory variables, and the ease of running these sorts of regressions.'

It's therefore important to choose a measure of social performance where there's a plausible link to financial performance, *before* looking at the data, to reduce the chance that any correlation is spurious.

Having decided how to measure social performance, my second decision was how to measure financial performance. Earlier studies looked at market share, revenues or profits, which run into the causality problems described earlier. So I studied future stock returns. This helps because the stock return is the *change* in the stock price between now and next year (plus dividends). For the stock return to be high, the stock price must not only be high next year, but also low today. The stock market is pretty good at taking into account financial performance – indeed, a common criticism is that it focuses too much on financials. If the stock price is low today, it probably means that financial performance is also low today.

How does this get us closer to causality? Assume that the fictional enterprise Super Supermarkets is on this year's Best Companies list, and consider a world in which employee satisfaction causes higher future financial performance. Super's financial performance is unremarkable today, and so its stock price is only 100. Over the next year, Super's motivated colleagues improve its profits and push the stock price to 120. The stock return is 20%, and let's say the market return is only 7%. Super beats the market.

Now consider a world in which reverse causality holds – employee satisfaction is simply the result of financial performance already being strong. Due to Super's high profits, its stock price is already 112 today. So the increase to 120 is a return of 7%, no different from the market. Thus, the Best Companies will beat the market only if employee satisfaction improves financial performance, not if financial performance improves employee satisfaction.

Looking at future stock returns thus reduces the problem of *reverse causality*. But we still have the problem of *omitted variables*. If Super's stock return was 20%, that could be due to many reasons other than motivated colleagues. Perhaps the entire supermarket industry performed well. Or perhaps Super is a small firm, and there's evidence that small stocks typically beat large stocks.[9] Or perhaps Super *had* performed well recently, and the market was slow to recognise this. Maybe I'm too quick to assume that the stock market is good at incorporating profits – perhaps Super's stock price should have been 112 today, but the market got it wrong and was only charging 100.

To isolate the effect of employee satisfaction, I thus did two things. First, I studied not only Super, but every Best Company traded on the stock market. If Super beat the market, it could be due to its small size or strong recent performance. But if many Best Companies – with different size and recent performance and in different industries – beat the market, then it's likely due to their one factor in common, employee satisfaction.

Second, I controlled for omitted variables. Studying hundreds of Best Companies only works if they're spread across different industries, are of different size and have different past performance. But if many Best Companies are tech firms, and the tech industry beat the market, then the Best Companies will also outperform even if employee satisfaction is irrelevant.

So I compared Super not only to the overall stock market, but also to other firms in the supermarket industry, or other small firms with good recent performance. I did the same for every Best Company. If Automatic Automobiles, a large car firm that performed badly recently, was also in the list, I compared it to other car firms, or other large firms with poor recent performance. Each enterprise thus had its own bespoke comparison group. In addition to industry, size and recent performance, I controlled for several other factors, such as dividends, current valuation and stock trading volume. Importantly, I could also control for risk. There's no established way to adjust market shares, revenues or profits for risk, but decades of finance research have come up with tools to adjust stock returns. The most well known is the Capital Asset Pricing Model; I used a more sophisticated version known as the Carhart model.

It took me four years to complete this study, to verify the robustness of the results and to rule out alternative explanations – including several more not considered here. After all that effort, studying 1,682 firm-years, what was the punchline?

I found that the 100 Best Companies to Work for in America delivered stock returns that beat their peers by an average of 2.3 to 3.8% *per year* over a 28-year period. That's 89% to 184% cumulative.

Are the Magnitudes Plausible?

Researchers typically want to find large results, as it makes their results more striking. 2.3% to 3.8% per year, for 28 years, is not to be sniffed at. If a fund manager beats the market by 2% every year for five years in a row, he's considered highly skilled. Thus, even higher outperformance over a much longer horizon is striking.

But we must also check whether the results are too large to be plausible. A study which found a trading strategy that beat the market by 20% per year would cause any investor to drop his coffee cup, and would be tweeted and shared. But, while it's reasonable to believe that there are trading strategies that can generate returns of 2.3% to 3.8% – some shares are indeed underpriced by the stock market – it's much less likely that you can beat the market by 20% per year over any reasonable time period. The study has probably only considered a short time period or failed to control for other factors. And if a business practice really allows a company to beat its peers by 20% per year, those that fail to adopt the practice will be quickly driven out of the market.

This real-world sanity check is far too rarely done. Most people understand the need for caution with deals that seem 'too good to be true' – bargain holidays, cars or TV sets. But the same caution doesn't always apply to evidence. The more striking the finding – the higher the returns a trading strategy or business practice claims to yield, or the number of pounds that a dieting pill claims to shed – the more attention it grabs. But while there *are* opportunities to make money and lose weight, they're unlikely to make 20% per year or cure obesity overnight.

The Peer Review Process

You may wonder why it took me four years to publish my paper, since the media, consultancies and investment houses release studies showing the returns to a business practice or trading strategy all the time. That's because of the stringency of the peer review process, which constantly pushed the paper to be far more rigorous than it would have been from my efforts alone. This also explains why this book predominantly draws from studies published in the very top academic journals.

The first journal I sent the paper to rejected it, claiming that I had an 'interesting but puzzling result'. Both the Editor and peer reviewer didn't believe that markets could be inefficient and give rise to a profitable trading strategy. And even if you could beat the market, they were sceptical you could do so with something fluffy like employee satisfaction. So I had to explain much more clearly why employee satisfaction might boost firm value rather than representing wasteful expenditure. And I had to clarify why, even if employee satisfaction were valuable, it might be ignored by the market.

Once a paper is rejected by a journal, you can't send it back to the same one. So I submitted it to a second journal, which also rejected it. At the time, I only studied the Best Companies list from 1998 onwards, when it was published by *Fortune* magazine. The Associate Editor was concerned that the time period I studied was too short to form generalisable conclusions, particularly since it contained the internet bubble. And, s/he worried that my results might be driven by a few outliers that performed exceptionally well and led to the Best Companies portfolio overall beating the market, even if most individual stocks didn't. The peer reviewer said I needed to pinpoint the mechanism through which employee satisfaction would lead to higher stock returns – what causes the Best Companies' stock prices to go up? It could be that employee satisfaction doesn't actually have value, but the market wrongly thinks it does and thus gives a higher valuation to employee-friendly companies.

So I went back to the drawing board again, extending the study back to 1984 by looking up the lists in the 1984 and 1993 books, and removing the effect of outliers to address the Associate Editor's concerns. To provide further evidence on the mechanism, I studied the Best Companies' future profits – if employee satisfaction improves recruitment, retention and motivation, this should boost the bottom line. But even studying profits isn't enough. If a Best Company announces record profits, but the stock market already expected this, the stock price shouldn't change. I thus compared the Best Companies' quarterly profits to what stock analysts like Goldman Sachs and Credit Suisse forecast they'd be beforehand.* I found that the Best Companies systematically beat analyst expectations (known as a positive 'earnings surprise'), causing their prices to rise significantly. Indeed, a good chunk of the 2.3% to 3.8% annual outperformance arose on the earnings announcement dates.

* Stock analysts, also known as equity research analysts, write evaluations of a stock. They typically include a recommendation on whether to buy, sell or hold it, and forecasts of future earnings.

I had one last roll of the dice, since only three finance journals were viewed as elite and thus would count for tenure at Wharton. The peer reviewer at the third journal also had many concerns, but at least gave me the opportunity to 'revise-and-resubmit' the paper to attempt to address them rather than rejecting it outright. I had to convince him/her that the magnitude of outperformance was plausible (see the 'Are the Magnitudes Plausible?' box above), and rebut three alternative explanations for why the higher stock returns may have arisen. One was that RI funds bought the Best Companies because they used employee satisfaction as a stock selection criterion, and those purchases drove up the stock price. The second was that companies with high employee satisfaction had good corporate governance, and it was the latter that caused the superior returns. The third was that employee satisfaction may not matter in any direction, but the market wrongly thinks that it's wasteful and values the Best Companies at a discount; the higher subsequent returns are simply the unwinding of the discount.

I addressed those concerns, making major changes to the paper and writing a 17-page letter to the peer reviewer explaining how I'd responded to them. But still s/he wasn't satisfied and requested another revision. I needed to compare firms that remained on the list throughout against newly added and newly dropped companies to ensure that the results weren't driven mainly by the original 1984 list. If so, not only might the results not be generalisable, but also it would be puzzling why the Best Companies list still generated higher returns two decades later. I also had to study how long the Best Companies' outperformance lasted for – a topic I'll come back to later. And in addition to all the referee's specific concerns, since four years had passed since I originally started the paper, I had to update the data for those additional four years, keeping my fingers crossed that the results still held.

Finally, the paper got in.

What Does It All Mean?

After all those years being (legitimately) knocked back by sceptical editors and peer reviewers, I finally published a study showing that companies that treat their employees well also perform well. That seems a bit underwhelming. It's almost obvious that happier workers would be more productive than unhappy ones. Did I really need to waste four years showing something we could have guessed based on common sense?

Actually, the result is far less obvious than it sounds. Take the supermarket Costco.[10] In 2014, Costco paid its colleagues $20 an hour, almost double the national average of $11.39 for a retail sales worker.[11] It gave 90% of them health care – in part due to making part-time employees eligible after just six months of service, compared to two years at its rival Walmart. Costco is shut on all major US public holidays, even though they're particularly profitable days to open because customers are off work and free to go shopping. But Costco closes to allow its employees to spend these holidays with their families. All these policies are expensive, and drive some stock analysts and investors crazy. One equity analyst, quoted in *Business Week*, lamented: '[Costco's] management is focused on . . . employees to the detriment of shareholders. To me, why would I want to buy a stock like that?'[12] Another complained that 'Whatever goes to employees comes out of the pockets of shareholders.'[13]

That's the pie-splitting mentality. It assumes that the amount of value that Costco can generate is fixed, so any slice that goes to colleagues is at the expense of investors. The title of a *Wall Street Journal* article[14] also conveys this mentality: 'Costco's Dilemma: Be Kind to Its Workers, or Wall Street?' The crucial word is 'or'.

But the pie is not fixed. Giving a dollar to colleagues in the form of pay, health care or holidays improves their productivity and morale, and increases the likelihood they stay. They may grow the pie by two dollars as a result, so investors gain rather than lose a dollar. Costco's Chief Financial Officer, Richard Galanti, said in the same *Wall Street Journal* article: 'From day one, we've run the company with the philosophy that if we pay better than average, provide a salary people can live on, have a positive environment and good benefits, we'll be able to hire better people, they'll stay longer and be more efficient.' Indeed, organisational behaviour scholars Ingrid Smithey Fulmer, Barry Gerhart and Kimberley Scott found that workers in a Best Company are more willing to remain with their employer.[15] Around the time I started my study, turnover at Costco was 17% (and just 6% after the first year), in contrast to 44% at Walmart.[16] Since the cost of replacing an employee is around 1.5 to 2.5 times his annual salary,[17] reducing turnover costs is good for shareholders. As Costco CEO Jim Sinegal said, 'We pay much better than Walmart. That's not altruism, that's good business.'

Turning to productivity and morale, organisational economists Daniel Simon and Jed DeVaro found that customer satisfaction is also higher, potentially because motivated employees design better products and are more positive in their customer interactions.[18] That might explain why I found that the returns to being a Best Company were similar across manufacturing and service industries, and high- and low-tech industries.[19] Initially, I thought employee satisfaction would be more important in companies like Apple, whose employees can significantly affect company performance through innovation. However, it's equally valuable in sectors such as retail, where colleagues are crucial for a positive customer experience.

So we can replace the word 'or' with 'and'. Treating colleagues as partners in the enterprise, rather than as a resource to be exploited or a cost to be minimised, benefits both workers and Wall Street. Growing-the-pie is not pie-in-the-sky – investing in workers works for investors.

Beyond Colleagues

My study showed that treating workers well benefits investors in the long run, but says nothing about other stakeholders.

Fortunately, there are studies that examine them using similar methodology. Marketing researchers Claes Fornell, Sunil Mithas, Forrest Morgeson and M. S. Krishnan investigated the link between customer satisfaction and stock returns. 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 to 2003.[20] Again, this result isn't obvious. Customer satisfaction would improve if customers were offered lower prices, more tailored products and free after-sales service, but all these measures might reduce profits. Indeed, let's now fill in the dots in the *Business Week* quote earlier. The analyst's full complaint was that Costco's 'management is focused on *customers and* employees to the detriment of shareholders'.

Turning to the environment, a measure of 'eco-efficiency' from Innovest Strategic Value Advisors gauges the value of a company's goods and services relative to the waste it generates. Jeroen Derwall, Nadja Guenster, Rob Bauer and Kees Koedijk found that highly ranked stocks beat lowly ranked ones by 5% per year between 1995 and 2003.[21]

Rather than focusing on one stakeholder group, another approach is to aggregate a company's performance across multiple stakeholders. KLD, a leading ESG data provider (now owned by MSCI), scores firms on 51 stakeholder issues across seven themes: community, governance, diversity, employee relations, product, environment and human rights. Accounting professors Mozaffar Khan, George Serafeim and Aaron Yoon studied 2,396 firms between 1992 and 2013. They found that those with high KLD scores beat the market by only 1.5%, which isn't statistically significant (in other words, it's so small that it might be a product of chance).[22] This study doesn't seem to be a ringing endorsement of Pieconomics.

But there's a twist. Recall the *principle of materiality*, that only delivering value to material stakeholders will ultimately benefit investors. The authors used the Sustainability Accounting Standards Board materiality map from Chapter 3 to divide the

51 issues into material and immaterial ones, given each company's industry. Firms that score high on material issues and low on immaterial issues beat the market by a statistically significant 4.83%. So it's actually better for a company to do well on only a few items, and show restraint on others, than to do well across the board. Indiscriminately investing in stakeholders doesn't deliver long-run value to investors, but targeted investment in material stakeholders does.

It's worth pausing for a moment to reflect on this result. Some investors evaluate companies in a box-ticking manner. If a stock ticks more stakeholder boxes, it's viewed as a better investment. But if it's prioritising all stakeholders, it might be deprioritising shareholders. By trying to be everything to everybody, an enterprise can end up being nothing to nobody.

While all the above studies investigate shareholder returns, Michael Halling, Jin Yu and Josef Zechner investigate the interest rate a company pays on its debt.[23] A commonly claimed benefit of responsibility is that it allows companies to raise funds more cheaply, potentially because purposeful companies are seen as safer investments. While you can't observe the returns that shareholders expect when investing in a company, you can for debtholders – it's the interest rate they charge. Michael, Jin and Josef find that better overall social performance reduces the interest rate, which appears a resounding victory for responsible business.

But digging deeper, they find it's the product-related dimensions that matter the most. Environment, community and human rights scores are actually linked to a higher interest rate, although the results are statistically insignificant. And the characteristics that matter vary over time and across industries. Over time, employee relations are insignificant during recessions. But in booms, where workers are scarce, good employee relations do reduce the interest rate – perhaps because they help retention and recruitment. Across industries, environmental scores are linked to lower interest rates in the agriculture, forestry, fishing and mining sectors, where they're likely to be especially material. But in transportation, communication and trade, high community scores actually increase the interest rate, perhaps because they signal that the company is focusing on unimportant issues.

Note that the last two studies don't imply that companies should focus entirely on stakeholders with high business materiality. They can always choose to prioritise other stakeholders, such as those with high intrinsic materiality. The research only suggests that doing so may not enhance long-term returns. That's fine if shareholders are willing to trade off long-term returns to pursue societal objectives – as highlighted in Chapter 2, shareholder welfare is more than just shareholder value. However, leaders and investors should be aware that there's a trade-off, in contrast to common claims that social performance always improves financial performance.

Instead of studying the output of investment into stakeholders, an alternative approach is to examine the use of stakeholder-oriented policies, an input measure. Examples are protocols to support worker skills training, improve water efficiency or use human rights criteria when selecting suppliers. Bob Eccles, Ioannis Ioannou and George Serafeim investigated whether companies had genuinely adopted these policies (rather than simply announcing intentions) by scrutinising their annual reports and sustainability reports, and interviewing over 200 executives. Companies that had adopted many of these policies by 1992 beat those which had adopted few by 2.2% to 4.5% from 1993 to 2010.[24] What's striking is that 1992 was well before responsible business became mainstream – even a decade later, only about a dozen Fortune 500 companies issued a sustainability report.[25] Companies weren't forced to adopt stakeholder-oriented policies due to regulator, investor or public pressure. Instead, they did so voluntarily, because they wanted their businesses to serve society.

This observation is important. Currently, responsible business is still nascent in some countries – local investors ignore social performance, and there's little public scrutiny of it. These countries are similar today to the US in 1992. So those enterprises which are particularly forward-thinking, and adopt the pie-growing mindset voluntarily, may become the winners of tomorrow. Since most firms aren't focused on social value, those that are should enjoy a unique competitive advantage.

Armed with this evidence, let's revisit the discussion in Chapter 2 on whether an enterprise should pursue profits or social value. There are indeed some true externalities which are very unlikely to feed back into profits. But the results suggest that there are fewer true externalities than commonly believed. What firms typically think of as externalities actually come back to affect profits in the long term. Overall, the studies reach the following conclusion: to reach the land of profit, follow the road of purpose.

Thinking Long Term

The first implication of the above studies is that the success of a company is linked to the value it delivers to its stakeholders. Thus, serving society is a CEO-level issue that's fundamental to how a business is run, not an optional extra to be delegated to a CSR department.

The second implication is more sobering and provides an important twist. Growing the pie benefits investors, but only in the long run. All the measures used in these studies are public information. For example, the Best Companies list is published to much fanfare in the February issue of *Fortune*, which has nearly 20 million print and online readers. If the stock market were efficient – if it did a good job of taking information into account – the prices of all Best Companies should jump as soon as the issue hits the news-stands in mid-January. So they should already be high by 1 February, which is when I start calculating stock returns, and so the Best Companies shouldn't outperform going forwards. That they do suggests that the market doesn't fully respond to list publication.

And the market's sluggishness doesn't last for just the two-week period between mid-January and 1 February. I found that it lasts for *over four years*. The earnings surprise result suggests that only once the Best Companies announce higher quarterly earnings did the market start to take note. And it also shows that even professional equity analysts didn't realise that employee satisfaction improves productivity – that's why they underpredicted the earnings of the Best Companies.

This result shines a light on what the stock market does and doesn't value. The market doesn't value many intangible assets directly, but only when they later show up in tangible outcomes such as profits. So a pie-growing mentality requires long horizons – treating other stakeholders well does benefit investors, but only in the long term. That's also true for other measures of social performance. Customer satisfaction, eco-efficiency and stakeholder-oriented policies are all public information, but take a long time to affect the stock price. We stressed in Chapter 2 how maximising shareholder value doesn't mean maximising short-term profits. Here, we emphasise that maximising shareholder value doesn't mean maximising the short-term stock price – since markets are inefficient, the stock price ignores some factors that matter for long-term profits and thus shareholder value. As Warren Buffett said, 'Price is what you pay. Value is what you get.' That's another reason why shareholder value is impossible to 'maximise' – we can study how a decision affects the stock price, but this doesn't reflect how it affects shareholder value.

The market's slowness is frustrating for companies. A leader can grow the pie without any immediate reward from the stock market. But this slowness is attractive to smart investors. Good companies aren't always good investments. If an enterprise is good, and everybody knows it's good, an investor pays for what he gets. It makes no sense to buy Facebook because it's a leader in social media. Everybody knows this, so its shares are expensive. A good investment is a company that's better than everyone else thinks. Stakeholder capital is a prime example of such hidden treasure: it ultimately leads to profits, but the market doesn't realise this. Some investors – like the analyst in *Business Week* – are stuck in the pie-splitting mentality, that stakeholder value is at the expense of returns. Or they understand the importance of stakeholder capital, but find it difficult to take into account. You might know that a company has an engaged workforce, but not how this information should change cell C23 in your valuation spreadsheet.

This result has profound implications for the relevance of social performance measures. The traditional view is that social and financial criteria conflict. To pursue social goals, such as improving workplace practices, a shareholder has to sacrifice financial returns. Thus, only 'socially responsible investors' with both social and financial objectives should consider social criteria. However, the results suggest that even an investor with purely financial goals should do so – social performance is typically labelled a 'non-financial factor', but it often becomes financial in the long run. The UN Principles for Responsible Investment thus contrast 'socially responsible investing' with 'responsible investing' – the latter is the use of social criteria to achieve purely financial objectives.

But I'd go further than the UN. We can drop not only the adverb 'socially', but also the adjective 'responsible'. Considering a financially material factor such as social performance isn't the exclusive domain of 'responsible' investing – it's plain and simple investing. Indeed, the Principles of Investment – not just Responsible Investment – are that you can only beat the market by selecting factors that aren't fully priced by the market. Social criteria may thus be superior to financial criteria, as they're more likely to be overlooked.

This observation also has implications for investor education. Asset management firms, business schools and professional bodies typically focus on teaching investors how to analyse balance sheets and income statements. But they have the responsibility to extend this training to social performance – or else their employees, alumni and members will be out of a job. ‘Smart beta’ funds, where a computer chooses stocks based on financial performance, have grown substantially in recent years and broke $1 trillion in December 2017.[26] If fund managers and investment analysts wish to avoid being replaced by artificial intelligence, they need to develop the ability to analyse what machines can’t.

To avoid confusion, this book will still refer to the use of social criteria as ‘responsible investing’ as this is standard terminology. But hopefully future books won’t need to do so – only once the term disappears will we be able to claim that responsible investing has become mainstream. There’s no such term as ‘financial investing’ as it’s taken-for-granted that investment decisions should consider a company’s financial performance. One day, the same will also be true for its social performance.

An example of responsible investing in practice is the Parnassus Endeavor Fund (formerly named the Parnassus Workplace Fund). It started in 2005 with a single investment criterion – employee satisfaction. One of its advisors was Milt Moskowitz, who co-authored the original 1984 and 1993 Best Companies lists. By 2017, it had returned 12.2% per year, compared with 8.5% for the S&P 500. That year, the investment research provider Morningstar found that, out of all funds that invest in large growth stocks, the Endeavor Fund was the single best performer over every period, from one year to ten years.[27]

Responsible Investing in a Crisis

A common concern with responsible investing is that it may only pay off in economic upswings – when times are hard, money is tight and companies should focus on short-term survival. But an alternative view is that responsibility might be even more valuable in crises, where trust in business is low, so enterprises that have built trust through serving society may be uniquely placed to weather the storm.

To see which view is correct, we'll again look at the evidence. Karl Lins, Henri Servaes and Ane Tamayo studied 1,673 firms from 2007 to 2013. Like Mozaffar Khan and co-authors' materiality study, they found that companies with high KLD scores don't typically beat the market.[28] But when they honed in on the financial crisis, they found that high-scoring firms beat low-scoring peers by 4 to 7 percentage points. Interestingly, the effect of stakeholder capital was half as large as the effect of cash holdings and leverage, arguably the most important determinants of whether a firm survives a crisis. High-scoring firms also enjoyed better profitability, sales growth and sales per employee. They also outperformed during a quite separate crisis period – the Enron and Worldcom fraud scandals.

What about the pandemic? Shortly after it broke out, multiple studies heralded how RI funds or high-ESG firms had outperformed. These studies were widely covered by the media and lapped up by readers – but confirmation bias may have been at play. One study found that responsible firms outperformed between late February and late March 2020, and was widely trumpeted. However, had it found the opposite result, responsible business advocates would have attacked the study for being too short-term – one month was far too brief to evaluate performance. So they should have employed the same scepticism even though the findings were in their favour. Other analyses found that the strong performance of ESG was entirely due to an industry effect – an ESG portfolio was long tech and short energy – or failing to control for other variables.

At the time of writing, it's too early to conclude whether responsible businesses outperformed in the pandemic. Some academics argued that they did, but others conclude the opposite.[29] We do know that stakeholder capital paid off in prior downturns, inconsistent with the concern that it's a luxury that only matters in good times. But the financial crisis and the Enron and Worldcom scandals were shocks to public trust in business, so it makes sense that trustworthy enterprises outperform. In contrast, the coronavirus pandemic wasn't caused by companies, so it shouldn't lead to a loss of trust in business. Certainly, some companies have reacted irresponsibly, but others have responded heroically. While it's premature to say that social performance definitely helped financial performance during COVID-19, there's not yet evidence that it hurt.

Further Nailing Causality

Linking social performance to future stock returns, rather than market share, revenues or profits, takes us closer to causality. But it doesn't fully prove it. While I controlled for many other factors, such as industry, size and recent performance, I can only control for what's observable. Something unobservable, like management quality, can't be controlled for. Now the earnings surprise test helps. It's reasonable to assume that analysts take management quality into account when forecasting earnings – they talk to a company's leaders all the time and constantly evaluate them. Since the Best Companies beat these forecasts, it must be something over and above management quality that's driving their profitability. But that's still an assumption, and there's no way to directly test it.

A different way to get at causality is to study what happens to a company's stock price when news breaks out about its social performance. This news is a sudden change to a company's social performance and thus unlikely to be correlated with changes in management quality, financial performance or anything else. Another advantage of analysing events is that they can be positive or negative, whereas the studies in the prior section typically use positive measures of social performance (such as the Best Companies list) – they show that good performance helps, but not that bad performance hurts.

Philipp Krüger studied 1,542 negative stakeholder events and found that they reduce the stock price by an average of 1.31%, or $90 million. Negative events relating to the community or the environment have the biggest impact, with the decline exceeding 3%.[30] Strategy professor Caroline Flammer focused on environmental events. Positive news, such as a company introducing a recycling programme, boosted the stock price by an average of 0.84%, but negative news, such as the release of hazardous waste, reduced it by 0.65%.[31] Indeed, there are numerous examples of how negative stakeholder events can damage the reputation of even world-leading companies that might have seemed untouchable, in turn hurting investors. News that Volkswagen cheated emissions tests, Facebook shared users' data with Cambridge Analytica and Wells Fargo created fake bank accounts wiped €28 billion, $95 billion and $35 billion (respectively) off their market values.[32]

But studying events still doesn't quite nail causality. Even if the news is explicitly about social performance, it might be a signal of management's competence more generally, and the market might be reacting to that. If a company releases hazardous waste, maybe the CEO has little control over what's going on in her enterprise more generally. So in a separate paper, Caroline Flammer dug deeper and used a quite different approach.[33] She studied investor proposals, where a shareholder asks a company to take a specific course of action. This action might be a financial one – for example, to pay more dividends – but Caroline focuses on proposals related to social performance. In 2018, 43% of US shareholder resolutions concerned such issues.[34] All investors vote on the proposal at the firm's annual general meeting. A proposal is non-binding, so the firm can choose to ignore it even if it passes, but 52% of those passed are eventually implemented.

Here are two recent examples. The following proposal was made to Lear, a supplier of car seats and electrical systems:

> *[T]he shareholders request that the company commit itself to the implementation of a code of conduct based on the aforementioned ILO human rights standards and United Nations' Norms on the Responsibilities of Transnational Corporations with Regard to Human Rights, by its international suppliers and in its own*

international production facilities, and commit to a program of outside, independent monitoring of compliance with these standards.

Another was made to HCC Insurance:[35]

The Shareholders request that management implement equal employment opportunity policies based on the aforementioned principles prohibiting discrimination based on sexual orientation and gender identity.

Proposals are sudden changes to an enterprise's social orientation, which are unlikely to coincide with (say) sudden changes to management quality. But this alone won't get around the causality issue. It could be the proposal came from a large engaged investor – and it's this investor's engagement more generally, over and above the proposal, that improves performance. So Caroline uses a methodology known as *regression discontinuity*. She compares proposals that narrowly pass (with just over 50% of the vote) to those that narrowly fail (with just under 50%). The Lear proposal failed with 49.8% of the votes and the HCC Insurance proposal passed with 52.2%. Whether a proposal narrowly passes or fails is virtually random. It's unlikely to be caused by an engaged investor, because such an investor would have increased the vote from 49.8% to (say) 70%, not 52.2%.

Caroline pored through 2,729 proposals between 1997 and 2012. She found that narrowly passing one improves stock returns by 0.92% compared to a narrow rejection. Since an approved proposal is implemented 52% of the time, adoption improves shareholder value by an average of 0.92% / 52% = 1.77%. Importantly, the increase comes from pie-growing, not pie-splitting – operating performance, labour productivity and sales growth also rise, suggesting that a social orientation inspires both colleagues and customers.

The Importance of Principled Investment

While Pieconomics argues that investing in stakeholders can ultimately benefit shareholders, it also stresses the need for such investments to be disciplined. Chapter 3 introduced three principles to guide a leader in knowing which investments to take and which to turn down.

What's the evidence that these principles matter? The studies by Mozaffar Khan and co-authors, and Michael Halling and co-authors, highlighted the importance of the principle of materiality. Investigating multiplication and comparative advantage is tricky because it's very difficult for an outside researcher to estimate the social value created by an investment. However, we can study the effect of a common investment that clearly violates the principle of comparative advantage – donating to charity.

In Chapter 2, we discussed how charitable donations allow a leader to support her own preferred social causes rather than the ones favoured by investors, colleagues or customers. Indeed, Ron Masulis and Walid Reza find that 62% of firms donate to charities where their CEO is a trustee, director or advisor. Moreover, US companies are required to disclose donations that are made in the name of its executives or directors, as it considers them a form of pay. This allowed Ron and Walid to study the value implications of such donations. When a firm announces such a donation for the first time, and if it's to a charity affiliated with the company's directors, the stock price drops by 0.87%. That's $90 million when applied to the average firm size of $10.4 billion.[36] Interestingly, the average donation is in the order of $1 million. Even if investors expect this donation to be repeated every year until the CEO departs, this won't come close to $90 million. So why does firm value fall so much? Because the donation is only the tip of the iceberg. If the CEO is donating to affiliated charities, she may be spending money in many other ways that don't satisfy the principles and thus be destroying value.

Ye Cai, Jin Xu and Jun Yang hone in on donations to charities affiliated with the firm's *independent* directors.[37] They're supposed to hold the leader accountable for performance, but a donation to their charity might buy their favour. Indeed, Ye, Jin and Jun find that it leads to the CEO being paid 9.4% more. This increase is even higher when the charity is affiliated with a member of the remuneration committee – the sub-group of the board that sets pay – and highest still when it's tied to the chair of that committee. Even worse, a leader is less likely to be fired for poor performance if she donates to charities affiliated with a large fraction of the board. This self-serving behaviour is at the expense of investors – stock returns are 2.4% lower per year.

These studies highlight the importance of boards and shareholders carefully scrutinising a firm's investments in stakeholders – in particular, whether they're in accordance with the three principles. Leaders have private incentives to make certain investments, even if the principles aren't satisfied, and doing so shrinks the pie.

The Other Side of the Coin

So why hasn't Pieconomics been more widely adopted? Because it's important to acknowledge the evidence isn't all one-way.

Earlier I mentioned the Parnassus Endeavor Fund as an example of the success of responsible investing. But that's a single fund – it's not evidence. One of the most challenging pieces of counterevidence is that ESG funds in general don't beat the market. Luc Renneboog, Jenke Ter Horst and Chendi Zhang found that, in the US, the UK, and several European and Asian countries, ESG funds underperform by 2.2% to 6.5% per year – although these differences become insignificant after controlling for risk.[38] The same researchers conducted a separate meta-analysis which concluded that ESG funds perform similarly to non-ESG funds in the UK and the US, but underperform in Europe and Asia.[39] Turning from public to private investing, 'impact funds' are those with social as well as financial objectives. Brad Barber, Adair Morse and Ayako Yasuda studied 159 such funds over 20 years and found that they underperform traditional venture capital funds by 3.4% per year.[40]

Some ESG advocates sweep these findings under the carpet. One claimed in the *Financial Times* that: 'The outperformance of ESG strategies is beyond doubt.'[41] Such a claim is unfortunately not true, but often accepted uncritically given confirmation bias. We'd like to live in a world in which ethical investing works – we want the good guys to win, and we can pretend we don't need to deal with any of the awkward trade-offs discussed in Chapters 2 and 3.* A *Forbes* article heralded an unpublished meta-analysis which found that ESG outperforms,** explaining: 'That is the premise of a new report, and it is an accurate one, judging by many conversations with those interested in better business, better corporate governance and a sustainable future.'[42] But whether a report 'is an accurate one' depends on its scientific rigour, rather than whether those who are 'interested in better business' – and thus predisposed to like its results – deem it accurate. As Mandy Rice-Davis, who gave evidence in the 1963 trial that discredited the government of UK Prime Minister Harold Macmillan, is commonly paraphrased: 'They would say that, wouldn't they?'

So we must take seriously the fact that most ESG funds don't outperform. But most ESG funds may not actually be practising Pieconomics. Many funds use screens to assess whether a company creates value for society. They screen out a stock if it fails to tick a box (for example, has insufficient board diversity) or ticks the wrong box (for example, is in the oil and gas industry). Indeed, out of the $30.7 trillion invested in ESG strategies that we mentioned in Chapter 2, the most popular approach (accounting for $19.8 trillion) was screening. This method has

* Creditably, the *Financial Times* subsequently published a letter highlighting the ambiguity of the evidence: David Tuckwell, 'Case on ESG Investing is Far from Closed', *Financial Times* (28 November 2017).

** This meta-analysis studies the link between social performance and stock returns, unlike the meta-analyses by Margolis and Walsh (2003) and Orlitzky, Schmidt and Rynes (2003), mentioned earlier in this chapter, which study other measures of financial performance.

three shortcomings, which may explain the average ESG fund's poor performance.

First, box-ticking measures are superficial, and thus incomplete at best or prone to manipulation at worst. As an example of incompleteness, the proportion of minorities on the board is sometimes used as a diversity measure, but says little about the board's diversity of thinking or culture of dissent, nor the extent to which these pervade the entire firm. As an example of manipulation, an enterprise could care little about diversity, but appoint a minority to the board to tick the box.

Second, box-ticking is one-size-fits-all. It assumes that better social performance is always beneficial to investors, but this ignores the principle of materiality that's central to Pieconomics. Which stakeholders are material varies from company to company, and the study by Mozaffar Khan and co-authors showed that investing in immaterial stakeholder issues doesn't improve returns.

Perhaps the most important drawback is that box-ticking is piecemeal rather than holistic – if a company fails to tick one box, it's automatically ruled out, no matter how well it performs on other dimensions. In particular, most boxes focus on 'do no harm' instead of 'actively do good', which can lead to the exclusion of entire industries. A most common screen is to exclude energy stocks, but Lauren Cohen, Umit Gurun and Quoc Nguyen find that they produce more 'green patents' (innovations that solve environmental problems) and higher-quality green patents than nearly every other sector.[43] An energy company is a portfolio of 'brown' fossil fuel assets and 'green' renewable investment projects, and the promise of the latter might outweigh the downsides of the former.

Even if its industry isn't excluded, 'do no harm' boxes can lead to a company being screened out even it creates substantial value. In Chapter 2, we discussed how Apple provides a stimulating working environment with opportunities for growth and development, but this isn't captured by many social performance measures. Instead, these measures typically focus on employee controversies, where Apple fares less well. It's been criticised for long hours and an intense working culture, paying minimum wage to its Genius bar workers and poor labour practices in its supplier factories, which allegedly drove some employees to suicide.[44] Of course, these controversies are serious concerns that a responsible investor should pay significant attention to, but it shouldn't evaluate them without simultaneously considering the positives. No company will be perfect on every dimension – what may be a stretching and motivating culture to some colleagues may be a pressure cooker to others. The complexity of evaluating employee satisfaction means that it can't be whittled down to a single box that can be ticked. As we'll discuss in Chapter 6, properly evaluating social performance involves getting your hands dirty – if the company is a retail chain, you visit its stores. But some investors hold so many stocks that they don't have the capacity to do this, and instead make these judgments from their desk.

Not only is it hard to measure a company's contribution to one stakeholder, but also the pie contains many stakeholders. Is Amazon a pie-growing enterprise? It's a boon to customers by making thousands of products available at low prices, and its online platform allows them to compare products' specifications and customer reviews. Its 2020 Annual Report estimated that the time saved from shopping online was worth $126 billion to its 200 million Amazon Prime customers, after subtracting the cost of Prime and conservatively estimating the value of time at $10 per hour. It helps the environment by saving on physical stores in prime locations (instead, having warehouses where land is less scarce), and allows customers to resell rather than dump second-hand goods. But its treatment of colleagues is much more mixed. Amazon's warehouses involve long and intense hours, high injury frequency and little skill development. Some workers are allegedly afraid to use the toilet because it's far away and might lead to them being disciplined for idling, so they use bottles instead.[45] Against that, a 2021 LinkedIn survey ranked Amazon the most sought-after employer in the US. Amazon's overall effect on the environment is similarly unclear as the above benefits must be weighed against the large usage of cardboard packaging and shipping resources.

Pieconomics involves trade-offs. Just as navigating them requires judgment from leaders, assessing them requires judgment from investors. Funds labelled as 'responsible' might underperform, not because social performance harms financial performance, but because they don't properly evaluate social performance. Conceptually, a *screening* or *exclusion* approach to RI can't ever outperform, as it simply restricts an investor's choice set. Instead, in Chapter 9, we'll discuss a newer approach to RI – *integration* – which considers social performance alongside financial performance. Since integration broadens the set of information that an investor might use – in particular, to include information typically overlooked by the market – it has the potential to generate significant outperformance.

So the performance of responsible *investors* tells us little about the performance of responsible *investing*, because many investors may not be implementing it correctly. Statements such as 'RI works' or 'RI doesn't work' are rather meaningless since RI means many different things – just as 'food is good for you' and 'food is bad for you' mean little as it depends on the type of food. Similarly, the performance of responsible *investors* tells us little about the performance of responsible *enterprises*. ESG funds don't just assess social performance. They also look at conventional criteria such as leadership and strategy, as they indeed should, but may get these assessments wrong, like conventional funds often do. Indeed, conventional funds also underperform the market, but that doesn't mean investors should ignore leadership and strategy when picking stocks.

Another inconvenient truth is the outperformance of 'sin' industries. Harrison Hong and Marcin Kacperczyk found that, over a 42-year period, alcohol, tobacco and gaming beat the most closely related non-sin industries (soda, food, entertainment and meals) by 3.2% per year.[46] But this wasn't due to pie-splitting, i.e. these industries taking from customers by selling addictive products. If so, they should earn higher profits, which the authors didn't show. Instead, they found that sin stocks are shunned by institutional investors, such as pension funds and universities, who may be unable to hold them due to social norms. Since only a limited set of investors (not bound by social norms) can own sin stocks, the ones that do hold large risky positions. So the higher returns are simply compensation for risk.

Finally, even the studies supportive of Pieconomics may not generalise. All of the papers in this chapter study public companies because they have stock returns – they reduce reverse causality concerns and can be risk-adjusted. However, most of the studies also show that profitability improves, so it's likely that the results also extend to private firms (which don't have stock prices). Moreover, the conceptual arguments for Pieconomics aren't specific to public firms, such as how it enables long-term investments that might otherwise be passed over. But the link between social and financial performance in private firms has not yet been rigorously shown, and hopefully future datasets will allow this.

In addition, the results may not extend to other countries. Together with Lucius Li and Chendi Zhang, I extended my study of the Best Companies to Work for in America to a global setting.[47] The Best Companies list exists in 45 countries worldwide. We found 17 other countries with enough Best Companies that were locally headquartered and traded (i.e. weren't just subsidiaries of a US firm) for us to study them. The original US results did generally hold – in 12 of the 17, the returns to the Best Companies were even higher than in the US.

But they didn't *always* hold. The Best Companies don't outperform in countries with heavily regulated labour markets, such as France and Germany. That makes sense. In those countries, the law already guarantees workers a decent level of wellbeing, for example by providing dismissal protection. When the average enterprise is already treating its colleagues well, a firm that's right at the top may be investing in employee satisfaction excessively.

This result is important for two reasons. First, it highlights that even evidence – a cornerstone of this book – has limitations. Evidence is not proof. A proof is *universal*. When Archimedes showed that the area of a circle is pi times the square of its radius, he proved this not just for circles in Ancient Greece in the third century BC, but for circles in Modern Greece today and for circles throughout the world. But evidence may only apply to the country or industry in which it was gathered – evidence that the Best Companies outperform in the US doesn't mean they'll do so in France. And it may only apply to that time period. In the future, perhaps the stock market will be faster to recognise the benefits of employee satisfaction, and so investors can't earn higher returns by buying them after the list is announced. Second, the findings show how the pursuit of social value shouldn't be unfettered, as emphasised in Chapter 3. Investing beyond the point where the social benefit justifies its cost will shrink rather than grow the pie.

What's the conclusion from all this research? Pieconomics isn't a too-good-to-be-true pipedream – serving stakeholders can in fact deliver higher long-term returns to investors. But it doesn't in every single situation. So while a company's primary goal should be to create value for society, it's important that it does so in a discerning way. Foundational to this approach are the concepts and principles introduced earlier in Part I, the evidence-based reforms we'll now discuss in Part II, and the action plan of Part III.

In a Nutshell

- Many studies find a positive correlation between social and financial performance. However, there could be *reverse causality* – the latter causes the former. Studying future changes in the stock price mitigates reverse causality, because financial performance should already be incorporated in the current stock price.

- The '100 Best Companies to Work for in America' delivered stock returns that beat their peers by 2.3% to 3.8% per year over a 28-year period (89% to 184% compounded). They also generated future profits that beat analysts' expectations.
- Customer satisfaction, eco-efficiency, stakeholder-oriented policies and performance on material stakeholder issues are also correlated with superior long-run stock returns. However, performing well on all stakeholder issues, regardless of materiality, is not.
- Even if the value an enterprise generates for stakeholders can be measured today, it takes several years for this value to show up in the stock price. As a result, investors and society should use long horizons when evaluating leaders.
- Stock returns increase when shareholder proposals to improve social performance are passed. Comparing proposals that narrowly pass with those which narrowly fail addresses *omitted variables* – factors that both drive shareholder proposals and social performance.
- Responsible investment funds typically don't outperform the market, but this is likely because social performance is very difficult to measure, rather than it being a poor investment criterion. This highlights the dangers of a box-ticking approach to assessing social performance.
- Even if social performance is correlated with financial performance in one industry or country, this may not apply in others. Nor does it mean that increasing social performance without limit always increases financial performance.

Part II

What Grows the Pie? Exploring the Evidence

This Part studies the evidence for what grows the pie. Now there's a virtually unlimited array of practices that increase the value an enterprise creates for society. Better leadership, state-of-the-art production techniques and incisive marketing are unambiguously beneficial. We won't study these mechanisms here because Pieconomics doesn't have a unique angle on them. You knew that good leadership, production and marketing were desirable before reading this book. Since they create value for both investors and stakeholders, you don't need the pie-growing mentality to understand their worth.

We'll instead focus on three determinants of the pie – executive pay, investor stewardship and share repurchases – that are particularly controversial as they're viewed as benefiting leaders and investors at the expense of stakeholders. That's why they're the subject of major reform proposals around the world. But we'll see that viewing these factors through a Pieconomics lens – recognising that the pie is not fixed – shifts our thinking on them. Gains to leaders and investors needn't be at stakeholders' expense, but result from growing the pie for the benefit of all. This isn't just wishful thinking, but is borne out by rigorous, large-scale evidence. A careful scrutiny of the data will also show that many commonly held beliefs about pay, investors and repurchases, which are currently shaping influential reform ideas, aren't actually true.

Chapter 5 considers executive pay, which is seen as enriching managers at the expense of workers. Chapter 6 discusses stewardship – investor monitoring and engagement – which some argue pressures companies to prioritise short-term profit over long-run growth. Chapter 7 analyses share repurchases, which shareholders allegedly use to extract cash that could otherwise be invested in stakeholders.

I'll acknowledge that some of these concerns are founded and these mechanisms can be improperly used. But I'll also present evidence that, correctly designed and executed, they can grow the pie. The key words are 'correctly designed and executed' – which they're not always at present. I'll propose ways to significantly improve pay, stewardship and repurchases from current practices. So I'll agree with common wisdom that they need to be reformed. But the reforms that we should undertake are quite different when we realise that the pie can be grown.

5 INCENTIVES

Rewarding Long-Term Value Creation While Deterring Short-Term Gaming

In April 2010, Bart Becht became the UK's public enemy number one. Not because of any fraud, customer harm or worker mistreatment he'd committed as CEO of Reckitt Benckiser. His crime was, in many people's eyes, far worse. News broke out that, last year, he'd been paid £92 million – shattering British records for executive pay.

The media were quick to express their outrage. One newspaper argued that Bart's pay was 'so shocking it may be necessary to take a lie-down'.[1] If high pay makes you an alien, then 'Bart Becht is the Emperor Dalek'. Its trump card was to link Bart's pay to the banker bonuses that allegedly caused the 2007 financial crisis – something that would surely incite reader anger – expressing concern that the 'excess enjoyed by bankers . . . is spreading to other sectors'.[2] The newspaper suggested that bankers' pay might even be *more* justified than Bart's, because 'at least bankers do something that is hard to get your head around'.[3] Reckitt didn't sell CDOs (collateralised debt obligations) or LYONs (liquid yield option notes), but household products that had actual names rather than acronyms – Dettol antiseptic, Strepsils cough sweets and Vanish stain remover. So running it 'is not rocket science'.

A publicity-shy workaholic, Bart loathed every ounce of shame. A year later, on 14 April 2011, he resigned without warning. Yet his departure didn't spark victory parades. The same journalists who'd slammed him a year ago for being an out-of-touch alien didn't claim credit for humiliating him into quitting. Nor did they celebrate a £92 million step towards greater income equality.

Because the facts were indisputable. Bart's departure wiped £1.8 billion off Reckitt's market value, nearly 20 times his 2009 pay. The pie shrinkage from losing Bart was orders of magnitude higher than the slice of pie that could be redistributed to other stakeholders. Some equity analysts now suggested selling Reckitt stock, with Investec calling the resignation a 'strongly negative event' because 'it's hard to overstate his impact and we think Reckitt now faces an uncertain future'.[4]

The fears expressed explicitly by analysts and implicitly by the £1.8 billion fall don't prove Bart's worth. Perhaps Bart's huge pay duped the market into thinking he was special. But Reckitt's subsequent performance vindicated those fears. In the five years prior to 2011, sales, operating income and net income had grown by 14.0%, 21.4% and 21.0% per year, respectively. Over the next five years, these figures fell to 0.0%, –1.1% and –0.2%. From a human perspective, the slump was even more tangible – each year, the number of employees was lower than in 2011.

Bart lived and breathed Reckitt Benckiser. He'd been at its helm for 15 years, becoming CEO of Benckiser in 1995 and leading the combined company after the 1999 merger with Reckitt & Colman.[5] And he wasn't an ivory-tower CEO, but one who got his hands dirty – literally, as he still cleaned his own home, for which he was dubbed 'Becht the skivvy', and metaphorically, by engaging with customers at ground level. As Bart explained: 'I talk to shoppers in the store. I ask them why they're picking up the product, and then go into their house and find out why they do the laundry the way they do. If you don't like to do that you shouldn't be in this business.'[6]

His leadership had been a clear success. Since the 1999 merger, Reckitt's shares had soared from £7 to over £36 on the day his payout was announced. This represented £22 billion of value created to investors, even excluding dividends, and made Reckitt the fourth-best-performing company in the FTSE 100 over the past decade. More importantly, Bart was a pie-grower. These shareholder gains weren't from price-gouging, but from creating value for all stakeholders.

Customers benefited under Bart. Even though household products might seem vanilla, Reckitt became widely recognised for innovation. It won *The Economist*'s Innovation Award in 2009 and is the subject of Harvard and INSEAD case studies on innovation. Reckitt didn't simply throw money around: it actually spent less on R&D than its rivals Henkel, Procter & Gamble and Unilever. Nor did it hype big new launches – Cillit Bang cleaning products were the only new brand launched during Bart's tenure. Bart instead preferred incremental, yet continuous, improvements to existing offerings. He compared his approach to baseball, where teams rarely win with just home runs, but instead by stringing together a series of hits.

Bart focused Reckitt's innovation on nineteen 'Powerbrands' – which included Dettol, Strepsils and Vanish – where growth potential was high, even if the market wasn't currently large. It would have been easy to coast along with tried-and-tested laundry detergent. But this market was already saturated and so there weren't unserved customer needs to be met. So Bart shifted to automatic dishwasher products and made advances to simplify customers' lives. They'd previously used three different products in their dishwashers – powder, salt, and a rinse agent. In 2000, Reckitt launched Finish Powerball 2-in-1 tabs, which integrated a rinse agent with powder. The next year, it unveiled Finish 3-in-1 Brilliant, which included salt. In 2005, it added a glass protector with Finish 4-in-1.[7] None of these innovations cured river blindness like ivermectin. But they did make an everyday household chore, and thus millions of citizens' everyday lives, a little more pleasant.

While the output of innovation benefited customers, the process of innovation empowered colleagues. Reckitt's inventions came not only from the lab, but throughout the firm, due to the entrepreneurial culture and flat hierarchy that Bart created. As employees told the *Financial Times*, 'it's like running your own company'.[8] Workers at all levels were encouraged to generate ideas, and required relatively few committee approvals to test them out. Bart wanted his colleagues to take risks and understood that this required tolerance of failure. The executive who spearheaded the failed Dettol Easy Mop still flourished at the company afterwards. Bart invested in his people through both headcount (which grew 50% over the 2000s[9]) and skills (encouraging junior executives to switch countries and roles frequently, to develop an entrepreneurial mindset). He saw the power of diverse viewpoints – in 2008, the nine people on Reckitt's global executive committee came from seven countries, as did the top 10 US managers.

The environment benefited too. Reckitt launched the Vanish Eco Pack in 2008, which reduced plastic packaging by 70% by moving from a round tub to a resealable pouch. Between 2000 and 2011, Reckitt planted 5.4 million trees in Canada, reduced its greenhouse gas emissions by 48% and lowered energy use per unit of production by 43%.[10] During Bart's leadership, Reckitt headed the UK's Business in the Community Corporate Responsibility Index and was awarded top status in the US Environmental Protection Agency's Safer Detergents Stewardship Initiative.

So Bart's slice wasn't at the expense of society. It was the by-product of more than a decade's worth of value creation. Yet few of the articles on Bart's pay mentioned how much he'd grown the pie. And the amount that went to Bart was far less than claimed. While headlines declared that he earned £92 million in a single year,[11] only £5 million was 'compensation' for him working in 2009. The remaining £87 million came from selling shares and options that he'd received from 1999.[12] These shares and options resulted from ten years of service, not a single year's graft – they'd have still been his even if he'd quit at the start of 2009. Bart simply sold what he already owned, just like withdrawing money from your bank account doesn't give you a windfall nor make you richer. In fact, Bart could have cashed out some of these awards as early as 2003. If he'd done so, he'd have avoided any large number in a single year. Instead, he held onto them far longer than he needed to, keeping himself accountable for Reckitt's long-run performance.

Out of the £87 million of cash-in value, £80 million arose because Reckitt's stock price soared after the shares and options were granted.[13] Not only did Bart have to work for a decade to earn the shares and options, but that decade had to be an extremely successful one for them to be worth so much. Had Reckitt underperformed, Bart would have cashed in far less – avoiding any public outcry, but at the expense of society. Now the share price increase wasn't entirely due to Bart – colleagues contributed substantially to Reckitt's success, and the overall stock market also increased. We'll discuss these important complexities later. For now, the key point is that we can't label a leader's pay as excessive without assessing how much she's grown the pie.

At the same time as the cash-in, Bart actually gave an even greater amount (£110 million) to his charitable trust, which supported organisations such as Save the Children and Médecins Sans Frontières.[14] So even the slice that went to Bart was reinjected into society, but this was often excluded from the media coverage. This isn't an isolated case: 211 individuals and couples have signed the Giving Pledge, a commitment to give more than half of their wealth away. The pledges currently total over $500 billion.

Bart's departure was at the expense of both the enterprise and society. It's no wonder that during the public outcry, Bart 'was criticised by politicians but not by any of his major shareholders'.[15] Even though it's investors who bore the £92 million cost, they recognised that Bart had helped create £22 billion of value. The heavy criticism, which may have contributed to his departure, is a prime example of how a pie-splitting mindset can obstruct pie growth.

Bart's story is consistent with many people's view of executive pay. The level of pay is perhaps the single most-cited piece of evidence that business is out of touch with society. In the US, the average (mean) S&P 500 CEO earned $14.8 million in 2019, 264 times the average employee – a ratio that's increased six-fold since 1980, when it was 42.[16] In the UK, the median FTSE 100 CEO earned £3.6 million in 2019, 119 times the median worker – a ratio that's increased eight-fold since 1980, when it was 15. The High Pay Centre, a UK think tank, marks 4 January each year as 'Fat Cat Day' – the day by which a CEO has earned more than a typical colleague earns in a whole year.[17] That high pay is a recent phenomenon seems to immediately rebut any argument that pay is justified given a CEO's talent. Leaders aren't obviously more talented now than in 1980, so why has the pay ratio increased six- to eight-fold?

No other company decision, such as its product launches, pricing strategy or even its carbon footprint, attracts as much attention – and fury – as how much it rewards its executives. In the past, politicians sought voter approval by promising to reform health care and education. Now they also promise to reform executive pay. In the 2016 US Presidential election campaign, one of the few issues Donald Trump and Hillary Clinton agreed on was that pay was too high. Clinton lamented: 'There's something wrong when the average American CEO makes 300 times more than the typical American worker.' Trump, more bluntly, called high CEO pay 'a total and complete joke' and 'disgraceful'. As mentioned in the Introduction, the 46th US President Joe Biden highlighted the soaring level of CEO pay as needing urgent reform. Jean-Luc Mélenchon, the leader of the Left Party (Partie de Gauche) in France, wants to cap the ratio between the highest and lowest salary in an organisation to twenty. Similarly, in January 2017, Jeremy Corbyn, then-leader of the Labour Party in the UK, suggested a maximum wage.

Reforms have not only been proposed, they've also been passed. In 2013, the Swiss public voted for a reform to the Swiss Constitution 'gegen die Abzockerei' (against rip-off salaries). This banned sign-on bonuses and severance pay, and gave investors a binding say-on-pay vote that allows them to veto executive pay packages. Violation is punishable by up to three years in prison. In 2014, the EU limited bonuses on senior bankers to twice their salary. In 2016, Israel removed the tax deductibility of banker pay exceeding 35 times the salary of the lowest-paid worker (or 2.5 million shekels, if this is lower).

There are many reasons why CEO pay is controversial. By paying herself millions, a leader takes resources that could instead be used to pay colleagues or invest in R&D. Even worse, the CEO may cut wages or investment to hit bonus targets. And the millions she receives directly contribute to income inequality, which has been rising almost constantly since the mid-1970s.

Each of these concerns is serious. So they need to be evaluated seriously, with the highest-quality evidence. Let's start with the first concern, that a leader's pay is at the expense of stakeholders. The AFL-CIO, the US's largest federation of trade unions, releases its Executive Paywatch data under the headline 'More for Them, Less for Us'. *Forbes* published an article arguing that 'CEOs are taking too much of the pie at the expense of workers'.[18]

But this argument is founded on the pie-splitting mentality. The amount that can be reallocated through redistributing the pie is tiny. The median equity value in the S&P 500 is $24 billion. Even if a CEO were willing to work for free, reallocating her $14.8 million would release at most 0.06% of the pie.* (In the UK, FTSE 100 CEO pay of £3.6 million is 0.04% of the median firm size of £8.3 billion.) Even if we aggregated this across the whole C-suite, and accounted for trickle-down effects on the level below, it would still be dwarfed by the value increase from improving social performance, which runs into several percentage points, as discussed in the last chapter. As authors Yaron Brook and Don Watkins point out, the pie-

* The 0.06% is a significant overestimate as it is a proportion of shareholder value. The pie includes both shareholder and stakeholder value.

splitting mentality made sense centuries ago when most wealth was in the form of land – there's a fixed amount to go round. Now most wealth is financial, and financial wealth can be created.[19] A leader being paid more doesn't require colleagues to be paid less. Non-wealth factors that affect citizens' welfare can similarly be improved – curbing climate change benefits both CEOs and workers alike.

That's not to say we should be indifferent to the level of pay. Almost any potential saving (such as reducing energy usage) becomes small when you divide it by $24 billion. Instead, it highlights that how much pay costs (its *level*) is less important than how pay affects behaviour (which depends on its *structure*). Unlike Robin Hood, you don't need to rob from the rich to give to the poor. Like in the Elves and the Shoemaker, the best way to give to the poor is to directly create value.

Pay structures can either encourage or hinder value creation, so the second concern – that pay packages can distort CEO behaviour – is entirely valid. As Michael Jensen and Kevin Murphy titled their influential 1990 *Harvard Business Review* article, 'it's not how much you pay, but how'. So our bottom line is this: *The goal of pay reform should be to incentivise leaders to create long-run value for society, rather than reduce the level of pay*.

Three dimensions of pay structure are particularly important, and each leads to a desirable social outcome. *Sensitivity* leads to *accountability*, *simplicity* to *symmetry* and *horizon* to *sustainability*. We discuss each element in turn.

Sensitivity

CEO pay should be *sensitive* to performance – leaders shouldn't be paid millions for simply showing up at the office. That's why we refer to pay as reward, rather than compensation. 'Compensation' implies that a leader finds hard work so unpleasant that she must be compensated for it. This difference isn't just semantic; it affects the philosophy behind pay design. Compensation is for *effort*. It's not clear that a CEO, whom some see as flying in a private jet to meetings, puts in more effort than (say) an oil rig diver. So a compensation criterion could never justify the level of CEO pay. In contrast, reward is for *value creation*. Pay should *reward value creation* rather than *compensating effort*.

Measuring value creation is difficult because the pie consists of many slices, and it's unclear how to weight them. The evidence of Chapter 4 shows that the *long-term* stock return captures not only shareholder value, but also various measures of stakeholder value. It's reduced by pie-splitting, such as cutting R&D or employee training, even if these actions improve the short-term stock price. Consistent with the principle of (business) materiality, the long-term stock return puts highest weight on the most material stakeholders. For these reasons, it's the best available measure of the pie, even though it's not a perfect one due to externalities.

The best way to make a leader *accountable* to the long-term stock return is to cut her salary, which she receives irrespective of performance, and pay her more in shares. Note that such a remedy would be ignored by the standard focus on the level of pay. A level of $14.8 million doesn't tell you whether this is $14 million of cash and $0.8 million of stock, or $14 million of stock and $0.8 million of cash. Yet these two schemes have substantially different effects on how accountable the CEO is for performance. Under the former, the CEO is a salaried bureaucrat. Under the latter, she's an owner, who's invested – literally – in its future success, similar to the founder of a start-up. She can't earn more unless she grows the pie; if the pie shrinks, her slice shrinks. *Sensitivity* leads to *accountability*.

Are leaders paid like owners in reality? Common wisdom is that they're not. A 2016 report by Chris Philp, a UK Member of Parliament, argued that 'there is clear evidence that high CEO pay is no longer strongly associated with performance, and two academic studies clearly show in fact high CEO pay negatively correlates with performance'.[20] These studies use US data. The 2019 House of Commons Report on Executive Pay declared that 'there is no perceivable link between corporate financial performance and the sums paid out to CEOs. There is academic evidence to suggest that this link is in any case statistically weak or non-existent',[21] quoting a third paper using UK data. Outside of these reports, these three studies have been widely cited by practitioners, perhaps because they confirmed popular beliefs that CEOs don't deserve their pay.

But as we discussed in the Introduction, a study claiming a result doesn't mean it's true, because there's a huge range in the quality of studies. Indeed, none of these three papers has been published because they all make a basic error. When calculating the link between pay and performance, they only consider the amount of *new* pay that a CEO receives in a particular year. This indeed doesn't change much from year to year – Steve Jobs was famously paid $1 a year at Apple, regardless of performance. But new grants ignore the main source of a leader's incentives – her *existing* stake in the firm, which can be substantial. Despite his fixed salary, Jobs did care about performance because, in addition to intrinsic motivation, he had over $2 billion of his wealth invested in Apple stock when he died in October 2011. More broadly, the average Fortune 500 CEO holds $67 million of equity,[22] and so a 10% fall in the stock price costs her $6.7 million. That's equivalent to a $10 million pre-tax pay cut (if the CEO doesn't have capital gains against which she can offset this loss). For the UK, these figures are £660,000 and £1.2 million. As noted by PwC: 'Analysing pay using only the amounts paid in a year but ignoring previously awarded equity is like analysing investment returns based on dividends but ignoring capital gains. In other words, it doesn't make sense.'[23]

The omission is also inherent in many quotes. US Senator Bernie Sanders claimed: 'Wall Street CEOs who helped destroy the economy, they don't get police records. They get raises in their salaries.'[24] While this quote has outrage value, it simply isn't true, and no evidence was cited in support. Bear Stearns CEO Jimmy Cayne once had a $1 billion stake in his firm, which he eventually sold for $60 million. Lehman CEO Dick Fuld owned over $900 million of stock, which ended up worthless when Lehman went bankrupt. Certainly, these CEOs remained wealthy, and it's a fair question whether regulators should have the power to impose additional penalties (which we'll return to in Chapter 10). But the claim that they benefited from the financial crisis is false.

So most CEOs have large stakes in their firm. Do these stakes actually improve performance? Let's look at the evidence. Ulf von Lilienfeld-Toal and Stefan Ruenzi studied the relationship between CEO voluntary stock ownership and long-term stock returns over 23 years.[25] Firms with large CEO stakes beat those with small stakes by 4% to 10% per year, far higher than the maximum 0.06% gain from splitting the pie differently. Much more value is created by properly incentivising the CEO than is saved by cutting her pay. The firms also enjoyed higher return on assets, labour productivity, cost efficiency and investment, all consistent with growing the pie.

Of course, correlation doesn't imply causation. One interpretation is that incentives work – high stock ownership today causes CEOs to improve the stock price tomorrow. But perhaps causality is the other way. When leaders expect tomorrow's stock price to be high, they ask the board to pay them in stock rather than cash, or buy shares themselves. Either way, they hold more stock today.

To test if the first explanation is true, Ulf and Stefan studied whether the effect is greater in settings where incentives are more likely to matter, because the leader would otherwise be unaccountable for poor performance. These are cases in which few institutions own the company's shares, there are few industry competitors, takeover defences are strong, the CEO founded the company and recent sales growth is high. (The last two make it less likely that the board will fire the CEO.) In all five cases, the link between stock ownership and long-run returns is stronger, suggesting that the former causes the latter.

That incentives improve performance isn't obvious. One common argument is that they're irrelevant because leaders should have sufficient intrinsic motivation. A pharmaceuticals CEO should invent new drugs to transform citizens' health, rather than to line her pocket. When John Cryan became Deutsche Bank CEO in July 2015, he said, 'I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less.' This quote is widely cited as 'evidence' that incentives are unnecessary, but Cryan's claim that he'd work just as hard without financial accountability is unverifiable. Despite his claim, Cryan initially accepted the bonus component of his contract, but Deutsche Bank ended up making losses each year of his tenure, so he felt pressure to waive it.

There's no doubt that intrinsic motivation is important. If you have a CEO for whom intrinsic motivation isn't enough, you've got the wrong CEO. The solution is to fire her, not to give her more equity. But Ulf and Stefan's results suggest that incentives can still have an incremental effect, beyond the intrinsic motivation that should already be abundant.

People act differently when they're owners. Tenants should take care of their landlords' property, but even an honest and conscientious tenant would look after a home even better if she owned it herself. Intrinsic motivation should drive a leader to ensure good performance. But great performance often involves very tough decisions, such as admitting a past mistake and reversing a strategy that the CEO herself came up with. Even honest leaders may not always take these difficult actions. Supplementing intrinsic motivation with a substantial amount of wealth at stake may shift performance from good to great, which is what Ulf and Stefan found.

In addition to encouraging value creation, incentives also curb value destruction. Recall from Part I that charitable donations don't satisfy the principle of comparative advantage, but a CEO has private incentives to make them. The study by Ron

Masulis and Walid Reza, which we encountered in Chapter 4, found that a 10% rise in CEO ownership reduces the likelihood of corporate giving by 40%. When the CEO is a shareholder herself, she thinks twice about spending shareholders' money.

Another argument against incentives isn't that they're irrelevant – they do affect performance, but in a negative way. Many studies show that incentives backfire, because a worker focuses only on the performance measure being rewarded.[26] In 1902, the French colonial government ruling Vietnam wanted to incentivise rat hunters to kill more rats. So that it wouldn't be flooded with rat corpses, the government asked hunters to bring in rat tails to get paid. But this led to the hunters amputating tails from rats while keeping them alive, so that they could continue to breed and create more tails to be chopped off. In a more modern example, paying teachers based on test scores can lead to them teaching-to-the-test rather than instilling a love of learning and a respect for authority. All these problems are succinctly summarised in the title of Steven Kerr's classic article, 'On the Folly of Rewarding A, While Hoping for B'.[27]

But these studies typically investigate non-CEO workers, for whom there's no comprehensive performance measure. Test scores only capture a small proportion of what society seeks from a teacher. But for CEOs, there's a reasonably comprehensive measure – the long-term stock price, which incorporates stakeholder as well as shareholder value.

In addition to showing that incentives matter, Ulf and Stefan's study shows that CEOs also matter. A common criticism of high pay, even in successful enterprises, is that the leader only played a small role. There are thousands of other workers, and the company may have already been thriving before she took over. These other factors are clearly important – but Ulf and Stefan show that leaders are too. They compared firms only by their level of CEO stock ownership, and held as many other factors as possible constant. Higher CEO ownership alone led to higher long-term returns – just like changing the manager of a sports team can drastically improve performance, even if the players don't change.

Other evidence also points to the importance of CEOs. When Tidjane Thiam announced his departure from Prudential to Credit Suisse, Prudential's shares fell 3.1% (£1.3 billion) and Credit Suisse's rose 7.8% (£2 billion). But that's only an anecdote, and perhaps Prudential's stock fell not because Tidjane created value, but because his departure signalled hidden problems within the company (an *omitted variable*). To move from correlation to causation, Dirk Jenter, Egor Matveyev and Lukas Roth investigated what happens when CEOs die.[28] Unlike a departure, death isn't voluntary, so it's unlikely to be due to problems within the firm. When younger CEOs die, the stock price falls by 4.2%, while deaths of older CEOs increase it by 3.6%. The key message for our purposes isn't so much that younger CEOs tend to be better than older CEOs, but that the choice of CEO matters. The difference between a good and bad CEO is around 7.8% (4.2% + 3.6%), which is far higher than the level of CEO pay. *It's costly to hire a good CEO – but it's even more costly to hire a bad one.*

You might still be sceptical. I said it's unlikely that the CEO's death was due to problems within the firm. But maybe these problems caused her to have a heart attack. Then, poor performance causes death rather than death causing poor performance. So Morten Bennedsen, Francisco Pérez González and Daniel Wolfenzon investigated the deaths of a CEO's family members, which are likely not caused by stress from the firm's troubles.[29] If the CEO's spouse, parents, children or siblings die, this diverts her attention. If she didn't matter, other executives could fill in. In contrast, the study found that profitability falls by 12% of its average level.[30] The exception is that, if the CEO's mother-in-law dies, profits go up (although the effect is statistically insignificant).

Even though the leader is a significant contributor, she isn't solely responsible for firm performance. Indeed, current pay schemes recognise this – CEOs in large US firms receive less than 0.4% of any increase in firm value.[31] And colleagues should also be rewarded for performance improvements, as I'll soon emphasise.

Simplicity

In 2015, BP suffered the biggest loss in its history – $6.5 billion. This was a big twist of fortune compared to its $3.8 billion profit in 2014. BP argued that a different measure, 'underlying replacement cost profit', was more relevant as it excluded one-off items such as Deepwater Horizon and the fall in oil and gas prices. But even this halved from 66 to 32 cents per share. Investors suffered a 14% stock price fall, and 5,400 colleagues lost their jobs.

Yet BP increased the pay of CEO Bob Dudley from $16.4 million to $19.6 million. And investors could do nothing about it. Even though 59% voted against the pay package, this vote was only advisory rather than binding. BP went ahead with the payout, saying that it was simply following the pay policy that 96% of investors had approved the previous year.* And BP was right.

It seemed pretty simple to see that Dudley had underperformed, so how did the policy come up with a 20% pay increase? Because his pay package wasn't simple, but highly complex. There were six components to Dudley's total pay; for brevity we'll focus on just two. One is *performance shares*. Unlike the standard shares considered so far, here the amount of shares that 'vested' – that Dudley received – depended on several different performance measures: total shareholder return (TSR – stock price growth plus dividends), operating cash flow, safety

* In the UK, investors have two say-on-pay votes. One is on the forward-looking policy report, which stipulates how the firm will determine pay in the future – for example, how pay will be linked to performance metrics, and the existence of any exit payments. Here, companies are required to adopt a binding vote at least once every three years. This is the report for which BP had 96% support in 2014. The second is on the backward-looking implementation report that describes how the board determined realised pay over the past year, for which the vote is annual and advisory. This is the report for which BP had 59% opposition in 2015.

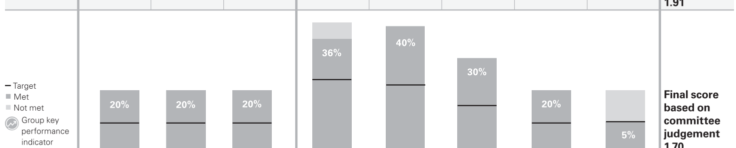
and operational risk, relative reserves replacement ratio and major project delivery. Each performance measure had its own target, and the different measures were combined and weighted by a formula. This formula churned out a figure of $7.1 million of shares, 78% of the maximum Dudley was entitled to – despite his failure on key dimensions.

The second was Dudley's cash bonus, which depended on even more measures. Figure 5.1 shows a table from BP's 2015 Annual Report which explained why he was awarded $1.4 million.

Confused? Well, you're in good company. Society, the media and even large investors couldn't figure out why Dudley was paid so much. Ashley Hamilton Claxton, Head of Responsible Investment at Royal London Asset Management, was one such investor. As she explained: 'This proposed increase is both unreasonable and insensitive. In a year in which BP has reported its worst ever annual loss, it has decided to sharply boost Mr. Dudley's remuneration . . . It shows that the board is out of touch.'

2015 annual cash bonus

	Safety			Value					
Measures	Loss of primary containment[a]	Tier 1 process safety events	Recordable injury frequency[b]	Operating cash flow	Underlying replacement cost profit	Net investment (organic)	Corporate and functional costs	Major project delivery	**Total bonus score**
Weight On target / Maximum	10% / 20%	10% / 20%	10% / 20%	20% / 40%	20% / 40%	15% / 30%	10% / 20%	5% / 10%	**100%** / **200%**
Weighted outcome %	20	20	20	36	40	30	20	5	**191% = score 1.91**



	Loss of primary containment	Tier 1 process safety events	Recordable injury frequency	Operating cash flow	Underlying replacement cost profit	Net investment (organic)	Corporate and functional costs	Major project delivery
Maximum	215 events	20 events	0.235/ 200k hours	$19.7bn	$5.0bn	-24%	11.8% improvement	6 projects
Plan/target	253 events	29 events	0.261/ 200k hours	$17.2bn	$4.2bn	-18%	5.9% improvement	4 projects
Threshold	291 events	38 events	0.287/ 200k hours	$14.7bn	$3.4bn	-7%	No improvement	2 projects
Outcome	208 events	20 events	0.223/ 200k hours	$19.1bn	$5.9bn	-27%	17.6% improvement	4 projects

[a] Adjusted in accordance with the treatment of the LOPC KPI on page 20. Full LOPC is 235.
[b] Recordable injury frequency excludes biofuels.

Figure 5.1 Executive Directors' Cash Bonus Calculation, BP Annual Report and Form 20-F 2015

But as with many issues, the arguments aren't all one-way. While BP underperformed on some dimensions, it outperformed on others. Worker injuries fell by 23% per hour worked, and safety was a key strategic priority after Deepwater Horizon. BP's 14% stock price decline actually outperformed its peer group,[32] which dropped 18%. This shows how much of BP's slump was due to the failing oil price, which was outside Dudley's control.

So reasonable people might disagree on whether Dudley's $19.6 million was justified. Instead, we'll focus here on the complexity of his pay structure – which is shared by many companies, not just BP. A bonus typically pays the CEO according to several performance measures. Sometimes these measures may be calculated over multiple years, in which case the bonus is known as a *long-term incentive plan* (LTIP). For each measure (say profits), there's a lower threshold (say £4 billion) that the leader must beat to receive any bonus at all; if she does, let's assume she gets £1 million. Since we want performance to be great, not just good, the bonus increases if profits rise above £4 billion. But we don't want her to be paid too much, so we cap the bonus at £2 million once profits reach £6 billion. Figure 5.2 illustrates this.*

Performance shares work in a similar way. In Figure 5.3, the CEO receives 100,000 shares, worth £1 million at a share price of £10, if profits are £4 billion. As profits rise, she gets more shares, until a maximum of 280,000 if profits are £6 billion. Above £6 billion, the number of shares doesn't rise, but their value does (since higher profits increase the share price).

It seems justifiable that these structures are complex, because they need to balance several considerations. A lower threshold seems critical for providing incentives, so that the CEO is rewarded only for good performance. The threshold also ensures fairness – ordinary employees don't get a bonus for

* The horizontal axis is not to scale.

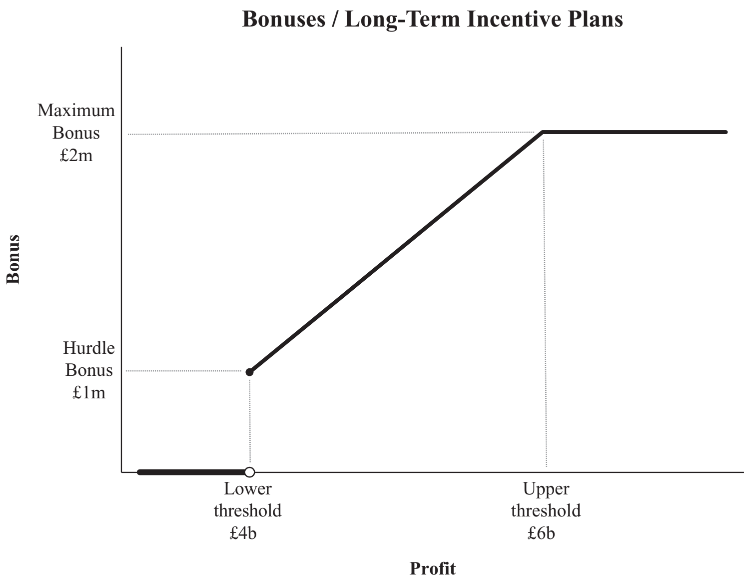


Figure 5.2

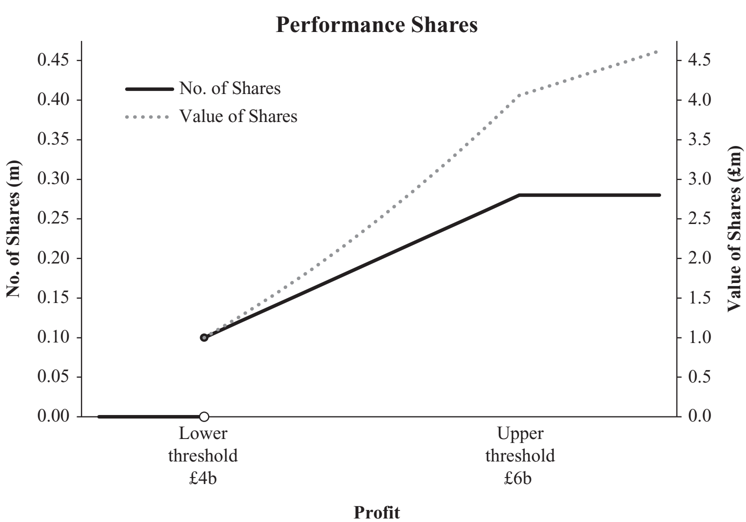


Figure 5.3

average results, so leaders shouldn't either. We need to fine-tune the lower target so that it's stretching, but also achievable, otherwise it would provide no motivation. For Dudley, was a 23% fall in injuries a good enough improvement to merit a bonus? It's not clear, so perhaps we need a detailed calibration.

The slope of the line after the £4 billion target must be high enough to encourage further improvement, but not too steep otherwise the CEO will capture too much of the gains. And we also require an upper threshold to prevent pay becoming unbounded. Thus, given a single performance dimension, we need to decide two thresholds and a slope.

But the complexity doesn't stop there. Since the CEO's job is multifaceted, her performance can't be whittled down to a single measure such as profits. Profits can be inflated through short-term actions, so we want long-term financial measures such as the relative reserves replacement ratio.* A pie-growing company should serve wider society, so we need non-financial metrics such as safety. Then, once we've decided on a comprehensive set of financial and non-financial measures, we need to weight them. Should it be 52% on profits, 27% on safety and 21% on the replacement ratio, or some other formula? Again, perhaps a giant spreadsheet might tell us the answer.

This problem is so intricate that boards have a dedicated 'remuneration committee' to come up with the solution. These committees in turn hire compensation consultants to advise them, costing the typical Fortune 100 firm $250,000 a year.[33] As we've discussed, the effect of incentives on firm value is so large that this time and money is well spent if complexity indeed improves their efficacy. And the above arguments suggest that it should.

But does it actually? Let's look at the evidence. Ben Bennett, Carr Bettis, Radha Gopalan and Todd Milbourn studied 974 firms over 15 years and found that companies were

* This measures the amount of new oil and gas reserves discovered relative to the amount of oil and gas extracted from existing reserves.

significantly more likely to just meet the lower threshold than just miss it. This seems to suggest that incentives work – perhaps unsurprisingly, performance targets encourage leaders to hit performance targets.

But they don't encourage them to create value. To paraphrase Steven Kerr, they reward A, but society and investors want B. The researchers studied what actions CEOs took to hit the targets. Leaders that just meet the target do significantly less R&D than those who just missed it, suggesting that they reached their goal by cutting R&D.[34] They also have more discretionary accruals, a way of using accounting policies to increase reported earnings.* So 'long-term' incentive plans actually lead to short-termism as the end of the evaluation period approaches. This highlights a fundamental problem with any target-based approach – non-targeted dimensions get deprioritised. Even if a bonus includes non-financial factors such as safety, it may encourage underperformance in other non-financial areas, such as corporate culture.

Another problem is that the CEO might take excessive risk. Let's say profits are just below £4 billion, so she expects no bonus. If she takes a risky project, there's a 50-50 chance of profits instead being £3 billion or £4.5 billion. Expected profits with the project are £3.75 billion, compared to just below £4 billion without it, so the project is bad for the firm. But it's good for the leader. If the project succeeds and profits are £4.5 billion, she gets a bonus of £1.25 million. If it fails, she gets nothing, but she'd have received nothing without the project. The bonus gives her a one-way bet – encouraging risk-taking even if it's pie-shrinking. It leads to *asymmetry*.

* Accruals arise when there's a timing difference between earnings and cash – for example, a magazine company receiving subscription money upfront, but only 'earning' the money when it sends out future monthly issues of the magazine. There are many legitimate reasons for accruals, but these reasons won't explain why accruals should be significantly higher for firms that just meet profitability targets than firms that just miss them.

And the problems aren't limited to the bottom end. If profits are just above £6 billion, there's no further upside. Rather than innovating, the CEO may coast and be excessively conservative. If the leader has a risky project with a 50-50 chance of profits being either £7 billion or £5.5 billion, expected profits are £6.25 billion, so the project is good. If it succeeds, she gets the maximum bonus (£2 million), but she'd have received that anyway. If it fails, her bonus falls. So she has a one-way bet in the other direction – discouraging risk-taking even if it's pie-growing. Indeed, Ben, Carr, Radha and Todd find that, where payouts taper off beyond a given target, leaders deliver results at or just above the target rather than beyond it.

These thresholds make no sense. Society loses if firm performance is bad (£3 billion) rather than mediocre (£4 billion). And society gains if firm performance is great (£7 billion) rather than good (£6 billion). But for the bonus, there's no difference between bad and mediocre, or between great and good.[35]

All of the above problems arise even if a bonus has a single performance measure. Further complexity arises if companies have multiple performance measures, because it's unclear how to weight them. Adair Morse, Vikram Nanda and Amit Seru found that the weightings sometimes change after the fact, to overweight the dimension that the leader performs best on.[36] The more complex a system is, the easier it is to game because you have more dimensions to play with.

What's the solution? It's simplicity – to replace formula-driven bonuses with standard shares that the CEO can't sell for several years (known as 'restricted shares'). The value of these shares is *automatically* sensitive to performance. It depends on the stock price in several years' time, so there's no need to lay on complex performance conditions or choose particular measures, weightings or thresholds.

Restricted shares lead to *symmetry* along three dimensions. First, the effect of performance on pay is consistent for all

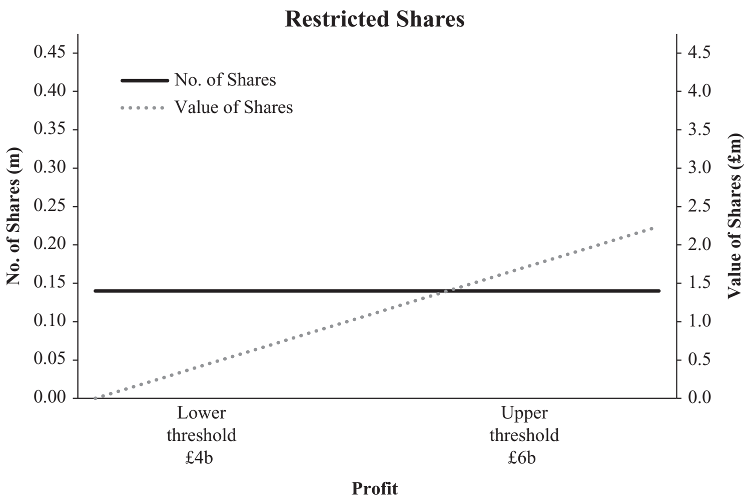


Figure 5.4

performance levels. That's shown by the constant slope of the dotted line in Figure 5.4, which illustrates what happens if we remove the £4 billion profit target and instead halve the number of shares. The leader gains from increasing profits at all levels and loses from all decreases in profits. There are no jumps in pay when hitting a target, removing incentives to cut R&D or take risks to do so. She's rewarded for delivering a performance flow, rather than meeting performance goals.

Second, restricted shares avoid the asymmetries associated with emphasising particular performance measures. The long-term stock return captures almost all actions that affect firm value, including those impacting stakeholders, and weights them according to their materiality, so we don't need an arbitrary weighting scheme. Judgment is still needed to determine how much stock to give, and it's here that the board might factor in externalities that even the long-term stock return doesn't take into account. Judgment is also needed to determine how long the stock should be locked up for, as we'll discuss shortly. But an otherwise complex problem is reduced to two dimensions – how much stock to give and how long to lock it up for.

A third dimension of symmetry is that restricted shares can be awarded to employees as well. This ensures they share in the firm's success that they helped create. When engineering firm The Weir Group introduced restricted stock for its executives in 2018, it simultaneously launched an All-Employee Share Ownership Plan for its colleagues. If a company is successful, it's never just down to the CEO. While Bart Becht created an innovative culture, it was employees who designed the new Finish products and reduced the plastic packaging in Vanish. If both leaders and workers are given shares, leaders can't gain without workers gaining also. But if leaders get bonuses and workers get shares, the bonus might pay off even if the stock price falls, leading to concerns of 'one rule for them, another rule for us'.[37]

Indeed, evidence shows that non-executive equity schemes are generally associated with higher firm performance. Han Kim and Paige Ouimet show that this link is higher when the scheme is motivated by the desire to share success with colleagues, rather than to defend the firm against takeovers or to preserve cash (since shares can be used in place of wages).[38] Yael Hochberg and Laura Lindsey find that the effect is stronger in companies with more growth opportunities, where a worker's ideas or efforts have a particularly large effect.[39] Importantly, the benefits only arise when equity is broadly distributed throughout the firm, rather than targeted to particular groups (such as the R&D team). That's consistent with the idea that giving an employee shares encourages him not only to work hard on his own tasks, but also help out colleagues, hold them to high standards and foster a performance culture throughout the organisation. Also supporting this idea, the effects of broad-based equity are stronger in small companies, where both individual effort and helping or monitoring others have a larger effect on overall performance.

There are potential concerns with paying executives in shares. Indeed, no reward plan will be perfect – but as the philosopher Voltaire noted, perfect is the enemy of good. And many of the concerns frequently voiced are actually much milder than they seem. Let's discuss some of them:

- *Even the long-term stock return depends on factors outside the executive's control, such as a rise in the stock market. So the executive gets a windfall.*

Market upswings benefit everybody. Companies buy more inputs from suppliers and hire new workers, existing workers benefit if they've been given shares, and investors gain also. The high value of leaders' shares isn't due to taking slices from other members, since the entire pie grows in an upturn. If a CEO were paid in cash rather than equity, she'd likely invest it in the broader stock market and thus still benefit from any upswing. It's much better for a CEO to be invested in her own firm, whose value is partly under her control, than other firms whose values are not.

Crucially, the effect works both ways. If there's a stock market decline, investors and stakeholders suffer – and the leader will also if she has substantial wealth tied up in her firm. But she won't if she's been paid in cash.

Despite the above arguments, windfalls might still be a concern due to the optics. In December 2017, UK house-builder Persimmon announced that CEO Jeff Fairburn's share options were worth £110 million – causing chair Nicholas Wrigley to resign as he was blamed for Fairburn's high pay. While Persimmon's market value had risen by £8 billion since the options were granted in February 2012, much of it was because low interest rates and the UK government's 'Help to Buy' scheme had boosted the housing market. It's true that, had Fairburn been given cash instead of options in 2012 and invested it in Persimmon, he'd have earned a similar amount. It's also true that, if interest rates had risen and the housing market collapsed, these options would have been worth nothing. But these arguments fell on deaf ears – what might have happened under different circumstances is far less salient than what actually happened.

If optics are a major concern, another solution is to use indexed shares whose value depends on TSR relative to industry peers. This ensures that the CEO isn't rewarded for favourable industry conditions outside her control. But a disadvantage is that she'll be insulated from a downturn, which seems unfair if colleagues are losing their jobs and investors their savings.

- *With bonuses, it's clear what the executive should do to get paid – hit a profit target of £4 billion or a sales growth target of 5%. The long-term stock return is so far off that the executive doesn't know how to hit it.*

This is true – *and is precisely the point*. It's clear how to meet short-term targets, which is why they encourage manipulation. It's much harder to improve the long-term stock return in instrumental ways – instead, it's a by-product of growing the pie. Removing targets frees the leader from trying to hit them and instead frees her to create value. She does so with the reassurance that she'll be rewarded after the fact, since creating value typically improves long-run returns. With shares, the CEO is an owner of the firm, who thinks and acts like an owner, rather than a hired outsider who's focused on maximising her bonus.

- *With stock-based pay, the payouts to an executive are unbounded. Since firm value can rise without limit, the value of an executive's shares can rise without limit.*

Pieconomics stresses that the main problem isn't paying a leader generously – giving her a large slice of the pie – but not growing the pie in the first place. With stock-based pay, the leader can *only* be paid more if value has been created. Her gain isn't at the expense of society; it's a result of creating value. If there's an upper bound, the CEO may coast as she approaches it – as the study by Ben Bennett and co-authors found.

- *If we removed the threshold in performance shares, the executive would receive her shares regardless of performance. The link between wealth and performance would be substantially weaker – she effectively receives shares for free.*

Paying an executive in shares isn't giving them for free – the firm should lower the CEO's salary so that her total package is unchanged. This observation is commonly overlooked. Bart Becht's pay was criticised for arising 'from cheap and free share schemes handed to him since the company was created in 1999'.[40] But the shares given to Bart weren't a free handout. Instead of paying Bart purely in cash in 1999, Reckitt Benckiser reduced his cash and paid him partly in equity. Indeed, doing so is like paying a CEO entirely with salary and then making her buy shares. That's a frequently suggested reform, but it allows the leader to time her share purchases to coincide with troughs in the stock price. Such gaming isn't possible if the CEO is simply paid stock in the first place.

And targets aren't needed to tie wealth to performance. I've heard some investors argue against restricted shares by calling them fixed pay, because the number doesn't depend on performance. This doesn't make sense, because their value depends substantially on performance. Recall that a US CEO suffers the equivalent of a $6.7 to $10 million pay cut for a 10% stock price fall, even without performance conditions. Targets only make her accountable for performance measures that long-term-oriented investors shouldn't care about. Creating a sudden drop if the CEO misses a threshold simply gives short-term incentives to hit it.

Indeed, shares without performance conditions are exactly what investors hold – another dimension of *symmetry* – and so fully align a CEO with investors. She's paid in exactly the same way investors are paid. Investor returns rise and fall with the stock price, rather than depending on complicated formulas. Investors don't suddenly receive more shares if profits cross a threshold, or forfeit their shares if they fall below, so the CEO shouldn't either.

Just like shares aren't free, targets shouldn't be removed for free. Since removal eliminates the risk of forfeiting shares, CEOs should accept fewer shares in return. When The Weir Group moved from LTIPs to restricted stock in 2018, it applied a 50% discount.[41] But a better alternative would be to *increase* shares and cut salary. In Figure 5.5, the solid line represents a package consisting of £1.2 million of salary plus the performance shares in Figure 5.3. The dotted line represents a new package consisting of £0.5 million of salary plus an increased level of the straight equity in Figure 5.4.

Would a CEO accept this? She should – particularly over alternative reforms to slash total pay. First, expected pay won't fall because the lower salary is balanced by more shares and no performance conditions. The line is higher in some places and

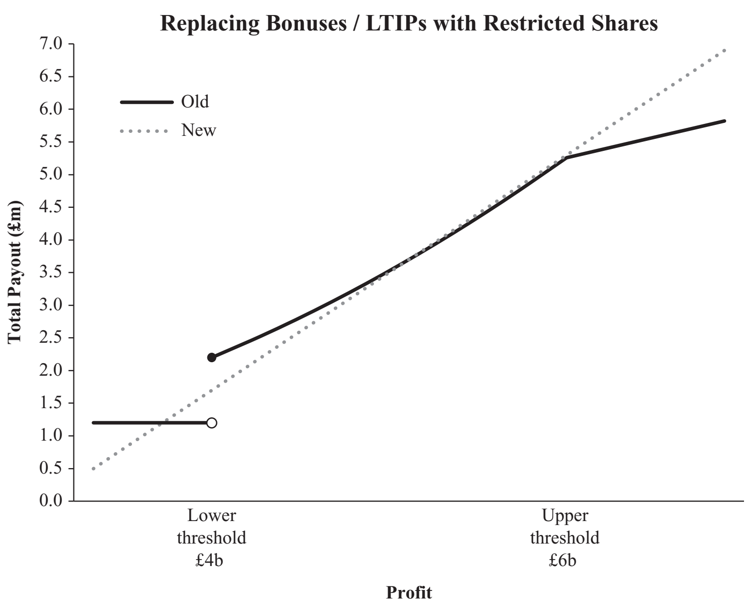


Figure 5.5

lower in others. Second, her overall wealth-at-risk (the slope of the line) won't rise. The substantial risk that the CEO used to bear at a single arbitrary threshold (£4 billion) is spread out over all levels of performance.

Restricted Shares with Underpins

If targets are removed, the CEO still receives shares upon poor performance. The shares are worth little, and Figure 5.5 shows that total pay is lower than if she'd been given performance conditions and a higher salary instead. But the optics, of a CEO keeping her shares upon poor performance, may be a concern. Critics may not recognise that she'd have received a higher salary had performance conditions been imposed. Just like with windfalls, the alternative of what might have otherwise happened is far less salient.

If these optics are a concern, share awards can be combined with an 'underpin', where they're forfeited upon a severe performance failure. An underpin is like a target, but much lower. Targets should be stretching and only reward good performance, but this encourages manipulation to hit them if performance is average. Underpins should be met except if performance is poor, and so there should be no need for manipulation. For example, The Weir Group's underpins include no material governance failures and not breaching a debt covenant. Of course, because an underpin is easy to meet, a CEO should accept a lower salary if given underpins rather than targets.

The idea of rewarding executives with restricted stock, rather than bonuses or LTIPs, is gathering momentum. The April 2017 corporate governance report of the UK House of Commons concluded that 'LTIPs' impact on incentivising performance is unproven at best, and, at worst, they can create perverse incentives and encourage short-term decision making'. It recommended they be replaced with 'shares which can only be sold after set periods of time'.[42] In the same month, the Norwegian Sovereign Wealth Fund issued a position paper on CEO pay, proposing that 'a substantial proportion of total annual remuneration should be provided as shares . . . The performance conditions of so-called long-term incentive plans are often ineffective and may result in unbalanced outcomes'.[43] In September 2019, the US Council of Institutional Investors overhauled its policy on executive pay, highlighting the merits of simple shares. Several UK companies have recently adopted restricted stock.[44]

But most still have not. This is partly due to misunderstandings of both the conceptual arguments and evidence for restricted stock, which this section has attempted to clarify. Indeed, despite these misunderstandings, the implementation challenges aren't insurmountable. When Clare Chapman, The Weir Group's remuneration committee chair, began consultations to replace LTIPs with restricted stock in 2018, she knew that many investors would be sceptical. So she met or had conference calls with almost all of Weir's anchor investors, plus ISS and Glass Lewis (proxy advisors who counsel investors on how to vote), to explain the rationale, which she always grounded in evidence. As a Harvard Business School case study explains: 'Throughout the discussions, Chapman emphasised the importance of data and evidence: "We could not afford to be working off people's opinions – we really did need to be working off a pretty solid fact base, otherwise we would have little chance of being strategically coherent to our shareholders."'[45]

But these meetings weren't just to persuade, but also to listen. Clare and her Weir colleagues heard investors' concerns and revised their initial proposal. They had a second round of investor consultations, listened to the feedback and modified it further. As a result, Weir became the first UK firm to obtain a positive vote recommendation for restricted stock from both proxy advisors. The proposal passed in April 2018 with 92% support.

Horizon

The key argument for restricted stock is that, in the long run, the stock price incorporates stakeholder as well as shareholder value. The critical words are 'in the long run'. In the short run, the stock price can be gamed – cutting R&D increases short-term profit and thus the stock price. Shouldn't the market see through such behaviour and not take profits at face value? Sanjeev Bhojraj, Paul Hribar, Marc Picconi and John McInnis compared firms that just beat analyst forecasts[46] due to low R&D, low advertising or high accruals, with those who just missed due to high R&D, high advertising or low accruals. Beaters outperformed missers by 2% to 4% in the short term, implying that the market did take the earnings increase at face value. However, over the next three years, they underperformed by 15% to 41%, suggesting that these tricks harm long-run value.

To deter such errors of commission and ensure *sustainability* of performance, share grants must be locked up for several years. Recall Angelo Mozilo from Chapter 3, who oversaw Countrywide's plunge into subprime loans. This expansion not only helped achieve Mozilo's market share objectives, but also generated short-term revenue, boosting the stock price and thus his wealth. He then cashed out $140 million of equity in the nine months to August 2007,[47] the start of the financial crisis. Countrywide's stock price fell 70% over the next five months and it had to be taken over by Bank of America. Even though Mozilo privately acknowledged that these loans might eventually become delinquent, he also knew he could cash out beforehand.[48]

Locking up equity should also deter errors of omission – not investing because the benefits will take time to appear. In Chapter 4, we saw that it takes five years for employee satisfaction to fully show up in the stock price. A CEO who's free to sell her shares in three years may not bother to improve it.

The optimal lock-up period isn't one-size-fits-all, but depends on the enterprise. It should be higher where a CEO's actions have particularly long-term effects, such as a pharma company. It should also last at least one industry cycle, so that a leader can't cash out when the stock price is temporarily high. Shares given to Exxon's executives vest half after five years and the other half after ten, requiring them to hold shares through the oil price cycle.

Importantly, deterring errors of both commission and omission requires companies to lock up a leader's shares beyond her departure. Otherwise, she may take short-term actions whose damage will be her successor's problem, or won't make investments whose fruit will be her successor's windfall. Jim Collins, in his book *Good to Great*, distinguishes between good leaders, where the company is successful only under their control (like Stanley Gault of Rubbermaid) and great leaders, whom we don't miss because the enterprise continues to flourish long after they're gone (like George Merck). We want greatness, but the way we revere leaders rewards goodness – if a company underperforms after a CEO leaves, we think her brilliance was essential to the firm. Requiring a leader to hold equity after she's left motivates greatness. Now an objection might be that this imposes too much risk on the leader. But this encourages her to reduce this risk by ensuring that the company has such strong long-term fundamentals – including a succession plan – that it's not vulnerable to her departure. Moreover, if the CEO were allowed to cash out, she'd invest most of the proceeds in the stock market, whose performance is fully out of her control.

Companies are increasingly introducing post-exit holding requirements. Former Unilever CEO Paul Polman had to hold stock worth five times his annual base salary for the first year after his departure in 2019 – a shareholding requirement exceeding £5 million – and 2.5 times for the second year. The 2018 revision of the UK Corporate Governance Code requires companies to develop a formal policy for post-departure shareholding requirements.

Clawbacks

Another way to hold a leader accountable for the long term is to impose clawbacks. Perhaps we pay leaders for hitting short-term targets – and if we later find out that they did so with bad actions, we claw back the bonus. The first settlement in the US forced former UnitedHealth CEO William McGuire to repay his company $468 million in 2007, for inflating his pay through a process known as backdating. In the UK, Barclays clawed back £300 million in staff bonuses following fines for interest rate fixing and mis-selling of payment protection insurance.

The rhetoric of clawbacks is attractive – it sounds like we're punishing leaders for bad actions. But it's like shutting the barn door after the horse has bolted. Clawbacks involve paying the leader prematurely – for good short-term performance without waiting to see what caused it – and then trying to take money back if you learn it was due to manipulation. It's far better not to open the door in the first place: not to allow the leader to sell her equity for several years. A clawback is costly to implement because it requires legal action. And a far bigger problem is that its scope is very limited. It can be applied in clear cases of fraud, such as backdating, but the lines are much greyer for short-termist actions, such as cutting R&D, which are far from fraudulent: as discussed in Chapter 3, reducing investment sometimes creates value. And it almost certainly can't be applied to errors of omission, such as failing to improve workplace culture.

What's the evidence that short-term equity causes leaders to take short-term actions? Finding convincing evidence is difficult because of the common causation vs correlation challenge. You might show that, when an executive sells shares, she cuts investment. But an *omitted variable* may drive both. If prospects are looking bleak, this might cause the CEO to rationally scale back investment, and separately to sell her shares.

Vivian Fang, Katharina Lewellen and I thus took a different approach. We measured short-term incentives not by the amount of shares the CEO actually sells, but the amount that's scheduled to vest (i.e. whose lock-ups are about to expire).[49] Upon expiry, CEOs typically sell their shares to diversify. So just before vesting, a CEO may boost the stock price so that she can sell her shares for more. Importantly, the amount of equity that vests today depends on how much equity was given several years ago, and so isn't associated with current prospects.

Studying over 2,000 firms, we found that the more equity is vesting in a quarter, the more slowly investment grows. This result was remarkably robust – it held for five different measures of investment, and also if we excluded performance shares, where vesting depends on hitting performance targets rather than the passage of time.

What do the results mean? One interpretation is that the CEO inefficiently cuts good projects to inflate short-term earnings. But a second is that she efficiently cuts bad projects. It takes effort to identify wasteful projects and shut them down, and doing so may make the CEO unpopular. When she's about to sell her shares, she's willing to take tough decisions. If true, then short-term pressures are motivating, rather than distracting – a bit like how an impending essay deadline forces students to stop procrastinating.

If vesting causes the CEO to get her act together, you'd expect her to improve performance not just by cutting bad investment, but also by slashing other expenses or increasing sales growth. We found no evidence of this, suggesting that the investment declines are myopic, rather than part of an overall efficiency programme. Also supporting this interpretation, the

CEO reduces investment more when she's more likely to get away with it – for example if she's closer to retirement and so is less concerned with the reputational damage from scrapping good investments.

Tomislav Ladika and Zach Sautner found independent corroboration that short-term equity causes short-term behaviour in a different setting. To identify causality, they studied the effect of the US accounting standard FAS 123R. This accounting change, effective from June 2005, reduced firms' profits by the value of any unvested executive options. To avoid this, many firms allowed their options to vest early – giving the CEO incentives to boost the stock price by cutting investment. One potential concern is that other events in 2005 may have affected companies' incentives to invest. So Tomislav and Zach compared companies with fiscal years ending between June and December, which had to comply with the new standard in 2005, with those with fiscal years ending between January and May, which didn't need to comply until 2006. They found that option vesting led firms to slash investment.[50]

In addition to studying the costs of short-term equity, as in the above two papers, we can also study the benefits of long-term equity. Caroline Flammer, who wrote the paper on shareholder proposals to improve social performance we saw in Chapter 4, teamed up with Tima Bansal to study a related subject – shareholder proposals to increase long-term incentives.[51] They used a similar 'regression discontinuity' approach, comparing proposals that passed with just over 50% of the vote to those that just failed. Investigating over 800 proposals between 1997 and 2012, they found that proposals that just passed improve long-term profitability and sales growth. Interestingly, performance decreases slightly in the short run, highlighting that long-term thinking requires short-run sacrifices. But the benefits outweigh the sacrifices – firm value rises overall.

So far, we've used the long-term stock return as a proxy for the size of the pie. However, it doesn't take true externalities into account, so it's only correlated with the pie, not identical to it. Caroline and Tima also investigated measures of stakeholder value. Ratings for the environment, customers, communities and especially colleagues improve. They also study innovation, which benefits both stakeholders and investors. Long-term incentives cause firms to generate more patents, higher-quality patents and more innovative patents.[52]

These three studies highlight the importance of pay horizons. Cutting the level of pay will win more headlines, but extending its horizon has a much greater effect on society as it affects the CEO's incentives to invest. Indeed, the 2018 UK Corporate Governance Code extended the minimum horizon from three to five years. Recall the Norwegian Sovereign Wealth Fund's pay principles, which argue that CEOs should hold significant equity in their firms. These principles also recommend that these 'shares are locked in for at least five and preferably ten years, regardless of resignation or retirement'.[53] Similarly, when the Council of Institutional Investors revised its pay policy in September 2019 to advocate restricted stock, it suggested that it 'might begin to vest after five years and fully vest over 10 (including beyond employment termination)'.

To sum up, the following table highlights the three key dimensions of long-term shares, and the positive outcomes they create:

Pay Dimension	**Pay Outcome**
Sensitivity	Accountability
Simplicity	Symmetry
Horizon	Sustainability

Pay Ratios

We've discussed three pie-growing ways to reform reward: make the leader a significant owner; simplify pay by removing complex bonuses; and increase the horizon of pay. We now turn to a frequently proposed pay reform, which, while well-intentioned, may backfire because it's based on pie-splitting.

This remedy concerns the ratio of CEO pay to average worker pay. The basic form of the remedy is to force firms to disclose this ratio, as the US and the UK have required from 2018 and 2019, respectively. In 2020, the World Economic Forum, in conjunction with the 'Big Four' accounting firms (Deloitte, EY, KPMG and PwC), released a set of Stakeholder Capitalism Metrics that they recommend all companies report – which included the pay ratio as a 'core' metric. Some investors take this further by using the pay ratio as an investment criterion or actively trying to lower it. In 2017, Black-Rock wrote to over 300 UK companies to say it would only approve salary increases for CEOs if worker wages increase by a similar amount. The media has frequently shamed companies for having a high pay ratio, and policymakers have started to penalise it too. In 2016, the Portland City Council in Oregon imposed an extra 10% tax on companies with pay ratios exceeding 100, and 25% if they exceed 250. San Francisco passed a similar law in 2020.

The idea behind pay ratio disclosure is that a high ratio is unfair. Indeed, Chapter 4 highlights the importance of treating colleagues fairly. Surely, paying them 264 times less than the leader is the antithesis of fairness? An unfair split of the pie may in turn shrink its size, by demotivating the workforce and damaging the culture. So it seems prudent for not only governments but also investors to closely monitor the pay ratio.

But fairness isn't the same as equality. What's fair is what's merited by performance. If I gave all my students the same grade, regardless of their performance, that would be equal, but unfair. A comprehensive meta-analysis by Yale psychologists Christina Starmans, Mark Sheskin and Paul Bloom, entitled 'Why People Prefer Unequal Societies', concluded that citizens dislike not inequality, but unfairness.[54] In a CEO context, fairness is pay that's proportionate to her contribution – pay should *reward value creation*.

That's what giving long-term equity achieves. The correct benchmark isn't how much a CEO's colleagues are being paid, but how much she's grown the pie. Indeed, the frequent shaming of high-ratio firms typically doesn't ask whether the leader's high pay is merited by performance. In 2017, JP Morgan CEO Jamie Dimon was lambasted for a ratio of 364 – but the stock price had risen 62% over the past two years.

The pay ratio measures how the pie is split between the CEO and employees. It ignores other stakeholders, but more importantly it ignores the size of the pie and thus the main way leaders can create value for society – growing the pie. The ratio can appear worse even if there's a Pareto improvement where everyone's better off. If an enterprise generates £8 billion of value, the CEO gets £4 million and the average worker earns £32,000, the ratio is 125:1. If the CEO innovates so that the enterprise generates £12 billion of value, she gets £6 million and workers earn £40,000 – everyone benefits – but the ratio increases to 150:1. Pieconomics holds a leader accountable for creating value, but a pay ratio instead holds her accountable for being paid not too much more than her colleagues.

This isn't just a hypothetical example. Sabrina Howell and David Brown find that when US firms win government R&D grants, they share a significant amount of this success with workers. Employees enjoy an average 16% pay increase, but the founder gains more – since she has a larger effect on the firm, her pay is more sensitive to both increases and decreases in performance.[55] So the pay ratio rises, even though everyone is better off. Indeed, in the Introduction, we mentioned research which found that, when the pay ratio is higher, firms are more valuable and perform better.[56] That paper, by Olubunmi Faleye, Ebru Reis and Anand Venkateswaran, used US data. A separate study by Holger Mueller, Paige Ouimet and Elena

Simintzi showed that, in the UK, higher ratios are associated with stronger valuations, profitability, long-run stock returns and earnings surprises.[57] For example, firms with a pay ratio in the top third outperform those in the bottom third by 9.7% to 11.8% per year, after controlling for other determinants of stock returns. Interestingly, Ingolf Dittmann, Maurizio Montone and Yuhao Zhu also documented a positive link between pay ratios and performance in Germany, even though its social norms are different from the UK and US.[58]

A separate issue is that the pay ratio is incomparable across firms. It's lower in Goldman Sachs (178:1 for 2019) than Walmart (983:1) – not because Goldman's CEO is modestly paid, but because his colleagues are richly paid. Even within an industry, it will depend on an enterprise's business model. It's lower in Goldman Sachs than JP Morgan (393:1) because the latter owns a retail bank, Chase. It's lower in Dunkin' Brands (42:1) than Chipotle (1,136:1) because Dunkin' franchises out all its Dunkin' Donuts and Baskin-Robbins restaurants; Chipotle franchises none and so directly employs lower-paid service staff. A company that hires more part-time workers, outsources or automates low-paid jobs, or pays more in salary rather than training, vacation days and working conditions, will report a higher average pay for full-time employees and thus a lower ratio. Indeed, leaders may take such actions to manipulate the ratio.

Rather than assuming that high pay ratios are either good or bad, Ethan Rouen studied what the pay ratio *should* be given a firm's circumstances. He estimated the appropriate level of employee pay given local economic conditions (for example, local average pay in the industry), firm characteristics (for example, profitability and sales growth) and workforce composition (for example, the percentage of employees working in R&D), and similarly the appropriate level of CEO pay given firm characteristics. This allowed him to decompose a firm's actual pay ratio into both an explained and an unexplained component. Company performance is decreasing in the unexplained component, highlighting how unwarranted inequality is destructive. But it's increasing in the explained component – justified disparities are supportive of firm value, echoing the three studies earlier of total ratios. Ethan's study highlights the danger of comparing pay ratios across firms, or even within a single firm over time, without taking circumstances into account.[59]

What about inequality? Social welfare depends not only on the size of the pie, but its distribution. But the pay of the 500 CEOs in the S&P 500 has very little effect on inequality across the 250 million adults in the US. Steve Kaplan and Josh Rauh show that pay in private equity, venture capital, hedge funds and law has risen faster than for CEOs.[60] The *Forbes* 400 list of the wealthiest American residents contains far more hedge fund, private equity and real estate investors than public company leaders.

Pay has risen even in non-corporate settings. Take Cristiano Ronaldo, the Portugal and Juventus footballer. Even though Ronaldo is a brilliant player, it's hard to argue that he's substantially better than Johan Cruyff. Cruyff is widely regarded as one of the greatest footballers of all time, and won the Ballon D'Or for the world's best player three times in the 1970s. Yet Ronaldo earned €31 million in 2020, even excluding endorsements. His salary is far more than the $600,000 per year Cruyff earned in his heyday.[61] Adjusting for inflation, that's €2.7 million in 2018. This difference is because football is now a multi-billion-dollar industry, due to TV advertising and a global marketplace. Even if Ronaldo is only a tiny bit better than the next-best midfielder, these tiny differences in talent could have a huge effect on Juventus's profits. If Ronaldo goals get Juventus into the Champions League, that's worth hundreds of millions. So it's worth paying top dollar for top talent. Indeed, we see pay rising in almost every scalable profession. J. K. Rowling isn't clearly more talented than Jane Austen, but is paid far more since her books can be sold worldwide, adapted into movies and used to create merchandise. Actors, musicians and even reality TV stars have a much greater reach, and thus command much higher pay, than in the past.

This observation can explain why pay has risen so much for CEOs. It's hard to argue that CEOs are more talented now than in the past. Instead, talent has become more important. Just as the football industry has become much bigger, so have companies. They also compete in a global marketplace, and technology changes so rapidly that the inability to keep up can render firms virtually extinct – contrast BlackBerry with Apple. Thus, just like in football, it's worth paying top dollar for top talent. Average firm size in the S&P 500 is $24 billion. So even if a CEO is only slightly more talented than the next-best alternative, and contributes only 1% more to firm value, that's $240 million. Suddenly, her $14.8 million salary doesn't seem so out of line.

That's the argument in one of the most influential finance papers so far this century, by economists Xavier Gabaix and Augustin Landier. It was cited as a reason for Xavier being awarded the Fischer Black Prize for outstanding research by a financial economist under 40 (similar to a Fields Medal for maths). Moreover, it's not just an abstract theory; you can test it.[62] The authors show that the increase in US CEO pay between 1980 and 2003 can be fully explained by the rise in firm size over that time. An update with Julien Sauvagnat, studying 2004 to 2011, shows that subsequent changes were also linked to firm size – in 2007 to 2009, firm size fell by 17% and CEO pay by 28%.[63]

The global marketplace for CEOs means that they sometimes leave firms because they're not being paid the market rate, even if their salary seems generous to the ordinary citizen. On 21 October 2019, Namal Nawana resigned from UK medical devices firm Smith & Nephew due to being underpaid. His base salary of $1.5 million, rising to $6 million if all targets were met, was much higher than his colleagues' average of $55,000. But that's not the correct comparison. Nawana previously ran US diagnostics company Alere, earning $11.1 million in 2015 and $8.6 million in 2016. He joined S&N knowing he'd be paid less, because – in his words – 'I genuinely like this opportunity.' So CEOs are willing to take a pay cut for a job that excites them. But just like any other employee, there's a limit to how much of a cut they're prepared to accept. In Nawana's case, the cut the board insisted upon was just too big. S&N's stock price had risen by 40% in his 18 months at the helm. His departure caused the pie to shrink – the stock price fell by 9% on the announcement, translating into £1.4 billion of value loss.

Why does this logic apply only to CEOs and not employees? Because a CEO's actions are scalable. If she implements a new production technology, or improves corporate culture, this can be rolled out firm-wide, and thus has a larger effect in a larger firm. 1% amounts to $24 million in a $2.4 billion firm, but $240 million in a $24 billion firm. Most employees' actions are less scalable. An engineer who has the capacity to service ten machines creates $80,000 of value regardless of whether the firm has 100 or 1,000 machines.

We can draw two takeaways from this observation. On the one hand, it means that high pay for CEOs is part of a general trend throughout society. It needn't imply that rising executive pay is an inside job, rubber-stamped by boards who are in the leader's pocket – no matter how attractive this story sounds. On the other hand, it suggests that the problem of inequality is much more serious and widespread than implied by skyrocketing CEO pay. Pay has been rising in any scalable profession, so addressing income inequality *within firms* is an ineffective way of addressing income inequality *within society*. Inequality within society should be addressed more systematically than just focusing on CEOs, such as a higher rate of income tax above £1 million or higher inheritance tax (without taxes becoming so high that they erode incentives). Doing so will address income inequality from all scalable professions, not just public company CEOs.

This scalability – and the resulting inequality – will only increase post-pandemic, given the rise in remote working. Bankers, lawyers and consultants can advise more clients since there's less need to travel to them. Business school professors can reach thousands of students through online courses, no longer constrained by the capacity of a lecture theatre. Elite fitness instructors aren't limited by the size of a studio; in the pandemic, celebrity trainer Joe Wicks taught a workout to a million viewers. While this was for free, the scalability highlights the monetisation opportunities for superstars and the potential cannibalisation of colleagues in the same profession.

Summing up all the evidence, what does it mean for executive pay reform? Current reforms try to crack down on the level of pay, but doing so will only split the pie differently and I know of no evidence that cutting CEO pay improves either investor or stakeholder value. The structure of pay – its sensitivity, simplicity and horizon – is more important and ensures that a leader is rewarded only for growing the pie for the benefit of both investors and stakeholders alike. Rather than bringing the CEO's slice down, reforms should encourage the CEO to bring other stakeholders' slices up.

When Levels Matter

Throughout this chapter, we've argued that the structure of pay is more important than its level, because the former provides incentives to grow the pie, while the latter is focused on its division. We argued that there needn't be a trade-off between the level of pay and stakeholder value, since a talented CEO can create substantially more value than her salary.

But there's one important case in which the level of CEO pay does matter – a downturn when the pie is shrinking. This is a situation where the division of the pie affects the size of the pie, for two reasons. First, if the CEO accepts a pay cut, this reduces the number of workers who have to be laid off or furloughed. While CEO pay is very small compared to firm value, in a downturn it might be sizable compared to a company's cash reserves, so a cut can indeed provide a lifeline to colleagues. We saw in Chapter 1 how Barry-Wehmiller cut the pay of all its employees, from secretary to CEO, in the aftermath of the financial crisis; by doing so, not a single colleague lost his job. Second, a pay cut signals that the CEO is in it together with her stakeholders and investors, and is willing to suffer when everyone else is – improving morale and fostering a team mentality. In the coronavirus pandemic, many leaders worked for free for several months; a quarter of CEOs in the FTSE 100 accepted pay cuts of at least 20%.[64] Importantly, these cuts were to cash salary rather than equity, so they didn't affect the leader's incentives.

The normal resistance to salary reductions is that an executive might leave, but very few firms were hiring in the pandemic – they lacked the money to do so, and didn't want to add to the disruption by changing their CEO. Thus, while a responsible business should recognise the importance of retaining a great leader, it should also recognise when these retention concerns subside and maintaining other investments becomes more paramount.

In a Nutshell

- Common criticisms of, and proposed remedies to, leader reward focus on the level of pay. This is based on pie-splitting. The amount of value that could be redistributed to other stakeholders by reducing pay is very small: CEO pay, while large compared to average wages, is tiny compared to enterprise value.
- Far more important than how much pay costs (its *level*) is its effects – whether it incentivises leaders to grow the pie by creating long-term value or shrink it by pursuing short-term targets. The goal of pay reform should be to encourage value creation rather than reduce the level of pay.
- The effects of pay depend on its *structure*, which comprises three dimensions:
    - The *sensitivity* of wealth to performance leads to *accountability*. Sensitivity is much higher than commonly believed, due to a leader's sizable

  shareholdings. These shareholdings are significantly correlated with future stock returns and the relationship is likely causal.
  - The *simplicity* of pay leads to *symmetry*. Complex target-based bonuses encourage a leader to focus only on the targeted performance measures, and may encourage excessive risk-taking close to the lower threshold or coasting close to the upper threshold.
  - The *horizon* of pay leads to *sustainability*. Lengthening the leader's horizon can deter both errors of commission (taking short-term actions that destroy value) and errors of omission (failing to invest for the long term).
- The pay ratio is based on pie-splitting and compares two incomparable quantities. A leader's pay should be tied to her performance, not worker pay. Colleagues should be paid fairly irrespective of executive pay. The pay ratio is incomparable across companies, even within the same industry, and a focus on the ratio can encourage manipulation.
- Fairness can be addressed by giving stock to all colleagues, not just executives, allowing them to share in any value increase that they help create.
- Pay has increased substantially across all scalable professions, not just CEOs, and for arguably justifiable reasons – their potential value creation has grown. The move to a virtual world post-pandemic will further increase the scalability of scarce talent. Thus, inequality should be addressed in a systematic way, such as a high income tax on earnings above £1 million, rather than trying to regulate the pay of CEOs only.
- The level of pay does matter in a downturn. Financial constraints bind, so a CEO pay cut can save other employees' jobs. In addition, cutting pay when other members are suffering fosters a team mentality.

6 STEWARDSHIP

The Value of Engaged Investors that Both Support and Challenge Management

In 1995, the Fidelity Value Fund was a prime place for Americans to invest their money. Its performance had outstripped its peers over the five years since manager Jeff Ubben took the reins, attracting hordes of new savers who wanted in on the action. This new money should have been an unmitigated blessing to Jeff, as it boosted the fund to $5 billion.

But there's a catch. A fund can't hold too large a position in any one stock, otherwise it bears too much risk. And if your stake exceeds 10%, US law classifies you as an 'insider', which restricts you from selling your shares – then you're stuck if your own investors need to withdraw. So this new money had to be invested in other stocks, which spread Jeff and his team too thinly. Jeff recounted: 'Every day, I ended up having new money coming in which would dilute my fund and I would end up with 120 positions, instead of concentrating on my best ideas. And every time I would get it back down, the fund would grow and I would end up again with 120 positions.'[1]

To focus on his best ideas, Jeff co-founded the activist fund ValueAct, which holds a concentrated portfolio of only 10–15 stocks. An *activist* fund doesn't simply buy a stock and wait for it to go up. Instead, it tries to influence how the enterprise is run, known as *engagement* or *activism*.* Investor activism is widely misportrayed, based on hand-picked anecdotes. The best-selling book and movie *Barbarians at the Gate* dramatises investor KKR's takeover of RJR Nabisco as a bloodthirsty

* The latter term is more commonly used for more confrontational engagement, but we'll use the two interchangeably.

battle, like barbaric invaders plundering a civilised city. Stories like these promote a popular image of activists as plundering companies by firing workers, price-gouging customers and slashing R&D.

In response, executives and policymakers push for defences against these barbarians. In 2014, France enacted the Loi Florange, a law that halves an investor's voting rights until he's held his stake for at least two years. Some enterprises, particularly young tech firms such as Facebook, Google and Snap, feature 'dual-class shares', where the shares sold to outside investors give only a tenth of the voting rights of shares held by the founders – or, in the case of Snap, no voting rights at all.

Certain instances of activism are indeed bruising battles, but these battles often create value rather than stealing it. In *Barbarians at the Gate*, the real barbarians were inside the gate – RJR Nabisco executives who wasted money on pie-in-the-sky projects like the Premier smokeless cigarette, a venture hidden from the board for several years that wasted over $800 million. Particularly egregious was their perk consumption. The firm had ten private jets and 36 pilots which flew not only executives, but also the CEO's dog (listed as passenger 'G Shepherd') to golf tournaments, and were housed by a hangar containing $600,000 of furniture and surrounded by $250,000 of landscaping. KKR created substantial value simply by ending such abuse of investors' – and society's – resources.

But most engagements are far more boring, and far more collaborative, than commonly believed. As Pieconomics stresses, investors and leaders are on the same team. Jeff and his colleagues at ValueAct are pie-growers. The 10–15 stocks they choose to own are ones where they believe the pie is much smaller than its potential. They then engage with each company to help it realise this potential.

A prime example is how ValueAct helped turn around Adobe. Ex-Xerox colleagues John Warnock and Charles Gerschke founded Adobe in 1982 to develop PostScript, a way for printers to handle different fonts and geometric objects. Such was its promise that Apple CEO Steve Jobs offered $5 million to buy Adobe after just a year. John and Charles turned him down, instead selling Apple a 19% stake and a five-year licence for PostScript. Thanks in part to Apple using it in its Laser Writer printers, by 1987, PostScript became the first industry standard for computer printing. Two years later, Adobe launched Photoshop, an image editing software, and in 1993 its Portable Document Format (PDF) which converts spreadsheets, presentations and documents into a universal format for easy sharing. The momentum continued, and a crowning moment was its 2005 purchase of rival Macromedia. That gave it a suite of new products, such as Dreamweaver for website design and Flash for video and audio streaming. Its stock price soared 584% from the start of 1999 to the end of 2007.

But then Adobe started to lose its way. It suffered poor sales on its Creative Suite products, into which it had integrated Macromedia. Apple, which had earlier catalysed PostScript's growth, hit Adobe with a hammer blow in 2010 by refusing to allow Flash on its products – instead preferring its rival HTML5. As a result, Adobe had to fire 2,000 employees across three rounds of cuts in 2008, 2009 and 2011.

ValueAct was well aware of all these problems, and more. It saw Adobe as an outdated company that focused too much on desktop products, had missed the mobile revolution and clung to the archaic model of selling rather than licensing its software. But it also saw potential in Adobe that the rest of the market didn't, and so invested in it. Between September and December 2011, ValueAct accumulated a 5% stake. Adobe management stated that they 'talked frequently' with ValueAct after it became a large investor, and found 'their input on our business and our strategy to be helpful'.[2] In December 2012, with ValueAct now owning 6.3%, Adobe appointed ValueAct partner Kelly Barlow to its board.

With a ringside seat, ValueAct started to do what its name promised – act to create value. Far from the common portrayal of going for the quick buck, this was a long-term game. As Jeff said, 'I don't need the quick hit . . . You can't just keep throwing stuff at the wall, you need to get in there, get the information and work on a long-term plan that is going to be sustainable.'

Left alone, Adobe might have tried to revive Flash. Having paid $3.4 billion for Macromedia, it was reluctant to cut its losses and admit that buying Macromedia was a mistake – just as Daewoo refused to exit the Vietnamese car market. ValueAct hadn't been involved in the Macromedia purchase, wasn't emotionally tied to it and so could provide an outside perspective. It encouraged Adobe to move away from Flash and embrace HTML5 rather than viewing it as the enemy. So Adobe started to create content using HTML5 and other open technologies, and ended Flash for good on the last day of 2020.[3]

The transformations extended well beyond Flash. Having fallen behind in the mobile revolution, Adobe started developing new and better mobile apps. It transitioned to a subscription-based revenue model, reducing piracy and giving Adobe a more stable income than one-off purchases. This not only pleased Adobe's finance department, but also encouraged innovation – like the removal of short-term targets discussed in Chapter 5. Photoshop creator Thomas Knoll explained: 'Engineers were very much in favour of the transition. Previously, they had to come up with new features every two years, and these features had to demo well, because you had to convince someone to buy a new version based on those features . . . Now the incentive is to create features people actually use and don't want to do without. I think it's a better incentive to have engineers making a product more valuable to its users than to make eye candy for a demo.'[4]

Adobe's revenue grew from $4.2 billion in 2011 to $7.3 billion in 2017. As Figure 6.1 shows, after seven years of stagnation, its stock price more than tripled between ValueAct's initial entry in December 2011 and its exit in March 2016. Stakeholders benefited too. Expanding into HTML5 allowed customers to integrate Adobe's products with Apple's, and

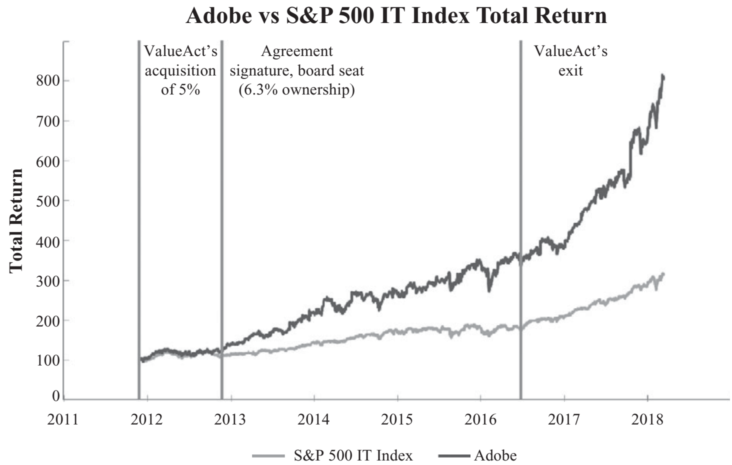


Figure 6.1

the mobile apps let them use Adobe's products across different devices. Between 2011 and 2017, Adobe's headcount grew from 10,000 to 18,000 and its tax payments soared from $202 million to $443 million.[5]

And ValueAct didn't just focus on turnarounds that would pay off during its own investment horizon, but also beyond – Adobe's stock price doubled in the two years since its exit. Why did ValueAct sell out? Because it had already set Adobe back on track, and found pie-growing opportunities in other companies. In September 2016, it bought 4% of Seagate Technology. Contrary to the common view that investors are the enemy, Seagate approached ValueAct to buy a stake[6] and granted it an 'observer' seat on the board (allowing participation in all discussions, but no vote). As CEO Steve Luczo explained, 'Seagate approached ValueAct to . . . become an investor in our company, given their commitment to and success in creating long-term value for the companies in which they invest.'

ValueAct's turnaround of Adobe is only a hand-picked anecdote. There are other cases where activists boost short-term profits at the expense of long-term value. Carl Icahn took a 20% stake in Trans World Airlines and sold its profitable assets, causing it to go bankrupt. So what usually happens – is ValueAct an exception or the rule? Why do some investors succeed in improving the companies they own, but others fail? And can shareholders enhance a firm's performance even without influencing how it's run? These are some of the questions we'll explore in this chapter.

The Long-Term Benefits of Hedge Fund Activism

Let's start with the first question – is ValueAct an outlier? To answer that, we first need to understand the type of investor that ValueAct is. It's a particular type of activist investor – an activist hedge fund. A *hedge fund* can short-sell stocks as well as buy them, whereas *mutual funds* can typically only do the latter. But while hedge funds are most known – and most notorious – for short-selling, that's not their most critical feature for Pieconomics. Two other features are more important. First, while a mutual fund charges its clients around 1% of the money it manages each year, a hedge fund charges 2% plus – importantly – a performance fee of 20% of the fund's profits. Second, while mutual funds aim to beat the market, hedge funds aren't evaluated against the market, but in isolation. So they strive to generate positive returns even in a down market.

If activist investors are seen as the worst species of shareholder, activist hedge funds are a particularly maligned breed. Perhaps their strong performance incentives and need to generate returns in all conditions spur them to inflate short-term profits. As author Peter Georgescu writes: 'Shareholder activists . . . are more like terrorists who manage through fear and strip the company of its underlying crucial assets . . . extracting cash out of everything that would otherwise generate long-term value.'[7] In 2016, US Senators Tammy Baldwin and Jeff Merkley proposed the Brokaw Act to crack down on activist hedge funds, claiming: 'Activist hedge funds are leading the short-term charge in our economy. They abuse lax securities laws to gain large stakes in public companies . . . We cannot allow our economy to be hijacked by a small group of investors who only seek to enrich themselves at the expense of workers, communities and taxpayers.' These concerns are serious, and if true, should be urgently addressed.

But are they actually true? Let's look at the evidence. Finance professors Alon Brav and Wei Jiang have spent over a decade studying the effects of hedge fund activism, in a series of papers with various co-authors. This research is important even though activist hedge funds are only a small part of the investment industry, and thus far from the only focus of this chapter, because they're viewed as the epitome of a pie-splitting investor. But the evidence shows they often grow the pie.

When an investor buys a 5% stake in a US firm and intends to affect how it's run, it must file a 'Schedule 13D' form, stating the changes it wishes to pursue in Item 4 of that form. Alon, Wei and legal scholars Frank Partnoy and Randall Thomas analysed over 1,000 13D filings by activist hedge funds. They found that a 13D increases the stock price by an average of 7%, with no long-term reversal.[8] In a separate study, Alon, Wei and Lucian Bebchuk discovered that even after the hedge fund exits, stock prices keep rising for the next three years – like the Adobe case, and contradicting common concerns that hedge funds 'pump and dump'.[9] As Paul Singer, founder of the activist investor Elliott, argues: 'The benefits of fixing a broken strategy, getting rid of a bad acquisition, redeploying an underperforming asset, or replacing an ineffective management team or board may show up right away in a company's stock price, but that immediate result doesn't diminish the long-term benefits.'[10] Moreover, hedge funds typically own a company for two years, attenuating concerns they're not around long enough to implement long-term improvements.

Now rising stock prices could simply be due to hedge funds extracting dividends or piling on debt to save taxes, rather than

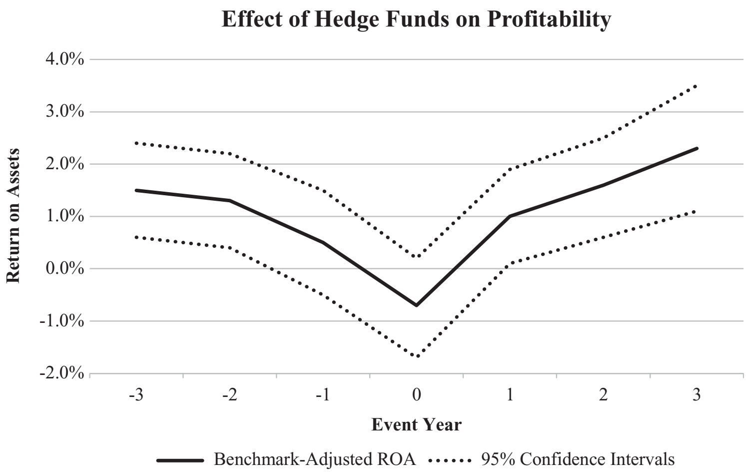


Figure 6.2

improving actual performance. So together with Hyunseob Kim, Alon and Wei then investigated hedge funds' impact on profitability.Figure 6.2 tells a thousand words.[11]

The 'Event Year' is when the investor files the 13D, and the solid line is return-on-assets (ROA) relative to the industry. ROA falls significantly before hedge fund entry, suggesting that hedge funds aim to turn around underperforming firms. After the 13D, ROA rebounds – and it's not just a flash in the pan.* The improvement becomes stronger year after year, and the results continue to hold even if you look five years out.[12]

Still, higher profitability isn't conclusive evidence of pie-growing – it might be at the expense of other stakeholders. Perhaps spurred on by the hedge fund's short-term demands,

* It could be that the changes in productivity were caused by factors other than hedge fund activism. The '95% confidence intervals' show the range for the possible impact of activism after taking random variation into account. Since even the lower dotted line is greater than zero from year 1 onwards, this shows that activism increased profitability even after accounting for random variation.

the company now overworks employees, compromises product quality or squeezes suppliers. To dig deeper and find out the root causes of the higher profitability, you'd have to obtain information on the productivity of each individual manufacturing 'plant'. But this data isn't available in any annual report or public filing – it's confidential and housed by the US Census.

So Hyunseob jumped through many hoops to get access. He first wrote a detailed proposal to the Census Bureau to convince them of the benefits of the research. This involved multiple rounds of revision and resubmission before it was finally approved. He then applied to become a special 'sworn status' researcher with the Census Bureau, which required background checks and an interview with a federal government agent.

After finally obtaining access to the data, Alon, Wei and Hyunseob found that plants targeted by hedge funds enjoyed a rise in total factor productivity, but there was no recovery for similarly underperforming plants that weren't targeted.[13] The recovery isn't just a bounce-back that would have happened anyway. In Figure 6.3, the solid line tracks the productivity of a targeted plant and the dotted line a similar non-targeted plant.*

You might still be sceptical. Total factor productivity measures output relative to wages (and other inputs). Maybe the hedge fund turns a plant into a sweatshop, cutting wages or increasing hours. So Alon, Wei and Hyunseob drilled further and studied labour productivity – output per labour hour.[14] This rose by 8.4% to 9.2% over the three years after the 13D. Indeed, working hours didn't rise and wages didn't fall.

Surely, the common concerns about hedge funds can't all be false? Indeed, they're not. The researchers found that hedge

* The scale on the y-axis is 'standardised' total factor productivity, which standardises the productivity measure to have a standard deviation of 1. The actual standard deviation is 0.32. Thus, a y-axis value of 0.1 corresponds to a 3.2% (= 0.1 * 0.32 = 0.032) increase in total factor productivity.

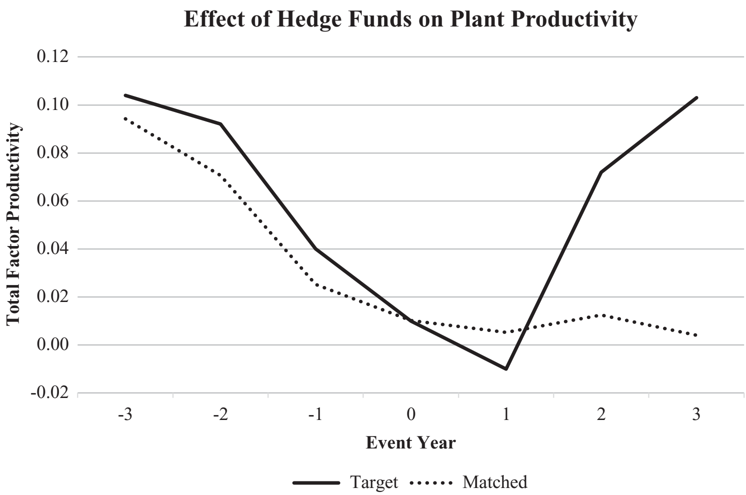


Figure 6.3

funds do lead to companies selling plants. When it comes to the accusation of being asset strippers, they're guilty as charged.

But there's a twist. The Census data allowed the researchers to track the productivity of the plants under their new owners. It improves – but it doesn't improve when plants are divested without the involvement of hedge funds. So hedge-fund-led disposals aren't myopic, but reallocate assets to buyers who can make better use of them. That's consistent with the principle of comparative advantage and recognises the social opportunity costs of holding onto a plant – doing so prevents another enterprise using it to deliver value. It's well accepted that it's a waste of talent if a promising athlete can't get into the starting line-up of his team, so he should be transferred – but this point is often not applied to selling assets or businesses.

What happens to investment? Inconsistent with concerns of short-termism, IT spending increases, which might be a reason for the productivity gains.[15] But even more important for society is innovation because of its spillover effects. In a further study, Alon, Wei, Song Ma and Xuan Tian found that, when a firm is targeted by a hedge fund, R&D falls by an average of 20% compared to non-targeted firms.

This appears to be a smoking gun. It confirms one of the worst fears about activism. Senators Baldwin and Merkley, when launching the Brokaw Act, claimed that 'firms targeted by activists experience lower investment and R&D'. While they didn't cite any studies, it turns out that they were spot on.

Yet here again there's a twist. Even though R&D input falls, R&D output rises – firms file 15% more patents, and each patent that it does file generates 15% more citations (a measure of patent quality). The firm produces more for less – the investor stops it throwing flour outside the baking tray.[16]

This is an important point. Investors, stakeholders and policymakers often use the level of investment to measure short-termism. For example, the World Economic Forum's Stakeholder Capitalism Metrics (introduced in Chapter 5) include both capital expenditure and R&D spending as two of their 'core' metrics that companies should report. But investment only measures how much you spend (the *input*), not what you do with what you spend (the *output*). It takes no skill to simply spend money. Recall from Chapter 5 how Bart Becht transformed Reckitt Benckiser's innovation not by throwing around cash – his R&D spend was lower than competitors' – but by focusing on the Powerbrands.

Just like the reallocation of plants, Alon, Wei, Song and Xuan find that engagement spurs the reallocation of patents and inventors. The firm sells patents, particularly those less related to its technological expertise – its comparative advantage. After the sale, the patent becomes more impactful, i.e. generates more citations. Inventors who leave produce more and better patents at their new employer. Those who stay also become more productive, compared to inventors who stay at firms not targeted by hedge funds.

How do these companies magically become more productive and innovative? The change starts at the top. Some CEOs leave; for those that stay, their share ownership increases significantly as recommended in Chapter 5. New directors added to boards have better credentials and more technology or industry expertise.*

And the wider societal benefits of activism are broader than just the firm in question. They spill over to its competitors – Hadiye Aslan and Praveen Kumar find that rivals take actions to remain competitive,[17] and Nick Gantchev, Oleg Gredil and Pab Jotikasthira show that they do so to pre-empt hedge funds taking a stake in them.[18] Peer firms improve their own productivity, cost efficiency and capital allocation, and cut prices and increase product differentiation to benefit customers.

The Value of Engagement

The activism studies turn the traditional view of investors on its head. Since investors need to generate profits for savers, the fear is that they'll take from stakeholders. But as Figure 2.1 showed, there's a limit to how much profit you can generate by pie-splitting. Most investors recognise that the only way to generate long-term returns is to ensure the companies they invest in create long-term value – so they're much more aligned with stakeholders than commonly believed. Indeed,

* Is this correlation or causation? Perhaps the investor predicted that a company would improve performance and so bought large stakes in anticipation. This is hard to reconcile with the breadth of the evidence – the investor would have had to predict improvements in labour productivity and innovation efficiency, the sale of underperforming plants and non-core patents, that some inventors would leave, but those that stay would become more productive, that the CEO would change and that new directors would be appointed. In addition, across their different papers, the researchers conduct a battery of additional tests to suggest causation. For example, the increases in productivity are stronger when the engagement is more confrontational or targets operational issues (such as strategy or asset sales) in Item 4 rather than undervaluation or capital structure. The improvements arise even when the investor owned a significant position prior to the 13D – so the fund didn't increase its stake much, but the 13D gave notice of its intent to engage. When the hedge fund exits, the market response is worse if it hasn't succeeded in implementing the Item 4 changes, suggesting that these changes would have added value.

Caroline Flammer's research in Chapter 4 showed how shareholders make resolutions for companies to treat stakeholders better. A more recent study finds that the majority of these proposals are made by asset managers, rather than religious groups or charities.[19] Similarly, after the Business Roundtable released its revised Statement on the Purpose of the Corporation, many shareholders proposed resolutions to force signatories to explain how they'll put their pledge into practice.

But CEOs and their advisors often view activists as enemies who attack the firm. Lawyer Marty Lipton, a prominent opponent of activists who's quoted in the Introduction, wrote a blueprint on how to deal with them which uses the word 'attack' and its variants 18 times.[20] Yet engagement improves long-run stock returns, profitability, productivity and innovation – exactly what leaders (and society) want to happen. Rather than viewing restructuring suggestions as an 'attack', and immediately going on the defensive and arguing they're wrong, executives' first reaction should be to entertain the possibility they may be right. Activists' challenges may be tough to hear, but this shouldn't detract from their value. It seems the main target that activists are attacking is underperformance, and companies should ally with them in this attack.

In 2014, investors raised concerns to UK outsourcing firm Carillion about its high debt, widening pension deficit and weak cash flow generation, and suggested a change in strategy. But management viewed this as an attack and ignored them. Carillion went bankrupt in January 2018, hurting not only investors, but society – its failure caused 3,000 job losses, jeopardised the pensions of 27,000 retirees and pushed some of its suppliers into bankruptcy. A UK government report found that 'had it been more receptive to the advice of key investors at an earlier stage it may have been able to avert the darkening clouds that subsequently presaged its collapse'.[21]

How can investors provide useful perspectives when they don't have inside knowledge of the business? By providing an independent sounding board, for example when brainstorming a new strategic idea or discussing competitive threats. While investors indeed don't work for the company day to day, this outsiders' view helps overcome a CEO's attachment to the status quo – a strategy she designed or a business she bought. As the fable goes, a frog placed in a jar of water won't notice if the water starts to boil. But an outsider can, by seeing bubbles form. Activist Bill Ackman explains: 'The value add of an activist . . . is that we can help prevent the next Kodak from disappearing, where tens of thousands of jobs are lost, by waking up a complacent company to the competitive threats it faces and the inefficiency that has crept into their business because of complacency.'[22]

Policymakers are indeed realising the value of engaged investors. Since the early 1990s, Japan has suffered prolonged economic stagnation – initially dubbed the 'Lost Decade', but now called the 'Lost 20 Years' due to its longevity. Profitability has been very low, partly because companies take the easy option of sitting on cash rather than finding innovative investment opportunities.[23] Former Prime Minister Shinzo Abe saw greater investor engagement as a solution and worked to strengthen investor rights. One example is creating the Japanese Corporate Governance Code in 2015.

However, as with most issues, the evidence isn't all one-way. While Alon and Wei comprehensively study hedge funds, recall that evidence is not *universal*. The results are more mixed for activism by non-hedge fund investors, such as pension funds and mutual funds. David Yermack's 2010 survey of the activism research to date (written before the hedge fund studies) found that 'the success of institutional investor activism to date appears limited'.[24]

So, just as ESG investing doesn't always pay off, as discussed in Chapter 4, engagement doesn't always pay off. The reasons are similar. ESG can be implemented in a box-ticking fashion – for example, choosing stocks based on pay ratios without considering pay horizons. Similarly, engagement can also be implemented through box-ticking – pushing for quick wins on ratios rather than deeper issues such as horizons. What matters is engagement quality, rather than simply engagement activity.

What Strengthens Engagement?

There are three reasons why activist hedge funds are particularly effective at Adobe-like engagements. Importantly, none is unique to hedge funds and other investors can adopt them too. The first is their *portfolio concentration*. Since ValueAct only owns 10–15 stocks, it has a substantial stake in each one. This gives it incentives to get into the weeds of every company that it owns.

This isn't the case for many mutual funds. There are two main types. *Index funds* hold an index – for example, the Russell 1000 Index of the thousand largest US companies. Since there's no fund manager who actively picks stocks, these funds are typically very cheap, with an annual management fee of around 0.1% (in September 2018, Fidelity launched zero-fee index funds). The second type is *actively managed funds*, or *active funds*. An active fund specifies a benchmark index that it aims to beat by choosing different stocks from it. To pay the fund manager and his team of analysts, the fee might be 1%.

Even though active funds in theory are free to select whatever stocks they like, in reality many hold hundreds of stocks to be close to the index and reduce the risk of underperforming it. Such 'closet indexing' means that a fund is spread too thinly to engage meaningfully with each stock. Morningstar found that 20% of European Large Cap funds could be classified as closet indexers.[25] Moreover, a dispersed fund may actually have negative incentives to engage. If a company represents 2% of the fund but 3% of the benchmark, improving its value will cause the fund to underperform.

Similar problems arise for pension funds. In the US, pension funds must follow 'prudent man' rules that require them to diversify.[26] Diversification may be prudent if all you care about is errors of commission – investing in bad stocks.

But Pieconomics is more about avoiding errors of omission; from this perspective, excessive diversification is imprudent. If a fund holds hundreds of stocks, it's unlikely to have a deep understanding of each one and will miss many opportunities to create value. In few other areas of life is excessive diversification prudent. It's well understood that taking on hundreds of commitments prevents you devoting sufficient time to each – yet this insight is sometimes overlooked by investors.

A hedge fund owns a concentrated portfolio because it isn't evaluated relative to an index. If it loses 10%, it can't use the fact that the index lost 15% as an excuse, because its stated mission is to generate returns regardless of market conditions. So every stock it owns is a *conviction holding* – a deliberate choice because the fund believes in its long-term potential, rather than a default because it's part of the benchmark. This large stake then gives it the incentives to engage.

A second reason for activist hedge funds' effectiveness is their strong financial *incentives*. Consider a hedge fund and a mutual fund who both own a $100 million stake. If a hedge fund's engagement raises firm value by 5%, its stake rises by $5 million. In the first year, the fund keeps $1.1 million of this increase ($1 million through the 20% performance fee and $0.1 million through the 2% annual fee). A mutual fund with a 1% annual fee will keep $50,000, so its incentives are 22 times less. These incentives are important because engagement costs money as well as time – Nick Gantchev estimated that the average campaign that ends in a proxy fight (a public battle for board seats) costs over $10 million.[27] Engagements should start off collaborative, but confrontation is a useful – yet costly – escalation mechanism if management is intransigent.

Some savers might balk at a hedge fund's 20% performance fee, just like citizens may object to high CEO pay. But the performance fee isn't at the expense of anyone – it's only earned if the hedge fund has grown the pie. Moreover, consistent with the long-term incentives advocated in Chapter 5, pay to hedge fund employees is typically deferred for several years.[28]

A third reason is the substantial *resources* activist hedge funds devote to engagement – it's a central part of the investment process. Some mutual funds market themselves primarily on cost and see engagement as a wasteful activity that simply adds expense. But engagement is a profit centre, not a cost centre.

Beyond Hedge Funds

The silver lining is that none of these three features is unique to hedge funds. Other investors can adopt the same practices – and many of the best do. As we'll discuss in Chapter 9, investors should pay their fund managers according to long-term performance and devote significant resources to engagement. Active funds should hold concentrated stakes rather than hugging the index. There's nothing special about hedge funds; they're just one example of a concentrated, incentivised and resourced investor.

Indeed, analyses of non-hedge fund investors with the above features find more positive results. The UK investor Hermes manages the British Telecom and Post Office pension funds, as well as client money. In 1998, it set up the UK Focus Fund, in response to concerns that its main funds were too diversified. As the name suggests, it held a small number of stocks – no more than 13 at any time. It was dedicated to engagement, only buying underperforming companies it believed it could turn around. Employees had a low base salary, but a strong incentive scheme that could yield seven-figure bonuses upon exceptional performance.

The fund's engagements aimed to apply the principle of comparative advantage and sell non-core assets. Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi found that stock returns rose by an average of 5.3% if an engagement achieved its goal.[29] The returns were higher for confrontational than for collaborative engagements, suggesting Hermes was overturning poor decisions by entrenched management. Profitability, which had declined in the two years before the engagement, rebounded over the next two.

A separate study by Elroy Dimson, Oğuzhan Karakaş and Xi Li investigated a large anonymous investor with specialist expertise in environmental and social engagement.[30] While such activism aimed to benefit stakeholders, investors gained also. The stock price rose by 2.3% over the following year and 7.1% if the engagement achieved its stated goals. Profits improved as well.

Private equity investors have similar characteristics to hedge funds, but to an even greater degree. They typically have majority stakes, not just large stakes, and board seats which give them greater influence over management. They're nearly as maligned by the public as hedge funds. But several studies show that, when they take over a company, profits rise,[31] productivity increases[32] and the quality of patents improves.[33]

Stakeholders benefit too. Jonathan Cohn, Nicole Nestoriak and Malcolm Wardlaw studied workplace injuries, obtaining plant-level data from the Bureau of Labor Statistics' Survey of Occupational Illnesses and Injuries.[34] On average, 6.7% of workers get injured each year; after a private equity buyout, this falls by 0.74–1%. If such a reduction occurred throughout the US, workplace injuries would fall by 650,000 to 880,000. Shai Bernstein and Albert Sheen obtained restaurant health inspection records from the US Food and Drug Administration and found that, after a buyout, restaurants become cleaner, safer and better maintained.[35] The effects are stronger in directly owned rather than franchised outlets, where the private equity investor has more control – suggesting it caused the improvements rather than buying the restaurants because it predicted they'd have happened anyway.

Turning from 'do no harm' to 'actively do good', Ashwini Agrawal and Prasanna Tambe showed that private equity investors increase IT investment, which gives employees transferable skills such as computer-aided design.[36] The authors obtained proprietary data from one of the largest online job-search websites in the US to track these employees' future career paths. Colleagues enjoy increases in both long-run employability and wages that persist even if they leave the firm. The effects are higher the greater the IT investment after the buyout, and stronger for workers in jobs related to IT.

And customers benefit too. Cesare Fracassi, Alessandro Previtero and Albert Sheen studied the retail industry, obtaining monthly store-level prices and unit sales for 2 million goods. After a buyout, sales rise by 50% compared to similar retailers not bought out. This increase wasn't due to price-gouging – prices barely change. Instead, it was due to the launch of new products and geographic expansion.[37]

Generalised Engagement

The activism that ValueAct undertook in Adobe, and that the above papers studied, is *specialised engagement*. Here, the best course of action is situation-specific. ValueAct had to deeply understand Adobe's specific problems and evaluate tailored solutions, such as changing its revenue model.

But that's not the only type of engagement that creates value. Some improvements can be implemented across the board, which we'll call *generalised engagement*. Increasing pay horizons or encouraging disclosure of carbon emissions is usually desirable, so investors can push for such changes without deep analysis. While specialised engagement is 'bottom-up', starting from the enterprise's strategy and operations, generalised engagement is 'top-down', applying a broad issue across several firms.

Specialised engagement is harder for index funds, since they hold every stock in an index and may be spread too thinly to focus on one particular company. But they're well placed to undertake generalised engagement, because the asset managers that offer them (such as Vanguard, BlackRock, State Street and Legal & General) are often the largest shareholders in a firm[38] and thus have strong voting power. In August 2019, the total size of US index funds surpassed active funds for the first time; ten years previously, index funds were only a third as large.[39]

Do index funds indeed exert governance? Ian Appel, Todd Gormley and Don Keim use the regression discontinuity approach to show causation. The Russell 1000 Index contains the largest 1,000 US public companies, and the Russell 2000 the next 2,000. Whether a stock is at the bottom of the Russell 1000 or the top of the Russell 2000 is essentially random, but has a big effect on its index fund ownership. The 1,000th largest firm will have little ownership by index funds that track the Russell 1000, because it's the smallest in its index. Firm 1,001 will have high ownership by trackers of the Russell 2000, because it's the largest in its index.

Ian, Todd and Don show that index fund ownership is 66% higher for stocks at the top of the Russell 2000 than those at the bottom of the Russell 1000. This increase is associated with better governance,[40] higher profitability and greater valuations. It also leads to lower voting support for management proposals and higher support for governance-related shareholder proposals – consistent with index funds improving generalised engagement through their voting power. A separate study by Fatima Filali Adib shows that voting support is greater for proposals that create more value, suggesting that index funds are indeed skilled at voting.[41]

These results are important. While some commentators like to classify active funds as 'good' and index funds as 'bad', such binary thinking is inaccurate. Different investors specialise in different types of engagement. Neither policymakers nor savers should expect investors to undertake every single type of stewardship, but focus on the mechanisms they have most expertise in. We'll revisit this point in Chapter 9, which discusses how investors can put stewardship into practice.

Investor Rights

Another way to shed light on the value of engagement is to study not actual cases of activism, but investor rights – shareholders' ability to influence how a firm is run.

Companies can put several mechanisms in place to reduce investors' influence. One is the staggered board. Let's say Paolo is the CEO. He's corrupt, spending the firm's cash on bad acquisitions, plush offices and, of course, a high salary for himself. He's also devious. He's chosen as his three directors Amit, Sarah and Delphine, all of whom are his buddies from business school and support his personal self-enrichment plan. And he's staggered their elections. Amit comes up for election this year, Sarah next year and Delphine in two years. An activist might try to get his own directors elected to the board to fire Paolo. But because only one-third of the board is up for election in any year, the activist can't get a majority unless he waits another year and wins a second election. Paolo is protected from investors and can continue to destroy value.

But staggered boards might not be bad. Rather than entrenching a pie-splitting leader, perhaps they protect a pie-growing leader from being fired for short-term losses, freeing her to focus on long-run investment.* So which is it? Let's look at the evidence. A seminal paper by Paul Gompers, Joy Ishii and Andrew Metrick gathered data not only on staggered boards, but also on 23 other mechanisms to protect management from shareholders.[42] The results were striking. Companies with the fewest protection mechanisms and thus the strongest investor rights beat those with the opposite by 8.5% per year. They also enjoyed greater sales growth and profitability.

* If insulation from short-term pressures is a concern, a better approach might be to have three-year terms, but have all directors come up for election in the same year – in years 3, 6, 9 and so on. Directors then become accountable for three-year rather than one-year performance, reducing short-term pressures. But if performance remains poor after three years, the whole board can be voted out.

Paul, Joy and Andrew conducted a separate study on dual-class shares and find that firm value is significantly lower.[43] Ron Masulis, Cong Wang and Fei Xie then uncovered the sources of this decline. Dual-class shares are associated with higher CEO pay, worse acquisitions and poorer investment decisions – suggesting that they entrench management and allow them to empire-build.[44]

These findings are important and go against current thinking. There are many calls to restrict investor rights, based on the claim that shareholders extract value from stakeholders, or interfere with the CEO's vision, by pushing for short-term profit. This narrative is popular given the differing perceptions of CEOs – particularly founders – and investors. Entrepreneurs create ideas; investors make money on the back of someone else's idea.

Entrepreneurs arguably grow the pie more than any other member of society. But Pieconomics stresses the importance of balance – between an entrepreneur's vision and investors' oversight, just as cars have both accelerator and brake pedals. This balance is crucial since there are several cautionary tales of promising businesses declining due to an untouchable founder. As *The Economist* described the Daewoo founder, 'Kim is used to making investment decisions on the spot, based on hunches',[45] rather than consulting others. Jerry Yang of Yahoo rejected a $47.5 billion takeover bid from Microsoft in February 2008 because he didn't want to cede control of what he saw as his company – but it was Yahoo shareholders' company as they owned it. By November, Yahoo's value had fallen to a third of Microsoft's offer, and two Detroit pension funds sued Yahoo for violating its fiduciary duty to investors by rejecting Microsoft. Travis Kalanick's uncompromising, do-what-I-want leadership style contributed to Uber's allegedly sexist workplace culture, departures of key executives, regulatory fines and poor public reputation. Groupon co-founder Andrew Mason turned down a $6 billion offer from Google in 2010. Poor sales growth, accounting restatements and unprofessional behaviour – such as wearing gorilla costumes in the office and giving a death stare when interviewed on why he didn't sell to Google – led to CNBC's Herb Greenberg naming him 'Worst CEO of the Year' in December 2012 and Groupon's value plummeting below $3 billion. He was fired on 28 February 2013, causing Groupon's value to jump by 4%; it ended the year at $8 billion.[46]

The studies on investor rights are upfront that they identify correlations. Two subsequent papers make progress towards causation. Vicente Cuñat, Mireia Giné and Maria Guadalupe use the same regression discontinuity approach as Caroline Flammer's study in Chapter 4, but analyse proposals to strengthen governance rather than social performance.[47] Implementing a proposal increases the share price by 2.8% on average. Acquisitions and investment fall, but long-term firm value rises – suggesting that the cuts are to empire-building rather than value-creating projects. Jonathan Cohn, Stu Gillan and Jay Hartzell investigated the proxy access rule, passed by the US Securities and Exchange Commission (SEC) in August 2010 (but struck down by the Court of Appeals in July 2011).[48] This rule would have helped investors put forward their own candidates in director elections.[49] Stock prices rose after events that increased the likely strength of the rule and fell after events that reduced it. The reactions were stronger in poorly performing firms, suggesting that investor power disciplines underperformance.

We'll now turn to how investors affect wider society. Alan Ferrell, Hao Liang and Luc Renneboog studied 37 countries and found that pro-investor laws were positively correlated with 11 different measures of stakeholder value, including labour relations, community involvement and environmental orientation.[50] Alexander Dyck, Karl Lins, Lukas Roth and Hannes Wagner analysed 41 countries and concluded that institutional investor ownership is associated with improvements in various environmental and social measures, such as renewable energy use, employment quality and human rights.[51] The effect is larger when the investors are from countries with strong social norms, such as Germany, the Netherlands and the Nordics, suggesting they export their norms to investee companies.

That investors grow the pie for both themselves and stakeholders is striking, since many commentators argue that shareholder rights must be stifled if business is to serve society. Indeed, the term 'ESG investing' may seem a paradox. Governance factors capture whether a company acts in shareholders' interest; environmental and social factors measure whether it acts for stakeholders. Under the pie-splitting mentality, these factors work in opposite directions. But it's not a paradox under the pie-growing mentality – all three factors (the E, S and G) can grow the pie. The only paradox is that some advocates of ESG investing also call for shareholder rights to be suppressed.

However, the evidence isn't all one-way. The above studies investigate what happens in general, but evidence isn't universal – limiting shareholder power may be valuable in certain cases. William Johnson, Jon Karpoff and Sangho Yi suggest that takeover defences can cement long-term stakeholder relationships. In 2000, IBM was the largest customer of contract manufacturer Pemstar. IBM had teamed up with Pemstar to open a manufacturing operation in Brazil and share its manufacturing knowhow. Such a relationship requires trust that Pemstar wouldn't abscond with the shared knowledge or suddenly increase prices.

After Pemstar went public that year, it ran the risk of being taken over. A new owner might try to milk the relationship by charging IBM higher prices.* Pemstar thus put five takeover defences in place. William, Jon and Sangho find that, if and only if an enterprise has a large customer, dependent supplier or strategic alliance, takeover defences increase its valuation when it goes public.[52] Martijn Cremers, Lubo Litov and

* Note that this concern requires the new owner to be irrational. A rational new owner would understand the value of stakeholder relationships and preserve them – indeed, acquirers often pay a premium price for these relationships.

Simone Sepe show that, when a company adopts a staggered board, its value increases if and only if it has the above business relationships.[53]

Takeover defences aren't the only way to preserve long-term relationships – as we'll see later, informed investors are often sufficient. Still, these papers are consistent with the idea that uninformed investors may ignore the value of a company's stakeholder relationships and intervene destructively. So the optimal design of investor rights isn't one-size-fits-all, which explains the variety across firms and countries that we see. It may also vary over time for a particular firm, with defences preserving stakeholder relationships for a company that's just gone public, but leading to entrenchment when it matures. The challenge for regulators is to ensure that protections from investors, which might be justified in certain circumstances, aren't abused by underperforming leaders entrenching themselves.

Monitoring

Engagement is a form of *stewardship*. The Merriam Dictionary definition of stewardship is 'the careful and responsible management of something entrusted to one's care'. An investor is entrusted with savers' money. Managing this money responsibly involves improving the long-term performance of the firms he invests in. We'll thus move from a stewardship definition that looks backwards at savers to one that looks forwards at companies, as Figure 6.4 illustrates. *Stewardship is an approach to investment that improves the value a company creates for society*. It seeks to grow the pie and enhance an enterprise's

Figure 6.4 The Investment Chain

performance, rather than taking it as given and profiting from finding undervalued pies.

While engagement is the best-known form of stewardship, it's not the only one. Investors can also undertake stewardship by deeply scrutinising a company's long-term value – looking beyond its short-term profit to its intangible assets, strategy and purpose. We'll call such behaviour *monitoring*. As I'll soon explain, this analysis grows the pie even if the investor only uses it to decide whether to buy, retain or sell a company rather than influence how it's run.

Legendary investor Peter Lynch, one of Jeff Ubben's mentors, was an extremely successful monitor. He ran the Fidelity Magellan Fund between 1977 and 1990, posting an average annual return of 29% and beating the S&P 500 11 years out of 13. In his book *Beating the Street*, Peter wrote: 'behind every stock is a company, find out what it's doing . . . often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long term, there is a 100 percent correlation between the success of the company and the success of its stock'.[54]

If Peter was thinking of buying a retail stock, he'd visit its stores to see first-hand how customers and colleagues were being treated. His favourite source of investment ideas was the Burlington Mall, which featured 'more likely prospects than you could uncover in a month of investment conferences', and he'd meet over 200 companies a year. On one visit, Peter's wife and kids dragged him to The Body Shop, a socially responsible cosmetics retailer. Peter was immediately impressed by how well it was managed, the enthusiasm of its colleagues and the hordes of customers. This sparked months of further analysis that led to him purchasing a large stake.

Perhaps Peter's most famous investment was in Chrysler, and a shining example of his investment approach. In 1982, Peter decided to buy into the car industry – he wanted a cyclical sector as the US was recovering from a recession.

	General Motors	Ford	Chrysler
1982 US Market Share	44%	17%	9%
1981 Profit	$333 million	–$1.1 billion	–$476 million
1982 Profit	$963 million	–$658 million	–$69 million*

* Excluding one-off $239 million gain from asset sales.

There were three main players at the time. The table shows their financial statistics.

Which would you choose? It seems a no-brainer – General Motors was the clear market leader, churning out profit even in the 1981 recession and tripling it as the recession ended. But GM was precisely the stock that Peter underweighted (although he still bought some shares, since he was bullish on the auto industry), while heavily overweighting the two loss-makers. Peter looked beyond the profits and looked to the strategy and leadership. He concluded that GM was 'arrogant, myopic, and resting on its laurels'.

While Peter purchased a large position in Ford, his top pick was Chrysler. He started buying it in spring 1982, even though the Wall Street consensus was that it would go bankrupt after its 1981 losses. In June, on what Peter later described as 'the most important day in my 21-year investment career', he visited Chrysler's headquarters and saw the new cars it was preparing to launch. One ended up becoming the first ever minivan with significant market presence. This potential convinced Peter to go all in, and by July, Chrysler represented 5% of Fidelity Magellan's assets – the maximum allowed by the SEC.

History proved Peter right. His industry bet paid off, with even GM tripling in price over the next five years. But his stock-specific bet paid off far, far more – Ford's stock price grew 17-fold over the same period, while Chrysler rose by almost 50 times.

How does monitoring help companies grow the pie? Didn't the Chrysler purchase just make money for Peter at the expense of shareholders who sold to him? In fact, monitoring is critical to Pieconomics. Without truly understanding a company's long-term value, an investor can't partner with it to grow the pie.

We've discussed the problem of short-termism several times so far. The heart of the problem is *information asymmetry*. Investors have information on a company's short-term performance because it's simple to gather – they can easily look up dividends, earnings and revenues on Yahoo Finance. They have less information on long-term performance because gathering it takes time – Peter had to get his hands dirty to find out about a company's customer relationships, corporate culture and product pipeline.

A non-monitoring investor may dump a stock that's suffered poor short-term earnings without asking whether these low earnings are in fact due to long-term investment. This drives the stock price down, reducing the value of the CEO's shares[55] and increasing her risk of being fired. Knowing that investors will assess her on short-term profits and not long-term value, a leader will prioritise the former. An influential survey of 401 Chief Financial Officers, by John Graham, Cam Harvey and Shiva Rajgopal, found that 80% would cut discretionary expenditure (such as R&D and advertising) to meet an earnings benchmark.[56] As one CFO pointed out, the market 'sells first and asks questions later'.

That's why monitoring is crucial. By taking the time to ask questions first – understand whether low earnings are due to mismanagement or investment – investors shield a leader from short-term pressures. Chrysler didn't worry that Wall Street doom-mongers were predicting its bankruptcy. They didn't own the stock – Peter did – and so what mattered was how he voted and whether he'd keep or sell his stake. They knew Peter cared about Chrysler's pipeline rather than its current losses.

Even more importantly than protecting the stock price, monitoring can safeguard a company's future. When Kraft made a takeover bid for Unilever in February 2017, offering investors an 18% premium to its current value, most weren't interested. They'd deeply scrutinised Unilever's long-term strategy, including its Sustainable Living Plan to halve its environmental footprint and improve customer well-being, and realised it wasn't captured in the stock price. Investors' response to Kraft was loud and clear. Mike Fox, Head of Sustainable Investments at Royal London Asset Management, said: 'For a lower quality business it would be acceptable, but for a business of Unilever's quality it is nowhere near the right price.' Kraft walked away two days later.[57]

Patience Isn't Always a Virtue

You might think the ideal investor is one who holds his shares for the long term and never sells. Such investors are known as 'patient capital' – loaded language, as patience is seen as a virtue, and so policies aim to encourage it. We've already discussed France's Loi Florange, which doubles the votes of investors who've held their shares for two years. Similarly, Toyota introduced a class of shares that pays 'loyalty dividends' if they're held for five years. And Hillary Clinton, during her 2016 Presidential election campaign, proposed a sharply higher capital gains tax on shares sold within two years.[58] In addition to explicit incentives to be patient, there's also strong political and media pressure. During the pandemic, many commentators called for investors to 'get behind American/British/[insert nationality] business' by committing not to sell their shares. To do so would be unpatriotic.

But patience isn't always desirable. The praise of patient investors is fundamentally flawed because it confuses the *holding period* of an investor with his *orientation*. The former is how long an investor holds shares before he sells. The latter is the basis – long-term value or short-term profits – that triggers an investor to sell.

Former Vanguard CEO Bill McNabb advocated patience, arguing: 'Our favourite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits.'[59] That makes sense for index funds, which Vanguard predominantly runs. But an active investor who holds onto his shares for the long term, regardless of how an enterprise is performing – whether it's creating value for society or exploiting it, or whether 'we like you' or 'we don't' – shouldn't be called a patient investor. He's an irresponsible investor who's failing to monitor the firm. Similarly, an investor shouldn't automatically 'hold your stock when you hit your quarterly earnings target'. He should investigate how the company hit the target, and take action if it did so by scrapping good investments.

Volkswagen's 'patient' shareholders, such as the Porsche family and the State of Lower Saxony, were asleep at the wheel, doing nothing to stop it cheating emissions tests. Kodak's investors sat back and enjoyed its high profits in the 1980s and 1990s, oblivious to the fact that Kodak was failing to invest in digital photography. Indeed, its market value hit an all-time high of $31 billion in 1997, 16 years after Sony unveiled the Mavica in 1981, despite Kodak having done little to respond.*

* Instead, Kodak took many actions suggesting that it didn't view the threat from digital technology as serious. In 1989, when CEO Colby Chandler retired, it chose Kay Whitmore as his successor, who represented the traditional film business, rather than Phil Sampler, a strong believer in digital technology who later became President of Sun Microsystems. In 1996, it spent $500 million to launch the Advantix Preview film and camera system, which allowed users to preview their shots before printing them on regular film. While it used digital technology to do this, Kodak saw digital technology as a way of enhancing its traditional film business, rather than replacing it.

Just as one of the worst things a leader can do is coast and fail to grow the pie, one of the worst things an investor can do is coast and fail to monitor.

Most people agree that customers should walk away from a firm that's delivering low-quality products, polluting the environment or mistreating its workers. Similarly, most view divestment as a legitimate way for investors to hold companies to account, which is why the praise of patience doesn't make sense. *Generalised divestment* involves selling a company due to the industry or country it's in, or another criterion that can be applied across all firms, such as insufficient board diversity. The 1980s campaign to divest from South Africa sought to influence its government to end apartheid. But there may be even greater need for investors to engage in *specialised divestment*, based on firm-specific factors, such as a company's contribution to society, intangible assets and strategic direction. Customers know a firm's industry or country and can boycott on that basis, but are less able to evaluate these more complex issues. Large investors have a comparative advantage in such evaluations, given their access to management and strong financial incentives to monitor.

Selling shares might thus not be an act of short-termism, but an act of discipline. Economists call this 'governance through exit' (while they label engagement 'governance through voice'). For exit to be effective, what matters is the information it's based on, which is what we mean by the investor's *orientation*. If he sells based on short-term earnings, that's indeed damaging, because the leader then prioritises short-term earnings. But if he sells based on long-term value, the CEO knows she'll be held to account for long-term value. For example, Ford announced record profits in 2015, followed by its second-highest profits in 2016. Yet the stock price fell 21% over those two years due to concerns that Ford wasn't investing enough in electric or self-driving cars. The stock price decline, despite soaring profits, led to CEO Mark Fields being fired in May 2017. Similarly, in a pandemic, we don't want investors to sell companies who are prioritising material stakeholders over quarterly earnings. But exiting from those who are doing the reverse is socially desirable, rather than unpatriotic, and allows these investors to reallocate their capital to growing sectors such as tech and pharmaceuticals.

So the crucial question isn't whether investors hold for the long term, but whether they trade on long-term information. How can we ensure the latter? The same way we promote engagement: investors taking large stakes. One of my papers showed that large investors, also known as blockholders, have the incentive to look beyond earnings and invest the time needed to truly understand an enterprise.[60] While stake size encourages monitoring, loyalty dividends and taxes on selling discourage it, by making it expensive to exit if the investor learns something negative.

Relatedly, we do want investors to be loyal. But *unconditional* loyalty – staying with a firm regardless of whether it's creating long-run value – simply entrenches management. Much better is *conditional* loyalty: remaining with a company, despite low short-term earnings, if and only if it's growing the pie. Unilever's shareholders rejected the Kraft bid because they knew that its earnings were below potential due to investing in the Sustainable Living Plan – but they might have sold if the modest earnings instead resulted from mismanagement. It's the combination of loyalty if the firm invests for the future, and exit if it doesn't, that represents good stewardship. That's also the key difference between blockholders and unconditional protections, such as dual-class shares, staggered boards and loyalty shares, which protect a leader regardless of her performance. For example, the Loi Florange allowed Vincent Bolloré to grab control of media company Vivendi, despite only holding a 14.5% stake, engage in empire-building acquisitions and be immune to external oversight.

The value of short-term decisions based on long-term concerns applies to engagement as well as trading. We'll use 'long-term-oriented' to describe investors who engage and trade based on long-term factors, in contrast to 'long term', which typically refers to investors who've held their shares for a long time. We'll instead refer to the latter as *low-turnover investors*.

Warren Buffett is a long-term-oriented investor. He buys a large stake to shield an enterprise from the short-term demands of uninformed shareholders, giving it freedom to build its brand. But he's not blindly loyal – he'll take tough decisions if a leader acts myopically. In 2000, Buffett's investment holding company, Berkshire Hathaway, bought paint manufacturer Benjamin Moore, which sold almost exclusively through independent dealers. Since its founding in 1883, Moore had usually been run by a member of the Moore family. Buffett knew that its dealers were worried that he'd switch to Home Depot and Lowe's – giant chains that offered higher profit potential. So he sent round video promising to stick with them.

Twelve years later, Benjamin Moore CEO Denis Abrams was nearing a distribution deal with Lowe's. Buffett fired him and stopped the deal, even though it would have increased short-term profits, and even though Abrams had delivered solid results in his five-year tenure and was praised by Buffett in Berkshire's 2009 Annual Report. Firing is seen as a short-term action but, like selling, can be based on long-term factors. Separately, this example shows how takeover defences aren't necessary to preserve long-term relationships – informed investors are often enough.

Policymakers should promote engagement by all investors, just as companies should encourage engagement by all employees. Excluding new hires from employee consultations would not only fail to tap a valuable source of ideas, but also deter creative minds from joining the firm to begin with. Similarly, requiring investors to wait several years before they have full voting rights will both hinder them from improving a stock they already own and deter them from buying a troubled company in the first place. And monitoring and engagement aren't separate stewardship mechanisms, but complementary ones. The power of voice often depends on the threat of exit. Intransigent leaders will listen to investors if they'll sell if underperformance continues, just as companies will listen to customers' feedback if they'd otherwise walk away.

The Informational Role of Stock Prices

Investor trading, which causes stock prices to reflect long-term value rather than short-term earnings, has benefits beyond incentivising leaders to prioritise the former. When prices reflect long-term value, they're valuable *signals*, just like profits can be as Chapter 3 discussed. High stock prices of Silicon Valley firms encourage bright undergraduates to learn computer science and go into tech rather than coal mining. Suppliers are willing to sink large investments to manufacture inputs for highly valued firms, as they're confident they'll be around for decades. Boards can use forward-looking prices to guide whether to fire the CEO.

And leaders themselves may use stock prices to guide investment decisions – evidence shows that, when stock prices are high, CEOs infer that their investment opportunities are good and invest more.[61] But when investors fail to gather and trade on long-term information, stock prices are poor signals and can lead to misguided decisions. By holding onto their shares despite Kodak not investing in digital cameras, investors kept the stock price high. This may have encouraged Kodak to continue with its film strategy, suppliers to continue manufacturing the inputs for film and employees to join or remain with the company. Had investors sold out and reduced the stock price, they may have shaken management out of their inertia.

We won't discuss this further here, because this is a vast topic in itself. Instead, I refer the interested reader to a book chapter I wrote with Philip Bond and Itay Goldstein, entitled 'The Real Effects of Financial Markets', which surveys the extensive research on how financial market trading can improve company decisions.[62]

The Value of Monitoring: The Evidence

Let's turn to the evidence. One strand of research studies the value of meeting management. Marco Becht, Julian Franks and Hannes Wagner obtained proprietary data from a global asset manager (Standard Life) on the private meetings it held with companies between 2007 and 2015.* [63] Such meetings were informative – often leading its stock analysts to change their internal ratings. A downgrade of a stock (from 'buy' to 'hold' or 'hold' to 'sell') predicted a 3.5% fall in the stock price from the day before the downgrade to five days after – the change was warranted. And it was valuable, because it prompted Standard Life to sell some shares, reducing its loss by 0.3–0.4%. The results are similar, although smaller, for upgrades.

One prominent example is a December 2015 meeting with the Chairman of Carillion – a company in which Standard Life was the largest shareholder, owning 10%. The stewardship specialist wasn't impressed, remarking that the Chairman was nonchalant about Carillion's poor performance that year: 'he was on chipper form. Looking unfeasibly tanned for this time of year, he . . . had just returned from Lesotho by way of a break at a spa in Thailand. He had been out in southern Africa as Chairman of . . . [a] children's charity.' The analyst mentioned the Chairman's multiple other outside commitments – combined with his limited knowledge of what was actually going on in Carillion. Two weeks later, Standard Life's internal

* In 2017, Standard Life merged with Aberdeen Asset Management, and the combined investment arm is now called Aberdeen Standard Investments.

analyst downgraded Carillion from 'hold' to 'sell' and most of its funds cut their positions by an average of 26%. These sales were prescient because, as we saw earlier in this chapter, Carillion went bust in January 2018.

While Marco, Julian and Hannes study the meetings that a single investor held with many companies, David Solomon and Eugene Soltes obtain proprietary data on the meetings that a single (anonymous) company held with many investors – in fact, 340 different investors over six years.[64] They similarly found that meetings were informative – if an investor bought shares in the same quarter it met the company, the stock price rose the next month; sales were followed by price declines.

So investors benefit from informed trading, but does it lead to short-termism among companies? The criticism of short-term trading isn't new. An influential 1992 article by strategy guru Michael Porter heralded the Japanese ownership structure, where investors hold long-term stakes that they rarely sell.[65] But the 'Lost 20 Years' since then suggests that Japan isn't the model economy previously thought. Japan's mediocre performance could be for many reasons, but there's direct evidence on the benefits of liquidity – the ease with which investors can trade their shares. To identify causation, a series of studies uses the decimalisation of the major US stock exchanges.

Here's how decimalisation works. All stock markets have a 'tick size' – the minimum amount a stock price can move. Before 2000, all three US exchanges, the NYSE, AMEX and NASDAQ, had a minimum tick size of 1/16 of a dollar. If IBM's stock price is $20 and an investor sells, he might only fetch $19 15/16 ($19.9375), which makes selling costly. Between August 2000 and April 2001, the three exchanges reduced the minimum tick size to one cent. So a sale might now only lower the price to $19.99 – selling is less costly. Vivian Fang, Tom Noe and Sheri Tice showed that decimalisation improved firm value.[66] Sreedhar Bharath, Sudarshan Jayaraman and Venky Nagar documented that this improvement was stronger in firms with blockholders and where the CEO owns a larger stake – suggesting that governance through exit was a key driver of the gains.[67] Vivian Fang, Emanuel Zur and I found that decimalisation made it easier for investors to acquire large stakes in the first place.[68]

Rather than studying liquidity, which makes trading easier, other researchers investigate actual trades. A key question is what drives them – a knee-jerk reaction to public information like earnings, or a shareholder's bespoke analysis? Sterling Yan and Zhe Zhang show that high-turnover investors trade on their own information and are actually better informed than low-turnover investors.[69] While contrary to the common critique of high-turnover (or 'short-term') shareholders, these results make sense. High turnover could arise because a shareholder has many insights not captured by the market and is acting on them. Lubos Pastor, Luke Taylor and Rob Stambaugh find that mutual funds are more profitable in periods when they trade more,[70] and numerous studies show that trades by large investors are particularly informed.[71] Turning to the consequences of trading, David Gallagher, Peter Gardner and Peter Swan found that short-term trades increase stock price informativeness and ultimately firm performance.[72]

A final strand of research investigates how companies act differently when they have blockholders. They manipulate earnings less and are less likely to announce earnings that later need to be corrected[73] – potentially because they know that blockholders will see through earnings inflation. They also invest more in R&D and produce more patents.[74] Blockholders deter firms from cutting R&D to meet analyst earnings forecasts, while fragmented investors encourage such behaviour.[75]

The above results could be because blockholder stewardship allows firms to think long term. But it might also be that long-term firms attract blockholders. Philippe Aghion, John Van Reenen and Luigi Zingales suggest that causality is in the first direction by investigating what happens when a company is added to the S&P 500 index.[76] This causes institutions to hold more of a stock,[77] which then leads to the firm generating more and better-quality patents.

While the studies in this chapter have their own individual findings, taken together we can draw two broad conclusions. First, while advocates of shareholder primacy claim that investors are unambiguously good, and opponents claim that they're blanketly bad, you can't lump all investors together. A closet indexer who hogs the benchmark and holds onto his shares regardless of performance is a world away from an investor who deeply understands every holding and partners with management to create value. Second, while investors are often seen as the enemy of stakeholders, the evidence suggests that large, long-term-oriented investors grow the pie for the benefit of all. Rather than heralding patient investors, who may just passively hold shares, society should promote investors who take their stewardship roles seriously. By doing so, they help build the great enterprises of the future.

In a Nutshell

- Investors engage in *stewardship* – improve the value an enterprise creates for society – through either *engagement/activism* or *monitoring*.
- Common criticism of investor *engagement* is based on pie-splitting – the idea that investors enrich themselves at stakeholders' expense. Instead, large-scale evidence suggests that hedge fund activism grows the pie by ousting underperforming leaders, increasing labour productivity and improving innovation efficiency.
- Hedge funds are effective at *specialised engagement* because they own concentrated positions, have strong financial incentives and devote substantial resources to engagement. These features can be adopted by other investors. Private

equity is an example, and it typically creates value for both stakeholders and shareholders.

- Index funds are effective at *generalised engagement* since they typically have sizable voting power and can apply best practices across hundreds of stocks.
- Greater investor rights, which facilitate activism, are generally linked to higher long-term performance. Protection from investors may add value in specific situations, for example where stakeholder relationships are particularly important.
- Through *monitoring* – looking beyond short-term profits to understand an enterprise's potential – investors can insulate a leader from the pressure to hit earnings targets and free her to create long-term value. Monitoring involves a combination of loyalty if the firm invests for the future and exit if it pursues short-term profit or coasts.
- It's critical to distinguish the *holding period* of an investor from her *orientation*. Selling shares need not be short-termist if based on an analysis of long-term prospects. The ideal investor is *long-term-oriented*, rather than simply holding for the long term. The evidence suggests that greater stock liquidity, which facilitates investor trading, is associated with higher firm value and superior stewardship. Blockholders – large shareholders – are associated with higher investment and less earnings manipulation.

7 REPURCHASES

Investing with Restraint, Releasing Resources to Create Value Elsewhere in Society

2014 was a disappointing year for the health insurer Humana. Its earnings per share (EPS) were on track to be $7.34, down from $7.73 in 2013. This was costly for not only investors, but especially CEO Bruce Broussard, who had an EPS target of $7.50 in his bonus. As we saw in Chapter 5, executives sometimes change accounting policies to hit bonus thresholds. And Broussard played this game. He claimed that expenses Humana incurred to pay debt early were one-off and should be excluded from the EPS calculation. But this was only enough to increase the EPS to $7.49, just shy of the target.

Broussard had one more trick up his sleeve – a share repurchase. By buying back $500 million shares in the final quarter of 2014, he reduced the number of shares outstanding. This nudged earnings *per share* up two more cents to $7.51,[1] which just beat the magic $7.50 number and netted Broussard a $1.68 million bonus – despite Humana's poor performance on what it was supposed to focus on, insuring citizens' health.

The Humana anecdote is most people's view of stock buybacks. If excessive CEO pay is seen as the pinnacle of pie-splitting behaviour, buybacks may well take second place. A buyback arises when an enterprise has spare cash, but rather than investing it or paying higher wages, it repurchases shares from existing investors.

CEOs have incentives to engage in buybacks even if they destroy value. Many bonus schemes include EPS as a performance metric because it's increased by many pie-growing actions, such as improving product quality to boost revenues or production efficiency to cut costs. But buybacks allow the leader to meet an EPS target artificially without actually raising firm performance, because they lower the number of shares – as with Humana.

It seems that buybacks split the pie in favour of investors and executives, at the expense of stakeholders, and so have no place in Pieconomics. An influential 2014 *Harvard Business Review* article by William Lazonick argued that, even though profits surged as the US economy recovered from the 2007 financial crisis, ordinary citizens didn't benefit because these profits went to buybacks. S&P 500 firms spent $2.4 trillion on buybacks between 2003 and 2012; when adding in dividends, 91% of net income went to investors. According to Lazonick: 'That left very little for investments in productive capabilities or higher incomes for employees.'[2] So buybacks might actually do worse than splitting the pie differently – they shrink it by preventing investment.

Now leaders often justify buybacks by claiming they've run out of good investment opportunities. But surely it's a CEO's job to come up with ideas? Not doing so seems an error of omission. If she can't think of anything better to do than buy back stock, you've got the wrong CEO.

For all the above reasons, politicians – surprisingly, from both sides of the political spectrum – are calling for restrictions on buybacks. In February 2019, Democratic Senators Chuck Schumer and Bernie Sanders published a plan to limit them, and a week later Republican Senator Marco Rubio announced his own proposal. In 2017, the UK government launched an inquiry into buybacks due to concerns that they 'may be crowding out the allocation of surplus capital to productive investment'. Even investors, who supposedly benefit from buybacks, seem to be feeling guilty about taking from other stakeholders. BlackRock leader Larry Fink wrote in a March 2014 open letter to company CEOs that: 'Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks.'

This chapter will take a more nuanced view. We'll draw from rigorous academic research as usual, but also the inquiry into buybacks that the UK government appointed PwC and me to jointly conduct. I'm grateful for the many discussions I've had with PwC, the government officials who worked with us on the study and numerous others who also provided input. I'll acknowledge that buybacks can sometimes destroy value. And I'll argue that pie-growing enterprises should engage in far fewer buybacks than those that practise ESV. But I'll also stress that, properly executed, buybacks can grow the pie.

Of course, the critical words are 'properly executed' and 'can'. So we'll use large-scale evidence to show that, in most – but not all – cases, buybacks do create value. That still doesn't mean that policymakers should take no action, and we'll close with suggestions for reform.

We'll explain how viewing buybacks through the lens of Pieconomics leads to a different conclusion from conventional wisdom. But we'll first see how some concerns come from misunderstanding how buybacks actually work and are independent of whether you have the pie-splitting or pie-growing mentality. This isn't to be an apologist for buybacks, but because we need to understand how they operate before suggesting how they can be reformed.

Buybacks: Correcting Some Misperceptions

Buybacks Are a Free Gift to Investors

Critics of buybacks view them as a free gift or windfall to investors. One article on buybacks was titled 'Congress Could Give Bank Shareholders a $53 Billion Gift'; another had the headline 'Shell Kick-Starts £19bn Windfall for Patient Shareholders'.[3] This perception may be distorted by terminology – buybacks are a form of 'payout'. But buybacks aren't a freebie where investors get something for nothing. Investors do get cash, but only in return for giving up their shares. That's like how an enterprise repaying debt gives cash to the bank today, in exchange for reducing the bank's future claim on the firm. No one would claim that repaying debt is a free gift to the bank.

Buybacks Are Needed for Investors to Cash Out

Other critics acknowledge that buybacks aren't a freebie, but claim they're a cashing-out mechanism. A selling investor is no longer interested in the enterprise's long-term future. Perhaps the stock price has gone up in the few months since he's bought the shares, and he demands a buyback to allow him to cash out.

This argument is also misguided since investors can sell their shares on the stock market at any time to other shareholders. They don't need the company to buy them back.*

Using Net Income for Buybacks Is at the Expense of Wages

The Lazonick statistic that 91% of net income is paid out to investors, which 'left very little for investments in productive capabilities or higher incomes for employees', is widely quoted as a smoking gun. For example, when Senators Schumer and Sanders launched their anti-buyback proposal, they wrote: 'When more than 90 percent of corporate profits go to buybacks and dividends, there is reason to be concerned.'[4]

But this statistic makes a very basic mistake.[5] Net income is already *after* deducting wages, other expenditures on colleagues such as training or wellness programmes, and intangible investments such as R&D and advertising. Indeed, a major reason for Humana's lower 2014 profits was its investment in health-care exchanges, adding nuance to the anecdote.

So the Lazonick argument makes no sense. It's like saying 'the kids can't have had much to eat because their plates are

* A more nuanced argument is that buybacks temporarily boost the stock price, allowing the investors to sell at a higher price. As we'll show, the evidence shows that buybacks increase the stock price even more in the long term than the short term. Thus, selling shareholders lose out on the long-term gain and it's continuing shareholders who benefit the most.

empty' – they already ate the food that was on the plates, which is why they're now empty.

Buybacks Aren't an Investment

It's true that buybacks aren't a *real* investment – the money spent doesn't train staff, advertise a brand or build a factory. But an investment is anything that costs money today and delivers value in the future. A buyback is a *financial* investment. It reduces the amount of dividends an enterprise has to pay in the future,* leaving more cash for future real investment – just like paying down debt reduces future interest payments.

When a citizen saves for his future, he'll consider both real and financial investments. If there are value-creating ways to renovate his house (a real investment), he should undertake them. After doing so, he'll then evaluate various financial investments – bank accounts, mutual funds and shares – and choose the best ones.

The same is true for companies. After a leader has taken all value-adding real investments, she'll evaluate various financial investments – bank accounts, mutual funds and even other companies' shares.[6] The returns to those investments have nothing to do with the CEO's performance. So if she fully believes in her abilities as a CEO and her strategy for long-term value creation, the most attractive financial investment is her own shares.

Buying back shares is investing in your own enterprise's stock. It signals confidence in your strategy, which is why a CEO purchasing equity with her own money is typically a good sign.

* We'll shortly mention the survey by Brav, Graham, Harvey and Michaely (2005), which finds that companies use cash first to maintain dividends and then to invest. Thus, reducing dividends frees up cash for investment. If a company doesn't pay dividends, it needs to give a return to investors instead through capital gains.

Profits Should Go to Stakeholders, Not Investors

Another charge against buybacks is that, if the enterprise has made unexpectedly high profits, they should be given to stakeholders, not just investors. We've already explained how a buyback doesn't 'give' profits to investors. Moreover, the claim that employees are as entitled as investors to any profit increase is actually not correct.

Colleagues will have played a major role in the profit increase with their hard work. The same is true for suppliers who provided the inputs and customers who spent their cash. And it's also true for investors who risked their money, which they could have otherwise invested elsewhere.

Many members contribute to a company's profits, so they all should share in its success. And they do – just as investors receive returns, workers receive salaries, suppliers receive revenues, and customers receive goods and services. The difference between investors and stakeholders isn't that only the former are rewarded for their contributions. Both are rewarded, but investors' rewards are risky while stakeholders' are generally safe.

Let's use the analogy of a house. A homeowner is thinking of selling her house, but decides first to re-roof it to increase the sale price. She hires a builder and pays him for his labour. The builder certainly contributes to the sale price of the house. By working harder, he'll improve the quality of the roof and thus the sale proceeds.

But the sale price depends on lots of factors outside his control – the state of the housing market and the homeowner ensuring the house is in good condition for viewings. Making the builder's pay-off depend on the sale price subjects him to a lot of risk. So the builder normally receives a fixed price, independent of how much the house sells for, and the homeowner bears all the risk. This protects the builder from a collapse in the housing market – he still gets paid and the homeowner suffers the entire house price decline. But the flipside is that, if the housing market booms, it's the homeowner who gets the benefit.

And the same is true for companies. Colleagues work hard to design, manufacture and market goods. In return, they receive salaries. Importantly, these salaries aren't clawed back even if the economy takes a nosedive and the goods fetch a lower price or can't be sold at all. Investors come right at the bottom of the food chain. Profits are what's left over after everyone else has been paid off first. In a downturn, workers and suppliers still get paid, but shareholder returns are often negative. But the flipside is that they enjoy the upside if the economy booms. That's just how the returns are divided up – stakeholders get safe claims and investors get risky claims.* Importantly, *any increased profits go to investors even without buybacks*. Even if the higher profits stayed within the firm, they're still owned by investors, just as the homeowner benefits from a price increase even if she doesn't immediately sell the house. So the buyback has nothing to do with how increases or decreases in profits are split.

Now giving stakeholders fixed claims isn't the only possible division. The roof could be so material to the sale price of the house that, to incentivise diligence, the homeowner lowers the builder's fixed pay and replaces it with a share of the sale price. Similarly, Chapter 5 advocated awarding colleagues shares. But while this division gives them a share of the upside, it also exposes them to risk on the downside.** They might still be

* One might argue that employees still bear risk. If economic conditions are poor, the firm might go bankrupt, leading to job losses. Even in this case, employees will still be paid for their *past* contributions to the firm – the work they've already done – but investors won't get a return on the money they've already invested. Certainly, employees are better off if the firm remains afloat and their jobs are preserved because they can make *future* contributions and be paid for them. In this sense, they share in its upside, by enjoying continued employment, unlike the builder who engages in a one-time transaction.

** One might think that companies could give colleagues a share of the upside with no downside risk. A contract could pay a worker $50,000 per year plus a share in any profits above $1 billion; if profits fall below $1 billion, he still gets his $50,000. However, such a contract still bears downside risk. Let's say half of the time profits will fall below $1 billion and so the worker gets willing to accept this risky division. But this division depends on whether workers are given shares, not whether companies buy back stock or instead reinvest spare cash within the firm.

As we've stressed, Pieconomics isn't about a firm only fulfilling its minimum contractual obligations. Even if it's offering fixed salaries, it could choose to share the profits with colleagues through pay rises, training programmes and superior working conditions. Indeed, Pieconomics classifies such uses of cash as an 'investment' – investment includes actions that benefit stakeholders even if there's no clear link to profits. Throughout this chapter, we'll consider a company's choice between buybacks and this broad definition of investment.

That buybacks come out of profits addresses another concern. Buybacks are only possible if the firm has earned profits to begin with. So just like high CEO pay, buybacks are often a by-product of growing the pie rather than at the expense of stakeholders. Indeed, as we'll later discuss, when companies underperform, buybacks are one of the first things to be cut.

While this section addressed some misperceptions about buybacks, other concerns remain true. For example, it's indeed the case that the money spent on buybacks could have instead been invested. We now look through the lens of Pieconomics to show that, despite these valid concerns, buybacks can still be fully consistent with growing the pie.

A Pieconomics View of Buybacks

It's tempting to think that any profits left over, after stakeholders have been paid, should be reinvested. Recall Senator Warren's concern that 'stock buybacks create a sugar high

nothing; half of the time they'll exceed $1 billion and his profit share is $20,000. So the expected value of the profit share is $10,000 and the worker's total expected pay is $60,000. Instead of this contract, the companies could offer him a fixed salary of $60,000. Thus, the first contract still bears downside risk, because if profits end up low, the worker is paid $50,000 rather than $60,000.

for the corporations. It boosts prices in the short run, but the real way to boost the value of a corporation is to invest in the future, and they are not doing that'.

But as stressed in Chapter 3, *growing the pie does not mean growing the enterprise*. Any investment involves opportunity costs to society because it uses resources that could have been reallocated elsewhere. In their quests for growth, Daewoo and Countrywide invested with little heed to the cost, causing substantial damage to society.

Importantly, the number of value-creating investment opportunities a company has will always be finite – no matter how hard a leader works or how many ideas she has. A homeowner wanting to increase her resale value might re-roof the house, build a conservatory and refurbish the kitchen. But after doing so, there are no investments left that are worth the cost. So she invests her remaining cash in the stock market. An inspired film director may think of additional scenes to add to a film, or special effects to put into a particular scene – but there's a limit to how much he can do before further additions reduce value. So he uses his remaining cash to pay down debt. The same is true for companies. A retail chain might build several new stores, choosing the most attractive locations first. But after a point, further shops would either be in unattractive locations or stretch management so thin that it couldn't properly run them. So the CEO uses her remaining cash to buy back shares.

Now there's a key difference between an enterprise that practises Pieconomics and one that practises enlightened shareholder value – and this difference is one reason why some critiques of buybacks are justified. Under ESV, a leader makes investments where she can, at least roughly, forecast an increase in profits. This approach might lead her to believe she only has a few good investments and so large buybacks are justifiable. But a pie-growing leader makes investments that will create value for society, even if she can't forecast an eventual increase in profits. She'll generally invest more, and buy back less, than a leader who pursues ESV. So a CEO who buys back stock, believing she has no more investment opportunities, *could* be accused of running out of ideas. She's failed to notice that some projects would create value for society even though the link to profits isn't clear.

But even under Pieconomics, the list of value-creating investments is finite. There's only a limited number of projects that satisfy the principles of multiplication, comparative advantage and materiality. So a buyback needn't mean that the CEO has run out of ideas or is narrowly maximising shareholder value. She may already be making many investments with no clear link to future returns, such as improving pay and working conditions. But she recognises that increasing pay even further will endanger the firm's future viability, particularly since it's very difficult to subsequently cut wages. A pie-growing leader can discern between projects that create value for society and those that don't, and she shows restraint and grows the pie by turning down the latter.

Yet many CEOs don't show such restraint. Recall from Chapter 3 that, even if growing the company destroys value, a leader may do so to increase her prestige and pay. Similarly, raising worker salaries may help the CEO justify higher pay for herself, particularly if society is scrutinising pay ratios. So using cash for buybacks rather than investment may actually be against the CEO's personal interests, contrary to popular perception.

The Evidence

The above arguments for buybacks' role within Pieconomics are conceptual. *If* leaders have taken all value-creating investments, then buybacks may be optimal. But that's a big 'if'. How can we tell if this condition is satisfied? Maybe CEOs are scrapping good investments to meet EPS targets.

Perhaps the biggest accusation against buybacks is that they lead to a temporary 'sugar high', which 'boosts prices in the short run', but destroys long-run value. That CEOs enrich themselves at the expense of society is a popular view, given current mistrust in business. It's also a plausible one, given the evidence in Chapter 5 that executives sometimes take myopic actions to increase their own pay. But when it comes to buybacks, this claim is widely made without looking at the evidence.

So let's do so. Buybacks do increase the short-term stock price – but they increase the long-term stock return even more.[7] A seminal paper by David Ikenberry, Josef Lakonishok and Theo Vermaelen found that firms that bought back stock beat their peers by 12.1% over the next four years. While this study was published in 1995 and analyses US firms, a 2018 investigation of 31 countries by Alberto Manconi, Urs Peyer and Theo Vermaelen showed that this result generally holds worldwide.[8]

One example is – surprisingly – Humana. Even though this story might seem like egregious manipulation, the reality is more nuanced. The $500 million buyback was announced on 7 November 2014 when the stock price was $130.56. It was completed on 16 March 2015 when the price was $174.31, and the average price Humana paid was only $146.21. So Broussard's confidence in his own enterprise was justified. The buyback did net Broussard a $1.68 million bonus, but continuing investors gained $96 million.[9] The long-term gains are even higher – the stock price ended 2020 above $400. Broussard's bonus wasn't at the expense of continuing investors. The only losers were shareholders who cashed out because they didn't see potential in Humana.*

* Note that this doesn't mean that Humana was justified in giving Broussard a bonus with a $7.50 EPS target. If he had received long-term stock instead of the bonus, he'd also have benefited from the buyback. The correct amount of the buyback depended on the investment opportunity from buying Humana's undervalued stock versus the investment opportunity from real projects. When deciding how many shares to buy back, a leader should trade off these two investment opportunities, rather than buying back just enough to meet an EPS target.

This example again illustrates the importance of the pie-growing mentality. In a *Financial Times* debate on 'should the US rein in share buybacks?', where I was asked to take the 'No' side, the 'Yes' side argued that 'research shows the corporate insiders who *execute buybacks* often benefit personally from their use'.[10] To evaluate such arguments, a useful rule of thumb is to substitute 'take good projects' in place of a contentious action.[11] If 'research shows the corporate insiders who *take good projects* often benefit personally', that wouldn't be an argument to rein them in. What matters is whether the action grows or shrinks the pie, rather than whether leaders share in any pie growth. Indeed, a fair incentive scheme rewards a CEO for good actions and punishes her for bad ones.

Other research investigates the link between buybacks and investment. Gustavo Grullon and Roni Michaely show that companies repurchase more when growth opportunities are poor,[12] and Amy Dittmar finds that they do so when they have excess capital.[13] Now that's only a correlation. To get closer to causation, we need to get inside firms and see how they actually make repurchase decisions – do buybacks have higher or lower priority than investment?

An influential study by Alon Brav, John Graham, Cam Harvey and Roni Michaely[14] does just this, surveying 384 US Chief Financial Officers (CFOs) on how they make buyback (and dividend) decisions. There's an obvious concern here – might they lie? Perhaps, but the CFOs admitted they'd cut investment to avoid cutting the dividend, attenuating concerns that they won't admit to short-termism. Strikingly, they reported no such pressure for buybacks. They only buy back stock if they have cash left over after taking all desirable investments. *It's low investment opportunities that lead to buybacks, rather than buybacks that lead to low investment*. PwC and I conducted a similar survey of 74 executives for the UK government study, which reached the same conclusions. Only a single respondent claimed that buybacks prevented the company from making all the investments it wanted to.

Now this evidence doesn't prove that firms are undertaking the right level of buybacks. Perhaps executives are defining 'desirable' investments as ones that have a clear link to investor returns, and thus are investing too little. Even if true, the cause of underinvestment isn't buybacks – it's CEOs practising ESV rather than Pieconomics. If buybacks were prohibited, ESV managers would invest the same amount, and save the leftover cash within the firm or pay down debt – that they chose a buyback means they think there are no good investment opportunities left. So buybacks are a symptom of a deeper problem rather than the problem itself. The solution isn't to tackle the symptom – take any special action against buybacks – but the problem, which is enterprises failing to adopt the pie-growing mentality. That's what the earlier chapters in Part II, plus Part III, aim to do.

The Bigger Picture

The social opportunity costs of an investment are central to Pieconomics, since our lens is society rather than just the enterprise making the investment. If a firm doesn't use real resources such as labour and raw materials, other firms can use them to create value. And the same is true for financial resources. Even though a buyback involves money leaving the firm, that money doesn't leave the economy – it gets invested elsewhere. The main difference is that it's shareholders, not the firm's CEO, who decide where to invest the money. Shareholders have a much wider range of investment opportunities to choose from, since they can invest outside the firm. Indeed, citizens who save for retirement using a bank account or mutual funds aren't lambasted for not creating jobs by instead renovating their house. The money they save doesn't disappear – the bank or mutual fund invests it.

Investors won't sell shares in a buyback to sit on cash, so they'll only sell if they have better investment opportunities elsewhere. Start-ups are financed by venture capitalists, who get their money from institutional investors that also own shares in public companies.[15] It's mature firms showing restraint and buying back stock (or paying dividends) which allows these investors to put money into venture capital, financing the enterprises of tomorrow. By first generating profits as a by-product of creating value for society, then investing in all pie-growing projects and finally paying out the remaining cash, an enterprise starts a virtuous circle that allows other companies to create value. In contrast, when leaders hoard cash, thinking it's theirs rather than investors', they prevent such redeployment. Such hoarding has contributed to the stagnation of Japan mentioned in Chapter 6. Capital is a scarce resource, and a system that deploys capital to its most effective use is a national competitive advantage.

The funds paid out in buybacks aren't recycled in only small private companies, but also medium-sized public ones. Huaizhi Chen follows the money and shows that, when a company pays out dividends or engages in a buyback, the cash is reallocated to other stocks held by its investors. This reallocation increases their prices and makes them more likely to issue equity in the future.[16] Jesse Fried and Charles Wang find that, even though US S&P 500 firms buy back more stock than they issue, non-S&P 500 firms (which are smaller and typically have better investment opportunities) do the opposite.[17]

This observation addresses a concern beyond buybacks – that the financial industry creates little value for society. This industry is enormous and worth $1.5 trillion in the US in 2018.[18] It pays some of the highest salaries, earns substantial profits and benefits from government bailouts, yet doesn't produce any goods. Finance apologists argue that they provide funding to allow other enterprises to do so. But in the US and (more recently) the UK, the amount raised on stock markets roughly equals the amount spent on buybacks. So the stock market isn't actually a net supplier of financing.

But looking at *net* financing flows is incorrect. The stock market's role is to allocate scarce funds to companies that need them the most. This involves firms with poorer opportunities paying out excess cash, allowing those with better opportunities to invest more. Zero net financing is consistent with some firms raising funds and others returning them, just as a zero net trade balance doesn't suggest that a country is failing to trade; some firms in that country could be importing a lot and others exporting. Indeed, at a country level, Joseph Gruber and Steven Kamin find no evidence that economies with high repurchases (or dividend payments) invest less.[19]

Buybacks vs Dividends

If an enterprise has taken all its pie-growing investments, buybacks aren't the only remaining option. It could hold onto the surplus cash as a buffer, to protect against adverse events and to allow it to make future investments nimbly without the time or cost of raising new funds. But cash balances across US firms were $5.2 trillion in 2019, 58% higher than in 2007,[20] so firms had a big enough buffer to withstand most shocks. This also contradicts the concern that buybacks starved firms of cash for investment. As Warren Buffett wrote in Berkshire Hathaway's 2016 shareholder letter: 'Some people have come close to calling [buybacks] un-American – characterizing them as corporate misdeeds that divert funds needed for productive endeavours. That simply isn't the case: Both American corporations and private investors are today awash in funds looking to be sensibly deployed. I'm not aware of *any* enticing project that in recent years has died for lack of capital. (Call us if you have a candidate.)'

Did the pandemic prove Buffett's claim that companies were 'awash in funds' wrong? The US airline industry needed a $50 billion bailout, which critics argued was only required because it had spent $45 billion on buybacks and dividends over the past five years – had it instead saved this cash, it wouldn't have needed the bailout. But almost nobody predicted the pandemic. Hindsight is always 20/20; the big question is whether paying out the cash was the right decision at the time. In blackjack, if you hit on 12, draw a face card and go bust, it doesn't mean that the decision to hit was incorrect at the time.

Companies should absolutely retain a cash buffer to guard against a reasonable level of risk. But they shouldn't hoard cash like 'contented cows' to protect against every single eventuality – just like a blackjack player's goal shouldn't be to never go bust. Doing so prevents investors from using cash to finance growing companies. Indeed, before the pandemic, many citizens were calling for the airline industry to downsize due to its carbon footprint, with Extinction Rebellion proposing a ban on short-haul flights. Shareholder payouts facilitate this by allowing society's scarce capital to be reallocated away from declining industries and towards expanding ones.

Moreover, cash burning a hole in the leader's pocket may make her trigger happy and more willing to empire-build, like having your phone on the table makes you more likely to check it. Throughout much of the 2010s, Yahoo was valued at below the sum of its parts, partly due to concerns it would fritter away its cash on bad acquisitions. Amy Dittmar and Jan Mahrt-Smith found that, in poorly governed firms, \$1 of cash is valued at only \$0.42 to \$0.88.[21] This highlights the value that can be unlocked by simply paying out cash rather than wasting or even retaining it.

A third option is to pay out the funds as dividends to investors – in nearly all countries, dividend payouts substantially exceed buybacks. Like repurchases, and unlike hoarding cash, dividends allow the funds to be invested elsewhere. But repurchases have several advantages. First, they're more flexible. Once you've paid out a dividend, you're committed to maintaining it in the future – potentially restricting investment down the line. Wei Li and Erik Lie show that reversing course and cutting the dividend reduces the stock price by an average of 4%,[22] which explains why the CFOs surveyed by Alon Brav and co-authors were so reluctant to do so. In contrast, an enterprise can chop and change its buyback policy depending on investment opportunities and suffer no stock price hit – it can repurchase one year, yet cut repurchases to zero the next, if profits drop and it needs every dollar for investment. In the second quarter of 2020, as the pandemic hit, S&P 500 firms cut buybacks by 55%, providing them with a vital lifeline, but dividends by only 6%.[23] More broadly, Murali Jagannathan, Clifford Stephens and Mike Weisbach find that repurchases are cut when profits fall.[24]

Second, repurchases are targeted. In a buyback, investors choose whether to sell. Those that do will be the ones with the best alternative investment opportunities or who value the stock the least. So buybacks get rid of investors with least buy-in to the company's long-term strategy and ensure the remaining investors are ones who believe in it. In contrast, dividends are paid to all investors, even those without good other uses for the cash and who may allow it to sit idle.

Third, repurchases – but not dividends – lead to more concentrated ownership. Both the CEO and continuing investors now have a greater share of the firm, increasing their incentives to create value (see Chapters 5 and 6). Indeed, in the 1980s, Warren Buffett used buybacks at GEICO to concentrate ownership in his own hands.

Finally, repurchases are a good investment if your stock is underpriced. Chapters 4 and 6 explained how the stock market may fail to fully appreciate a company's long-term value. A solution is for a CEO to put her money where her mouth is and buy her own enterprise's stock. Not only is buying shares profitable if they're currently undervalued, but it also signals the undervaluation to the market and helps correct it. If leaders can use buybacks to correct undervaluation, they don't need to worry about it as much – freeing them to pursue investments whose pay-offs arise only in the long term.

Dividend Policy in Responsible Enterprises

The inflexibility of dividends can be a serious barrier to Pieconomics, as companies may turn down pie-growing investments to maintain the dividend. Some firms may have paid high dividends in the past because they had few value-creating projects, but structural shifts mean they now have many. For example, power companies have attractive – and urgent – opportunities to develop renewable energy, but some can't pursue them because they need to keep up the dividend.

As we've stressed throughout this book, companies have a responsibility to shareholders. But paying dividends may not actually help investors. Shareholders care about total returns – dividends plus capital gains – and the former are at the expense of the latter. A dividend of £1 simply reduces the stock price by £1, just as withdrawing from an ATM gives you cash in your pocket but less in your account. And if the £1 dividend would have been invested in a value-creating project, it would have generated more than £1 of value, so investors actually lose.

It's true that some shareholders need liquidity, such as pension funds who need to pay retirees. But they can create liquidity themselves by selling their shares. Take a pension fund that needs to raise £100, and owns 100 shares trading at £10 each for a total of £1,000. If the company pays a £1 dividend per share, the fund's needs are met. But the share price falls to £9, so the fund's holdings are now worth £900. If the company scrapped the dividend, the price would remain £10. The fund could sell 10 shares to raise the £100. It's left with 90 shares worth £10 each – so its holdings are again £900.

Relying on dividends for liquidity also encourages investors to be passive – they can sit back and finance their obligations with dividends, without the need to figure out which companies to sell. When a company pays a dividend, it's effectively making the sale decision on behalf of shareholders. A 3% dividend yield means that, each year, an investor is selling 3% of his stake, regardless of how the company is performing. If they weren't so reliant on the dividend, active investors would have to truly be active – get into the weeds of every stock they own. They'll want to find out which companies have high share prices but poor long-term prospects and ensure they sell only them, and retain firms that are investing for the future. As discussed in Chapter 6, such monitoring in turn encourages leaders to focus on the long term.

What's the solution? For investors to show the same flexibility with dividends as they do with buybacks – allow companies to *first* take all value-creating investments and *then* pay out surplus cash as dividends or buybacks. Indeed, this flexibility is already afforded to 'special dividends', which are seen as one-off, so it's realistic to think it could apply to regular dividends as well. And investors even allow companies to pay no dividends at all, such as Amazon, Facebook and Tesla, because they're confident the cash will be reinvested profitably within the firms. If they're willing to accept no dividends, they should be willing to accept occasional dividends.* Moreover, flexible dividends needn't

* Another oft-cited advantage of dividends is that they're are a safe income stream for investors. Stock prices move around all the time, but if a company is paying a £1 dividend, an investor is guaranteed a £1 income. However, it's total returns that an investor cares about, and dividends don't guarantee returns. If the stock price falls from £10 to £6, a £1 dividend doesn't mitigate his loss, as it would cause the stock price to fall further to £5. The total return is independent of the dividend. This also highlights the fallacy of rules such as 'consume only from dividends, don't erode capital gains'. Consuming from dividends does erode capital gains, as the capital gain would have been even higher had the dividend not been paid. It's the total return that determines how much the investor's wealth has changed, and thus how much he can 'afford' to consume. How it's divided up between dividends and capital gains doesn't matter.

mean lower dividends. Under the current rigid dividend policy, if a company has spare cash, it might not increase the dividend, because it will be locked into the new dividend level. If dividends are flexible, it may be willing to pay out the spare cash as dividends, knowing it can cut it next year if times get tight or if good investment opportunities arise.

Of course, this doesn't mean that leaders should be able to cut the dividend at a whim, without any investor accountability. One advantage of dividends is they force a company to pay out cash rather than wasting it on pie-in-the-sky projects. However, at the moment, the market 'sells first and asks questions later' upon a dividend cut, without asking whether it's justified. The right amount of investment depends on how many good projects there are, not how much the dividend happened to be last year. If the dividend is cut, shareholders should scrutinise how an enterprise is using the saved cash, rather than reacting in a knee-jerk manner. And if they sense that a company is sacrificing pie-growing investments to maintain the dividend, they can proactively engage with leaders to communicate their willingness to accept a dividend cut.

How Buybacks Can Destroy Value – and How to Fix It

Even if the evidence suggests that most buybacks grow the pie, they may not do so in every case. And the analogy between a CEO and a homeowner isn't perfect. The homeowner owns the entire equity in the house and so has full incentives to increase value. But leaders often own only a fraction of their firm. They're partially paid with bonuses, which may have EPS targets that can be met using a buyback. So buybacks might be used to hit short-term targets rather than to create long-term value.

Does this actually happen? Let's look at the evidence. Recall from Chapter 5 the study by Ben Bennett and co-authors, which compared leaders who just hit bonus thresholds with those who just missed.[25] Hitters do significantly less R&D than missers, so CFOs are certainly willing to take certain actions to meet targets. But buybacks aren't one of them – the same study found no difference in repurchase behaviour between the two groups. It seems that Humana was an exception. Similarly, in the government study with PwC, we found that not a single UK FTSE 350 firm used buybacks to hit an EPS target over 2009–16.

Chapter 5 also noted that short-term pay incentives stem from not only bonuses, but also vesting equity, which Vivian Fang, Katharina Lewellen and I showed is linked to investment cuts. In a subsequent paper, Vivian, Allen Huang and I discovered that vesting equity increases the likelihood of stock buybacks and reduces the long-term returns to these buybacks.[26] While buybacks in general are associated with higher long-term stock returns, those induced by vesting equity aren't. Yet even these buybacks aren't the problem itself, but a symptom of the underlying problem – short-term equity – which causes other short-term behaviours like investment cuts.

So the solution isn't to restrict buybacks. This would do nothing to deter investment cuts and may actually increase them, if CEOs switch from buybacks to investment cuts as a way to boost the stock price. Instead, we should address the underlying problem by lengthening the horizon of equity, or boards scrutinising firm decisions more closely when equity is vesting.

The study with Vivian and Allen uncovered a more serious practice. CEOs typically sell their vesting equity shortly after the buyback, taking advantage of the short-term price increase it causes. This finding was independently corroborated by SEC Commissioner Robert Jackson.[27] For example, Angelo Mozilo used Countrywide's money to buy back $2.4 billion of shares between November 2006 and August 2007 – yet sold

$140 million of his own shares over the same period.[28] I earlier argued that buybacks signal the CEO's confidence in her own firm. But if she's selling her own shares at the same time as buying shares with the company's money, this is duplicitous. If the CEO really were positive about her firm's prospects, she'd hold onto her equity when it vests rather than selling it. A potential remedy would be to prohibit executives from selling their own shares within a given window (say six months) after a buyback.

Short-term incentives can stem not only from the CEO's contract, but also from the desire to meet analyst earnings forecasts. Heitor Almeida, Slava Fos and Mathias Kronlund compared firms that would have just met the EPS forecast without a buyback (and thus had no incentive to undertake one) with firms that would have just missed it (and so had strong buyback incentives).[29] The latter repurchase more shares, and cut investment by an average of 10% and headcount by 5% over the next year. As discussed in Chapter 5, these cuts could be either efficient (the EPS forecast encourages the leader to scrap unprofitable projects) or myopic, and the tests don't distinguish between these cases. But the results are certainly consistent with the idea that EPS-induced buybacks can destroy long-term value.

Even if true, buybacks are again a symptom of an underlying problem, the desire to meet analyst EPS forecasts. Recall that Sanjeev Bhojraj and co-authors found that this desire causes managers to cut R&D and advertising. Buybacks may simply be a by-product, undertaken out of the cash left over. As I'll stress in Chapters 8 and 10, the solution is to address the root cause of the behaviour – companies' desire to meet EPS forecasts – by ceasing to report quarterly earnings.

We've discussed how value-destroying buybacks should be addressed by general solutions to underinvestment. One final general solution may also be effective here: giving colleagues equity in the firm. This allows them to share in any value increase created not only by their hard work (as stressed in

Chapter 5), but also by buybacks – and means that buybacks don't just benefit shareholders, but employees too. Buying out investors who don't value the firm's long-run prospects increases the stake of colleagues who do.

In a Nutshell

- Share buybacks are often viewed as splitting the pie in favour of leaders and investors. This can indeed be the case, but many common criticisms are based on misperceptions. Buybacks aren't a free gift to investors, nor do investors require them to cash out.
- Pie-growing enterprises should take projects that are likely to create value for society, even if they don't clearly increase long-run profits. They should invest more, and buy back less, than firms that pursue enlightened shareholder value.
- But pie-growing enterprises shouldn't invest all spare cash. They should only take investments that satisfy the principles of multiplication, comparative advantage and materiality. Once they have done so, buybacks are a legitimate alternative use, particularly if the stock is undervalued.
- The evidence is consistent with a pie-growing use of buybacks. While a buyback increases the short-term stock price, it increases the long-term stock price even more. Companies buy back more stock when their investment opportunities are low and they have surplus cash. They make investment decisions before repurchase decisions, so buybacks are the result of low investment, not the cause.
- Buybacks are a better way of returning surplus cash than dividends because they're flexible, targeted to the investors who have least buy-in to the firm's long-term strategy, and concentrate the stakes of continuing investors (including leaders). They also create value for the company if its stock is undervalued.

- There's evidence that buybacks may destroy value when driven by vesting equity or analyst forecasts, but they're not used to hit EPS targets in bonus plans.
- Even where buybacks destroy value, they're symptoms of an underlying problem – short-term pressures – which lead to other symptoms such as investment cuts. Solutions should be targeted at the underlying problem.

Part III

How to Grow the Pie? Putting It into Practice

This Part discusses how to put the ideas in Parts I and II into practice. Creating value for society might seem a nice ideal, but unrealistic. When the rubber hits the road on Monday morning and you've got short-term targets to hit, investing in stakeholders may seem infeasible. We now explore how it can be made real.

There are separate chapters for enterprises (Chapter 8), investors (Chapter 9) and citizens in their role as customers, influencers and voters (Chapter 10). Part III will loosely mirror the evidence in Part II. Chapter 5 discussed incentives, which are implemented by companies; Chapter 6 tackled stewardship, which is undertaken by investors; and Chapter 7 addressed buybacks, which government policy can facilitate or constrain. Knowing what we know from Part II, we'll see how enterprises, investors and citizens can grow the pie.

But the lines are blurred. Incentives may be implemented by boards, but are voted on by investors and legislated by governments. Stewardship depends on the willingness to engage of not only investors, but also companies, and may also be regulated. Policies may be imposed by legislators, but also voluntarily adopted by shareholders or companies themselves.

In addition, there won't be full congruence with Part II, since it focused on pie-growing practices that most people believe to be pie-splitting. There are many factors that are widely accepted to be pie-growing, such as an enterprise having a purpose (few citizens advocate that companies should be purposeless). Here, the main challenge isn't so much proving that these factors are beneficial, but putting them into practice – so they appear only in Part III.

Part III also broadens out the ideas of Part II. Chapter 5 gave evidence on the value of long-term CEO incentives; Chapter 8 will discuss how to embed long-term thinking in companies more generally. Chapter 6 illustrated the value of stewardship by asset managers; Chapter 9 will discuss how stewardship is a responsibility of the whole investment chain, which includes asset owners, equity analysts, proxy advisors and investment consultants. Chapter 7 highlighted how value-destroying repurchases are typically a symptom of an underlying problem; Chapter 10 will highlight the wider market failures that regulation can address.

8 ENTERPRISES

The Power of Purpose and How to Make It Real

Excellence

The Great Rift Valley stretches for 6,000 kilometres across two continents, from Lebanon in Asia to Mozambique in Africa. It's bordered by some of Africa's highest mountains, yet houses some of the world's deepest lakes. In Kenya, the lakes are shallower and have no outlet to the sea. So in the dry season when the water evaporates, they're particularly rich in minerals. In Lake Magadi, the southernmost lake in the Kenyan stretch of the Great Rift Valley, the salt can be up to forty metres thick.

Millions have seen Lake Magadi in the thriller film *The Constant Gardener*. But fewer than a thousand people call Magadi, the township lying on the lake's east shore, their home. One of these people is Emmanuel Sironga, who makes a living for himself and his family trading goats.

For Emmanuel – like millions of Africans – cash used to be king. It's cash that Emmanuel needed to buy goats and equipment. It's cash that Emmanuel received from selling goats, which he'd first check for forgery and then store at risk of robbery. When he'd amassed enough, he'd take it to the bank. But the nearest bank was hours away, so a round trip deprived him of nearly a day of trade, and Emmanuel was restricted in where he could graze his goats because he couldn't be too far from a bank. And if he wanted to send money to his relatives, it's cash that he'd put in an envelope, before hiring someone to travel on a country bus to deliver it. Sometimes the cash might not get there because the bus broke down; other times the courier might run off with it.

But all that changed in 2007 with the launch of M-Pesa – a mobile money service that allows citizens to deposit, withdraw and send money using their phone. Unlike mobile banking, mobile money doesn't require you to have a bank account, which is critical since 15 million Kenyan adults were unbanked back then. M-Pesa changed Emmanuel's life. He no longer suffers the risk and inconvenience of using cash. He buys goods and takes payments on his phone, and M-Pesa's electronic records help with his accounting. He can send money to anyone, regardless of where he is or where they are, which frees him to focus on his vocation – tending his flock. In Emmanuel's words: 'As pastoralists, we have to travel long distances in search of greener pasture. M-Pesa has made our lives easier because we do not have to travel long distances to give our relatives and friends money.'[1]

How was this life-changing technology created? A seed was sown when researchers funded by the Department for International Development (DFID), the UK government's foreign aid arm, noticed that Kenyans were transferring mobile minutes to each other as an easier option than sending cash. While it was a government that sparked the initial idea, it took a pie-growing enterprise to transform it into reality. DFID introduced the researchers to Vodafone, the UK's largest telecoms company, which had been investigating how to use its mobile platform to improve Kenyans' access to finance. The ensuing conversations gave Nick Hughes, Vodafone's Head of Global Payments, the idea to use phones to transfer not mobile minutes, but cash. A vision was born and was named M-Pesa – M for mobile and Pesa being the Swahili word for money.

Vodafone was committed to making M-Pesa a success. It invested colleagues' time and £1 million of funding to overcome the substantial obstacles before M-Pesa could go live. Nowadays, apps that transfer money through smartphones are plentiful, but M-Pesa needed to run on the basic mobile phones that Kenyans had back then (and many still do). Vodafone had to establish a nationwide network of retail outlets and train a team of agents to allow customers, anywhere in the country, to open accounts, make deposits and cash out. The freedom provided by mobile money also makes money laundering easier, so Vodafone designed processes to combat illegal use.

Since Vodafone launched M-Pesa in 2007, it has transformed citizens' lives.[2] Entrepreneurs like Emmanuel can buy and sell goods, parents can pay their children's school fees, adults can fund their parents' health care and all can save for the future. Tavneet Suri and William Jack found that access to M-Pesa lifted 196,000 Kenyan households (2% of the population) out of poverty by 2014.[3] The effect is stronger among households headed by women, largely due to the career shifts that M-Pesa allows – 186,000 women switched out of agriculture and into business and retail. M-Pesa has since been rolled out to several other countries. It's now the largest payments platform in Africa, helping 40 million users to process over a billion transactions each month.

Let's now turn to a quite different example of Vodafone serving society. In 2012, Vodafone became the first company in the telecoms industry worldwide to release a tax transparency report, showing how much tax they paid to governments across the globe. That's particularly important in telecoms, where you can avoid tax by locating your intellectual property in low-tax jurisdictions.

Which of these two actions – M-Pesa or tax transparency – created most value for society? And which of these actions, if it had not been taken, would have led to the greatest public outrage, or worsened Vodafone's CSR ratings?

Nearly everyone I've asked these questions to has agreed on the answers. M-Pesa created most value for society. It lifted 196,000 Kenyan households out of poverty and contributed significantly to gender equality. But, turning to the second question, what would have been the public outrage had Vodafone not launched M-Pesa? Nothing. You don't get shamed for not innovating. The media, politicians and the general public would have never expected Vodafone to launch such a crazy idea – banking without a bank – to begin with. The same is true for other great innovations that we've discussed in this book, such as Merck developing ivermectin for human use.

But what's the public outrage from not being transparent on taxes? Potentially huge. Indeed, Vodafone suffered such outrage in September 2010, when the magazine *Private Eye* reported that Vodafone had (legally, but in their eyes not morally) avoided £6 billion of tax. Just four months earlier, UK Chancellor of the Exchequer George Osborne announced £6 billion of public spending cuts. Some citizens assumed these events were linked, and argued that they were suffering £6 billion of austerity because a greedy corporation dodged its tax obligations. This anger birthed the protest group UK Uncut, which organised mass boycotts of Vodafone stores throughout the country.

A responsible company absolutely needs to pay fair tax; doing so funds public services and helps ensure a fair split of the pie.* Indeed, many executives view responsibility as being about 'do no harm' – don't underpay taxes, don't mistreat workers and don't pollute the environment. That's clearly important, but it's not enough. Given the scale of the challenges facing society today, it's not enough for a business to simply 'do no harm'. It must 'actively do good'.

This highlights the main way in which enterprises can grow the pie – *excellence*. Companies can create even more value by having an uncompromising commitment to excellence in their core business than by pursuing ancillary social activities. Recognising the importance of excellence is critical for three key reasons.

Excellence Is the Best Form of Service

'Serving' society is often viewed as making financial sacrifices or undertaking actions of explicit service, such as Apple

* While the tax transparency report didn't affect the amount of tax Vodafone paid, transparency is important to ensure public trust in business.

building the gym without a calculation. Such actions are indeed valuable, and we've stressed them throughout this book. But, often, *excellence is the best form of service*. The biggest way that Vodafone serves society isn't by being transparent on tax, even though doing so is important, but by being excellent in delivering its existing mobile services and creatively leveraging its telecoms expertise to solve other social problems. Similarly, the manufacture of CPAP breathing aids, described in Chapter 1, was a tremendous act of engineering excellence – the team from Mercedes and University College London produced a prototype within 100 hours of its first meeting.

This observation highlights the difference between Pieconomics and CSR we introduced in Chapter 1. CSR is sometimes about undertaking non-core activities to compensate for a pie-splitting core business. In contrast, Pieconomics is about creating value through excellence using your core expertise.

Excellence Can Be Pursued by All Companies at All Times

We often think that companies can only transform society if they're in an industry like pharmaceuticals, which has the power to cure river blindness or coronavirus. This isn't true. Just like the different organs in a body each play their own part, a company creates value by fulfilling its unique role in the world in an excellent manner. An enterprise doesn't have a responsibility to solve all of the world's problems, but instead to focus on the issues it's uniquely well placed to solve.

Unilever is widely viewed as a leading example of a responsible company, even though it manufactures everyday products. As Sue Garrard, who led Unilever's Sustainable Living Plan, said: 'We make soup and soap.' But soap can transform entire communities by improving hygiene. Every 23 seconds, a child around the world dies from either pneumonia or diarrhoea,[4] yet handwashing reduces pneumonia infections by 23% and diarrhoea by 45%.[5] So, in 2010, Unilever launched a campaign to help 1 billion citizens improve their handwashing habits over the next decade – a target they achieved two years ahead of schedule. Many Westerners consider a mobile phone as a commodity, but as Matt Peacock, Vodafone's former Group Director of Corporate Affairs, pointed out, 'if you're in a developing country and put a mobile phone into someone's hands, you change their life'. So a telecoms company can create tremendous social value through excellence in its core activity, as Vodafone did with M-Pesa. Commuting may seem just part of the daily grind, but a great transport company can connect citizens to jobs, allow families to live closer to communities rather than the office and enable new enterprises to start. A children's toy company might not seem obviously socially responsible. But high-quality toys can make a big difference to children's happiness (and their parents' peace), and educate as well as entertain them. Of course, there's a small handful of core activities whose social cost outweighs their benefit, such as producing tobacco, but the set that does create social value is much larger than commonly thought.

Another reason why all companies can serve society through excellence is that it often costs little financially – you've already developed your expertise. So it can be pursued by start-ups, or large corporations when times are tight; it's not just a luxury to be indulged in when a company is awash with cash. While Vodafone did invest £1 million to develop M-Pesa, this was a drop in the ocean compared to its annual investment budget – £4.2 billion in 2007. Even more key to launching M-Pesa was the vision to use Vodafone's telecoms expertise in a new way.

Excellence Is Relevant to All Colleagues

The importance of excellence is even more relevant for colleagues, because many jobs may not have an explicit social function – but these jobs are no less important to the company or to society. All colleagues can engage in excellence, regardless of their job description, and doing so can have a profound impact on the enterprise's ability to create value. Keeping accurate financial budgets or meeting minutes allows others to take decisions in an informed manner; efficient procurement of goods or management of working capital enable a firm's resources to go further.

Companies often value employees whose jobs are directly linked to its vision – and indeed Roy Vagelos was inspired by hearing the lunchtime conversations of Merck's scientists, not payroll clerks. But it's critical that they acknowledge the extraordinary value of seemingly ordinary jobs performed with excellence, and recognise how every colleague is key to the business. Recall from Chapter 5 that shares for rank-and-file employees improve performance only if awarded throughout the organisation, rather than targeted at specific groups (like the R&D department). Similarly, a company needs to ensure that its mission connects with everyday tasks and activities. Otherwise, even a visionary statement will fail to inspire a payroll or procurement worker.

Isn't it obvious that all companies – not just responsible ones – should strive to be excellent? Not necessarily. A company focused on shareholder value will pursue excellence only in areas that are clearly linked to profit. A pie-growing enterprise should do so in activities that create value for society, even if the link to profit is uncertain and distant. Moreover, the importance of excellence is sometimes overlooked by firms who (correctly) recognise their need to serve society but (incorrectly) think this means they should focus on explicit 'serving' activities.

Similarly, an R&D department in a profit-focused firm will be driven to serve a known customer demand, but in a responsible firm it may be inspired by the excitement of making a scientific breakthrough. Many innovations happen by accident and fill a need that never previously existed, and never previously asked to be served. When 3M scientist Spencer Silver tried to create a strong adhesive for aircraft construction, he accidentally made a weak one, and called it a 'solution without a problem'. Colleague Art Fry realised it could stop him losing his bookmark in his church hymn book, and the adhesive was developed into Post-It Notes. More generally, many companies are good at problem-solving – noticing a market demand and figuring out how best to serve it. But the most radical innovation typically involves problem-finding – creating a new market that didn't previously exist, such as a use for the weak adhesive. This involves excellence rather than service, and a leader constantly asking herself what's in her hand – how she can creatively use her enterprise's resources and expertise to deliver value to society. Failing to problem-find won't lead to public outrage, as no one would view unrelated problems as your responsibility. But Pieconomics is about actively creating value, not just protecting your corporate reputation.

The principle of excellence in unrewarded areas also applies to individual colleagues. In my profession, academics are promoted and given tenure almost exclusively on their research, not teaching. On my first day as a professor, I asked the Deputy Dean how much weight was put in teaching on tenure decisions. He answered 'zero'. If I was initially shocked, his clarification made me even more so: 'zero or negative'. The warning I was given is that, if you win too many teaching awards, senior faculty will worry that you're not spending enough time on research. However, a responsible professor will take teaching seriously, despite the lack of extrinsic rewards, since she serves society through disseminating knowledge. Indeed, faculty create far more value through excellence in this core activity – ensuring their teaching materials are up-to-date and practical, not just theoretical – than doing no harm in non-core activities, such as biking rather than driving to work.

In contrast, one of the biggest ways in which a company can destroy value is to tolerate mediocrity over excellence – an error of omission. If Vodafone hadn't strived for excellence by exploring the idea of mobile money, there would have been no media backlash, but 196,000 Kenyan households would have been worse off. Sometimes, the pursuit of excellence may involve tough decisions, such as letting go of an underperforming colleague. A leader may use social objectives, such as wishing not to hurt a particular stakeholder, to justify the failure to take tough decisions. But the damage done to society from accepting mediocrity can be far greater.

Purpose

Pursuing excellence is a useful principle, but is insufficient by itself. Companies undertake many activities, and it's impossible to be excellent in each one. A company's resources are limited, so it must choose which activities to particularly excel in; many decisions involve trade-offs, so it must choose which stakeholders to particularly serve. Relatedly, the central idea of this book – that companies should grow the pie – sounds inspiring, but also somewhat ambiguous. A pharmaceuticals firm grows the pie in very different ways from a transport firm. How does a company actually 'grow the pie'?

That's the role of purpose. *Purpose is why a company exists – who it serves, its reason for being and the role it plays in the world*. It's the answer to the question 'How is the world a better place by your company being here?' Purpose represents the particular way in which an enterprise serves society and thus grows the pie. 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. That's similar to how a citizen's vocation isn't to earn a salary; instead, by choosing a career he enjoys, he'll flourish in it and end up being well paid. As founder of energy supplier AES, Dennis Bakke, wrote: 'Profits are to business as breathing is to life. Breathing is essential to life, but is not the purpose for living. Similarly, profits are essential for the existence of the corporation, but they are not the reason for its existence.' BlackRock CEO Larry Fink stressed that 'purpose is not the sole pursuit of profits but the animating force for achieving them'.[6]

But even though the purpose can't be to make profits, it must be something that will ultimately – even if indirectly – lead to the company's success, and all employees in the enterprise should understand this link. Otherwise, the leaders will never genuinely embrace it, and view it as being at the expense of financial returns. For example, Unilever found that its Sustainable Living Brands, which are most closely aligned to its purpose of 'making sustainable living commonplace', grew 69% faster than the rest of its business in 2018.

Purpose is powerful because it unites a firm's disparate stakeholders in a common mission. The traditional way to bring stakeholders together is through contracts. Economist Ronald Coase, whose Coase theorem we introduced in Chapter 2, viewed a firm as a web of contracts, where each member responds rationally to the incentives provided by those contracts. For example, a salesperson works hard to close deals because he's paid on commission. But, while contracts work in economic models where output is measurable, they're often ineffective in real life. First, you can't measure many ways a salesperson creates value, such as mentoring subordinates or helping colleagues, and so you can't enforce them with a contract. Contracts are even more ineffective due to the home-working sparked by the pandemic. Employees can't be closely monitored, so effort is increasingly discretionary and needs to be inspired by purpose. Second, contracts can only enforce compliance rather than commitment – stakeholders may only take the actions stipulated or rewarded by the contract. Indeed, a common way for employees to protest against management is not to break the rules but follow them – perform exactly their contracted tasks for the contracted hours (known as 'work-to-rule'). Third, leaders don't have the relevant knowledge to tell a stakeholder what to do in every situation. Rather than writing it into the contract (or, less stringently, setting guidelines), it may be better to let him decide. If a group of bikers tries to ride in lock-step, looking at the leader to ensure they follow her, they'll crash. If they look up and aim for the same destination, and are free to choose their speed and route, they'll get there safely.

That destination is the firm's purpose. Purpose has far more power to inspire action than any contract, because it unleashes the human side of enterprise. Rather than basing actions on an instrumental calculation of how much they're rewarded by the contract, a stakeholder is inspired intrinsically by the desire to contribute to the firm's purpose – just as a leader driven by societal rather than shareholder value will take more investments and ultimately deliver higher profits.

A shared purpose creates a sense of belonging, where members choose to be part of the company because they're inspired by its mission, even though they could obtain salaries, products and returns elsewhere. Purpose is what motivates colleagues to go above and beyond what's seen by their superiors, customers to choose the enterprise over cheaper rivals, and investors to stay with it even when profits are low. They become stakeholders quite literally, holding stakes – although personal rather than financial ones – in the enterprise's success, and so contribute far more than any contract could enforce.

As mentioned at the end of Chapter 1, purpose is a particularly important glue for millennials. The PwC/AIESEC study we mentioned back then concluded that 'millennials want to be proud of their employer, to feel that their company's values match their own, and that the work they do is worthwhile'.[7] In a Deloitte survey, only 27% of millennials responded that they intended to stay with their current employer for five years, but 88% said they'd do so if they 'were satisfied with the company's sense of purpose'.[8] The stakes are high – Gallup estimated that millennial turnover due to lack of engagement costs the US economy over $30 billion per year.[9]

To see the power of purpose, let's return to Merck. We discussed how Roy Vagelos gave ivermectin away for free because he saw Merck's purpose as using science to transform livelihoods. But Merck wasn't just lucky in having an unusually purposeful CEO at the right time. This purpose had been instilled in Merck from the outset, ever since George Merck emigrated from Germany to the US in 1891 to establish Merck's US subsidiary.[10]

The ivermectin story was far from unique, but simply the way Merck conducted business. Numerous other stories abound in Merck's history. In 1942, penicillin was still a new drug. It hadn't been made outside the lab before because it was too expensive. But George Merck, still serving as Merck's President, took a punt and Merck became the first company ever to manufacture penicillin on a large scale.

Ann Miller was a 33-year-old woman who lived in New Haven, Connecticut. She was married to Ogden Miller, the Athletics Director of Yale University. On 14 March 1942, Ann lay dying in a hospital bed, stricken with streptococcal septicaemia, which she contracted after suffering a miscarriage. Her fever had hit 104 to 106 Fahrenheit for eleven straight days, and everything the doctors tried had failed.

Until penicillin. Thanks to Merck, Ann became the first American ever to be treated with penicillin, and it saved her life. The very next day, her temperature was back down to normal. She went on to have three sons and lived until 90 years old.

Having discovered how to make a life-saving drug, Merck didn't use this discovery to make monopoly profits. Its number one core value was: 'Our business is preserving and improving human life.' So it shared the secrets of how to make penicillin with its rivals,[11] so that they could produce it also. Together, as a team effort, these competitors treated 100,000 Allied soldiers in the Second World War.[12] As George Merck said, 'We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they have never failed to appear.'

It was this commitment to using scientific breakthroughs to serve the people, rather than to generate profit, that attracted Roy to Merck. After receiving his medical degree from

Columbia in 1954, Roy held various scientific research roles at the National Institute of Health, the Massachusetts General Hospital and the Washington University School of Medicine. There, he did research not to develop commercial products, but to advance the boundaries of science and generate insights that could be shared with the public. He published over 100 papers; his work would later see him elected to the American Academy of Arts and Sciences and the National Academy of Sciences. So if Roy were to move into the private sector, he'd only join an enterprise that was equally committed to using science for social good.

That enterprise was Merck. Inspired by the employees he met at his family's diner, and Merck's past record of serving society, he joined as Senior Vice President of Research in 1975, three years before William Campbell's discovery. The rest is history. And vital to that history is that William's vision to explore the use of ivermectin for humans and Roy's decision to give it away for free weren't an anomaly. They were the fruit of Merck's purpose which had been embedded throughout the organisation since the days of George Merck.

While purpose is powerful in a large corporation such as Merck, it's arguably even more potent in start-ups. It's easier to instill purpose from the outset than reorient a giant corporation, and start-ups don't have millions to spend on CSR initiatives. Purpose inspires an entrepreneur to launch a new venture, taking on substantial personal risk – career risk in leaving or turning down a regular job, and financial risk in investing her own wealth. Colleagues join the enterprise inspired by its purpose, even though start-ups pay significantly less and working hours spill into evenings and weekends. Investors can't evaluate start-ups using traditional financial analyses, since they have no track record, but instead base their investment in part on the enterprise's purpose and leaders' passion for this purpose. Paul Gompers, Will Gornall, Steve Kaplan and Ilya Strebulaev surveyed 889 venture capitalists and found that only 22% use NPV to analyse investments.[13]

54% believe that passion is among the most important qualities in a management team, ahead of even entrepreneurial experience and teamwork/cohesiveness.

And once the start-up has been established, purpose drives its actions. In Chapter 2, we discussed how NPV is tricky for any company, but it's even harder in start-ups with no track record to use as guidance. So they instead evaluate decisions on whether they contribute to the firm's purpose. Online eyeglasses company Warby Parker was founded in 2010 by four Wharton MBA students, including a left winger and right defenseman from the Wharton ice hockey team I captained. At the time, the average price for glasses was $263. How much should Warby Parker charge? An NPV calculation might suggest $230, even $199 at a push – it would initially make a loss but attract customers, reap economies of scale and become profitable after a couple of years. Calculating the right price would be extremely difficult, as you'd need to estimate how many new customers you could draw in with a lower price, and how many of those would be repeat purchasers.

But Warby Parker's purpose was 'to offer designer eyewear at a revolutionary price', and this purpose made the pricing decision simpler. They charged $95 – a truly revolutionary price, dropping below three digits when some brands wouldn't drop below three hundred. $99 would have provided an extra $4 margin, critical for a cash-strapped start-up, but would seem like squeezing extra drops from customers.

From the outset, and eight years before it turned its first profit, Warby Parker donated a pair of glasses to low-income countries for each one sold, because its founders 'believe[d] that everyone has the right to see'. Just like George Merck, they led with purpose and trusted that the profits will follow. Perhaps this programme drew in new customers or employees, ultimately enhancing profits – the company is now valued at $3 billion.[14] But the profits couldn't have been predicted from the outset, so the decision would have never been taken without purpose as the north star.

When a start-up succeeds, large corporations launch divisions that try to imitate it.* But lacking the purpose that launched the enterprise's success, they often end up as also-rans. Founding an enterprise on purpose inspires it to take crazy, but ultimately profitable, decisions and gives it a lasting competitive advantage that no rival can imitate.

Defining Purpose

Purpose is far more than a statement. As we'll discuss in the next section, an enterprise must *live* purpose. But a statement of purpose is a necessary starting point, just like a hiker must decide which mountain to climb before figuring out the best path. So we'll first explore how a company can define its purpose. Some of the following insights draw on lessons learned while serving on the five-person Steering Group of The Purposeful Company, a UK consortium that aims to inject purpose into the heart of business, and the insights of various executives, investors, consultants, stakeholder representatives and policymakers who are part of our broader Task Force.

A purpose should contain two related dimensions – *who* it exists for and *why* it exists.** The *why* explains the company's reason for being. Using earlier examples, this may be to develop medicines, connect citizens through transport or to entertain children. While the *why* has rightly been receiving increased

* The market leader, Luxottica, which owns luxury brands such as Ray-Ban, launched glasses.com, where prices start at $90. However, Luxottica's most recent annual report mentions glasses.com by name once, potentially because 'revolutionary prices' are not a core part of its purpose.

** Some enterprises may have a different definition of purpose, and instead have a 'mission' or 'vision' statement that corresponds more closely to our definition. When giving examples of company purposes, we use the statement that most closely fits our definition, even though some companies use different terminology.

attention, the *who* tends to receive less focus. The *who* highlights which members an enterprise particularly seeks to serve. It's linked to the *why*, since a firm exists to serve these members. But the *who* is of independent value for two reasons. First, the *who* ensures that the purpose is to serve wider society. Otherwise, a purpose solely based on the *why* could have an exclusively financial focus – such as to make profits or beat the competition. Second, the *who* is important because many decisions involve trade-offs. An action may increase some slices of the pie and decrease others. The *who* helps weight these different slices and thus figure out whether the action grows or shrinks the pie overall. Effectively, the *who* asks which members are first among equals to navigate these difficult dilemmas – even though it doesn't mean completely ignoring others, nor prioritising these members in every decision.

Most statements of purpose focus on customers. Merck's current vision is: 'To make a difference in the lives of people globally through our innovative medicines, vaccines, and animal health products.' Network Rail 'connects people – with friends and family, and with jobs, underpinning a thriving economy.' The toy company Mattel's purpose is 'to inspire the wonder of childhood as the global leader in learning and development through play.' A statement of the *why* thus already sheds light on the *who* – sick people and animals, commuters and travellers, and children.*

But customers aren't the only important stakeholder, so a purpose statement should go beyond customers. Engie's purpose 'is to act to accelerate the transition towards a carbon-neutral economy, through reduced energy consumption and more environmentally-friendly solutions', which highlights

* Whether the *who* or *why* comes first will vary across firms. Some will first decide why they exist, and who they serve naturally flows from this reason for being; others will decide first who they wish to serve, and then the way they can best serve them. Importantly, these statements don't contain the *how* – the specific goods and services that the company will offer – because these will change over time as customer preferences and tastes evolve.

the environment. Agricultural firm Olam strives for 'prosperous farmers and food systems, thriving communities, [and] regeneration of the living world', emphasising suppliers, the environment and communities. Southwest Airlines highlights colleagues, aiming 'to provide our Employees a stable work environment with equal opportunity for learning and personal growth. Creativity and innovation are encouraged for improving the effectiveness of Southwest Airlines. Above all, Employees will be provided the same concern, respect, and caring attitude within the organization that they are expected to share externally with every Southwest Customer'.

How does a company decide on the why and the who, and thus define its purpose? Three points can offer guidance. We'll tackle these in turn.

A Purpose Should Be Focused and Selective

The first guideline is that a purpose should be focused and selective. Often the word 'purposeful' is used as a synonym for 'altruistic' – a purposeful company is one that serves society. But that's not what the word 'purposeful' actually means. A purposeful meeting is one with a clear agenda; if you do something on purpose, you do it deliberately. So while a purpose must be socially oriented – mass-producing weapons is a clear objective, but socially harmful – it must also be focused. A company shouldn't swing in the wind and react to whatever social issue happens to be flavour of the month, but focus on the social problems it's particularly well placed to solve (while recognising that the seriousness of problems may indeed change over time). By analogy, a citizen's purpose can't be to become a doctor, lawyer, teacher and entrepreneur – he should focus on one of these vocations. Rather than being viewed as constraining, this observation is actually freeing. As mentioned at the end of Chapter 3, some leaders may view becoming purposeful as daunting as they'll need to serve every stakeholder to avoid being called out for hypocrisy, but that's not what purpose is about.

A good rule of thumb is that *a purpose is only meaningful if the converse would also be reasonable*. Many companies have broad purpose statements, thinking the more stakeholders they serve, the better. But while a purpose 'to serve customers, colleagues, suppliers, the environment, and communities while generating returns to investors' might sound inspiring, it's meaningless, as no enterprise's purpose would be to exclude all of those members.[15] Since the converse – serving nobody – is unreasonable to begin with, a purpose statement that rules this out doesn't tell you anything. It's generic and could apply to any company. In contrast, Southwest Airlines' purpose that emphasises employees is meaningful, because it would also be reasonable for it to highlight the environment. Note that the 'converse' need not mean literally the opposite (for example, 'to provide our employees with an unstable work environment'), but other stakeholders that an enterprise might instead prioritise.

Similarly, for a given stakeholder, a purpose should highlight the specific issues that are most important. 'Providing rewarding work' is meaningless as no company would aim to provide unrewarding work; it also doesn't specify whether financial or intrinsic rewards are more important. In contrast, Netflix states that: 'Like all great companies, we strive to hire the best and we value integrity, excellence, respect, inclusion, and collaboration. What is special about Netflix, though, is how much we: encourage independent decision-making by employees; share information openly, broadly, and deliberately; are extraordinarily candid with each other; keep only our highly effective people; avoid rules.' This is meaningful as it's unique to Netflix. Other companies might emphasise job security over keeping only the best people, clear direction rather than independence, or other issues such as health and safety or generous pay.

Moving to the why, Costco's purpose of providing 'quality goods and services at the lowest possible prices' is meaningful as it highlights that price is of primary importance, while keeping quality above a threshold. It would also be reasonable for a retailer's purpose to be to provide 'the highest quality goods and services at affordable prices'. For example, Rolls-Royce says: 'Our strive for perfection guides us. Rolls-Royce is an everlasting expression of the exceptional, where everything we do reflects our persistence and commitment towards the remarkable.'

A selective purpose statement seems uncomfortable, because highlighting certain members or activities suggests deprioritising others. But the trade-offs enterprises face are uncomfortable. A broad purpose statement ignores the reality of trade-offs, but a focused statement provides guidance in three important dilemmas. The first is whether to take actions that help some stakeholders and hurt others. Engie took the difficult decision to close the Hazelwood plant, even though it led to job losses, because its purpose prioritised the environment.

The second is where to allocate an enterprise's limited time and resources. What a company leaves out in its purpose can be as important as what it includes. Purpose is as much about knowing what not to do as what to do. A discerning leader recognises her firm's resource and capacity constraints, and understands that it can't do everything. Instead, she directs them to where they can make the most difference. To paraphrase leadership expert Craig Groeschel, 'to do things no-one else is doing, you have to not do things everyone else is doing'.[16] This is similar to an effective strategy. Reckitt Benckiser could only concentrate on its 19 Powerbrands by reducing investment in its other products.

The third is which business opportunities to turn down. The pharmacy CVS's purpose is 'helping people on their path to better health'. In 2014, CVS stopped selling cigarettes even though they generated $2 billion in sales, shortly before renaming itself CVS Health. What seemed a crazy business decision had a simple justification. As CEO Larry Merlo said, 'put simply, the sale of tobacco products is inconsistent with our purpose'. CVS's sales rose from $139 billion in 2014 to $185 billion three years later. While many factors could have caused this increase, it's consistent with purpose not being at the expense of profit. In 2013, Barclays closed a division that helped clients avoid tax, sacrificing £1 billion of revenue and contributing to the loss of 2,000 jobs. CEO Antony Jenkins explained: 'There are some areas that relied on sophisticated and complex structures, where transactions were carried out with the primary objective of accessing the tax benefits. Although this was legal, going forward such activity is incompatible with our purpose. We will not engage in it again.'

We saw in Part I how pie-growing firms make decisions with judgment rather than calculation. The clearer the purpose, the easier it is to judge whether an action furthers it – such as whether selling cigarettes helps people on the path to better health. A large-scale study by Claudine Gartenberg, Andrea Prat and George Serafeim confirms the value of a clear purpose.[17] Recall from Chapter 4 that I examined the publicly disclosed list of the 100 Best Companies to Work for. Claudine, Andrea and George obtained proprietary access to the half a million individual survey responses used to construct the list. They used 4 of the 57 survey questions to measure the strength of a company's purpose – 'My work has special meaning: this is "not just a job"', 'When I look at what we accomplish, I feel a sense of pride', 'I feel good about the ways we contribute to the community' and 'I'm proud to tell others I work here'. The researchers found that these measures led to significantly higher profits and stock returns, but only when combined with clarity from management.[18] Companies with a strong and clear purpose beat the market by 5.9% to 7.6% per year, controlling for risk.

The Why Should Be Based on Comparative Advantage and the Who on Materiality

While the first guideline highlights that a purpose statement should be focused and selective, the second helps leaders decide what to focus on. The why should be based on the principle of comparative advantage and the who on the principle of materiality. Starting with the why, Chapter 3 explained that comparative advantage arises from what an enterprise is good at. Here, we also point out that it can also stem from what it's passionate about – *passion is a source of comparative advantage*. The passion of leaders, colleagues, investors and other stakeholders is a resource like expertise, land and capital, since it allows a company to get more out of these other resources.

After finishing my PhD at MIT, I started as an assistant professor at Wharton. There, numerous MBA students dream of launching a start-up. One of Wharton's most successful entrepreneurs in recent years is Will Shu, who founded the food delivery company Deliveroo. Over the two-year MBA, one of Will's classmates had about fifty different ideas for a start-up – on the face of it, he was certainly passionate about being an entrepreneur. After graduating, the one idea he ended up pursuing out of those fifty was to make high-quality pet toys, similar to an Etsy for pets. Only a few years later, Will caught up with his classmate and was surprised to find he'd packed it in. Will asked his classmate why. He replied, 'I realised that I just don't like dogs.' He pursued this idea because there was a market niche, a profit opportunity, not because he cared about the idea. In coming up with his fifty ideas, he was more passionate about being able to introduce himself as an entrepreneur at parties than the way his start-up would serve society.

Will founded Deliveroo because he was passionate about food delivery. What was that? You can be passionate about curing diseases, inventing smartphones, even entertaining kids, but delivering food? Indeed, you can. Will's passion came from his time as an analyst at Morgan Stanley. Will joined Morgan Stanley in the same year as me, although he was in New York and I was in London; we didn't know each other until nine years later at Wharton. As an analyst, you might arrive in the morning after four hours' sleep and know that you'll work past midnight again. But there was one thing that you could look forward to – dinner. If you stayed after 8pm, which was almost always the case, you were entitled to free food. In New York, this was a treat, because you could order from Seamless, a web-based platform where you had your pick of hundreds of restaurants. And if you were particularly lucky, you might even be able to take a 15-minute break away from your desk, to eat it with fellow analysts in a meeting room, where you'd complain to each other about your bosses.

But when Will moved to London as a third-year analyst (just as I was leaving for MIT), he was dismayed to learn that all the stereotypes about the poor quality of English food were true. And importantly there was no shared platform. Analysts would pass around individual menus for Domino's Pizza, Chili's Bar and Grill, a Chinese restaurant called Good Friend and a Mediterranean grill named First Edition – but those were your only options. The one small oasis in your day was dry.

That's how Will became passionate about food delivery. There were thousands of young professionals in London, working long hours and surviving on little sleep as they tried not to fall off the first rung of the ladder, but they couldn't even get a decent meal. This passion is what caused him to reject an offer from a leading hedge fund where he'd interned in the summer of his MBA. Instead, he started a career in delivering food. And this passion would be his comparative advantage. It made him willing, eager in fact, to spend five hours a day for the first nine months carrying the food himself – partly because Deliveroo was strapped for cash as it was getting off the ground, but more importantly because Will wanted to understand first-hand the challenges of being a rider. It also had unexpected side benefits, as Will's former Wharton classmates, now working as bankers and consultants in London, would order food from Deliveroo to have him deliver it to them. Even now as the CEO of a billion-dollar business, Will tries to do a shift a week as a Deliveroo rider. When I took my MBA students to visit Deliveroo, he made all of us (including me) do a shift as he said it was crucial for us to understand his enterprise.

Like most gig-economy firms, Deliveroo faces major challenges in ensuring that it treats its colleagues fairly. But passion, which translates into willingness to work as a rider, gives Will a comparative advantage in understanding these challenges – while he recognises that working the odd shift is a far cry from riding being your main source of income.

The *who* of an enterprise's purpose should be based on the *principle of materiality* – which stakeholders are material to the firm (business materiality), and which stakeholders the firm is particularly concerned about (intrinsic materiality). An enterprise might prioritise stakeholders with high business materiality because doing so also improves returns to investors, as shown in Chapter 4. It may also focus on intrinsically material stakeholders simply because its leaders, colleagues and investors care about serving them – just like comparative advantage, passion is a source of intrinsic materiality.

Often, business and intrinsic materiality overlap. For example, IKEA's purpose is to 'offer a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them', highlighting that its *who* is ordinary households. This could be both because of intrinsic materiality – a passion to serve the average citizen, not just the elites, and to allow the many to enjoy what was previously reserved for the few – and business materiality, since a broad customer base makes the enterprise more resilient to downturns. Similarly, we discussed previously how the agribusiness Olam prioritises suppliers, the environment and communities in its purpose, and Southwest its employees. Their respective priorities could also stem from both intrinsic and commercial grounds.

A Purpose Is Both Deliberate and Emergent

The third guideline is that *a purpose is both deliberate and emergent*. Leaders should be willing to allow purpose to evolve in two ways. One is in response to changing conditions, such as shifting societal needs. An energy company's purpose stresses the urgency of decarbonisation much more today than in the past. Thus, while clarity of purpose is valuable, it shouldn't come at the expense of flexibility. The second is in response to employees' actions and suggestions. Leaders should set the tone from the top, but also recognise they don't have a monopoly in defining the enterprise's purpose. Purpose may bubble up from colleagues – when they've helped shape purpose, they feel ownership of it and are more likely to put it into practice. This requires viewing employees as a source of ideas rather than just a way to execute them. For example, the consulting firms McKinsey and the Disney Institute team up to help companies define their purpose. This involves interviewing colleagues at all levels on what inspires and matters to them, and holding workshops where employees from different departments share ideas.

Moreover, an enterprise's purpose can be shaped by employees' actions outside of formal consultations. When Nick Hughes and his team decided to explore the idea that eventually became M-Pesa, Vodafone's main priorities were growth through acquisition, winning spectrum licence auctions and increasing their market share in developed countries where revenue potential was highest. But the success of M-Pesa showed Vodafone how much social value they could create by using its technology innovatively, and its purpose today is 'to build a digital society that enhances socio-economic progress'.

Purpose can also be guided by external as well as internal stakeholders. The Constitution of the UK's National Health Service (NHS) includes a statement of its purpose. When it was initially drafted based on internal discussions, it focused on a purpose of helping people stay healthy and recover from illnesses. But the NHS then engaged in an extensive consultation with a variety of external stakeholders, such as citizen representatives, patients, health charities, trade unions, public health authorities and politicians. One of the many insights was the importance of a decent death when the time came – for a service so focused on wellness, this need could have been easily overlooked without external testing. This feedback materially changed the purpose stated in the Constitution when it was eventually published: 'The NHS belongs to the people. It is there to improve our health and well-being, supporting us to keep mentally and physically well, to get better when we are ill and, when we cannot fully recover, to stay as well as we can to the end of our lives.' Similar to consultations with employees, outside input not only sharpens the purpose statement, but also leads to stakeholders rallying around it and helping to embed it. The external stakeholders that fed into the purpose statement have remained engaged and continue to hold the NHS accountable for putting it into practice – not only the prevention and cure of illnesses, but also palliative care.

Once a purpose has been decided upon, it must go beyond a statement and live in the enterprise. Living purpose means two things – communicating purpose externally and embedding purpose internally. We'll now look at how to do so.

Communicating Purpose

Communication starts with a company reporting its purpose. This starts with a short *purpose statement*, but also includes a broader *purpose roadmap* which elaborates on what this statement means in practice. This might include why the company has chosen its purpose – why fulfilling this purpose will contribute to both human flourishing and its own success – and what it decided to leave out. The roadmap could outline how the enterprise will put the purpose into practice (we'll discuss ways to do this later in this chapter), the stakeholders and stakeholder issues it considers most material, and how it will make decisions, navigate trade-offs and allocate resources.

A purpose statement should be no more than a couple of sentences to ensure that it can be clearly communicated to and understood by members, especially colleagues. But a purpose roadmap might be a few pages and help the enterprise navigate its journey. Most of the examples we've given earlier are from purpose statements, but some are from purpose roadmaps – many companies focus on customers in their statement and other stakeholders in their roadmap.

Even more important than the statement and roadmap themselves is to communicate how successfully they're being implemented. A starting point is to set various long-term targets relevant to its purpose, and then report on progress. Communicating non-financial measures of stakeholder value goes beyond traditional reporting, which focuses on financial measures of shareholder value. This more complete model is known as *integrated reporting*, and is illustrated in Table 8.1.* The International Integrated Reporting Council (IIRC) provides a framework for how to structure an integrated report – for instance, a company should disclose the value of six capitals (financial capital, manufacturing capital, human capital, social and relationship capital, intellectual capital and natural capital). The Global Reporting Initiative provides standards to guide what non-financial information to report and how to calculate it.[19] For example, for air pollution, it recommends disclosing nitrogen oxides, sulphur oxides and persistent organic pollutants. The Sustainability Accounting Standards Board (SASB) provides standards that differ by industry. Clothing firms should report supply chain water consumption and pollution, labour conditions and material

* Currently, most companies that disclose non-financial information do so through a stand-alone 'Sustainability Report' – we'll later show an excerpt from Marks & Spencer's. This goes alongside the Annual Report which contains their financials. 'Integrated reporting' is sometimes reserved to refer to a single report which combines both financial and non-financial information. While most Sustainability Reports simply report non-financial information, an integrated report will also discuss what it implies for future financial profitability – for example, Nestlé reports how its healthier foods have higher growth rates and margins than its standard offerings. Here, we use 'integrated reporting' to refer to the combination of financial and non-financial reporting, whether undertaken in a separate report or one single report.

Table 8.1 Traditional vs Integrated Reporting

Traditional Reporting		**Integrated Reporting**	
What?	**How?**	**What?**	**How?**
Shareholder value (financial)	Quantitative (numbers)	Shareholder value (financial)	Quantitative (numbers)
		Stakeholder value (non-financial)	Quantitative (numbers)
			Qualitative (narratives)

sourcing; banks should disclose data security, financial inclusion and risk management.

All of these frameworks help increase reporting comparability across companies, and the specificity of these items address concerns that non-financial reporting is vague. In November 2020, IIRC and SASB announced they would merge into a unified organisation, the Value Reporting Foundation, to further strengthen comparability.

Historically, non-financial measures have focused on 'do no harm', such as the examples above. These metrics are often generic and applicable to most companies, at least within a given industry. For a few firms, 'do no harm' might indeed be the main way they serve society, such as an energy company decarbonising. But for most companies, it's more important to 'actively do good' – and the relevant metrics here will be tailored to a company's purpose. For example, agribusiness Olam targets the number of smallholder farmers who participate in its sustainability programmes, which provide training and disseminate best practice. Gaming company Electronic Arts measures not only female workforce composition (like most companies), but the percentage of female programmers and software developers, since those are professions where women are particularly under-represented. Unusually, it also targets diversity in its historically male-dominated customer base, in keeping with its purpose of 'to inspire the world to play'. Staying with customers, MYBank (China's first digital bank) reports the number of small and micro enterprises that receive its loans – borrowers typically under-served by commercial banks – and the proportion of these customers who never previously obtained a bank loan.

Numbers are valuable because they're concrete and objective, addressing concerns that purpose is nebulous. But numbers alone are incomplete, and so they must be supplemented by narratives to provide the broader context behind them. As Table 8.1 stresses, non-financial *information* not only means non-financial *numbers*, *measures* or *metrics* – qualitative dimensions are a critical component.

One source of incompleteness is that numbers only capture what's measurable, so they focus on results rather than process. This in turn leads to two problems. First, an enterprise might 'hit the target but miss the point' – take strategic actions to boost the numbers. It could meet a goal for youth employment by focusing on the quantity but not quality of jobs, and holding onto junior colleagues even if they're underemployed and would flourish better outside the firm. As Goodhart's Law states: 'When a measure becomes a target, it ceases to be a good measure.' Narratives are valuable to explain the actions the company undertook to reach its goal. Second, even if a company doesn't try to manipulate the numbers, whether they're high or low depends much more on luck than we often think – as Nassim Taleb highlights in his book *Fooled by Randomness* – and much less on the company's actual actions. Focusing too much on the numbers can lead to our view of a company being driven by short-term randomness. Instead, it's the processes that determine long-term performance.

A second source of incompleteness is that whether a company hits its targets depends on how stretching they were in the first place, not just how it performed. An enterprise *should* be missing some of its non-financial targets. If it's not, it's not setting them high enough. While numbers show *whether* a company hit or missed a target, narratives can explain *why* it did so – and if it's off-track, what it's doing to get back on.

Third, numbers only capture what's been achieved to date, but narratives can be forward-looking. For innovation, numbers can report how many patents have been generated; narratives can describe a firm's efforts to recruit and train a top-quality R&D team, and create an innovative culture that embraces risk-taking and tolerates failure. Similarly, narratives can communicate how purpose has driven a company's strategic decisions, even when the benefits can't be quantified immediately. M-Pesa leveraged Vodafone's technology to solve a serious social problem, but only many years later would Tavneet Suri and William Jack be able to estimate how many citizens it lifted out of poverty. Likewise, purpose can sometimes lead a company *not* to take a profitable action that harms stakeholders, but it's difficult to provide numbers on the damage avoided at the time.

The incompleteness of numbers highlights the danger of linking pay to ESG metrics, as is commonly proposed. Doing so may lead a CEO to focus on only the ESG metrics included in her contract, and underweight both qualitative dimensions of the ESG issues in the contract as well as other ESG issues not linked to her pay. As the study by Ben Bennett and co-authors showed in Chapter 5, putting *any* target into a pay contract can encourage manipulation to hit it, and this applies regardless of whether the target is financial or social.

Even though narratives are crucial, investors and stakeholders will inevitably place less weight on them than numbers. Some members won't bother to read discussions as it's much faster to look at figures. Even if they do, narratives may still have less impact on their decisions – numbers are concrete and comparable, whereas it's sometimes difficult to know whether a narrative is genuine or a made-up excuse for missing targets. You can see which company in an industry has created the most jobs, but not which has the strongest corporate culture – nor whether claims to have improved culture are valid or to mask failure to increase employment.

This means that integrated reporting should involve not only including narratives, but potentially *excluding* certain numbers. We often think that more information is always better, so even though numbers are incomplete, they're still better than nothing – thus, companies should disclose as many numbers as possible. But Mirko Heinle, Chong Huang and I show that this isn't the case, because a company's decisions depend not on the *total* amount of information it releases, but the *relative* amount of quantitative versus qualitative information.[20] Take an enterprise that has $1 million to spend on either creating more jobs (improving quantitative information) or enhancing the quality of existing jobs (improving qualitative information). Assume that improving job quality grows the pie more, so if the company reported nothing, quality would be the chosen investment. But if the company reports job creation, and investors and stakeholders pay close attention to this figure, it might choose this investment instead. It's true that the company can try to communicate job quality. Total information goes up, because both quantitative (job creation) and qualitative (job quality) information is being disclosed. But, because quantitative information is more credible and comparable, the former rises more *relative* to the latter. So, the enterprise takes the decision that improves quantitative information the most – creating jobs – even if it grows the pie less.

This observation is important. Some reformers are demanding ever-more information disclosure on non-financial performance, under the assumption that more information is better. Information is typically taken to mean numbers, such as the World Economic Forum's set of

'Stakeholder Capitalism Metrics'.* Indeed, the common saying, 'what gets measured gets done', is often used to highlight the importance of measurement. But this saying should instead warn against the dangers of excessively relying on measurement, since some factors simply can't be measured and so will end up not getting done. In a purposeful enterprise, *what gets monitored gets done*. Monitoring certainly involves measurement, but also understanding the context behind the numbers, qualitative dimensions of performance, and changes to policies and practice that might not manifest in numbers for some time.

Most people already recognise the incompleteness of numbers when it comes to financial information. On his first day as Unilever CEO in 2009, Paul Polman decided to stop reporting quarterly earnings, because doing so might pressure him to deprioritise long-term value. Even though he could justify missing a quarterly earnings target by explaining that he's investing for the long term, such a narrative is less salient than numbers. More broadly, we discussed in Chapter 6 how 80% of Chief Financial Officers (CFOs) admitted they'd cut investment to meet an earnings benchmark. While that's a survey of what CFOs say they'll do, two studies of what they actually do confirm that quarterly reporting reduces investment.[21] As a result, the Investment Association (the trade body of the UK investment industry) launched a campaign in 2016 for companies to stop issuing quarterly reports, to give them the freedom to focus on long-term value. Indeed, during Paul's ten-year tenure, Unilever's shares rose 150%, double the returns of the FTSE 100.

Most people also recognise the incompleteness of numbers when it comes to non-financial information in non-business settings. School league tables based on exam results may turn schools into exam factories rather than teaching education

* Despite the name, some of these 'metrics' are qualitative, but most are quantitative.

more broadly. Yet this observation isn't fully acknowledged in business, with a seemingly unstoppable trend towards greater disclosure. This is absolutely not to argue against transparency, nor to downplay the substantial progress made by reporting frameworks. Rather, it's to highlight that more information isn't always better, nor is quantitative information superior to qualitative information. As a result, investors and stakeholders should be wary of requesting too many metrics, or putting excessive weight on them when assessing a company's social performance.

Let's look at an example of reporting on purpose. The food and clothing store Marks & Spencer has embodied its purpose into an initiative called Plan A, 'because there is no Plan B'. Plan A aspires to 'build a sustainable future by being a business that enables our customers to have a positive impact on well-being, communities, and planet through all that we do'. Marks & Spencer made this concrete by initially setting 100 specific targets (later expanded). For example, its environmental goals include ones for energy consumption, food waste and recyclability of packaging. Every year, it discloses whether a target had already been 'Achieved' or 'Achieved – Late'; for those still ongoing, it reports whether it is 'Progressing' or 'Behind'. These numbers are supplemented by a narrative report on progress. Figure 8.1 shows an extract from the Energy Consumption and Sourcing section of Marks & Spencer's 2017 Plan A report.

Non-financial transparency needn't be confined to a company's annual report, which is read primarily by investors, but can extend to formats viewed by other stakeholders and focus on issues particularly relevant to them. When a customer clicks on a product on the website of Nudie Jeans, a Swedish denim brand, he can view the suppliers involved in every stage of the value chain, such as the spinning of the yarn, dyeing of the fabric and storage in a warehouse – including (where relevant) if the supplier complies with the Global Organic Textile Standard. In some cases, you can read Nudie's

ENERGY CONSUMPTION AND SOURCING

UK AND ROI ENERGY EFFICIENCY (1) ACHIEVED

AIM

Improving energy efficiency in UK and ROI stores, offices and distribution centres by 35% per sq ft by 2015.

See 2015 Plan A Report

UK AND ROI ENERGY EFFICIENCY (2)** BEHIND

AIM

Improving energy efficiency in UK and ROI stores, offices and distribution centres by 50% per sq ft by 2020.

PROGRESS

This year, we improved total energy efficiency across our stores, offices and warehouses by 39%, to 35.1 KWhs/sq ft compared with 2006/07 (57.4 KWhs/sq ft).

Store energy efficiency was +38% at 42.3 KWhs/sq ft, compared to (67.9 KWhs/sq ft) in 2006/07. Gas usage included in our calculation has been adjusted using standard degree days to reflect changes in the number of cold days (44.2 KWhs/sq ft before adjustment). This performance is slightly down on last year due to an increased proportion of new Food sales floor, which consumes more energy than Clothing & Home.

We improved energy efficiency in our warehouses by 41% at 15.7 KWhs/sq ft compared with 2006/07: 26.4 KWhs/sq ft. We improved energy use in our offices by 36% at 31.8 KWhs/sq ft (2006/07: 49.4 KWhs/sq ft).

UK and ROI Energy Efficiency
Total store, office and warehouse energy usage in KWhs/sq ft

2006/07 Actual	2015/16 Actual	2016/17 Actual	2020 Target	Achievement on 2006/07
57.4	34.9	35.1	28.7	-39%

INTERNATIONAL ENERGY EFFICIENCY** PROGRESSING

AIM

Improving energy efficiency in our international stores, offices and distribution centres outside of the ROI by 20% per sq ft by 2020 against a newly developed baseline.

PROGRESS

Last year we operated stores in 16 countries outside the UK and ROI, including a joint-venture business in India. Around a third of this international footage uses energy provided by a landlord and is outside our operational control. We've only included the energy and footage where we have operational control.

In 2016/17, we reduced our energy consumption by 9%, achieving 25.5 KWhs/sq ft compared to 2013/14 (27.9 KWhs/sq ft). Energy consumption in our International stores is much lower than in those in the UK and ROI as most don't sell chilled food and use heating and air-conditioning provided by a landlord.

We have four international warehouses. Their primary function is to support our UK business. These warehouses showed a 77% improvement in efficiency, due to changes in the way they use their footage.

International stores (outside of ROI)
Total store energy usage in KWhs/sq ft

2013/14 Actual	2015/16 Actual	2016/17 Actual	2020 Target	Achievement on 2013/14
27.9	27.5	25.5	22.4	-9%

Internationally located warehouses
Total warehouse energy usage in KWhs/sq ft

2013/14 Actual	2015/16 Actual	2016/17 Actual	2020 Target	Achievement on 2013/14
9	6.9	2.1^	7.2	-77%

^ The main reason for this improvement is the removal of a warehouse in Hong Kong from the data, due to its multi-user status.

STORE REFRIGERATION – DOORS** ACHIEVED – LATE

AIM

By 2015, we will conduct a trial to retrofit doors on fridges in stores in the existing estate, then fully evaluate it, with recommendations for future roll-out.

PROGRESS

We are not reporting additional progress this year but plan to install further refrigeration energy efficiency measures during 2017/18.

Figure 8.1 Energy Targets and Outcomes, Marks & Spencer Plan A Report 2017

supplier audit, which drills down into issues as detailed as the cleanliness of toilets and the timeliness with which work schedules are updated. Even more radically, Nudie voluntarily discloses complaints it receives in its production facilities. While this may risk some customers not buying due to these issues, it reassures other customers that Nudie has a complaints procedure that colleagues trust and is committed to learning their concerns.

There are numerous benefits of integrated reporting. One is to attract investors and stakeholders aligned with the firm's purpose. A second is that many investors directly value non-financial information, because they recognise its relevance for long-term returns. In February 2020, BP announced its plan to have a net zero carbon footprint by 2050 – and the stock price rose slightly, inconsistent with concerns that investors only care about short-term earnings. A third is that it may cause investors to place less emphasis on financial information. Laura Starks, Parth Venkat and Qifei Zhu found that firms with higher ESG ratings are less likely to experience investor selling after negative earnings surprises. This suggests that investors recognise that quarterly earnings are less relevant for companies that deliver strong stakeholder performance.[22]

Arguably, *the greatest role of integrated reporting is to spark integrated thinking*. It triggers conversations about what the company's purpose is and whether it's fulfilling it, and leads to employees analysing major decisions in terms of their stakeholder as well as investor impact. As mentioned earlier, 'what gets monitored gets done'. Recall in Chapter 2 that Walkers reduced the carbon footprint of its crisps, ultimately benefiting investors. This reduction was sparked by Walkers adopting carbon labelling, which made its carbon footprint visible and motivated Walkers to reduce it. As *The Economist* noted: 'It's not so much the label itself that matters . . . but the process that must be gone through to create it.'[23] Just as purpose is the goal of an enterprise and profit the by-product, integrated thinking should be the way a company operates and integrated reporting the by-product.

Concerns with Integrated Reporting

Integrated reporting is often viewed as desirable in theory, but unrealistic in practice, because non-financial measures aren't comparable between companies. Employee satisfaction scores may be compiled using different methodologies across firms. But non-financial measures are *inherently* incomparable because they depend on an enterprise's unique purpose. Even if two firms prioritise colleagues, one may emphasise health and safety, another independence and challenge (like Netflix). So comparability is a red herring. Peter Lynch would visit each store independently and assess it on the dimensions most relevant for its particular situation. He'd need to do a comparison to decide which enterprise to invest in, but based on his overall qualitative assessment rather than directly ranking individual metrics. As mentioned in Chapter 3, people make decisions all the time based on overall assessments that include many non-comparable dimensions. Homeowners choose a house on more than its square footage, parents select a school on more than its exam results and a citizen takes a job on more than its salary – even though these metrics are comparable.

Moreover, demanding predominantly comparable metrics may backfire for investors, as it makes them ripe for replacement by computers, as we discussed in Chapter 4. To prevent them from being replaced by artificial intelligence, investors should ask companies for non-comparable, narrative information that can only be understood within the context of the enterprise's purpose – an assessment that can only be done by humans.

From Reporting to Communication

Reporting purpose is a critical first step, but communicating purpose goes beyond just reporting. First, *reporting is impersonal, while communication is personal.* Reporting occurs through documents such as annual reports; communication occurs best through face-to-face meetings – a significant amount takes place through non-verbal means. Investors can glean far more information from a meeting, where answers are from the heart and they can observe how a company's leadership team interacts, than a sanitised report. Focusing Capital on the Long Term, a global consortium of companies and investors, provides a roadmap of ten topics that such conversations can be centred around, to maximise their effectiveness.[24]

Second, *reporting is one-way, while communication is two-way*. An enterprise's members are allies in growing the pie, but too often are an untapped resource. At employee 'town halls' or webinars, colleagues can ask questions, make suggestions and share their own experiences. Leaders can similarly learn from their investors in private meetings. Many only reach out when there's an emergency, such as a takeover bid or an upcoming vote, but they should do so as a matter of course. Companies pay advisors high fees for advice on issues such as strategy and capital allocation, but investors and stakeholders are happy to share their ideas and act as a sounding board for free. Moreover, their incentives are aligned as they have skin in the game, while advisors are paid for completing a transaction even if it destroys value. Similarly, meeting investors on a routine basis is one of the best ways to pre-empt confrontational shareholder activism. Doing so allows leaders to notice simmering investor concerns and address them before they boil over.

The value of moving from reporting to communication can be substantial. When a company receives an unwanted takeover bid, it typically has to go on the defensive and argue why the bid is too low. But when Kraft bid for Unilever, it was Unilever's shareholders who led the defence and quickly rebuffed the bid. That's because Unilever had invested in regularly meeting its major investors, explaining how a substantial part of its value was its Sustainable Living Plan and keeping them appraised of progress. As a result, it got the investors it deserved. Shareholders that disagreed with its purpose had sold out; the ones that remained had bought into Unilever's long-term vision and wouldn't be tempted by Kraft's 18% premium. If Unilever had waited until an emergency to reach out to its investors, it would have been too late.

The term *share capital* (or *shareholder capital*) is often used to describe how much money shareholders initially contributed to the firm. But *stakeholder capital* describes the value of a firm's relationship with its stakeholders, not the amount that stakeholders contributed. We thus define the term *investor capital* as the value of the relationship a company has with its investors. This goes beyond the money they invested, and even the current value of this investment. It includes the extent to which the investors have bought into the enterprise's purpose, understand the metrics that matter and are willing to engage to ensure excellence.

One study documented the benefits of investing in this relationship. A company's stock price rises by an average of 2% after it presents at 'CEO Investor Forums' – events run by the US Strategic Investor Initiative for leaders to share their long-term plans with their anchor investors. Reactions were particularly positive when companies disclosed specific and actionable information around purpose.[25]

Say-on-Purpose

One way to improve communication with investors is to give them a 'say-on-purpose' vote, similar to the two-part 'say-on-pay' votes they have in the EU.* An enterprise issues a purpose statement which clarifies the principles that apply to trade-offs it might make: between investors and stakeholders (that it will sacrifice profits to reduce carbon emissions), or between different stakeholders (decarbonisation may lead to redundancies). Every three years, investors will have a 'policy vote' on this statement, to express whether they've bought into it and the trade-offs it implies. An investor will vote against if he disagrees with the priorities, and abstain if it's so vague it gives little guidance on what the company stands for. Every year, investors will also have an 'implementation vote' on whether they're satisfied with how the

* This is an idea I developed with former PwC partner Tom Gosling, and covered in our December 2020 *Wall Street Journal* article, 'How to Give Shareholders a Say in Corporate Social Responsibility'.

statement is being put it into practice. Both votes will be advisory, but meaningful opposition will show a company's leaders that they're off-course and may precipitate investor selling or a change in management.[26]

The power of the policy vote is that it gives clear guidance to leaders on how to make decisions that involve trade-offs, but with the legitimacy provided by investor support. In particular, they'll know whether they're justified in choosing the right-hand side of Figure 2.2, where investors have a smaller share of a larger pie. Economists Oliver Hart and Luigi Zingales proposed that investors should vote on major corporate decisions, so that they can express their views on the resulting externalities.[27] Say-on-purpose achieves the same objective in a more practical way that retains decision rights within the board. Enterprises need to make decisions on a timely basis, but communicating information on externalities to guide an investor vote might be time-consuming and divulge secrets to competitors; one might swoop in and take the action itself. In addition, investors may not have the capacity to vote meaningfully on multiple decisions per year.

The power of the implementation vote is that it holds the company accountable for putting purpose into practice. And like integrated reporting, what matters isn't just the outcome – the vote itself – but the process that must be undergone to reach it. To vote meaningfully, investors need to deeply scrutinise a company's long-term value and stakeholder relationships. This in turn feeds back to management decisions. Knowing that shareholders will be evaluating long-term performance, leaders will have the confidence to make long-term choices. Say-on-purpose will thus enrich the dialogue between investors and management, leading to the two-way communication we've advocated.

Investors already have a 'say-on-pay' vote in most countries, but a firm's purpose is more important than its pay policy. While a bad pay policy can make a company bad, a great pay policy can't make it great. But purpose can. Say-on-purpose would allow investors to vote on perhaps the most important aspect of a firm to society. These investors will then help ensure that purpose remains embedded even when the current CEO leaves.

One concern might be that say-on-purpose will lead to investors' resources being spread thinly with yet another vote, taking their time away from actual engagement. But the vote will enhance engagement, rather than being at the expense of it, since investors will be more informed and any engagement will be on long-term issues. The need to get into the weeds of the company will deter actively managed funds from being spread too thinly. They'll have to be truly active, holding a small number of concentrated positions so that they can vote meaningfully.

Overall, say-on-purpose provides a way for factors beyond shareholder value to be legitimately taken into account while retaining investor accountability, and to elevate the dialogue between companies and investors beyond short-term profit. Importantly, say-on-purpose can be initiated by companies themselves, without the need for regulation. For example, Unilever considers its climate change plan a key part of its purpose. So in December 2020, it announced it would put this plan to an investor vote at its May 2021 AGM, report on progress every year from 2022 and hold a vote every three years on any material changes.

Embedding Purpose

A purpose statement is meaningless unless it translates into action. We'll now discuss five channels through which purpose can be embedded in an enterprise – strategy, operating model, culture, internal reporting and board ownership.

Strategy

Let's start with strategy. A company's purpose should shape the activities it's involved in and sometimes lead to decisions that wouldn't be justified by even long-term shareholder value. Outdoor clothing company Patagonia's purpose is environmental renewal, as highlighted by its statement 'Patagonia is in business to save our home planet'. These aren't just aspirational words. On Black Friday – the biggest shopping day – in 2011, it placed a full-page advert in the *New York Times* which pictured a Patagonia fleece with the headline 'Don't Buy This Jacket'. The advert highlighted its Common Threads Initiative, encouraging customers to repair and reuse their clothes rather than buy new ones. The initiative repaired over 30,000 items in 18 months – and ended up not being at the expense of sales, which rose 30% in 2012. In 2017, Patagonia created its Worn Wear online marketplace for used clothing, even though this would reduce its sales of new items. Similarly, we earlier saw how CVS didn't just rename itself CVS Health, but made the strategic decision to stop selling cigarettes, and Barclays closed its tax avoidance division.

The potential to build credibility through strategy is another advantage of the targeted purpose we advocated earlier. It's easier for stakeholders to verify whether a focused purpose statement is being put into practice than a vague one that tries to do everything, and so almost any strategy might be consistent with it.

Operating Model

A second way to embed purpose is to align the operating model – how an enterprise runs its core operations – with it. When the UK supermarket Tesco defined its core purpose as 'to create value for customers to earn their lifetime loyalty', it needed to ensure that its processes were uncompromisingly geared towards customers. It already had over 90% efficiency in getting products onto store shelves, but this wasn't enough for an aspirational purpose such as 'lifetime loyalty'. So it redesigned its processes to ensure customers could always buy the products they wanted when they wanted them.*

* As an example of a process improvement, milk used to be first loaded onto pallets at the bottling plant, then wrapped in plastic, then loaded onto trucks and transported to stores. Once they reached the store, they were unwrapped from the plastic, taken off the pallets, put into cages and then brought to the

Similarly, it made a promise that all stores would have 'a manager who helped me', but didn't yet have a management or training system to deliver this promise. So it simplified its store routines and delayered its hierarchies to give managers freedom to serve customers rather than spending time in unnecessary upwards reporting. It also launched a major programme of leadership development.

You might think that an operating model with efficient processes and management training should be a feature of any good company, not just a purposeful one. Even ESV would advocate improving processes and upskilling managers if the benefits can be roughly estimated. But all enterprises face trade-offs. Even in the best companies, many dimensions of their operating model can be enhanced. Operating model alignment involves prioritising the dimensions that most urgently need to be improved to put purpose into practice – which again highlights the need for purpose to be focused.

Internal Reporting

A leader should ensure that integrated reporting occurs inside the enterprise as well as outside. This involves gathering a rich set of information on how employees, teams and projects are performing on purpose-related dimensions. One use for this information is performance evaluation. Sometimes a CEO gives a rallying speech about purpose, only for senior management just below the C-suite to tell their team to ignore her and focus on their division's financial targets. Sue Garrard, who led

shop floor. Based on colleague input, which Tesco actively sought, it scrapped this inefficient process. Now it puts milk straight into cages at the bottling plant. These are wheeled into the trucks, transported and wheeled off the trucks onto the shop floor, and the milk is sold off the cages. This significantly shortened the supply chain, increasing product availability, as well as saving on labour and packaging costs. In addition, Tesco was one of the first UK retailers to invest in hand-held computers for its in-store stock controllers. This improved stock control accuracy and thus product availability, as well as giving employees meaningful work, as they no longer needed to count products.

Unilever's Sustainable Living Plan, described this senior management layer to me as the 'clay', which blocks purpose from flowing throughout the enterprise just as clay blocks water flow. Such blockage isn't deliberate sabotage, but arises from the reality of how senior managers are evaluated. One professional services firm invited me to speak at their purpose offsite, but in their briefing admitted that their most important metric remained short-term profit per partner. In contrast, when Marks & Spencer launched Plan A, it evaluated business unit and store managers using a 'balanced scorecard'. This combined traditional financial metrics with several non-financial measures tailored to the Plan A goals most under their control.*

Not only does integrated internal reporting allow bosses to evaluate employees, but it also allows employees to evaluate themselves, so that they know how they're performing and can make more informed decisions. This requires breaking down company-wide targets into sufficient granularity that workers can affect them. Marks & Spencer reports its overall greenhouse gas emissions and breaks them down by region, activity (for example, refrigeration vs heating) and department (for example, food vs clothing). But even that's not granular enough to guide an individual colleague, who manages a single store rather than a region. So Marks & Spencer internally tracks information at an individual store level. It also measures the emitting activity (for example, electricity, gas and refrigeration) rather than the emissions generated, because it's the former that employees have direct control over. Similarly, many companies externally report employee satisfaction

* How does this square with our recommendation in Chapter 5, that a CEO's reward should be primarily based on the long-term stock return and not additional factors? The CEO is responsible for the entire enterprise, for which the long-term stock return is a comprehensive measure – it incorporates many dimensions of stakeholder value. An individual division doesn't have its own stock price, and any one measure (such as divisional profits) will be very incomplete. In addition, CEOs are likely wealthier and thus more able to accept pay being deferred for many years.

scores, but a score of 73% gives little guidance to managers on how to improve it. More informative are the specific dimensions of employee satisfaction that are flourishing and lagging, so that they can come up with concrete plans for improvement.

A second way in which internal reporting should go beyond external communication is by providing leading as well as lagging indicators. We earlier discussed how externally reported numbers are typically backward looking, focusing on outcomes achieved. Leading indicators are useful for colleagues to predict these outcomes and take action accordingly. For example, employee turnover is a key lagging indicator, which can be predicted by leading indicators such as lateness, absenteeism and performance. A company should monitor them internally, but may not be willing to disclose them externally – either because they're commercially sensitive, or because they're difficult for outsiders to interpret out of context. Disclosure might lead to excessive focus by outsiders that in turn encourages manipulation. For example, if investors use lateness and absenteeism to assess a company, it may seek to lower these figures by punishing such behaviour. Thus, forward-looking information is mainly disclosed to outsiders in narrative form.

Culture

A fourth way to embed purpose is by aligning the enterprise's culture with it. While purpose concerns why a company exists and who it serves, culture captures how it operates – in simple terms, it's 'the way we do things around here'. Culture is critical to ensure that a purpose permeates throughout the company. Recall the study by Claudine Gartenberg and co-authors, which documents strong performance of companies perceived by their employees as having a clear purpose. This link was driven by the perceptions of middle managers rather than senior leaders, likely because the former are particularly important for ensuring that purpose translates into day-to-day actions. This highlights a further benefit of a focused purpose statement – the simpler it is, the less likely it will be lost in translation when passed down the organisation.

For purpose to live in the enterprise, the right culture needs to be promoted. Importantly, there's no one universally right culture; instead, culture must be closely aligned to the firm's purpose. For example, a purpose that prioritises innovation, such as Reckitt Benckiser's ('to create healthier lives and happier homes through our product innovations'), is best supported by a culture that emphasises autonomy, rewards risk-taking and tolerates constructive failure. In contrast, a purpose that prioritises cost (such as Walmart's, 'to save people money so they can live better') should be accompanied by a culture that emphasises efficiency and clearly defines job roles.

Leaders shape culture through their strategic choices and own behaviours, but can't change it single-handedly. Some companies thus task selected employees with ground-level culture change. Biotech firm Novo Nordisk has developed a set of cultural principles, known as the 'Novo Nordisk Way', to support its purpose to 'drive change to defeat diabetes and other serious chronic diseases'. It has a team of 'facilitators' that visits business units to help them implement the Novo Nordisk Way. The team observes a unit in action, interviews managers and employees, examines its policies, and then reports to company leadership. French personal care company L'Oréal has developed four ethical principles to support its purpose of 'cosmetic innovation for all',* and has a network of 75 ethics correspondents to embed them across the company and in every country. They adapt these principles to local customs, ensure that employees are trained on ethical behaviour, and act as a sounding board for ethics queries.[28]

Another way to shape culture is by hiring colleagues with a strong cultural fit. Recall Patagonia's purpose is to 'save our

* For example, one of the ethical principles is courage, which supports its purpose of innovation. Another is transparency, which is particularly important for an enterprise that aims to serve all citizens.

home planet'. As founder and CEO Yvon Chouinard explains: 'whenever we have a job opening, all things being equal, hire the person who's committed to saving the planet no matter what the job is'. The shoe manufacturer Zappos gives new hires a month-long training programme, which includes an induction on the company's values, and offers them $2,000 to leave if they don't share them. (A similar programme has since been adopted by Amazon, which bought Zappos in 2009.) Herb Kelleher, the co-founder of Southwest, placed cultural fit over experience and education when recruiting – as exemplified by his motto 'Hire for attitude, train for skill'.

Board Ownership

Finally, embedding purpose requires the board to take ownership of it. Lucian Bebchuk and Roberto Tallarita found that only 2% of leaders who signed the Business Roundtable statement ran it past their board. Since major corporate decisions require board approval, this suggests that few CEOs expected to change how they ran the company as a result of signing the statement.* [29] In contrast, in other enterprises such as EQT Ventures, the entire board signs the purpose statement.

Some commentators suggest that boards should set up subcommittees dedicated to purpose. A 2014 *Harvard Business Review* article reported that only 10% of US public firms had a board committee dedicated to purpose, and advocated that this practice become more widespread.[30] The 2020 European Commission study on sustainable corporate governance proposed the creation of a new board role – the Chief Value Officer. But purpose should be a formal duty of the entire board – it's fundamental to a company's business, rather than an ancillary activity that can be delegated to a sub-committee. Every board

* A justification might be that the signatories were already serving stakeholders as well as shareholders and so no change of direction was needed, but a study by Aneesh Raghunandan and Shiva Rajgopal found that they lagged their peers on financial and ESG performance.

member should be a Chief Value Officer concerned with the enterprise's long-term value.

To take ownership of purpose, the board must base its decisions on it. For example, it could require management to explain how any major decision it presents for approval (such as an M&A deal, strategic initiative or capital expenditure proposal) is consistent with the firm's purpose. Similarly, a board typically devotes two days per year to discussing and agreeing strategy; these sessions should be anchored to purpose. The board can also ensure the company's non-financial targets are both appropriate and aspirational given its purpose, and monitor whether it's achieving these targets. Every three to five years, it can also review whether the company's purpose remains relevant given the enterprise's comparative advantage and the challenges faced by society.

How does a board monitor the delivery of purpose? Board papers will contain both numbers and narratives. But, just like communication goes beyond reporting, monitoring goes beyond reading reports. The UK's Financial Reporting Council recommends that non-executive directors 'walk the shop floor' to truly understand an enterprise.[31] At present, there are proposals in the UK and US to put workers in the boardroom, and some European countries already do. But a more effective approach is to bring the boardroom into the workforce – for it to spend time in the business and hear from colleagues first-hand, through structured site visits. I served for three years on London Business School's Governing Body (the equivalent of our board) as an elected faculty representative – loosely analogous to a worker director.[32] Even though I tried to talk to non-Finance faculty and non-academic staff, I couldn't represent their views to my fellow governors as accurately as those of other Finance faculty. At a Governing Body Away Day, a colleague thus challenged the external governors to spend time on campus and understand the 'smell' of London Business School, to hear the voice of the broader workforce and student body.

While purpose should be the responsibility of the full board, committees can be useful for monitoring specific dimensions of purpose. Most boards focus exclusively on shareholder value, and thus have committees dedicated to remuneration, director nominations, risk and audit. The last two are geared towards downside protection. But Pieconomics stresses the importance of upside value creation, and so an Innovation Committee may be valuable for some firms. In addition, after an enterprise has decided on the *who*, it can create committees responsible for key stakeholders, such as a Human Capital Committee or an Environment Committee – or, alternatively, these issues should be major agenda items for the full board. Setting the tone at the top helps ensure that purpose flows throughout the organisation.

Stakeholders as Partners

Enlightened shareholder value views stakeholders as a means to an end – a company only invests in them if it can calculate, at least approximately, an effect on future profits. In contrast, a pie-growing enterprise acknowledges *stakeholder mutuality* – the long-term, two-way relationship it has with its stakeholders, who are partners in the company rather than factors of production. This recognition transforms the relationship along two dimensions. First, rather than seeing customers, workers and suppliers as sources of only revenues, labour and inputs, the enterprise views them as sources of ideas and collaborators in fulfilling its purpose. Second, instead of only taking from stakeholders – receiving their revenues, labour and inputs – it strives to deliver long-term value to them, beyond its contractual obligations.

This highlights the importance of purpose having a *who* as well as a *why*. An enterprise is a network of relationships, which it must nurture and grow, not just a web of contracts. This section discusses what a partnership approach to stakeholders involves. For brevity, we'll focus on colleagues rather than going through every stakeholder, but the principles naturally extend.

Many influential books have already been written about managing people, so my goal isn't to provide an encyclopaedia. Instead, we'll focus specifically on what Pieconomics teaches us about how to lead a workforce. We'll apply three tenets of Pieconomics to employees, each of which implies an attitudinal shift. One tenet is to avoid errors of omission rather than just commission by granting workers autonomy, the *attitude of empowerment*. A second is to invest in colleagues even if the link to profits is unclear, the *attitude of investment*. A third is to share the benefits of pie growth with employees, the *attitude of reward*. (As mentioned, these principles can be applied to other stakeholders – a company can empower customers by actively seeking their feedback, ensure that its products improve their long-term welfare and share the benefits of success rather than extracting the highest possible price.)

The three attitudes are closely linked not only to Pieconomics, but also to what's measured by the Best Companies survey, which Chapter 4 showed is linked to long-term performance. Recall that the survey gauges workers' perceptions of credibility, fairness, respect, pride and camaraderie. These perceptions reflect, in part, whether leaders display the attitudes of empowerment, investment and reward, as can be seen by the sample questions in the table below.

Credibility	People here are given a lot of responsibility
Fairness	I feel I receive a fair share of the profits made by this organisation
Respect	I am offered training and development to further myself professionally
Pride	My work has special meaning: this is not 'just a job'
Camaraderie	People care about each other here

These sample questions highlight how improving employee satisfaction involves an attitudinal shift, rather than simply spending money, which makes it hard to replicate. We'll now see what underpins this competitive advantage.

The Attitude of Empowerment

The *attitude of empowerment* views employees as a source of ideas, inspiration and innovation. Failing to tap into this source is an error of omission, but traditional management practices are based on avoiding errors of commission.

Henry Ford is widely seen as one of history's most creative business leaders, often credited with the quote 'If I had asked people what they wanted, they would have said faster horses' – an example of the importance of problem-finding, not just problem-solving. He didn't invent the car, but he developed the first car that middle-class Americans could afford (the Model T) by introducing the assembly line into the manufacturing process.

The assembly line was based on Frederick Taylor's *Principles of Scientific Management*, published in 1911.[33] Taylor viewed ground-level workers as having two characteristics. The first is that they're effort-averse and so, left alone, will shirk. The second is that they're unintelligent and unable to think for themselves, as vividly captured by his description of Schmidt,[34] a pig iron handler at Bethlehem Steel:

> *Now one of the very first requirements for a man who is fit to handle pig iron as a regular occupation is that he shall be so stupid and so phlegmatic that he more nearly resembles in his mental make-up the ox than any other type . . . He is so stupid that the word 'percentage' has no meaning to him, and he must consequently be trained by a man more intelligent than himself into the habit of working in accordance with the laws of this science before he can be successful.*

Taylor believed that there was a single best way to carry out any task, and so leaders had two responsibilities. The first was to find out this best way through scientific experimentation – quantify how much pig iron to carry at a time, and how long to take breaks. The second was to ensure that workers followed this one best way. As Taylor told Schmidt:

> *You will do exactly as this man tells you to do to-morrow, from morning till night. When he tells you to pick up a pig and walk, you pick it up and you walk, and when he tells you to sit down and rest, you sit down. You do that right straight through the day. And what's more, no back talk.*

Taylor conceded that this was 'rather rough talk', but with a man of 'the mentally sluggish type as Schmidt', it was 'appropriate and not unkind'. And this leadership approach was effective, at least in the short term and for routine jobs – it quadrupled Schmidt's haulage from 12 to 47 tons of pig iron a day.

The assembly line was inspired by Taylor. It forced employees to keep up with the pace of production and took division of labour to the extreme – workers repeated a narrow set of tasks non-stop without thinking. While modern-day working conditions aren't so extreme, elements of scientific management still persist, aiming to prevent errors of commission from shirking or making mistakes.*

The desire to prevent shirking is based on the assumption that employees are naturally work-shy. So good management involves squeezing as much as possible out of them, by creating a long-hours culture or shackling workers to targets. Just as Taylor gave Schmidt targets for pig iron haulage, Wells Fargo handed its bank employees daily sales goals, and any shortfall was added to the next day's target. Former CEO John Stumpf coined the term 'Going for Gr-Eight', encouraging employees to sell at least eight products to each customer, regardless of need or want. Why eight? Not because an analysis showed that eight

* One may wonder why shirking is not labelled as an 'error of omission' as it involves omitting to work. Throughout the book, we've used 'errors of omission' to refer to not launching new ideas, rather than the failure to perform routine tasks.

products improve customer welfare. Simply because 'it rhymed with great'.[35]

The desire to prevent mistakes is based on the assumption that, even if a worker won't shirk, he lacks the expertise to take the correct decisions himself. This assumption leads to micromanagement and hierarchy, risking errors of omission by failing to tap into employees' skills and knowledge. In my second year in investment banking, a client I'd worked with for many months asked me to investigate a US situation. I called a US Associate (the level above Analyst, my rank) to enquire, and was told that Jeff, a US Managing Director, was the relevant person to ask. The Associate advised me 'you should call Jeff', before correcting himself to 'you should get your Associate to call Jeff'. The unspoken concern was that, as an Analyst, I was too junior to speak to a Managing Director. Perhaps my rank meant that I couldn't speak articulately and would waste Jeff's time, an error of commission. Even though I knew first-hand what the client wanted and why they were interested in this situation, the hierarchy required me to brief an Associate, the Associate to call Jeff and then report back to me – wasting her time and risking the message getting lost in translation. (I ended up calling Jeff anyway, who turned out to be very helpful.)

The *attitude of empowerment*, in contrast, argues that you don't need close supervision to avoid errors of commission. Colleagues are intrinsically motivated to work hard due to their 'seeking systems', a term social psychologist Dan Cable uses to describe their innate desire to explore and create.[36] Indeed, the move to home-working in the pandemic has shown how employees are still driven to contribute even without being closely monitored. They also have specialist expertise and ground-level information to come up with the best way of achieving a goal. The challenge for leaders is to activate and channel these seeking systems.

Empowerment was a key pillar behind Japan's success after the Second World War. In Ford's American assembly line, factory workers executed tasks designed by superiors, who then checked the quality of the final product. In contrast, under the Andon system used by Japanese manufacturers such as Toyota, factory workers were themselves responsible for quality, and had the authority to stop the production line whenever they saw a defect. A flashing light would come on to call for help – hence the name, Andon, taken from the Japanese word for a paper lantern. This attitudinal shift was radical, since stopping production was previously seen as management's call. Japanese factories became hubs of continuous improvement, since those closest to the action could contribute to innovation efforts. When I toured a Toyota factory in Tokyo, the Toyota employee proudly pointed out every feature of the production process that came from workers.

This attitude is now adopted by many Western enterprises, and is measured, in part, by the Best Companies survey question 'People here are given a lot of responsibility'. For example, Kim Jordan, New Belgium Brewing Company's co-founder, describes her firm's approach as follows: 'We have a high involvement culture. Everyone knows where the money goes and everyone is expected to participate and build strategy. It's created an environment not only with a level of transparency that fostered trust, but also a shared "we're in this together" feel.' We discussed in Chapter 3 how New Belgium acknowledged its environmental impact. It runs a crowdsourcing scheme, 'Bright Ideas', which asks colleagues for ideas on how to reduce it. One was to eliminate the cardboard dividers it had been using inside its boxes to separate bottles. This saved hundreds of trees, as well as $1 million per year in raw material costs. But there were several indirect benefits. It sped up production, which had previously been slowed down at the packaging phase. The smaller boxes meant that more could fit into a delivery truck, reducing fuel costs and carbon emissions.[37] This is an example not only of the value of empowerment, but also the principles of Pieconomics – actions taken to benefit the environment ultimately benefiting investors.

Empowerment also involves tolerance of mistakes to avoid errors of omission. As discussed in Chapter 5, Bart Becht entrusted Reckitt Benckiser managers to launch new ideas without requiring a stack of approvals. This increases the risk that initiatives fail, but such failures are less costly than stifling innovations. Financial software company Intuit and conglomerate Tata go further than tolerating mistakes – they actively celebrate them by giving awards for ideas that ultimately failed, but provided valuable learnings.

Large-scale evidence backs up the takeaways from these examples. A meta-analysis of 142 studies by Scott Seibert, Gang Wang and Stephen Courtright found that individual empowerment is associated with higher performance along several dimensions – routine tasks, 'organisational citizenship behaviour' (going above and beyond regular duties) and innovation. They similarly found that team empowerment is linked to significantly higher team performance.[38]

While empowerment can unleash untapped potential, it shouldn't be unfettered, but guided effectively through purpose and training. Micromanagement and hierarchy may not be driven by the assumption that employees are lazy – even if they're diligent, their efforts may be misdirected on immaterial issues. That's why purpose is powerful – captured, in part, by the survey question 'My work has special meaning: this is not "just a job"'. If colleagues are inspired by the company's purpose, they'll contribute to it even if the shackles are released; if the purpose is targeted and clarifies the priorities, they'll know where to direct their energies. In a quote attributed to author Antoine de Saint-Exupéry: 'If you want to build a ship, don't drum up the men to gather wood, divide the work and give orders. Instead, teach them to yearn for the vast and endless sea.'[39] Indeed, as discussed previously, Claudine Gartenberg and co-authors documented the benefits of a strong and clear purpose, particularly as perceived by middle managers rather than senior leaders.

Another way to ensure that employees make best use of their autonomy is by continually investing in their skills. This is the attitude of investment, to which we now turn.

The Attitude of Investment

The *attitude of investment* seeks to enhance a colleague's skills and well-being, not only because he'll become more productive, but also because you care about him as a person. This attitude is measured, in part, by the survey question 'People care about each other here'.

The classic economic model of Nobel Laureate Gary Becker argues that a company should only invest in *firm-specific* training that's of value exclusively within the firm, such as how to use its databases.[40] If it invests in *general* skills, which have value in other potential employers, the worker can command a higher salary – so he, not the company, captures the benefits of his increased productivity. These economic models aren't just abstract theory, but affect practice. Most general education isn't financed by employers but by governments (for example, public schools), workers themselves (for example, Masters of Business Administration degrees[41]) or a combination of both (for example, public universities).

But the attitude of investment doesn't calculate how firm-specific or general the training is, or how much of the benefits the company will capture. Indeed, the survey question 'I am offered training and development to further myself professionally' doesn't make these distinctions. The attitude of investment views it as an enterprise's responsibility to develop its workers' skills, increasing not only their value to their current firm, but also their future employability if they leave the firm. In her book *Janesville*, Amy Goldstein relates how the 2009 closure of General Motors' factory in Janesville, Wisconsin led to chronic unemployment that seriously depressed the entire city.[42] Since GM had focused on teaching its colleagues specialised skills, retraining efforts were largely unsuccessful. Many didn't know how to use a computer and so couldn't take the courses offered by local technical colleges.

As an example of the attitude of investment, in August 2016, the Singapore offices of Standard Chartered bank launched the Skills-Future@sc programme, giving employees paid study leave and free tuition to take one of fifty bank-sponsored courses. It particularly targets workers whose roles are at risk from changes in technology, and trains them in not only technology, but also human skills that technology is unlikely to replace, such as customer interaction. Moreover, investment in skills doesn't always require financial expenditure or official programmes, but management practices such as coaching and empowerment. We've discussed how empowerment taps into colleagues' initiative today; a separate benefit is that it invests in their future potential by giving them the chance to step up.

Earlier, we referred to investment as 'enhancing a colleague's skills *and well-being*'. For a physical asset, investment expands its maximum capacity – if you upgrade an IT system, it can process more data. For colleagues, investment can similarly expand their maximum potential by upgrading their skills. However, many workers operate below their potential due to poor mental or physical well-being. Thus, for employees, investment involves not only raising their potential, but also helping them achieve their current potential.

In 2015, the leaders of UBS Wealth Management recognised that their demanding culture might be harming employees. So they created a Health Matters Initiative, which they asked Claudia Oeken to lead. In this role she put on major events to improve physical health, such as a '100 days, 1 million steps' initiative, encouraging employees to form teams and each take 10,000 steps per day, with each step leading to a charity donation. Quantifying the benefit of such initiatives, a meta-analysis by Katherine Baicker, David Cutler and Zirui Song found that \$1 spent on well-being programmes is associated with a \$3.27 fall in medical costs and a \$2.73 reduction in absenteeism costs.[43]

We've discussed how the attitude of investment takes into account the benefits of training for the employee even if the firm doesn't capture them. The same attitude also takes into account the costs of additional work to the employee even if the firm doesn't need to pay him overtime. This contrasts with the attitude of *free disposal* – a boss views subordinates' time as hers, free to spend as she pleases 'just in case' the work ends up being useful, without considering the cost of time to them. She might request multiple analyses in a presentation appendix, just in case the client asks a technical question. Chapter 3 explained how the pie shrinks if the firm takes an action whose benefit is less than the social rather than private opportunity cost. An employee's time often has no private cost to the firm, but a significant social one, as he could use that time for recreation. Commissioning work ignoring this social cost shrinks the pie.

This consideration means that well-being initiatives should be expanded in two ways. First, from physical to mental wellness. While the importance of physical health has long been recognised, only more recently have enterprises – and society – acknowledged the criticality of mental well-being, which is severely harmed by the attitude of free disposal. Joel Goh, Jeffrey Pfeffer and Stefanos Zenios estimate that workplace stress in the US causes 120,000 extra deaths per year and increases health-care costs by $190 billion – ultimately borne by companies themselves through higher insurance premiums.[44] Mental wellness is particularly important in a pandemic, when most employees are working from home. This blurs the separation between home and office as some bosses think they can call on their team at all hours. Home-working also removes the main source of human interaction for colleagues who live alone.

Second, well-being initiatives should expand from one-off programmes to ongoing culture change. In addition to major events, Claudia continuously educated employees on energy and stress management, and managers on the criticality of respecting their colleagues' evenings and weekends. The attitudinal shift from free disposal to investment is often substantial. A leader's own time was viewed as freely disposable when she was junior, so she's used to viewing juniors' time similarly; she may even perceive being always on call as a rite of passage to move up. That's why employee satisfaction can be a competitive differentiator that's hard to replicate – it requires a major culture change, rather than simply spending money.

Claudia told me her main challenge is measuring the success of an initiative, as it's impossible to know how many sickness and burnout days would have occurred without it. Indeed, the meta-analysis of Katherine Baicker and co-authors doesn't make strong causality claims because other factors, such as changing management practices, may have led to the benefits. This highlights the importance of the attitude of investment – investing in colleagues even without a calculation. Companies already recognise the importance of safety if their employees have physically dangerous jobs. BP made workplace injuries a strategic priority after the Deepwater Horizon disaster. Here, calculations are easier. Since on-the-job injuries often arise from a company's working conditions, improving them will indeed reduce the injury rate.

But workplace safety extends far beyond injuries to the physical sickness and mental burnout caused by an attitude of free disposal and a culture of long hours. If a colleague becomes physically or mentally ill, we don't know whether that's due to the workplace or factors outside work. But this doesn't matter to a company with the attitude of investment – it strives to provide a healthy, safe and fulfilling environment even if the benefits can't be quantified.

The Attitude of Reward

The *attitude of reward* shares the benefits of pie growth with colleagues. The most obvious way is to give employees *financial ownership* – equity in the company, as recommended in Chapter 5. Traditional economic theory, based on rational economic agents, argues that a rank-and-file employee should never be given shares. He has little effect on the firm's stock price, so equity shouldn't make him work harder. But humans don't act based on economic cost-benefit analyses. Giving a colleague shares treats him as a partner in the enterprise, who deserves to share in its success. This is captured, in part, by the survey question 'I feel I receive a fair share of the profits made by this organisation'.

Just like investment, rewarding employees doesn't just involve money. Due to their seeking systems, colleagues are also motivated by the desire to contribute. The attitude of reward thus involves sharing the intrinsic as well as financial benefits of pie growth by giving them *task ownership* – responsibility for a task, sometimes unconditionally. One benefit of task ownership is empowerment, as discussed earlier. But another is the fulfilment the colleague enjoys when he completes the task. Sometimes a senior might wish to rewrite part of a document that a junior has written. The changes might lead to a genuine improvement, but a minor one. The small cost of sticking with the original is outweighed by the reward the employee enjoys from having had full responsibility for the final product.

In my second year at Morgan Stanley, my Executive Director (William) often worked with me without either an Associate or Vice President in between. Usually, the executive summary of a presentation is the prerogative of senior bankers. But rather than leaving this page blank for William to fill in when he commented on my other slides, I dared to take first crack at it. The first few times, he'd suggest major changes – not only improving the presentation for the client, but also coaching me. Having learned from those changes, I slowly improved. I still remember the fulfilment when, for the first time, an executive summary came back to me unchanged. Almost certainly, William could have suggested incremental improvements, but chose not to. This cost to the final product was little, but the reward to me was significant, and remains vivid two decades later.

In a Nutshell

- The main way in which an enterprise can grow the pie is *excellence.* Serving society goes beyond taking actions that are explicitly 'serving'. Almost all firms and colleagues make a major contribution to society by being excellent at their specific role, regardless of whether it directly affects stakeholders.
- An enterprise's *purpose* is its reason for being – how it seeks to serve society. Three points can guide how to form an effective purpose statement:
  - ✳ A purpose should be *focused and selective* – it cannot be all things to all people. A purpose is only meaningful if the converse would also be reasonable, as then it provides guidance to leaders in navigating trade-offs and clarity to members on what the enterprise stands for.
  - ✳ A purpose defines *who* the enterprise is for and *why* it exists. The *who* is based on the *principle of materiality* and the *why* on the *principle of comparative advantage*.
  - ✳ A purpose should be both *deliberate*, guided by executives, and *emergent*, shaped by colleagues rather than being merely executed by them. Input from external stakeholders, particularly customers, is also valuable.
- A purpose is far more than a mission statement and must live in the enterprise. It must not only be *defined*, but also *communicated* externally and *embedded* internally.
- Reporting should expand beyond financial measures of shareholder value to non-financial measures of stakeholder value, and understand the importance of narrative as well as quantitative reporting – *what gets monitored gets done*. The main value of such *integrated reporting* is to spark integrated thinking, where stakeholder concerns are integrated into all major decisions.
- Communication goes beyond reporting to a two-way in-person process. It may involve giving investors a 'say-on-purpose'.

Doing so builds *investor capital*, which is much more than investors' financial contribution to the company.

- Leaders can put purpose into practice through the firm's strategy, aligning its operating model and culture, developing an internal 'balanced scorecard' that includes relevant non-financial measures, and making purpose a priority of the board.
- An enterprise should recognise *stakeholder mutuality* – stakeholders aren't simply factors of production, but are members of the enterprise. Applied to colleagues, this involves adopting three attitudes, each based on a tenet of Pieconomics:
  - *The attitude of empowerment* is based on the importance of errors of omission rather than just commission. It views colleagues as intrinsically motivated and intelligent. If given freedom, and guided by a clear purpose, they'll generate ideas rather than shirk.
  - *The attitude of investment* is based on delivering value to stakeholders even if the link to profits is unclear. It seeks to enhance a colleague's skills and well-being because the company cares about him as a person. This involves internalising both the benefits of investment and the costs of additional work.
  - *The attitude of reward* is based on sharing the fruits of pie growth with stakeholders. It gives a colleague both financial and task ownership, so that he enjoys both the pecuniary and intrinsic gains from success.

9 INVESTORS

Turning Stewardship from a Policy into a Practice

Chapter 6 defined stewardship as ‘an approach to investment that improves the value a company creates for society’, and presented evidence that both investor engagement and monitoring grow the pie. We now discuss *how* investors can put stewardship into practice. Chapter 8’s framework on implementing purpose – defining purpose, embedding it internally and communicating it externally – also applies to stewardship, and we’ll draw many parallels throughout. Some of this chapter draws on my work with The Purposeful Company – in particular, numerous discussions with Tom Gosling, who co-led all of TPC’s stewardship initiatives with me.

Before we start, I’ll stress two points. The first is the urgency of improving stewardship. Just as purpose isn’t an optional extra for companies to confine to a Corporate Social Responsibility (CSR) department, stewardship isn’t an optional extra for investors to confine to a stewardship department. Most obviously, stewardship serves savers – investors’ clients – by improving long-term returns and achieving their non-financial goals. More broadly, stewardship is important for the legitimacy of the investment management industry. Society views investors as having stewardship responsibilities and has blamed corporate collapses, such as the 2007 financial crisis, on investors failing in these responsibilities.[1] Moreover, these stewardship expectations extend beyond financial returns and include social objectives; for example, investors can push companies to increase diversity or take action on climate change. And good stewardship can be a national competitive advantage. Former Japanese Prime Minister Shinzo Abe saw Japan's historically passive investment industry as a cause of its low equity returns, and undertook multiple structural reforms to address this.

Given the importance of stewardship for society, several countries have introduced Stewardship Codes.[2] While a good first step, complying with codes should be seen as a bare minimum. If investors don't improve stewardship by themselves, they may be faced with tougher codes or regulation. Arguments to decrease investor rights are based on the concern that investors aren't using these rights responsibly.

The second key point is that 'investors' aren't a single entity, but consist of an entire investment chain, as shown in Figure 9.1. Chapter 6 focused on *asset managers* – investment management companies such as ValueAct and Fidelity. They run individual *funds*, such as the Fidelity Magellan active fund or the Fidelity Mid Cap Index Fund. *Investor* is a general term that can apply to both asset managers or funds.

But asset managers aren't the only link in the chain. They manage money on behalf of *asset owners* or *savers*. These may include citizens who buy funds directly, or institutions such as a pension fund, university endowment or sovereign wealth fund. They play a critical role in holding asset managers to account for stewardship – for example, Japan's $1.5 trillion Government Pension Investment Fund uses stewardship as a major criterion in its selection and evaluation process.

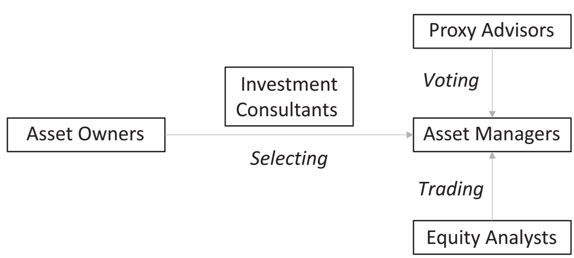


Figure 9.1 The Investment Chain

Institutional asset owners typically choose asset managers using *investment consultants*, such as Aon Hewitt, just as people use financial advisors. Asset managers use their own consultants – *proxy advisors* to guide voting decisions and *equity analysts* to guide trading decisions.[3] Investment consultants and proxy advisors are collectively known as *service providers*. Regulators typically don't view equity analysts as service providers, nor see them as playing a role in stewardship. But they influence investors' trading decisions, which is a form of stewardship, so we include them in this chapter.

As a result, improving stewardship requires reforming the entire investment chain, yet stewardship codes typically focus on asset managers. We'll first explore asset managers and explain how they can *define* their stewardship policy, then *embed* this policy by turning it into a practice, and finally *communicate* outcomes externally – the same three steps we described for implementing purpose in Chapter 8. Later in this chapter, we'll describe this process for the other links in the investment chain.

Defining Stewardship

Stewardship codes often assume a one-size-fits-all approach – that engagement is always more effective than monitoring and that more stewardship is always better than less. But this ignores the principle of comparative advantage. An asset manager may choose not to engage in stewardship, because it's costly and requires expertise. If an investor is small, or if stewardship isn't its comparative advantage, the best way it serves society might be to provide savers with low-cost access to equity markets, so that they can share the fruits of economic growth. If so, it might undertake minimal stewardship, or outsource it to a third party that engages with companies on behalf of investors, such as Federated Hermes Equity Ownership Services. A clear definition of stewardship is therefore important. What matters isn't so much that a fund engages in extensive stewardship, but that it does what it says it will. This should avoid the problem of 'closet indexers', who charge high fees for active management without actually practising it.

The starting point for stewardship is a fund's purpose. This purpose should explain how it aspires to serve savers and society. Its stewardship policy then follows, by outlining how it aims to use stewardship to achieve its purpose. The policy should cover not only engagement, but also monitoring – in particular, *investors should have a policy for what will cause them to sell*. This helps ensure that selling isn't a knee-jerk reaction to short-term earnings, and recognises that selling can be an effective stewardship mechanism. Some investors currently have a policy on generalised divestment, such as selling (or never buying) tobacco companies, but few have a policy on specialised divestment – long-term, intangible factors that will cause them to exit. Whatever divestment policy the investor adopts, it should ensure that it only sells companies based on this policy, not short-term profit. Equally importantly, it should indeed sell when these lines are crossed and engagement is unsuccessful, rather than being asleep at the wheel.*

For example, related purpose and stewardship statements might be:

Purpose: 'To create long-term real returns by investing in companies with high-quality intangible assets that are not priced by the market, and supporting companies in building these intangibles.'

* Note that an investor's policy might be to rarely sell, but to continue to engage even when management is intransigent. While an asset manager will have an overall stewardship policy, individual funds may have different approaches. An index fund will undertake less specialised engagement than an active fund. But each fund should carry some traits of the general policy, just as a manufacturer's different products should all fit within its purpose. Stewardship policies (and, as we'll discuss later, stewardship performance) should be reported at the fund level, since savers buy funds, not asset managers. To minimise the reporting required, a fund can cross-reference the asset manager's general policy when defining its own approach.

Stewardship policy: 'We believe that prioritising short-term profit can discourage investments in intangible assets that drive long-term returns, such as marketing, human capital and innovation. We thus pay particular attention to evaluating the quality of a company's intangibles, and track not just the amount of money spent, but also the output of such investment. We engage routinely with management – sometimes in collaboration with other investors – to encourage intangible asset creation, with a focus on organic rather than inorganic growth. We commit to evaluating management performance on the basis of intangible asset growth rather than short-term earnings. We will exit companies that are investing insufficiently in intangible assets and where engagement with management fails to produce change.'

Within the broad mechanisms of monitoring and engagement, there's a variety of possible approaches. Just like purpose, a stewardship policy should be focused – an investor isn't responsible for solving every company's problems all of the time, so what the policy leaves out is almost as important as what it includes. Engagement can vary by *form* – informed voting, private meetings with management or confrontational public activism. It can also differ by *theme* – the issues the investor will prioritise in engagements, either due to comparative advantage in assessing them or viewing them as particularly material. An indexed fund may prioritise a generalised theme, such as diversity in senior management. However, it may not have the resources to engage on specialised themes such as strategy, which require it to get into the weeds of a particular company. These should be the focus of active funds. Similarly, monitoring may be based on either specialised or generalised issues.

Another key aspect of focus is that an investor's responsibility is ultimately to clients, and so stewardship should only be undertaken if it's in their interest. Thus, it must be on an issue with either high business materiality, so that it ultimately improves long-term shareholder returns, or high intrinsic materiality due to clients having preferences beyond financial returns. Investors should ensure they understand these preferences – for example, pension funds can survey their beneficiaries to learn their social objectives. Asset managers shouldn't feel pressure to react to whatever issue happens to be the order of the day, but instead focus on the ones that are most important to returns and/or to clients. Similarly, policymakers shouldn't hold investors accountable for implementing public policy initiatives. That's their own responsibility, and – as we'll discuss in Chapter 10 – they have taxation and regulation as powerful tools to do so.

Having defined its stewardship policy, the next step is for an investor to put it into practice. That's the issue to which we now turn.*

Embedding Stewardship

Recall that Chapter 6 highlighted three features of hedge funds that make them particularly effective at engagement – their portfolio concentration, financial incentives and resources. These same features also enhance monitoring. We stressed that these dimensions aren't unique to hedge funds, so the first step to embedding stewardship is to adopt these features. Starting with *portfolio concentration*, an investor that claims to be active should truly be active, holding only a small number of companies.[4] Its default position should be not to own a stock, rather than to own it because it's part of the benchmark. Then, every company is a conviction holding, whose long-term story the investor either believes in or believes that it can turn around. A good rule of thumb is that, if a fund chooses to own a particular

* For companies in Chapter 8, we started with external communication. For asset managers, we start with internal embedding, to familiarise readers outside the investment industry with how it operates.

company, it should hold it to a greater degree than the benchmark. This avoids the paradox mentioned in Chapter 6, where successful engagement might lead to a fund underperforming its benchmark because it's underweight in the company.

Some investors argue that a concentrated portfolio exposes their clients to too much risk. But if a client has chosen an active fund, it believes in the manager's stock selection ability and is paying for him to use it. A client that wants more diversification than what the fund provides can simply allocate more of its portfolio to index funds. Instead, these arguments are often out of self-interest – a fund manager doesn't want to risk underperformance, as it may lead to client withdrawals or him being replaced.

The second feature is *incentives*. Just as Chapter 5 stressed that leaders should be paid like owners, the same is true for fund managers. Ajay Khorana, Henri Servaes and Lei Wedge show that when a manager owns 1% more of his fund, risk-adjusted performance rises by 3%.[5] Chris Clifford and Laura Lindsey found that mutual funds with performance-sensitive fees lead to CEOs also receiving more performance-sensitive pay, and the companies they invest in improve profitability more in situations where engagement is likely to be effective.[6] Ownership stakes should be locked up for the long term, since stewardship may take several years to pay off.

The third characteristic is the *resources* an investor dedicates to stewardship. One resource is the stewardship team (sometimes known as the 'responsible investment', 'ESG' or 'corporate governance' team). This is a specialist department that doesn't manage money, unlike fund managers, but focuses on engagement and monitoring. What's important isn't just the size of this team, but also its prominence. At Legal & General Investment Management (LGIM), the UK's largest institutional investor, stewardship head Sacha Sadan sits on the board and reports directly to the CEO.

Stewardship resources aren't just confined to the stewardship department. Just like the *integrated thinking* we stressed for purpose in Chapter 8, stewardship should be integrated into an asset management's investment process. Fund managers should (and sometimes do) have explicit responsibility for stewardship and be evaluated for it, and lead voting decisions and engagements jointly with stewardship departments. One asset manager requires all graduate hires to rotate through the stewardship department so that, when they become fund managers, they're able to direct stewardship efforts.[7] However, there remains significant room for improvement in integration. A recent survey found that only 23% of investors have stewardship capabilities embedded throughout the organisation.[8]

While a concentrated portfolio, incentives and resources lay the ground for stewardship, an investor still has to do it. The next two sections provide guidance on practising effective monitoring and engagement.

Effective Monitoring

Monitoring can only improve investor returns if it's based on factors that aren't incorporated by the market. While the stock market is pretty good at taking into account financial performance, Chapter 4 shows that it tends to overlook social performance – even if it ultimately improves shareholder returns in the long term. This requires a shift in thinking among investors. Effective monitoring requires investors to evaluate stocks by how much value for society they create, not just how much profit. Then, when the investor trades on this information, he'll put it into the stock price and cause it to more closely reflect long-term value – a form of stewardship.

But how do we actually assess an enterprise's social performance? How can we tell which companies are truly responsible rather than just greenwashing? This section will critically assess the different data sources available to investors.

SPECIFIC THIRD-PARTY DATA SOURCES

A starting point might be to draw from the academic studies in Chapter 4. Since they analyse hundreds of companies, they need large-scale, comparable measures. These metrics must also be objective – if they required the researcher's subjective judgment, he could get the result he wants by deeming a company 'responsible' if it's enjoyed strong financial performance.

Comparability, availability and objectivity are desirable for investors as well as academics, so such measures indeed seem promising. And there are several available – just as the Best Companies to Work for list and American Customer Satisfaction Index measure employee and customer welfare, consistent metrics exist for other social dimensions. For example, Interbrand estimates brand value, Trucost environmental impact and Equileap gender equality.

But, paradoxically, because comparability, availability and objectivity are so attractive to *investors*, this makes them less attractive as *investment criteria* – other investors may take them into account and so the stock price will incorporate them. It's true that, in the past, a shareholder could have beaten the market by buying the Best Companies. But, now that published research has shown that employee satisfaction is pie-growing rather than pie-splitting, other investors may trade on it. Indeed, recall from Chapter 6 the study by Paul Gompers, Joy Ishii and Andrew Metrick, which showed that companies with the strongest shareholder rights beat those with the weakest by 8.5% per year. The study was published in 2003, and circulated as a draft a few years prior. Lucian Bebchuk, Alma Cohen and Charles Wang found that shareholder rights no longer predicted stock returns in the 2000s. This wasn't because governance stopped being important – indeed, better governed firms continued to enjoy higher sales growth and profitability, just as Paul, Joy and Andrew found in the 1990s. Instead, it was because the market now realised that governance was important. Companies with strong investor rights already had high stock prices at the start of the 2000s, and so didn't outperform going forwards.[9]

More generally, David McLean and Jeff Pontiff study 97 trading strategies uncovered by academic research, and find that their profitability falls by an average of 58% post-publication.[10] Once a trading strategy is published, the market starts to incorporate it. The fall isn't 100% because markets aren't fully efficient – some investors might not read academic research and thus be unaware of the strategy. Perhaps measures of social performance are particularly likely to be overlooked if investors are stuck in the pie-splitting mentality. So these large-scale, comparable metrics still have some value, but investors can do better.

GENERAL THIRD-PARTY DATA SOURCES

The natural next step would be to move from a single dimension of social performance to an aggregate measure across all stakeholders, such as the KLD ESG ratings we've mentioned before. Ratings providers collect a range of information on a company's ESG performance – its own disclosures, third-party reports (for example, from non-governmental organisations such as the World Bank), news items, and surveying and interviewing the company themselves. They come up with an overall ESG rating, and individual scores for each of the E, S and G as well as sub-issues under each of the three pillars. These numbers are accompanied with narratives to explain the rationale for the scores.

But a major challenge is that multiple companies provide ESG ratings – such as MSCI,[11] Sustainalytics, Vigeo Eiris, RobecoSAM and Asset4 – and consensus among them is low. The correlation across different providers is 0.54. This contrasts with credit ratings, where the correlation between S&P and Moody's (the two main providers) is over 0.9. There's strong consensus on a company's creditworthiness, but significant disagreement on its ESG performance.

Florian Berg, Julian Kölbel and Roberto Rigobon did a deep dive into the sources of the inconsistency.[12] They found that 35% is due to *scope*: different raters include different attributes. For example, all of them include greenhouse gas emissions in the 'E' score, but only some include electromagnetic radiation. One provider may believe that lobbying is unethical and thus include it; another may view it as legitimately providing input into policy, like responding to a government consultation, and exclude it. 40% is due to *measurement*: even if raters agree that a dimension should be measured, they may do so differently. Labour practices may be evaluated using employee turnover, or instead the number of labour cases against the firm. Female friendliness can be gauged with the gender pay gap, the percentage of women on the board or the proportion of females in the workforce. One rater's measure of 'volume of fossil fuels used' captures the usage by all of Walmart's logistics activities, but none of Amazon's delivery system because it's outsourced. The final 25% is due to *weight*: different providers place different weights on the individual components when calculating the overall score.

What does this confusion mean for investors? It doesn't imply that ESG ratings are worthless or that providers are incompetent. ESG performance is simply difficult to measure, and reasonable people will disagree – just as one equity research analyst will rate a company as a Buy and another as a Sell. Indeed, another word for 'inconsistency' is 'diversity'. Just as investors read multiple equity research reports to obtain a diversity of views, the breadth of viewpoints across ESG rating providers allows investors to get a much richer picture than if all providers said the same thing.

Some investors lament the inconsistency of ESG ratings as it means they can't just take a rating off the shelf and trade on it. But no investor would automatically follow an equity analyst's Buy or Sell recommendation – he'd first read the whole report and cross-check the underlying analyses. Similarly, investors need to carefully scrutinise an ESG rating report and understand what the rating is actually capturing. A low score may be partly due to high electromagnetic radiation, but a particular investor may consider this immaterial. As a result, the rating is less useful than the underlying drivers – just as the overall calorie content of food isn't as informative as the individual amounts of protein, carbohydrate or fat.

Investors should supplement these individual rating drivers with their own analyses. While companies' integrated reports, news stories and World Bank studies should theoretically be incorporated in ESG ratings, the original sources may provide important nuances absent from the ESG report, or may have been overlooked entirely by the rating agency. Similarly, the rating agency may have focused too much on *whether* a company has hit certain ESG targets and less on *why* it did so. More importantly, we've stressed that Pieconomics is far more than just ESG. Many ESG ratings focus more on 'do no harm' rather than 'actively do good', and don't fully incorporate excellence and innovation – the main ways in which enterprises grow the pie.*

MEETING MANAGEMENT

Just as Chapter 8 highlighted that communication by companies involves far more than just reporting, monitoring by investors involves far more than just reading reports. Thus, the most valuable monitoring tool may be the 'boots on the ground' approach of visiting companies and meeting management, like Peter Lynch did with Chrysler. Below is a list of questions that investors might ask to structure conversations about a company's social performance – either for a potential investor who uses it as an investment criterion, or an existing investor to monitor social performance on an ongoing basis. (Of course, this list would not apply to meetings on other topics, such as concerns about financial performance, competitive dynamics or an upcoming pay vote.) This list has been

* Measures of how much an enterprise 'actively does good' are more commonly studied by impact investors – investors who are willing to sacrifice financial returns to achieve social goals – in contrast to responsible investors who wish to use social criteria to achieve financial returns. However, it's not the case that measures of 'actively do good' are only relevant for impact investors. Such measures are more likely to grow rather than merely split the pie compared to those of 'do no harm', and thus most likely to improve financial returns as desired by responsible investors.

informed by conversations with a wide variety of investors on the questions they find particularly insightful:*

Questions for Company Managers

Investors can ask the following questions to identify whether an enterprise is growing the pie.

Purpose

1. What is your company's purpose, and how does fulfilling it contribute to both society and your own success? What did you omit from your purpose and why?
2. What leading and lagging indicators do you use to measure whether purpose is being put into practice?
3. How do you embed purpose internally – in the boardroom and at ground level – and communicate it externally? What steps have you taken and what processes have you put in place?
4. Can you give examples of recent decisions that were driven by purpose and would not have been made if your objective were only shareholder value?

Excellence and Innovation

5. Can you give examples of areas in which you have pursued excellence, to improve stakeholder rather than only shareholder value?
6. What innovations have you recently undertaken to create value for society?
7. What are your main sources of comparative advantage and how are you deploying them to address society's challenges?

* The idea for a list of questions to ask management is thanks to the UK think tank Blueprint for Better Business, which proposes eight questions. Our list of ten is particularly centred on Pieconomics, and thus issues such as excellence, innovation, managing trade-offs and focus.

Stakeholders and Trade-Offs

8. What are the main concerns of your employees and other key stakeholders, and what concrete actions have you taken to address them?
9. How do you manage trade-offs between different stakeholders? Can you give examples of recent trade-offs that you have had to make?
10. How do you decide which investments in stakeholders to turn down? Can you give examples of recent decisions where commercial necessity outweighed social desirability?

One might worry that leaders, anticipating these questions, will ask their communications department to prepare sanitised responses. However, investors have found even seemingly obvious questions to be highly revealing. A senior investor told me that she frequently asks CEOs a version of question 8 focused on employees. Some can immediately reel off an answer; others say, 'I didn't know you were going to ask me about my people; next time I'll bring along the HR director.' She thus learns which leaders view colleagues' concerns as a CEO-level issue central to the firm's success, and which delegate them to the HR department.

Moreover, the above list is intentionally general so that it can be used by investors regardless of their industry or company focus, but it becomes particularly powerful when tailored. So its main value is to highlight principles that investors should apply to a particular context to devise more specific questions – rather than to be a questionnaire investors read verbatim to any company, without doing their own research, to tick off a stewardship box. Tailoring these questions will also reduce the likelihood that leaders can prepare stock responses.

For example, if a company has recently changed its purpose, question 1 can be refocused to understand why. Using Microsoft as an example, an investor might ask: 'Your new purpose is "to empower every person and every organization on the planet to achieve more". It used to be "to create a family of devices and services for individuals and businesses that empower people around the globe at home, at work and on the go, for the activities they value most". Can you explain the thinking behind these changes and how they'll affect the way you do business?' Similarly, questions 2, 3 and 4 might be adapted to 'What does this change mean in practice for the indicators that you're measuring, the culture you're trying to instill and the way you make decisions?' Questions 8 to 10 should be tailored to the main stakeholder issues faced by an enterprise. Question 8 for a clothing retailer might investigate worker welfare not only in its stores, but also supply chain; Question 9 for a decarbonising energy company can ask how it's ensuring a 'just transition' that also takes into account employees and customers.

AN INTEGRATED APPROACH

Combining these different information sources is one of the major advances in responsible investing. Historically, it was based on *screening* or *exclusion*. Investors used quantitative metrics such as a company's industry or pay ratio to decide the acceptable universe; from that universe, they'd then choose stocks purely on financials. ESG got your foot in the door, but no further.

In Chapter 4, we discussed several shortcomings of this approach in improving investment performance – it's based on superficial measures that can be manipulated, is one-size-fits-all, and is piecemeal rather than holistic. Here we highlight how exclusion is also ineffective in changing company behaviour. Chapter 6 discussed how divestment can be a powerful stewardship mechanism, but only if the divestment decision is based on an enterprise's performance. If an investor has a blanket policy to divest from energy stocks, then there's little reward for a company implementing an ambitious transition plan – it will be screened out whatever it does. Instead, a discerning policy that allows the investor to hold 'best-in-class' stocks gives companies a strong incentive to ensure they're indeed 'best-in-class'.

The other stewardship mechanism we discussed in Chapter 6 is engagement, and an investor can only engage if it has a seat at the table. An energy company is much more likely to meet investors to discuss its transition plan if they hold sizable stakes, and take their concerns seriously as they can vote against management if dissatisfied with progress. Indiscriminately screening out companies that cross a red line is like a doctor who'll only see healthy patients and turns away the sick. Moreover, an investor can only sell if someone else buys, so divestment might lead to energy stocks being held by shareholders who care little about social performance and won't hold them to account.

For all of these reasons, responsible investing increasingly involves *integration* – considering ESG alongside financials. Recall from Chapter 4 that, in 2018, the most popular ESG strategy was screening, accounting for $19.8 trillion assets under management. However, integration wasn't far behind, at $17.5 trillion – and had grown by 69% since 2016 compared to only 31% for screening.

An integrated approach is crucial since financial and ESG dimensions interact. As we saw in Chapters 4 to 6, social performance, executive pay structures and governance ultimately affect financial performance. But if that's the only reason for considering them, then even if a company's ESG performance is weak, it might still be an attractive investment if its stock price is low enough or its financial outlook strong enough. So it should never automatically screen out a stock because of its ESG. But if the investor views an ESG issue as a moral one, then no valuation will persuade it to invest. Thus, the investor should be clear about its rationale for considering an ESG factor – and if it's purely a financial one, it should be integrated with financial analysis rather than used as a screen.

This consideration also affects the 'engage vs divest' conundrum. While wholesale exclusion of companies that cross a red line is unwarranted, investing in every stock and trying to turn it around is also ineffective. The conundrum can't be resolved without simultaneously considering valuation. An investor should estimate what a company would be worth upon successful ESG engagement, and compare this to its current price. If its potential value still lies below its current price, then divestment is the best option. Conversely, buying a best-in-class company with little room for improvement, and not engaging, is warranted if this strong ESG performance isn't yet reflected in the company's current price.

In addition to considering financial and social performance together, integration considers all of the above information sources together when assessing social performance. As a result, it assesses both a company's positive and negative effects on each stakeholder – not just whether it crosses red lines, but how much value it creates – and weighs them by their materiality. This process is sometimes called a 'net benefit test', and it answers the question 'Does the company deliver a net benefit to society?' The output of a net benefit assessment is an internal report. The report will contain quantitative data on metrics relevant to the enterprise's business (such as water consumption for a drinks manufacturer, compared to peers) and external assessments such as ESG ratings or Best Company status. This data addresses common concerns that a net benefit test is purely subjective and hinges on the value judgments of the analyst conducting it. However, data should only be used to *build* the case, rather than *be* the case – it needs to be put into context and combined with qualitative information.

Some subjectivity will thus remain, as we saw when discussing Amazon in Chapter 4. There's no unambiguous answer to whether Amazon benefits society overall – it creates substantial value for some stakeholders, but extracts value from others. This ambiguity makes the use of social criteria *more* attractive rather than less, as other investors may make the wrong call. In the late 1990s, shareholders viewed Enron as a poster-child for ESG, having won the Climate Protection Award from the Environmental Protection Agency and the Corporate Conscience Award from the Council on Economic Priorities – yet it collapsed in 2001 due to accounting fraud. If there were a single, unambiguous ESG rating or set of measures, then responsible investing could be done by a computer. Instead, there's substantial scope for human fund managers to add value because we need to discern which quantitative measures of social performance are relevant for a company's strategic context, and supplement them with qualitative information and meeting management. That's why responsible investment is practised even by investors with purely financial goals. The ideal investment criterion is one that's financially material, but hard to assess and likely to be missed by other investors. Social performance fits the bill.

Data providers are responding to these limitations. For example, Arabesque S-Ray uses artificial intelligence to continually update the weights it applies to individual components when forming its overall ESG rating. The Impact Weighted Accounts initiative aims to measure the positive value created by an enterprise's products, thus capturing 'actively do good' as well as 'do no harm'. But, no matter how sophisticated data sources become, human investors will always be needed to put them into context. By analogy, recruiters can now run psychometric tests and scrape the social media profiles of potential hires. However, it's unlikely that anything will ever replace the job interview – only with an interview can this information be put into context. I'm sometimes asked, 'How do you measure whether a company is responsible?' You can't *measure* social value – just like you can't measure whether an employee will be a good hire. But you can evaluate it, using a combination of both data and qualitative assessment. Thus, human investors can continue to add substantial value even in a big-data world.

The ambiguity of a net benefit test does have downsides. It's almost always possible to claim that a company is creating social value, because nearly every enterprise does well on at least one stakeholder dimension. A fund manager might choose a stock based on short-term profits and then argue that it's pie-growing by highlighting the social dimensions on which it outperforms. You can rationalise almost any investment, but in the words of psychologist Stephen Covey, you'd be telling yourself 'rational lies'.[13]

One way to reduce this risk is for the investor's stewardship policy to stipulate what will cause it to sell or prevent it from investing. Some investors might formulate 'red lines' that they apply to all companies, such as bribery or human rights, and others that may be relevant only for certain industries. While it's almost impossible to form a red line for qualitative criteria, an investor can formulate principles to assess them – such as multiplication, comparative advantage and materiality for an enterprise's span of activities – to reduce the scope for fudging.

A second way to reduce the risk of 'rational lies' is to have an external advisory committee; I serve on one for Royal London Asset Management. Once the investment team has proposed a stock as a potential investment, we provide an outside opinion on whether it passes the net benefit test. Since we weren't involved in the financial analysis that led to the stock being recommended, this reduces the risk that it distorts our assessment of social performance.

In addition to assessing individual stocks, an advisory committee can give guidance on broader themes – for example, whether being in the alcohol industry or having a high CEO pay ratio should be a 'red line'. Most of these questions are nuanced and specialist, so a diversity of perspectives and expertise is valuable. The outcome of these discussions could be published in a position paper, clarifying an investor's stance to savers. To highlight the tricky nature of these issues and the potential value of outside opinions, here are examples of topics we've discussed:

- Does genetic modification create value for society? Modified seeds may escape into the wild and disrupt biodiversity, or they may discourage farming of organic or non-modified foods. But with millions of people in the world starving, is it irresponsible not to use the best technology?

- Do enterprises that pay low taxes create value for society? Are they splitting the pie by locating their activities in low-tax countries purely to maximise profit, or simply responding to tax incentives to invest in underdeveloped areas or undertake R&D?
- Does artificial intelligence create value for society? Might robots eliminate jobs, or instead allow colleagues to be reallocated to more fulfilling jobs? What safeguards are companies adopting to reduce the risk that robots get out of control?
- Does social media create value for society? It connects people to friends throughout the world and allows sharing of photos, stories and news. But it creates the potential for cyber-bullying, addiction, fake news and misuse of personal data.
- Should evaluations of a firm's social responsibility be absolute or relative (to either its peers or itself in the past)? If a company is in a controversial industry but best-in-class, is it investible? If a company has a poor social record but is improving, is it investible? For a company in an emerging market, should we evaluate it according to local standards or global standards?

The answer to a thorny question will often be 'it depends'. But the value of such discussions is to understand what it depends on. In particular, they can highlight what issues an investor should particularly look out for, and potentially grill management on, when investing in a controversial sector. For example, for genetic modification, an investor might investigate whether the product is used to improve crop yields in emerging countries or just developed ones, and whether it's compatible with traditional farming or requires farmers to adopt newer techniques that may be less sustainable.

Why should asset managers bother asking such tricky questions? First, as discussed in Chapters 4 and 6, using ESG factors as screens, without taking into account strategic context, doesn't improve long-term returns. Indeed, Deniz Anginer and Meir Statman found that companies that ranked at the top of *Fortune*'s list of 'America's Most Admired Companies' underperformed those at the bottom by more than 2% per year over a 24-year period.[14] The Most Admired List is based on perception, not reality – it surveys senior executives, directors and stock analysts on factors such as social responsibility, management quality and product quality. Executives and directors of other companies – unlike investors – don't have skin in the game and are unlikely to have detailed knowledge of these issues. Thus, their perceptions can be distorted by greenwashing – companies pursuing eye-catching CSR initiatives unrelated to their comparative advantage, to give the impression of being responsible and having high-quality management. Deniz and Meir's study highlights the criticality of being discerning with the data and not believing that higher CSR scores are always better.

Second, if asset managers simply engage in screening, clients can do this themselves. In August 2020, Australian state pension fund QSuper withdrew its $400 million sustainable investment mandate with AMP Capital, instead bringing it in-house. The reason was precisely that AMP was focusing on 'do no harm' rather than 'actively do good'. As QSuper's Chief Investment Officer, Charles Woodhouse, said: 'Rather than simply focusing on a set of negative screens and what is left out, we believe our positive impact approach . . . is something unique among our peers.'

Effective Monitoring by Corporate Customers

An often overlooked category of 'investor' is a company's customers. In Chapter 1, we explained how customers provide 'funding' to their suppliers, much like investors provide financing. Corporate customers have arguably even more power through their responsible procurement policies than shareholders have through their responsible investment policies. An investor can only sell if another buys, so while selling drives down an enterprise's stock price, it doesn't deprive it of capital. But if a responsible procurer stops buying, it may be that no one takes its place. On the flipside, buying a company's shares from another investor doesn't give it new capital, but moving to a new supplier infuses it with fresh funds it can use to expand production and create jobs. The sheer size of companies' purchases gives them tremendous power to effect change. The average procurement budget of a FTSE 100 company is £4 billion, 400 times the average CSR expenditure of £10 million.

Corporate customers are also less constrained than responsible investors. Some investors are evaluated relative to benchmarks, so feel pressure not to deviate substantially from them. Or they can't invest in private companies, or buy small stocks because they're illiquid. But procurement departments can source from both large public suppliers and small private ones, and have no benchmarking concerns.

Despite this power, responsible procurement is less developed than responsible investing. Many companies' responsible procurement policies look like responsible investment did a decade or two ago, focusing on exclusion – whether a supplier crosses red lines such as using forced labour or engaging in corruption. However, a pie-growing supplier doesn't just do no harm; it actively does good. The parallel between sourcing and investment has been largely overlooked, but procurement departments can take advantage of the substantial developments in responsible investing to similarly move from screening to integration. For example, they can apply a net benefit test which considers 'goods' as well as 'bads', make use of ESG ratings while understanding their limitations and ask potential suppliers the ten questions. Doing so not only helps promote responsibility in a company's suppliers, but may also improve its own profits as a by-product – customers are more willing to buy from an enterprise that sources responsibly, and employees are more motivated to work for such a firm.

Some procurement departments have indeed recognised their power to support pie-growing customers rather than just avoid pie-shrinking ones. Twenty-four large UK companies have signed up to the Buy Social Corporate Challenge to source from social enterprises that actively do good, spending £65 million in the first three years since its launch. For example, PwC buys toiletries for its washrooms from The Soap Co., which employs blind and partially sighted citizens. Each time a colleague uses the washroom, he's reminded of how his employer supports social enterprises. The frameworks we've explored might help companies achieve even more bang for buck through their sourcing. Over a quarter of suppliers that are part of the Challenge primarily deliver social impact by donating part of their profits to charity, even though this doesn't satisfy the principle of comparative advantage.

And monitoring is undertaken by more than just providers of funding. Boards and internal auditors can conduct a net benefit test or ask the ten questions to ensure that a company is truly being led for the long term and for all material stakeholders. Corporate affairs departments can do so to proactively manage a company's reputation.

Effective Engagement

We'll now turn from practising effective monitoring to effective engagement. One key engagement channel is voting on issues such as new directors, auditor appointments and pay. To save having to tackle each topic from scratch, most investors develop house policies – for example, to vote against director nominations that don't bring female board representation up to a given target. LGIM holds a stakeholder roundtable event each year to obtain external insights, from academics, consultants, asset owners and stakeholder representatives, to inform its house policies. While valuable, house policies shouldn't be automatically applied, because they may not be appropriate in every situation. A potential director might have the ideal skill set to complement the existing board, even if he doesn't help meet a gender target.

Since analysing a director's record or pay package requires expertise, many investors use input from proxy advisors such as Institutional Shareholder Services (ISS) or Glass Lewis. Like a house policy, independent advice has value, but shouldn't be blindly followed due to concerns with proxy advice we'll discuss later. The best way to use it may be as a red flag – to follow a recommendation if it coincides with the house policy, and focus the investor's limited time on cases where they conflict.

The vote alone is a blunt tool, since it's a yes/no choice. An against vote doesn't tell the company which aspects the investor is unhappy with; a for vote doesn't mean he's satisfied with all dimensions. So the vote should be viewed as only one outcome of a broader engagement process. If an investor has voted against management, it should tell the company why, so that it can address the shortcomings.[15] Even if the investor has supported a proposal, it may not agree with every aspect and can voice its concerns. More powerful than engaging after a vote is to do so beforehand. Voting against management is sometimes praised as the ultimate act of rebellion. But it's more effective for investors to discuss their concerns privately with management, so that it ends up making proposals they're willing to support.

Investors don't have a vote on many key issues, such as strategy, financial performance and capital allocation, so private meetings are the main way that they engage. One important consideration is the regularity of meetings. Some investors only engage when a company is in intensive care, but prevention is better than cure. This involves meeting management regularly even if there are no fires to be fought, and providing positive as well as negative feedback – otherwise an enterprise may make changes not knowing that investors support the status quo. Investors can also get on the front foot and proactively tell companies the actions they'll support, rather than reacting after the fact. In the pandemic, companies faced trade-offs between maintaining dividends and helping out stakeholders. Some leaders feared that investors would object to cutting the dividend to pay furloughed colleagues, and didn't do so. Reassuring CEOs that investors are willing to make short-term sacrifices would avoid these errors of omission.

At the other extreme, some clients and policymakers use engagement frequency as a measure of engagement quality, as if more is always better. That's equally problematic, because while engagement should be routine, it must also be purposeful – every meeting should have a clear set of objectives that the investor wishes to achieve. Not all companies have problems all of the time. Sometimes the meeting might be to persuade the enterprise to take a certain course of action; other times it may simply be to get up to speed on specific issues. But in both types of meeting, it's clear what the meeting is for.

In addition to frequency, the theme of engagement is also important. Investors should typically stay away from day-to-day decisions where leaders have far more expertise, and be careful not to micromanage the enterprise. A good rule of thumb is 'noses in, fingers out' (sometimes abbreviated 'NIFO') – to know what's going on in the business, but not to interfere with operational matters. Some investor guidelines border on micromanagement, such as whether companies should adopt flexible working patterns after the pandemic is over, and what demographic mix of employees to hire. Leaders are much better placed to make the best decision for their enterprise's unique circumstances.

Instead, investors' main value-add is on long-term issues, for which an outside perspective is particularly useful. For example, if a CEO is considering a major investment, shareholders can evaluate whether it satisfies the principles of multiplication, comparative advantage and materiality from Chapter 3. Similarly, while a company may be in certain businesses by historical default, investors can challenge management on whether it still has a comparative advantage in each one. An investor may also have expertise on a particular issue, such as executive pay or decarbonisation, and so focus its engagements on these topics. The resources to guide monitoring, discussed in the last section, can also guide engagement. The ten questions can help shape discussions; an advisory committee can highlight the topics to prioritise, informed by evidence, societal need and client demand.

An often untapped resource is other investors. A single investor may have too small a stake to make engagement worthwhile, and too few votes to make the enterprise take notice. Collective engagement, where several investors work together, addresses both problems. Canada's *Globe and Mail* wrote: 'It's one thing to feel the scorn of a 3% shareholder; it's another to face down 10 institutions holding half your float.'[16] The UN Principles for Responsible Investment Collaboration Platform and the Canadian Coalition for Good Governance are two platforms that coordinate collective generalised engagement, such as writing joint letters to companies on executive pay. The UK's Investor Forum coordinates collective specialised engagement, allowing several investors to engage without sharing insider information. These three frameworks are described in Appendix B, along with evidence of their success.

If collective engagement is effective, why don't investors work together more frequently? One reason is the pie-splitting mentality – viewing other investors as a benchmark to be beaten. Then, an investor sees his ideas on how to improve an enterprise as his own intellectual property, to be jealously guarded. But if investors don't work together, all lose from missed opportunities to grow the pie.

Another barrier is the view that different investors have different objectives, and so can't be allies. For example, activist hedge funds are allegedly short-term due to their high turnover, but index funds are long-term. Larry Fink, CEO of leading index provider BlackRock, cautioned: 'activists are trying to improve the company, in most cases, in the short term because they improve the company and then leave. We are not going to leave.'[17]

But Chapter 6 showed that hedge funds make changes with long-term benefits. It pointed out the common contrast between high- and low-turnover investors is a false dichotomy, because an investor's holding period is different from its orientation. As activist Paul Singer argues, 'This divisive framing is objectively false and has done harm to the goal of generating sustainable returns for all investors.'[18] All investors benefit from improved profitability, productivity and innovation – the pie-growing changes we saw in Chapter 6.

Since index funds have significant voting power, hedge fund engagements often need index fund support to succeed. US activist investor Nelson Peltz will fly over to discuss a potential activism campaign with Sacha Sadan, the stewardship head of LGIM in the UK, which predominantly runs index funds. The need to partner with index funds helps ensure that engagement benefits all investors. Indeed, evidence suggests that such a partnership is effective. Recall from Chapter 6 that Ian Appel, Todd Gormley and Don Keim used a regression discontinuity, involving Russell index inclusion, and found that index funds improve governance. A second study by these authors uses the same methodology to show that index funds allow hedge funds to run more aggressive campaigns – in particular, those in which they seek board representation – and increase campaign success.[19] Successful engagements also increase firm value, but there's no evidence that they raise payouts or debt – outcomes often interpreted as being short-termist.

Communicating Stewardship

After defining and embedding the stewardship policy, the third step is to communicate it externally. Reporting starts with the policy itself. For monitoring, the investor should explain what factors it will pay particular attention to when deciding whether to buy a stock and what will cause it to divest. It may also specify what dimensions it will choose not to monitor, if it views them as less relevant for long-term value. The engagement policy includes the *themes* the investor will prioritise and the *form* engagement will take – including what might lead it to collaborate with other investors or escalate (and what escalation may involve). For voting, it can disclose any house policy and its approach to the use of proxy advisors.

Even more important is to report outcomes – how the policy has been put into practice. Starting with voting, most investors report the frequency of votes against management, broken down by theme. But more informative – and reported by some investors – is how often they vote against proxy advisor recommendations or house policy, to ensure that neither are used mechanically. As we discussed for companies in Chapter 8, numbers are incomplete and so should be supplemented with narratives. Some investors publish their rationale for every vote against management or abstention.[20] This provides clarity to companies on the investors' concerns, so they can address them, as well as informing savers on how it's stewarding their capital responsibly.

Turning to engagement, an investor could report how many company meetings it held on each engagement theme. This is only a starting point as frequency doesn't imply quality, so it should be supplemented by case studies of successful engagement. An increasingly popular practice is 'impact reporting', which aims to show the social return that clients obtain from investing in a fund. A fund might claim that £1,000 invested in it generated X megawatt hours of renewable energy, avoided Y tons of carbon dioxide emissions and created Z jobs. But such reporting is misleading. The companies it holds shares in may have achieved these outcomes anyway – it's very difficult to separate out the extra amount resulting from the fund owning it. For the fund to have bought, another shareholder had to sell, so it didn't provide the company with any new capital. At a maximum, a fund can state that 'the companies we invested in achieved these outcomes'. But that's very different from 'your investment led to these outcomes' – the first statement claims causality, the second only correlation. In addition to misleading savers, impact reporting may distort the behaviour of funds themselves – encouraging them to invest in companies that already have strong social performance, when they might create more value by buying laggards and turning them around. This may spark a backward trend away from integration towards screening – it's easy to report positive 'impact' on certain dimensions by simply screening out stocks that underperform on those criteria.

While many investors already report on their voting and engagement, few do so for monitoring. Some disclose the average ESG scores of companies they own, but this has the same problem of encouraging them to focus on the healthy rather than cure the sick. More informative might be to report how they've put their divestment policy into practice. For each major disposal, an investor could explain what caused it to sell and whether this reason is consistent with its disposal policy. Indeed, asset managers already explain the reasons for voting against a company, but selling a stock is an even greater sign of disagreement. Some investors describe cases (with company names anonymised) where they were intending to invest in a stock for financial reasons, but pulled out due to its social performance. Conversely, an investor might report cases where monitoring led to it buying or retaining a stake despite poor short-term numbers. It could also discuss each major holding and explain why it has continued to own it, if doing so doesn't give away proprietary information, to ensure that holding is an active rather than default decision.

Financial reporting could also be modernised. As well as reporting fund performance – performance of the stocks a fund owns – it could disclose the subsequent performance of shares it sold. This holds the investor accountable for selling prematurely, and rewards it for far-sighted divestment. A fund might report not only its raw annual management fee, but the fee adjusted for its 'active share' – a measure of how much it deviates from the benchmark – to help savers identify closet indexers.* Investors might also stop reporting certain traditional statistics. Just as some companies no longer disclose quarterly earnings, investors could report only long-term and not short-term performance.**

We now turn to defining, embedding and communicating stewardship for the rest of the investment chain.

Asset Owners

The power that can be unleashed if asset owners recognise the value of stewardship is substantial. Asset managers have a fiduciary duty to their clients, and so they, not regulators, are best placed to hold asset managers to account for practising it. But many asset owners underestimate the role of stewardship in enhancing long-term returns. A 2016 survey by the Investment Association found that over half of asset owners hadn't signed up to the Stewardship Code, versus 3% of asset managers. The most common reason was that they weren't even aware of it, followed by other priorities being more important. More surprisingly, only 59% of them strongly agreed that they had stewardship responsibilities.

Let's go through the three steps for asset owners, starting with *defining stewardship*. The stewardship policy should describe the asset owner's approach to voting and engagement,

* For further detail, see Alex Edmans and Tom Gosling: 'Fund Industry Can Flush Out the Close Trackers', *Financial Times* (8 May 2019).

** While savers can still calculate short-term performance, by looking at historic fund prices, they'll place less emphasis on it than if funds reported it themselves and include it prominently in reports and marketing materials.

if it undertakes these activities itself rather than delegating them to asset managers. More unique to an asset owner, the policy can also explain how asset manager selection depends on stewardship performance. At present, many clients look at short-term returns or tracking error – how close a fund is to its benchmark, even though such closeness discourages stewardship. Given such behaviour, it's rational for asset managers to deprioritise stewardship and become closet indexers.

Communicating stewardship is relatively simple for asset owners. Outcomes to report include the voting record for asset owners who vote, how they've monitored asset managers and the rationale for any manager changes. The harder part is *embedding stewardship*. Asset owners can do this at three stages of their relationship with asset managers: selection, appointment and monitoring. We'll now go through each in turn.

Selection

The first stage is *selection*, which should be informed by whether an asset manager is itself communicating and embedding stewardship. For communication, asset owners can verify whether it's following the earlier recommendations – publishing a voting policy and voting record, reporting case studies of engagement and divestment, and disclosing the rationale for 'against' votes. Evaluating the embedding of stewardship is harder. Like investors evaluating companies, this goes beyond reading reports and involves having 'boots on the ground'. Since an asset manager is a company itself, the questions for company managers that we recommended earlier may be of value. In addition, below are questions tailored to asset managers which asset owners might ask:*

* Asset owners can ask these questions either in person, or through a Request for Proposals, where they invite asset managers to pitch for a mandate. An asset manager needs to fill in a detailed questionnaire to pitch, which can include questions on stewardship.

Questions for Asset Managers

Asset owners can ask the following questions to evaluate the stewardship of asset managers.

Stewardship Policy

1. What is your stewardship policy, how is it distinctive and how does it help you to be successful as an investor? What are your priority areas and what have you chosen to deprioritise?
2. How do you evaluate a company's ESG performance to decide whether to buy, hold or sell a stock and whether you need to engage with it? What is distinctive about your evaluation method?
3. What leading and lagging indicators do you use to measure the success of your stewardship activities?
4. Can you give examples of recent investment decisions that you would have made differently without your stewardship policy?

Human Capital

5. What criteria do you use to evaluate and reward your stewardship team and fund managers? How are they aligned with your stewardship approach?
6. How do you ensure that you attract and retain top talent, and that they have sufficient training on ESG issues? Have you experienced recent personnel changes?

Investment Process and Trade-Offs

7. How is stewardship integrated into your investment process? Who makes stewardship decisions? How do you resolve conflicts if the stewardship team and fund managers disagree on whether to own a stock, whether to engage or how to vote?

8. How long do you give an engagement before it fails, and how do you assess whether it has failed? What do you do in such circumstances?
9. What are 'red lines' that would prevent you from investing in a company rather than engaging? How do you balance ethical justifications for exclusion with the potential return impact?
10. Do you evaluate a company's ESG performance in absolute terms, or relative to its country peers, industry peers or own past performance?

The first four questions on stewardship policy broadly mirror the questions on purpose for companies. Just as it's critical for a company to believe that fulfilling its purpose leads to success, Q1 stresses the need for an investor to understand the importance of stewardship in driving investment performance – otherwise stewardship will never be a priority. For companies, the next section was on excellence and innovation. Product innovations are rarer for asset managers, so Q5–6 are on human capital – the main source of excellence in an investment firm. As with companies, the final section concerns trade-offs. Not all dimensions of social performance ultimately improve financial performance. The stewardship team might advocate excluding a stock due to an issue, or engaging with a company on an issue, even if the fund manager deems it financially immaterial – so it's important to understand how such trade-offs are resolved. Another trade-off is between relative and absolute performance. Some asset managers may have 'red line' issues that they will never compromise on, such as being in the tobacco industry, or having insufficient board diversity even if it's 'best-in-class' compared to its country peers.

With companies, a well-defined purpose is naturally distinctive as companies operate in different industries and thus serve society in unique ways. There's less differentiation between asset managers as they're in the same sector. Thus, asset owners should try to tease out what's distinctive about an asset manager's stewardship policy and investment approach. While Q1 and Q2 explicitly ask about what's unique, this angle should be folded into most questions.

As with the questions for companies, the above list is general and only intended as a starting point. An asset owner can ask more specific questions about particular stocks that an asset manager owns. For example, it could enquire: 'For company X, why did you approve the CEO's incentive structure? What questions are you asking the company about its business model and purpose? What are its long-term opportunities and risks?' Doing so will give it a window on the investment approach in action.

Appointment

The next step in the asset manager relationship is *appointment*. Once an asset manager is selected, the asset owner drafts a contract (sometimes referred to as a 'mandate' or 'investment management agreement'). One important element is the contract's length. At present, many mandates are 'at will', so asset managers focus on short-term performance for fear of being dropped. Replacing this with a 3–5-year term will lay the grounds for long-term stewardship. A second is the fee structure, which should be based on long-term performance. In April 2018, the Japanese Government Pension Investment Fund slashed the base fee it pays asset managers, but scrapped the cap on its performance-based fee – recognising that high fees will only be a result of exceptional performance, and not at their expense. The majority of the fee is deferred, and the fund only awards contracts on a multi-year basis.

The contract can also contain expectations for both the practice and reporting of stewardship. Zurich Insurance's template for its contracts states: 'The Investment Manager will have a process for assessing and monitoring current or potential investments in relation to . . . ESG factors. The Investment Manager will ensure that its staff receives adequate training, access to relevant data and information, and applies due care and diligence to applying this process.' Turning to reporting, the mandate can specify lagging indicators that the asset manager must disclose, such as portfolio concentration, departures of key personnel and voting record, plus leading indicators such as changes to the stewardship process or succession planning.

Monitoring

The final stage is *monitoring* the relationship – whether the asset manager is fulfilling the stewardship expectations in the contract. This involves scrutinising asset managers' disclosures and asking the ten questions on an ongoing basis. And just as Chapter 8 stressed that the dialogue between enterprises and investors should be two-way, the same is true for the relationship between asset managers and asset owners. While a contract states formal requirements for asset managers, some asset owners have 'accords' which clarify the expectations that the asset manager can have of them. The Brunel Pension Partnership's Accord states that it won't drop an asset manager based on short-term performance, will provide ongoing feedback to asset managers and will work with them to repair mandates rather than retendering them without notice. Importantly, the Accord stresses that asset managers should tell Brunel if they feel the regular dialogue is pressuring them to focus on short-term factors. Just like the asset manager–company relationship, regular engagement mustn't turn into micromanagement.

We've highlighted the factors that asset owners should pay attention to when assessing asset managers. But it's also important to emphasise the metrics they should be cautious of. One downside of the increasing popularity of responsible investing is that some clients may be misled by eye-catching metrics as they rush to get on the train. We earlier discussed the problems with impact reporting. Other metrics may only capture 'do no harm'. For example, MSCI has launched a tool that analyses the 'warming potential' of a portfolio. Semiconductor stocks score poorly since the manufacturing process releases perfluorocarbons, which are much worse than carbon dioxide in trapping heat. Yet they 'actively do good' by powering solutions to global warming – for example, by being used in solar panels. (And, if the asset owner has concerns beyond global warming, semiconductors are used in many other applications which have a huge benefit to society, such as mobile phones.) Similarly, an investment strategy of buying carbon emitters and engaging to reduce their footprint would create genuine impact, but have a poor warming score. This isn't to say that measures of 'impact' and 'warming' should be ignored. But, just like any metrics, users should be very careful not to take them at face value without understanding their limitations.

We'll now turn to service providers. For brevity, we won't have a separate section on investment consultants – since they assist asset owners in the *selection* and *monitoring* of asset managers, they should follow similar principles to the above. Instead, we'll turn to proxy advisors and equity analysts, because their stewardship roles are quite different. In both cases, we'll look at the evidence before proposing reform, because diagnosis precedes treatment.

Proxy Advisors

The Evidence

Proxy advisors give investors voting recommendations, which can carry substantial weight. But estimating their actual influence is difficult – if an advisor recommends voting against a proposal and it's defeated, it might not be responsible for the defeat. Perhaps the proposal is low-quality, and this led to both the proxy advisor recommending against it and shareholders voting it down; they'd have opposed it anyway even without the recommendation. In other words, the quality of the proposal is an *omitted variable*.

Nadya Malenko and Yao Shen identify causality using the regression discontinuity approach we've seen before. They focus on executive pay proposals, and exploit the fact that ISS uses a cutoff (based on one- and three-year TSR) to screen which proposals to analyse – ISS only performs a deep dive for firms below the cutoff. Whether a company is just above or just below is essentially random and unrelated to proposal quality. Falling just below the threshold leads to a company being rigorously scrutinised and significantly increases the likelihood that ISS recommends voting against management. Nadya and Yao find that such a recommendation reduces voting support by 25% in the US.[21] *

Proxy advisors' strong influence on voting behaviour could be rational, since they have a comparative advantage in assessing complex voting situations. But it's suboptimal if investors are blindly following recommendations rather than doing their own analysis, or if proxy agencies' advice is uninformed or conflicted. Various studies suggest that, at least in some cases, these concerns are valid.

First, do investors automatically follow proxy advisor recommendations? Peter Iliev and Michelle Lowry found that over 25% rely almost entirely on ISS.[22] However, funds with greater ownership of a company are more likely to vote actively. They also find that funds that deviate more from ISS also earn higher risk-adjusted returns – stewardship pays off. Separately, funds that disagree with ISS are more likely to sell their shares in the next quarter – contradicting concerns that divestment is short-termist, but instead suggesting it's a result of doing their own research.

Second, are proxy advisor recommendations uninformed? They have to give advice on thousands of companies in a short

* A study by PwC analyses the UK, where there is no analogy to the screen used by ISS in the US, and so it doesn't make strong causal claims. But it does move away from mere correlation by studying voting behaviour across different shareholders. If negative ISS recommendations are blindly followed, they should have the same impact on the voting behaviour of both small and large investors; if not, large investors with greater incentives to do their own analysis should be more likely to deviate.

space of time (typically April, when most annual general meetings take place). To handle this sudden spike in workload, ISS hires temporary employees and outsources work to contractors in Manila.[23] These workers might be able to follow general guidelines, but likely don't have the experience to tailor advice to a company's unique circumstances. So there's a danger that recommendations are one-size-fits-all.

Do these dangers play out? One study measures the quality of ISS recommendations by whether a negative call is associated with worse future industry-adjusted profitability – if so, it was likely justified. It finds that this link only exists for companies that don't have December fiscal year ends, and so ISS's workload isn't so high.[24] Another shows that, when US-based ISS and Glass Lewis make recommendations on German firms, their recommendations are similar to each other but differ from IVOX, a German proxy advisor. This suggests that US-based advisors don't fully take local context into account.[25]

And even their recommendations on generalised issues, where little tailoring is needed, may be flawed due to faulty methodologies. For example, ISS calculates pay-for-performance ignoring the incentives provided by existing shareholdings, a major omission as discussed in Chapter 5.[26] In a rather ironic example, ISS recommended voting against the 2017 pay package of Willis Towers Watson, a leading compensation consultant, and made basic errors when doing so.[27]

Third, are proxy advisor recommendations conflicted? Some proxy advisors sell not only voting recommendations to investors, but also consulting services to firms, to help them devise proposals that investors are likely to vote for. They may be biased towards consulting clients[28] – either to thank them for the business, or to show that its consulting helps design successful proposals. The Ohio Public Employees Retirement System dropped ISS's services, commenting that 'the thing that tipped us was [ISS's] actual or perceived conflicts due to the corporate consulting'.[29]

To see whether potential conflict turns into actual conflict, let's look at the evidence. Tao Li scrutinised votes at 26,304 shareholder meetings.[30] Simply showing that ISS is more likely to recommend voting 'for' consulting clients doesn't suggest bias, because it could be that consulting genuinely improved proposal quality. So Tao looked at the market entry of Glass Lewis, which provides no consulting services. Afterwards, ISS issued 'against' recommendations much more frequently – particularly for larger firms that were most likely to have been clients of ISS. These findings suggest that, before Glass Lewis's entry, ISS was more favourable towards its clients.

Also supporting a conflict explanation, Glass Lewis's entry had a greater impact on more complex votes (for example, on governance and pay) where it's easier to be biased, rather than 'no-brainer' votes where bias might appear blatant (for example, uncontested director elections). Importantly, any potential bias has real outcomes – it matters. To zone in on proposals where conflicts may have been pivotal, Tao compares proposals that just pass to those that just fail. At firms with the former, executives have higher pay relative to peers, and faster pay growth – suggesting that any bias allows managers to be overpaid.

Practising Stewardship

What's the remedy? The same three-step framework as for asset managers.[31] The first step is for proxy advisors to define their purpose and approach to stewardship. Starting with purpose, do they see themselves as an outsourcing service, providing asset managers with recommendations that they can automatically follow?* Or as providing an expert outside opinion that's only one input into clients' voting decisions? Turning to the stewardship approach, an advisor should have a clear research methodology to determine its recommendations and, if relevant, a house voting policy.

* Such a role can still add value, since some investors don't have in-house expertise in voting.

The next step is to put these policies into practice. Let's say a proxy advisor sees its role as providing an expert outside opinion. Then, for an issue that requires strategic judgment, it should only highlight the pros and cons and label the issue as 'For Strategic Judgment' rather than providing a recommendation. Indeed, if say-on-purpose becomes a reality, a risk is that some investors will simply delegate their votes to proxy advisors. However, what an investor views as the appropriate purpose might depend on its preferences, as they affect intrinsic materiality. Some investors may consider the environment most important, others employment. Thus, proxy advisors shouldn't make the decision for them – they should only highlight the arguments for and against. Separately, a proxy advisor can subject its most important screening methodologies to external review to ensure it uses state-of-the-art techniques, and implement robust policies to address potential conflicts.

Finally, advisors should publish their research methodologies and house policies. Again, communication involves more than just reporting. Proxy advisors should proactively explain to companies why they've made a particular recommendation, and reactively be willing to meet with those who wish to explain the rationale for an unusual proposal. Sometimes such requests are turned down, and it's difficult to see how such a refusal is responsible stewardship.

While it's popular to blame proxy advisors for what's seen as excessive influence, the finger shouldn't be pointed entirely at them. Investors are responsible for how they use advisor recommendations. They'd never automatically follow an equity analyst's 'buy' or 'sell' advice, but scrutinise the rationale and use it as only one input into their trading decision. Yet some investors – who are paid high fees by savers, in part to undertake stewardship – are effectively outsourcing voting to proxy advisors by following them like sheep. If an investor has clearly stated that informed voting isn't part of its stewardship policy, perhaps due to lacking in-house expertise, it's reasonable to automatically follow proxy advisors. But that's not the case if it's claimed that voting is a key stewardship tool.

Equity Analysts

The Evidence

Equity analysts* make buy and sell recommendations which substantially influence investor trading. A single analyst's buy recommendation leads to stock prices jumping 3% in the first three days and continuing to drift up 2.4% in the next month. In contrast, a sell recommendation reduces stock prices by 4.7% in the short term and 9.1% over the following six months.[32] But stewardship codes don't consider analysts as having a stewardship role, because they don't recognise the importance of trading for stewardship. If investors trade on short-term earnings, because they're influenced by analyst recommendations based on earnings, companies will focus on profits not investment. And trading affects engagement. If shareholders don't invest in a stock due to analyst recommendations, they won't have any votes or standing to engage with it.

Existing regulation (like the US Global Settlement) addresses analysts being unfairly biased towards their employer's clients. But this isn't enough. Even if an analyst isn't biased, his recommendations may be based on short-term factors.

Analysts particularly influence trading through their earnings forecasts. Missing a forecast reduces the stock price by 3.5%[33] and causes the CEO's bonus to fall.[34] In Chapter 6, we discussed the survey by Graham, Harvey and Rajgopal which learned that 80% of Chief Financial Officers (CFOs) would cut investment to meet an earnings benchmark. Benchmarks might be past earnings, yet the survey found that 73.5% considered analyst forecasts an important benchmark. A separate study by Stephen Terry found that firms that just meet analyst earnings

* Here we use 'analyst' to refer to either an equity research department of an investment bank, or an independent equity research company.

forecasts have 2.6% lower R&D growth than those that just miss, suggesting they cut R&D to hit the forecast.[35]

Analyst reports do go beyond forecasting earnings. They discuss long-term factors such as strategy, market outlook and management quality – but typically only those with a clear link to profits rather than stakeholder value. Eli Amir, Baruch Lev and Theodore Sougiannis find that analysts don't fully value intangible assets, particularly in R&D-intensive firms where intangibles are particularly material.[36] As a result, Jack He and Xuan Tian find that, when the number of analysts covering a stock falls, both the number and quality of patents rise.[37]

Practising Stewardship

Let's apply the same three-step framework used for asset managers. The first is for analysts to define their purpose, which involves acknowledging their role in stewardship. An analyst's purpose might be to promote responsible investment. If so, its stewardship approach should involve scrutinising a company's social performance, and this assessment influencing its investment recommendations. A different purpose might be to provide an exclusively financial analysis.

The second step is for analysts to embed their stewardship approach internally. This involves ensuring they have adequate resources to evaluate an enterprise's stakeholder capital. Equity research departments have different teams covering each industry (for example, banks, chemicals), but most now also have a specialist responsible investment unit. Its main clients are responsible investors, but social performance matters to all shareholders. An analyst should have processes to ensure that ESG factors enter all reports, not just those by the responsible investment team.

The final step is external communication. The Global Settlement requires analyst reports to include a breakdown of their buy, hold and sell recommendations across all stocks, so that investors can evaluate if they're overly optimistic. Similarly, analysts could report how often they give a buy recommendation despite a pessimistic forecast of quarterly earnings.[38] This will allow investors to assess the extent to which analyst recommendations are driven by short-term forecasts.

These three steps will help analysts to acknowledge and fulfil their stewardship responsibilities. But it's also important for regulators and the rest of the investment chain to acknowledge them too. Regulators should include equity analysts when contemplating stewardship reforms, and investors should consider analysts' approach to stewardship when deciding which ones to particularly heed. The attitudinal shift required is substantial, since analysts are currently ignored in stewardship discussions. But it's an important one, because analyst recommendations ripple through investor trading decisions and ultimately affect firm behaviour.

In a Nutshell

- Stewardship is the responsibility of the entire investment chain – not just asset managers, but also asset owners and service providers. Improving stewardship is critical to increasing long-term returns and ensuring the legitimacy of the investment management industry.
- An investor should pursue stewardship similarly to how an enterprise pursues purpose. It starts by *defining* its stewardship policy clearly, *embedding* this policy into the investment process in an integrated manner, and *communicating* both policies and outcomes externally.
- A stewardship definition should include a divestment policy and the *form* and *themes* of engagement. The chosen approach to stewardship should follow from the asset manager's purpose and thus be based on the principle of comparative advantage.
- Embedding stewardship involves ensuring that asset managers have large stakes, long-term financial incentives and stewardship resources.
    - ✳ Effective monitoring assesses the value an enterprise creates for society – information that's likely not in the

current stock price. A company's integrated report and ESG ratings are useful inputs, but should only build the case for investment rather than *be* the case. They should be supplemented by qualitative assessments of an enterprise's social performance, potentially guided by meetings with management.

  - ✳ Effective voting is informed by proxy advisor recommendations and house policy, but also considers an enterprise's unique circumstances.
  - ✳ Effective engagement focuses on pie-growing (such as purpose and strategy) rather than pie-splitting issues (such as the level of pay), and may involve collective engagement with other investors and an escalation mechanism.

- Communicating stewardship involves quantitative metrics on voting behaviour and portfolio concentration. The most valuable communication may be qualitative – engagement priorities, monitoring themes and case studies of successful engagements or divestments.
- Asset owners should select asset managers in part based on their stewardship record – and be wary of quantitative metrics such as 'impact reporting' because numbers are incomplete. They can ensure that contracts are based on long-term performance and are clear about their stewardship expectations, as well as providing ongoing feedback to asset managers about their performance.
- Proxy advisors' contribution to stewardship can be strengthened by ensuring adequate resourcing to provide tailored recommendations, implementing policies to address potential conflicts, subjecting their screening methodologies to external scrutiny and viewing their purpose as an advisory rather than outsourcing service.
- Equity analysts can play a key role in stewardship by basing their recommendations more on companies' intangible assets and social performance rather than short-term earnings.

10 CITIZENS

How Individuals Can Act and Shape Business, Rather than Be Acted Upon

In this chapter, we'll explore how citizens can help grow the pie. They shape business through playing the following roles:

- Members. As investors, colleagues and customers, citizens can hold enterprises to account by choosing which ones to invest in, work for and buy from.
- Policymakers. Only some citizens work in policy jobs. But all affect policy as voters (and, in some cases, writing to policymakers or responding to public consultations). We'll discuss the role of both hard legislation and soft codes of conduct.
- Influencers. These include the media, think-tanks and those viewed as experts. It also includes citizens who influence by the content that they share, purchase or comment on. Influencers can hold individual companies to account, and guide policy by shaping public opinion about business in general.*

The sheer size of global corporations might make it seem that citizens are powerless to shape business – but the above shows that we have much more power than commonly believed. A single colleague, Sherron Watkins, blew the whistle on accounting fraud in Enron, alerting CEO Kenneth Lay to accounting irregularities and then testifying before the US House of Representatives and Senate. A single citizen, Dan O'Sullivan, started the 'Delete Uber' campaign on Twitter.

* As with many taxonomies in this book, the lines are blurred. Codes of conduct can be adopted by industry participants themselves without policymaker involvement. Enterprises and investors can also be influencers.

When the New York Taxi Workers Alliance called a strike to protest against Donald Trump's travel ban on Muslim countries, Uber removed surge pricing, which would normally lead to higher fares. Dan and the campaign argued that Uber was trying to profit from the strike, and 500,000 customers supported it by deleting their accounts.* Greta Thunberg was just 15 when she started a 'School Strike for Climate' in August 2018. Later that year, she spoke at the United Nations Climate Change Conference, and she's since heightened awareness of the climate crisis among both country leaders and children. And citizens can even propose policies without being legislators. The Swiss referendum against rip-off salaries, mentioned in Chapter 5, was launched by Thomas Minder, an entrepreneur who made toothpaste and mouthwash for airlines.

We'll call this power *agency*: people's capacity to act independently and influence their environment, rather than being acted upon. As the 14th Dalai Lama once said, 'If you think you are too small to make a difference, try sleeping with a mosquito.'

Let's first discuss how citizens can grow the pie in their role as investors, colleagues and customers.

Members

In Chapter 6, we explained how institutional investors have two stewardship powers – monitoring (deciding which firms to own) and engagement (changing the behaviour of firms they do own). These same powers apply to individual investors, colleagues and customers.

Monitoring

The first source of agency is our freedom to choose which enterprises to be members of – those whose values we share.

* Other citizens claimed that Uber cut prices to help customers, as it often does during emergencies, and so the boycott was unjustified. Regardless of whether the campaign was justified, this example shows the power of individuals to substantially affect firm value.

We saw in Chapter 4 how investors should select stocks partly based on social performance; doing so improves not only social but also financial returns. In Chapter 9, we recommended that savers select asset managers according to their stewardship performance. The UK charity ShareAction, which promotes saver engagement, ranks mutual funds on this dimension to help such selection.

Many citizens' biggest investment decision isn't a financial one, but who to work for. They have the power to turn down a job offer, even if its salary and title are attractive, if the employer has a reputation for exploiting its customers and suppliers, damaging the environment, or mistreating female and minority colleagues. Since employees are the key asset in nearly every company, the threat of losing talented staff is a powerful deterrent to pie-splitting behaviour.

A firm that exploits society may not only clash with an employee's own value system, but also be unsuccessful in the long run and jeopardise his job. Indeed, some company collapses were potentially predictable ahead of time by studying social performance. For example, Business Insider's October 2012 list of '13 Companies that May Be Riskier than You Think', based on ESG ratings by the data provider GMI, cautioned against Wells Fargo due to numerous governance issues.[1] The next year, a *Los Angeles Times* article reported that 'relentless pressure to sell has battered employee morale and led to ethical breaches . . . To meet quotas, employees have opened unneeded accounts for customers, ordered credit cards without customers' permission, and forged client signatures' – but little attention was paid to these revelations at the time.[2] In September 2016, the Consumer Financial Protection Bureau announced that Wells Fargo had opened 2 million fake bank and credit card accounts. The fines and lost reputation caused the bank to announce plans to close 400 branches and cut up to 10% of its workforce. Even if a worker succeeds in finding a new job, he suffers a salary cut. Boris Groysberg, Eric Lin and George Serafeim showed that senior managers who left firms that engaged in financial misconduct earn 4% less than their peers – even if they left before the scandal broke out.[3] Simply having a tarnished firm on your CV harms your earnings potential.

The same agency is enjoyed by customers. Rather than choosing products only based on price, they can buy from companies that reflect what they'd like to see in the world – just as many purchase organic or locally sourced food despite the greater cost. This need not require substantial time and effort. Chapter 9 mentioned several freely available data sources on a company's social performance, and there are additional resources tailored to customers. For example, the Good Shopping Guide and Ethical Consumer websites allow you to choose a product (ranging from bananas to kettles to insurance) and then see environmental and social ratings of different brands. The Nudge for Change app lets you select which issues matter most to you, and then rates a retailer on those issues as soon as you walk into its store. With Buycott, a customer scans a product barcode and learns about its societal impact; GoodOnYou gives similar information when entering a brand name.

When many customers walk away from a company, it becomes a boycott – which is particularly powerful today as it can spread rapidly on social media. We've discussed the Volkswagen and Uber campaigns which seriously affected the targeted firms, but a boycott can also spread to the rest of the industry. The 1990s saw many demonstrations against sweatshop conditions at Nike factories. Nike responded by acknowledging the issues, improving wages and conditions, and creating the 'Fair Labor Association' with other companies to establish independent monitoring and a code of conduct.

In addition to deciding which company to buy from, an even more powerful source of agency is the freedom not to buy at all, or to buy a different type of product. For example, not upgrading your phone, reducing air travel and resisting 'fast fashion' purchases all help the environment.

Websites such as the WWF Footprint Calculator, REAP Petite and CarbonFootprint.com allow households to calculate their carbon footprint, so that plans for reduction are based on the best available data.[4]

Engagement – Investors

The second source of agency is our ability to engage with enterprises we're members of. As we saw in Chapter 4 with Caroline Flammer's study, investors can make shareholder proposals to improve social performance. Importantly, these can be made by individual as well as institutional investors. In May 2018, retail shareholder Keith Schnip asked McDonald's to issue a report on its efforts to develop substitutes for plastic straws. The proposal was defeated, but still contributed to behaviour change – the next month, McDonald's announced it would phase out plastic straws in the UK and Ireland from 2019.* And a shareholder proposal at one firm can have spill-over effects on an industry or even economy. A 1973 resolution at the oil company Mobil demanded better working conditions for black employees in their South African operations. This raised awareness of apartheid and helped spark the campaign to divest from South Africa, mentioned in Chapter 6.

In addition to formal proposals, shareholders can ask questions at an annual general meeting (AGM). Every night, Abdul Durrant worked hard to clean the London offices of HSBC, including that of chair Sir John Bond. But he struggled to support his five children on his wages. So Telco, an alliance of charities in East London, bought Abdul a few shares, allowing him to attend HSBC's 2003 AGM. He braved himself to speak up at the meeting and address Sir John, saying, 'I am here on

* As with many decisions, it's unlikely that McDonald's decision to phase out plastic straws had a single cause. UK politicians had proposed prohibiting plastic straws earlier in 2018, but the proposal was not implemented until May 2019. Moreover, the fact that McDonald's was one of only a few companies to voluntarily take action suggests that Schnip's shareholder resolution was a contributing factor.

behalf of all the contract staff at HSBC and the families of East London. We receive £5 per hour – a whole £5 per hour! – no pension, and a measly sick pay scheme. In our struggles our children go to school without adequate lunch. We are unable to provide necessary books for their education. School outings in particular they miss out on.'

Moved by this plea, Sir John gave HSBC's cleaners a 28% pay rise.[5] At the following year's AGM, Abdul stood up to thank Sir John: 'The cleaners at HSBC are very pleased at your decision to raise our standards and raise our money. I have come here to thank you . . . I now have more time with our children and can give them quality time. In the language of the street, they say "big respect"'. This shows the power of a single employee to change the wage policy of a large multinational. You might think that Abdul's intervention was unnecessary – Sir John should have known that cleaners wanted higher wages. But all leaders face trade-offs; those higher wages may have been at the expense of other stakeholders. Abdul speaking up highlighted just how important it was to improve cleaners' pay – even more than HSBC's other priorities.

More generally, ShareAction has a team of 'citizen shareholders' that attends AGMs and asks boards to pay the Living Wage. This amount is higher than the legal minimum wage, and calculated to meet basic needs for a worker's family. When ShareAction launched its Living Wage campaign in 2011, only two FTSE 100 firms paid the living wage; now the number stands at 39. Even though it's shareholders who ultimately pay the higher wages, many only want to earn returns from companies whose employees are able to live a dignified life. Moreover, these higher wages typically grow the pie by improving retention and motivation, and aren't at the expense of long-run profits.

Engagement – Customers

Customers often feel powerless to change a large company, so their only option, if dissatisfied, is to walk away. But their ability to engage with companies is now higher today than it's ever been.

One engagement channel is providing feedback on a company's products. Nowadays, review websites make it easy to write evaluations, and mean that they influence other customers as well as the company. Feedback on sites such as TripAdvisor, Airbnb and Amazon can cause businesses or products to live or die. Customers can also provide input to spur company innovation. After coming close to bankruptcy in 2004, Lego became the world's largest toy company by revenue in 2015. Central to this turnaround was Lego creating the Ambassador Programme to engage with its most avid customers, gaining ideas for new products and helping it refocus current ones.

A second engagement channel is to support shareholder proposals. Keith Schnip's resolution came about because the consumer watchdog SumOfUs first launched a petition asking McDonald's to ban plastic straws. After collecting half a million signatures, it asked Keith (who was both a SumOfUs member and a McDonald's shareholder) to submit the resolution on SumOfUs's behalf. By working together, customers and investors achieved far more than they could have alone.

A quite different source of agency arises because it's customers who own a company's product after purchase, so they get to decide how it's used. A company may launch initiatives to reduce its products' environmental impact – Patagonia runs programmes to repair damaged clothes or resell unwanted items; Hewlett Packard has designed its toner cartridges to be reusable and allows customers to send them back for free. But these initiatives only work if customers play their part, rather than throwing them away out of convenience. Customers are partners of the enterprise in ensuring that its products are put to their intended use, throughout their life cycle.

Engagement – Colleagues

As colleagues, engagement involves adopting the same pie-growing mentality we've stressed for enterprises. Just as companies should create value for stakeholders even if there's no clear link to future profits, employees should create value for the organisation even if it's not explicitly rewarded in their evaluation system.

Employees in management or supervisory positions – no matter how junior or senior – can view their department or team as a small enterprise, and apply the leadership principles we've developed throughout the book. A manager can think about his department's 'micro-purpose' – the part it plays in helping the company fulfil its overarching purpose – and how best to embed it and measure progress. He can ask himself 'what's in my hand?', to consider how he can deploy his team's resources and expertise to contribute to the company's purpose.

Agency extends to all workers, even those not in managerial positions. One example is treatment of co-workers, as discussed at the end of Chapter 8. Importantly, the attitudes of empowerment, investment and reward can be practised by everyone. A colleague doesn't need to accept the culture he finds himself in; he has the power to change it. Almost everyone manages someone else. Even if a worker is the lowest rank in his department, other departments may support his. A colleague can solve simple IT issues himself rather than viewing the IT department's time as freely disposable. If an IT technician has been particularly helpful, a worker can practise the attitude of reward by providing direct feedback to him, as well as finding out who his boss is and relaying it to her.

Another example is managing up. Those on the bottom rung often believe they have little agency. In my first few months in banking, I operated under the assumption that my employer wanted analysts to passively do what they were told. I didn't have any evidence for this assumption; I just believed it because that's what everyone else said.

My Chemicals team was next to Transport which was run by Ben, who'd become at 31 the youngest head of any industry group. He once saw me unhappy from over-work and took me to lunch, despite having no official responsibility for me – the attitude of investment. He explained the folly of my assumptions and how the analysts he – and the bank – valued were those that expressed agency, because they could contribute far more than those who just executed.

A few weeks later, I did a valuation analysis that involved 15 comparable companies. Because one was Syngenta, an agrochemicals firm, my boss (Mark) suggested on the fly to add Monsanto, another agrochemicals firm. I explained that, with 15 comparable companies already, a 16th would add little value to the client. But it would require a huge number of calculations to be changed because the comparison group fed into every analysis. Mark's suggestion might appear to convey the attitude of free disposal, but he simply wasn't aware of how much extra work it would cause. In his mind, he paired Syngenta with Monsanto and suggested the latter as a reflex action. I was the only person who could make him aware, and if I didn't, I'd only have myself to blame. Mark listened open-mindedly and then quickly withdrew the suggestion. My first official evaluation, six months in, said: 'Notably for a first-year analyst, Alex has the willingness to speak up and contribute his own views, which is to be encouraged.' This said far more about Mark, and my employer more generally, than me – it showed the value they placed on agency.

Beyond co-worker relationships, colleagues' agency extends to contributing to the enterprise, regardless of your position. In Chapter 8, we discussed the Japanese Andon system, where factory workers have the responsibility of checking product quality and the authority to stop the production line. But it's up to them to leverage this responsibility. It's easy – and often cathartic – to complain about a problem, but harder to do something about it. But not much harder. The main barrier is simply adopting the mentality that the pie can be grown, rather than you being stuck with it; sometimes little effort is required to make a suggestion. Many successful innovations came from an employee idea – new products, such as Post-It Notes; new processes, such as New Belgium eliminating its cardboard dividers; and new policies, such as Barry-Wehmiller colleagues suggesting that you could take extra furlough in place of a co-worker.

While it's citizens' duty to use any agency they've been given, it's an enterprise's duty to unleash it. Companies can create substantial value by harnessing the collective wisdom of their employees and customers, but sometimes don't bother. Just as Frederick Taylor viewed Schmidt as unmotivated and unintelligent, executives sometimes view consumers as only being interested in taking from a company (by buying its products) rather than giving back. Some company websites provide forms where customers can make complaints, but not give suggestions. They're implicitly assuming that customers have the pie-splitting mentality – they'll only get in touch to demand compensation, not suggest ideas that benefit both parties.

These assumptions aren't true. So the first step is for leaders to reset any false perception of their employees and customers as self-interested individuals and instead to see them as citizens – as creative, collaborative, empathetic members of communities. Then, the challenge is to find ways to encourage and channel their citizen energy, tapping into who they naturally are. In Chapter 8, we discussed how many companies now view their employees as partners, and some are doing so with their customers. Patagonia could have only launched the Common Threads Initiative if it trusted its customers to invest their time in repairing its products. Lego's Ambassador Programme sees its customers as an extension of its R&D department. More broadly, organisations such as the New Citizenship Project work with enterprises to unleash the citizenship potential of their customers.

We now turn to how policymakers, or voters with views on policy, can help grow the pie.

Policymakers

One way in which policymakers can support Pieconomics is through regulation. This should be viewed broadly – as any way to 'regulate', or moderate, behaviour. It includes not only legislation, but also codes of conduct, such as Stewardship Codes.

Even though regulation can play a positive role, it often has unintended consequences. We'll first discuss some important caveats to heed when designing regulation. Then, bearing these in mind, we'll describe several ways in which regulation can help.

1. The Pie-Growing Mentality

The pie-growing mentality stresses the importance of errors of omission. But regulation is most effective in punishing errors of commission – it's very difficult to fine an enterprise for not creating value. Not only does regulation fail to reduce errors of omission, but it may make them more likely. By trying not to commit an error, a company may omit to innovate.

In December 2017, upon the request of the UK government, the Investment Association launched a register of companies who achieve less than 80% support in a shareholder vote, such as say-on-pay or director elections. It aims to name and shame companies that make proposals that investors object to. The register is colloquially known as the 'naughty step', given the stigma created, and so leaders wish to avoid being featured.

But this 'one-strike-and-you're-out' rule deters innovation. Failure is not only a consequence of innovation (since innovation risks failure), but also a cause (since the lessons from failure can inform future innovation). If a company suggests a pay reform and 'only' gets 75% support, it can listen to the concerns of investors voting against. Indeed, the feedback loop that existed before the register seemed to be working well. Companies that fell below the 80% threshold for say-on-pay improved their support by an average of 17 percentage points the next year.[6] Author Matthew Syed calls this 'open-loop thinking' (taking concerns seriously and responding to them), in contrast to 'closed-loop thinking' (assuming that investors must be wrong and pushing ahead regardless).[7]

And it's not clear what such a register aims to achieve in the first place. If there's a benefit to shaming companies, we should shame those who fail to create social value. If there's value to a register on pay, a company should be listed only if it gets low support two years in a row. This gives it one chance to respond to investor concerns and allows the feedback loop to work.

2. Evidence over Anecdote

Evidence can guide regulation in two ways. First, it can diagnose the extent of a problem and whether it even requires a solution to begin with. Regulation can sometimes be a knee-jerk reaction to a few bad apples, even if the rest of the apple cart is fresh.

In 1982, William Agee, the CEO of Bendix, received a $4.1 million 'golden parachute' when he was let go after his firm was taken over. The public was furious that someone could get paid for losing his job and demanded action. In response to this single case, Congress in 1984 imposed a high tax rate on golden parachutes above three times salary. This law actually increased the use of golden parachutes – it alerted CEOs to the possibility of being paid for getting fired, so they requested these parachutes. Previously rare, 41% of the 1,000 largest firms had them by 1987, rising to 70% by 1999. Firms who used to award golden parachutes increased them to three times salary, because the regulation implied that this is an acceptable level.[8] Others hiked salary to get around the regulation.

It might seem that these unintended consequences resulted from this particular law being poorly designed. But the lessons are general. Regulation always has unintended consequences – companies either can get around it or are encouraged to go right up to the limit. These outcomes are like the side effects of medical intervention. In medicine, diagnosis precedes treatment. A patient should only be subjected to invasive surgery, with all its side effects, if his condition is severe. Thus, we should only impose regulation, with all its side effects, if the problem is widespread across a large number of companies.

A second role for evidence is to guide the treatment of a problem, as potential solutions may have been tried in other countries. Proposing extreme reforms gets you lauded as a revolutionary, but is risky in the absence of evidence they work. Indeed, research may uncover counterintuitive results that go against what hunches might suggest. When launching her 2016 campaign to become UK Prime Minister, Theresa May announced the intention to make annual say-on-pay votes binding rather than advisory, to give investors more power to control pay.[9] But looking at 11 countries around the world with say-on-pay laws, Ricardo Correa and Ugur Lel find that advisory votes are slightly more effective than binding votes at both lowering pay and linking it more closely to performance.[10] Despite appearing surprising, this result is quite logical – investors may be reluctant to vote against a pay package if a negative vote is binding and thus likely to cause greater disruption.

Indeed, the plans to make say-on-pay binding were later abandoned, due to the concerns raised during the consultation May launched a few months after becoming Prime Minister. This responsiveness to evidence is to be applauded. Voters often lambast politicians for doing a U-turn on a proposed policy. But listening to concerns is much better than the closed-loop thinking of ignoring contradictory evidence. If politicians can't hold consultations and subsequently abandon ideas, they may refrain from proposing ideas to begin with – an error of omission. Or they may stick dogmatically to a planned course of action regardless of whatever new evidence they learn.

3. Tangible Versus Intangible

It's much easier for regulators to hold enterprises to account for tangible measures because they're easier to verify. Regulators can prosecute a company for missing a measure (for example, not paying the minimum wage) or misreporting it (for example, fraudulently disclosing earnings).

But the focus on tangible metrics runs two major risks. The first is *quantity over quality*. Since quantity is tangible but quality isn't, regulation may improve the former but worsen the latter. In the US, a 2003 law made it a mutual fund's fiduciary duty to vote[11] – but many ended up following proxy advisor recommendations rather than doing their own research. Uninformed votes are arguably worse than not voting at all. Similarly, India requires large companies to spend at least 2% of their profits on CSR initiatives. However, while the quantity of expenditure is verifiable, the quality – whether the expenditure satisfies the principles of multiplication, comparative advantage and materiality – isn't. Simply spending money can shrink the pie, if it would have delivered more value elsewhere.

The second is *compliance over commitment*. Regulation may lead to enterprises complying with the tangible metrics highlighted in the policy, rather than committing to its spirit. Some companies may be aware of the benefits of employee satisfaction discussed in Chapter 4. Unregulated, they'd aim to improve all dimensions of satisfaction. But pay ratio disclosure may cause them to focus on pay and underweight intangible dimensions such as working conditions or on-the-job training. Regulation also sends the message that improving employee satisfaction is costly for companies, so you need regulation to force them to do so. This in turn may lead to firms complying to the minimum extent possible.

4. Ex Ante Versus Ex Post

Regulation aims to correct problems after an action has been taken. But in doing so, it may erode the incentives to take the action to begin with.

As discussed in Chapter 7, there are several proposals to limit share buybacks. We've already discussed how these aren't supported by the evidence, which shows that buybacks are generally associated with higher long-term value. A further problem is the effect on ex ante incentives to issue equity. Restricting buybacks will discourage an enterprise from raising money in the first place. If it no longer needs this money, it values the option to return it through a share buyback, reducing the dividends it needs to pay in the future. If a law prevented repurchases, a company might not issue shares to begin with, causing it to invest less. By analogy, a citizen values the option to repay his credit card balance in full each month, to lower his interest. If he were only allowed to make the minimum payment, he wouldn't take out the credit card to begin with and spend less.

Similarly, as discussed in Chapter 6, policies have been put forward to lock in shareholders. Not only are they unsupported by the evidence, which shows that exit is an effective governance mechanism, but they also ignore the effect on ex ante incentives to invest. If management destroys value and is unresponsive to an investor's engagement, he values the option to exit. Without it, he may be unwilling to invest in the first place. The UK Parliament's inquiry into the 2018 failure of outsourcing company Carillion found that investors tried to engage with management as early as 2014, but were unsuccessful due to management giving misleading information and the board being unresponsive.[12] Many thus sold before the collapse, saving their clients millions of pounds. Without the option to sell and avoid substantial losses, investors may not have bought shares to begin with.

5. System-Wide Thinking

Criticism of particular business practices sometimes ignores their role in the bigger picture. Patents allow a drug to generate substantial profits, but as Merck CEO Kenneth Frazier stressed in Chapter 3, these profits are necessary to pay for the losses from failed drug development efforts. 'Loyalty' policies hinder an investor, who's already engaged successfully in one firm, from reallocating his capital to turn around another – as ValueAct did after transforming Adobe.

System-wide thinking is also important because reforming one area may be ineffective, or even damaging, without reforming a second – particularly if the first area is a symptom and the second is the underlying problem. Poor pay design is often a symptom of ineffective investor engagement. Assume that Ricardo Correa and Ugur Lel hadn't found that advisory say-on-pay is more effective than binding votes. Even if so, making investor votes binding might worsen pay decisions if they vote in an uninformed manner, because their stakes are too small to make it worthwhile to become informed.

6. One Size Rarely Fits All

A final concern is that regulation is typically one-size-fits-all. Another problem with India's requirement to spend 2% of profits on CSR is that the optimal amount varies across firms. For mature firms with few investment opportunities, the appropriate figure might be more than 2%. Companies could still go above the minimum, but they won't if regulation gives the impression that investing in stakeholders is a compliance exercise rather than in the firm's long-term interest. Other companies may have substantial investment opportunities in the core business, and the 2% law would divert funds away from these pie-growing projects.

As another example, in 1993, US President Bill Clinton sought to limit pay to $1 million by making executive reward above this threshold non-deductible from corporation tax (unless it was performance-related). But what's excessive varies from firm to firm. In a large company (where a talented leader can have substantial effect) in a highly competitive industry (where many firms are bidding for CEOs), $2 million might be fair. In a small enterprise in a non-competitive industry, $500,000 might be appropriate. The regulation led to pay packages being homogenised: companies that paid salaries below $1 million raised them to exactly $1 million,[13] and those above lowered salaries to $1 million – regardless of firm size or competitive dynamics.

Rather than stipulating a one-size-fits-all level of pay, perhaps the regulator could decide how much pay would be fair in each of the 100 largest firms. Even if the regulator had the resources to implement this idea, it might have imperfect incentives or information. First, it's unlikely to be aligned with the pie. It may be subject to lobbying by firms justifying high pay, or public pressure to crack down on pay even at the expense of value creation. In contrast, large investors care about both the size of the pie and its division, since both affect investor returns. Second, blockholders, directors and compensation consultants are much more informed than the regulator on the CEO labour market and pay design.[14]

It's true that markets are also imperfect in both incentives and information. Compensation consultants may be conflicted, and investors may be uninformed. So there's certainly a role for regulation, but to improve the incentives and information of market participants, rather than override them. Indeed, having discussed the limitations of regulation, we now discuss how it can help grow the pie. A good principle to guide regulation is: *Is there a market failure, and can regulators improve on this market failure?* Based on this principle, we now discuss several ways regulation can help.

1. Information

Investors, employees and customers are the ultimate regulator of enterprises by walking away from a pie-splitting company. Crucially, their assessment can include intangible dimensions and be tailored to a firm's circumstances. This requires members to be informed, and regulation can help by mandating the disclosure of relevant information. Since 1998, Norway has required companies to report their environmental impact and mitigation activities; Brazil, Denmark, Hong Kong, India, Malaysia, Singapore, Sweden and the UK are some other jurisdictions that stipulate or recommend the disclosure of societal impact more generally.[15] Regulation can also ensure that disclosure is on a comparable basis where possible – for example, that all asset managers report performance net of fees.

Instead of harmonising the reporting methodology, regulation can harmonise the topics being reported. The UN's Sustainable Development Goals (SDGs) are a collection of 17 objectives for the world to achieve by 2030. Importantly, the SDGs aren't prescriptive about how a company should achieve a particular goal, nor do they suggest it put equal emphasis on each goal – its priorities should depend on its purpose. Instead, the SDGs provide a common language that enterprises can use for reporting, by explaining whether and how they contribute to each objective. This increases comparability to members, who can see what a firm is doing to achieve the goals that matter most to them.

For example, Danone's purpose is to 'bring health through food to as many people as possible', while Vodafone's purpose is 'to build a digital society that enhances socio-economic progress'. Thus, while both contribute to all goals, they emphasise different ones. One of Danone's priorities is Zero Hunger (SDG number two), which it supports by producing safe and nutritious food. While Zero Hunger isn't one of Vodafone's core focuses, it still contributes by providing technology and mobile money to improve farmers' productivity. This shows how companies with distinctive purposes can undertake quite different activities to contribute to a common goal. However, the tail shouldn't wag the dog – companies shouldn't pursue initiatives to tick off one more SDG. Instead, they should focus on the activities that satisfy the principles of multiplication, comparative advantage and materiality, and report against the SDGs after the fact.

Policymakers can provide a common language to harmonise other areas of reporting. To increase the comparability of stewardship reporting by investors, regulators could devise a unified set of stewardship themes, such as executive pay, capital allocation and climate change. Then, an investor could highlight which topics it prioritises and explain its unique approach to each. It might use say-on-pay-votes to improve executive pay, engage with companies on capital allocation and divest from firms that don't take action on climate change.

Note that more disclosure isn't always better. Tangible metrics may be incomplete, prone to manipulation or encourage a focus on only the disclosed measures. So one role of regulation might be to prohibit or discourage certain disclosures. From November 2015, the EU stopped requiring companies to report quarterly, yet many still do.[16] Policymakers could go further with a 'comply-or-explain' provision whereby the default is for companies not to report quarterly unless they explain the reason for doing so. Moreover, as discussed in Chapter 8, this problem applies to non-financial as well as financial metrics. Mandating disclosure of non-financial numbers may skew companies to improve them at the expense of qualitative measures of non-financial performance – such as job creation rather than job quality.

2. Externalities

A key difference between ESV and Pieconomics is that firms that practise the former don't take into account externalities. This is something that can be addressed by regulation.

The simplest – and often most effective – solution is to *prohibit* practices whose negative externalities outweigh any benefit, and *mandate* those whose positive externalities outweigh any cost. Examples include several environmental, employment and human rights laws, such as banning child labour and imposing health and safety requirements. This avoids a 'race to the bottom' where a pie-splitting company can cut costs and drive a pie-growing company out of business before its investments have paid off. Violation should lead to not only companies being fined, but also executives being punished. In Chapter 5, we mentioned that William McGuire had to repay UnitedHealth $468 million for inflating his pay; he was also barred from serving as an officer or director of a public company for ten years. Some Enron executives were imprisoned for fraud or concealing information on Enron's financial position. In both cases, executives defrauded investors; similar sanctions should be imposed for harming stakeholders. While the UK Companies Act states that a director 'must . . . have regard to' stakeholders, no director has ever been punished for failing to do so.[17]

Other actions that create negative externalities may also have social benefits (such as air travel), so outright prohibition is unwarranted. Instead, a solution is to assign *property rights* to goods affected by externalities, so that companies take these externalities into account and weigh them up against the benefits. For example, the government can give citizens the right to clean air, or equivalently companies the right to emit pollution up to a limit. Making these rights tradable allows those with a comparative advantage in emissions reduction to sell their permits to those without. This system exists in some territories for carbon emissions.

Regulators can also *tax* actions that create negative externalities. In January 2019, the *Wall Street Journal* published the largest public statement of economists in history, signed by over 3,500 US economists, including 27 Nobel Laureates and four former chairs of the Federal Reserve, which advocated a tax on carbon emissions.[18] Alternatively, they can *subsidise* activities that generate positive externalities. To encourage innovation, many countries offer R&D credits that reduce an enterprise's tax bill at the time R&D expenditures are incurred. In Chapter 6, we highlighted how the success of innovation should be measured not by its input (R&D spending), but its output (such as the number of patents generated). Eleven EU countries have 'patent boxes' which reduce the tax on income arising from intellectual property, thus subsidising only successful innovation rather than expenditure on innovation.

Government regulation works best where an issue can be clearly measured, such as carbon emissions. Thus, it may have a greater role to play for environmental factors than social issues. While some social concerns (such as child labour and minimum wages) can be enforced, others such as the attitudes of empowerment, investment and reward are much harder to. This is why we've highlighted the business case for responsibility throughout this book. While the government has an important role to play, the repurposing of business requires the commitment – not just compliance – of enterprises and investors.

3. Redistribution

We've discussed how the most harmonious outcome of pie growth is a Pareto improvement, where some members gain and none lose. But we've also stressed how Pareto improvements are rare, because most actions involve trade-offs. While pie-growing companies compensate the losers from a decision, to the extent possible, there might still be losers.

Firms are rarely able to create Pareto improvements by themselves. When Engie closed the Hazelwood power station, it participated in the Latrobe Valley Worker Transfer Scheme. But this was only possible because the government of Victoria established the scheme to begin with – subsidising other power generators in the Latrobe Valley for hiring ex-Hazelwood colleagues.

Governments can help create Pareto improvements by redistributing the gains and losses from pie-growing activity. Chapter 5 discussed the role of taxes to redistribute the high returns to any scalable skill, not just CEO ability, so here we'll discuss redistribution through spending policies. One force that grows the pie but – without remedial action – shrinks individual slices, is technology. As mentioned in Chapter 8, Standard Chartered's Singapore franchise launched SkillsFuture@sc to help colleagues develop skills that will be enhanced rather than replaced by technology. This initiative was inspired by the Singapore government's own SkillsFuture programme, which provides ongoing training to citizens at all stages of their career.[19] Every Singaporean above 25 receives S$500 ($370), topped up periodically, to take local or online courses. SkillsFuture also offers citizens free advice, such as career guidance and personalised upskilling plans, so they know what skills to acquire for particular roles.

Another pie-growing but inequality-enhancing activity is free trade. Consumers benefit from greater access to goods, and certain industries gain from cheaper inputs. But thousands of workers and firms lose from foreign competition, and further employees are displaced through offshoring. The US Trade Adjustment Assistance (TAA) is a programme that retrains employees and helps them find new jobs.[20] Finding causal evidence for the effect of such initiatives is usually difficult, because governments often launch them concurrently with other measures to address unemployment. In addition, only certain workers are eligible for a programme and they may have different skills from ineligible ones. It could be that these skill differences drive future employment outcomes.

Ben Hyman used an ingenious methodology to identify causality.[21] A worker is eligible for TAA if he was laid off by a company whose sales declined due to imports or offshoring. But this eligibility assessment is subjective and depends on human judgment. Ben found that some case investigators are strict, accepting few applications across the board, and others are lenient. Whether an applicant is assigned to a strict or lenient case investigator is random, but has a significant effect on whether he's accepted for TAA. Ben showed that TAA increases a worker's cumulative income by $50,000 over the next ten years. A third of these returns are from higher wages, with the remainder stemming from a higher likelihood of finding a job.

Two counties in Denmark used a random eligibility assignment when they launched a job activation programme. If a citizen became unemployed between November 2005 and March 2006 and had a birthday between the 1st and 15th of any month, he was eligible for a programme that coached him on how to find and apply for jobs, monitored his search efforts, and trained him in technical, social or language skills. Those born on or after the 16th weren't eligible and so are a control group. Since a worker's birth date has no effect on his future employability, any difference in employment outcomes between eligible and ineligible workers can be attributed to the programme. Brian Krogh Graversen and Jan van Ours found that it reduced the median duration of unemployment by 18%.[22]

4. Financial Literacy

Even more effective than retraining of adults is education of the young. Most governments correctly recognise the importance of education in STEM subjects (science, technology, engineering and mathematics) for future employability, as well as core skills such as numeracy and literacy. But financial literacy is a crucial core skill to safeguard citizens' long-term financial future. Guidance on how to budget, tax-efficient ways to save, the role of interest compounding and simple rules of thumb (such as paying down credit card debt first) can have a significant effect on citizens' financial health. This in turn helps address inequality – disparities in wealth stem from not only disparities in income, but also how people spend, borrow and save.

Moreover, financial literacy can prevent customers from being exploited by pie-splitting companies. Some credit card companies offer low 'teaser' rates which jump afterwards. Financially illiterate customers may not know to look beyond the teaser rate. Hong Ru and Antoinette Schoar found that US credit card issuers target less-educated customers by offering lower teaser rates, but higher rates upon default, late fees and over-limit fees.[23] Relatedly, financial literacy is key to promoting citizen engagement. If workers understand what happens to their money when they invest in a pension – how it has the power to influence companies – this may galvanise them to express their non-financial goals to their pension provider and hold it accountable for pursuing them.

5. Competition

Competition plays several important roles in Pieconomics. It disciplines managers against pursuing their own interests, such as wasting cash on unrelated acquisitions. It also allows employees, suppliers and customers to switch to a rival if a company is exploiting its stakeholders. In contrast, market power facilitates pie-splitting, by allowing companies to hike prices to customers, lower wages to workers and worsen terms for suppliers. Indeed, Effi Benmelech, Nittai Bergman and Hyunseob Kim show that local employer concentration has a negative causal effect on wages.[24]

The pricing distortions arising from monopoly power don't just hurt stakeholders – they also lead to misallocation of resources. Under perfect competition, an enterprise can charge no more for a good than the cost of production. Thus, the private cost to a customer equals the social cost of production. As discussed in Chapter 3, this causes the customer to take opportunity costs to society into account in his purchasing decisions. But monopoly leads to mark-ups, where prices significantly exceed production costs. Thus, even if a customer derives more value from a product than the cost of production, he may not buy it, and a pie-growing trade doesn't take place. Since policies to promote competition have been covered extensively elsewhere, I refer the reader to those sources.[25]

6. Removing Distortions

Markets fail if regulations create distortions. So one way for policymakers to create value is to remove unintended distortions from existing regulations.

We've already discussed distortions arising from disclosure requirements. A second source is the tax system. As mentioned earlier, President Clinton removed the tax deductibility of pay exceeding $1 million, except forms that Section 162 (m) of the US Internal Revenue Code deemed 'performance-related'. Bizarrely, the Code didn't view restricted shares as performance-related, because the number of shares doesn't depend on performance – even though their value clearly does. But performance shares did count, skewing boards to give them despite the problems discussed in Chapter 5.[26] Note that the distortion extends well beyond the tax implications. By labelling restricted shares as non-performance-related, the regulation discouraged boards and investors from supporting them.

In 2017, the Trump Tax Cut and Jobs Act extended Section 162(m) to *all* forms of pay exceeding $1 million. This had the beneficial, although unintended, side effect of removing the above distortions. Now, boards can choose the pay structure that will lead to the most long-term value creation, rather than tax optimisation.

Perhaps the greatest tax distortion affects an enterprise's choice of financing. In nearly every country, debt interest is deductible from corporation tax, but equity returns aren't. This asymmetric treatment makes no sense.* Evidence indicates that it skews companies to finance themselves with debt,[27] which increases the risk of bankruptcy – an event that imposes negative externalities on colleagues who lose their jobs, suppliers who lose revenue and customers who lose after-sales support.

Now there are many benefits of debt financing. It allows both equityholders and executives to have concentrated stakes and thus strong incentives to create value.[28] ** Policymakers shouldn't discourage debt, but remove distortions that cause enterprises to choose it based on tax avoidance rather than pie growth. One option would be to extend the tax deductibility of

* One explanation is that debt is costly because the founder has to pay interest, but equity isn't because she doesn't have to pay dividends. This argument is incorrect – equityholders must be compensated for the opportunity cost of being unable to invest their money elsewhere.

** Consider a $100 million firm with no debt, and assume the CEO can invest $1 million of her wealth into the firm. She owns 1% of the equity. If the same firm is 50% debt financed (so it's financed by $50 million debt and $50 million equity), then the same $1 million now gives her a 2% stake.

debt to equity. Belgium did so in 2006, which indeed led to firms using less debt.[29] Another would be to remove the tax deductibility of debt, and reduce corporation tax to keep the overall tax burden roughly constant.

7. Best Practices

A final role for regulation is the diffusion of best practices. If market forces worked perfectly, there'd be no such role. An enterprise that employs bad practices would underperform and be driven out of the market. Members would notice bad practices, such as an ineffective board structure, and walk away. But market forces don't work perfectly. Underperforming firms can survive through market power, and members may not have the expertise to evaluate board structure.

Regulation can help the diffusion of best practices, but should recognise that they may not be appropriate for every firm. So they're most effectively disseminated through soft codes rather than hard legislation. *Comply-or-explain* provisions can strike the required balance and are used by several Corporate Governance Codes and Stewardship Codes throughout the world.[30] These are guidelines that a company should follow, but can choose not to if it explains its reason. Several ideas in this book could be implemented through comply-or-explain provisions, such as rewarding leaders with restricted stock that's retained post-departure, giving investors a say-on-purpose and not reporting quarterly earnings.

Aside from formal codes, regulators can spread best practice simply by making it widely accessible. In November 2017, the UK launched the 'Be the Business' movement to tackle its productivity problem.[31] It provides articles and 'quick tips' on various topics related to digitisation, employee engagement and planning. It also establishes communities where businesses can share best practice and a national mentor programme for small business leaders.

Finally, policy involves far more than regulation, and includes other tools such as education, training and funding research. The list of policies that can grow the pie is potentially endless, and beyond the scope of this book. To give an example of these other tools, we'll discuss just one – financing small businesses. That's because small businesses play many roles in Pieconomics. They increase competition; they also invest more because growth opportunities typically decline as a firm ages. In addition, policymakers can attach conditions to the financing of small businesses to ensure that they adopt the pie-growing mentality from the get-go. Note that there are many other ways to support young enterprise, such as tax incentives and reducing red tape, which have been written about elsewhere.[32] We focus on finance because it's a particular challenge for small businesses since they don't have the scale, tangible assets or track record to raise substantial funds.

Governments or government agencies can finance small businesses directly – as do NRW.BANK, the state development bank of North Rhine-Westphalia in Germany, and the EU's European Investment Bank.[33] They can also give citizens tax incentives to do so, as with the UK's Enterprise Investment Scheme, France's Madelin Provision and Germany's INVEST. Rather than funding all small businesses, a more radical solution is to reserve funding or tax incentives for 'purposeful' small businesses. This idea is compelling in theory – public support should be reserved for firms that generate strong positive externalities. The major practical challenge is that evaluating whether a business is 'purposeful' is highly subjective. Companies may be tied up persuading the government that they're creating value for society (for example, through excessive reporting) rather than actually doing so.

These challenges may not be insurmountable. Governments already need to make a subjective judgment on whether an organisation qualifies for charitable status, based on whether it serves the public interest. The awarding of purposeful status could be similar. It's critical that any reporting requirements don't go beyond what a purposeful enterprise should be doing anyway. Chapter 8 might be a useful guide – a company should state its purpose, explain how it intends to embed it internally and specify the measures that it will track to verify its delivery. Then, every year, it would report these measures to the government.

Purposeful companies should already be doing this, but not all will know best practices. Far from being onerous, such a reporting requirement might be a beneficial nudge. Since the culture of a firm is difficult to change, it's especially valuable to encourage it – right from the start – to think seriously about what its purpose is, how to put it into practice and how to measure progress.

Influencers

We now turn to the role of influencers – such as the media, think-tanks and those viewed as experts – in growing the pie. We'll discuss how the first two caveats we considered for policymakers also apply to influencers, as well as citizens who may be swayed by influencers' opinion. (The other four caveats apply to influencers the same way they apply to policymakers.)

1. The Pie-Growing Mentality

Influencers can help hold companies accountable for not creating value. But it's easier to gain influence by inciting public outrage, so some may focus on how much profit a company makes or how much a CEO is paid. Since the pie-splitting mentality is prevalent, many readers may assume that pay and profits must be at the expense of other stakeholders.

For example, the level of pay is often criticised without considering whether the leader has created long-term value. Similarly, recall the Humana buyback that we discussed in Chapter 7. Most articles focused on how the buyback netted the CEO a $1.68 million bonus. They omitted the fact that it created $96 million of value for continuing investors, so the bonus wasn't at their expense.

In addition to ‘naming and shaming’ pie-splitters and particularly pie-shrinkers, influencers have the power to ‘name and fame’ pie-growers. This presents a more balanced picture of business and should reduce the public’s mistrust. Influencers don’t have a responsibility to reduce mistrust in business where it’s deserved. But they do have a responsibility to portray business accurately so that it gets the level of trust or mistrust that’s warranted.

Naming and faming pie-growers encourages citizens to invest in, buy from or work for them, and provides aspirational examples for other firms to follow. It gives leaders confidence that, by looking away from profit targets and looking up to how they can make a difference to the world, their enterprises may end up more successful.

2. Evidence over Anecdote

Influencers can become impactful by presenting a black-and-white view of a topic. A newspaper article that claims that buybacks are always good has a clear punchline, and will be shared and cited by buyback supporters. A guru who argues they’re always bad will become famous for this position, and be interviewed whenever a journalist wants an anti-buyback quote. Influencers can get away with presenting one-sided views because readers are primed to view an issue as either good or bad, a psychological tendency known as ‘splitting’, ‘black-and-white thinking’ or ‘all-or-nothing thinking’. That’s compounded by *confirmation bias* – the temptation to accept any argument, no matter how flimsy, that supports your pre-existing view on whether an issue is good or bad, and disregard anything that contradicts it.

One way to present a one-sided view is by using a story. Stories are both powerful and dangerous. They’re powerful because they’re vivid and bring a topic to life, so they’re more likely to be remembered and retold than a statistic. And they’re also powerful because you can hand-pick an anecdote that shows what you’d like to show in the starkest manner.

I admittedly hand-picked Humana for Chapter 7 because it would have just missed the CEO's EPS target without the buyback and just met the target with it. But the same power means they're dangerous. Even if a result is generally false – leaders don't use share buybacks to hit EPS targets – you can always find a counter-example to suggest that it's true.

Influencers should certainly not stop using stories. Articles would be dull and fail to influence anyone if they were based on regression coefficients. But stories are particularly valuable when they give a real-life example of a large-scale phenomenon – otherwise they misinform. So a good principle for influencers to follow is *not to extrapolate from a story to make a general point, unless they also quote large-scale evidence that supports this general point*.

But simply moving from stories to evidence isn't enough. Just like with anecdotes, you can always hand-pick a study that shows what you'd like to show. That's a major problem because there's a huge variation in the quality of studies available. Some make basic methodological mistakes, like the miscalculation of CEO incentives we saw in Chapter 5; others claim causation when they find only correlation. So it's crucial to weight evidence by its quality and rigour, rather than by whether we like the conclusion.

How can influencers evaluate the quality of a study – without having to delve into the weeds and scrutinise its methodology, which would require specialist expertise and be impractically time-consuming? Here's five questions that are quick to ask and simple to answer:

1. Does the Research Actually Exist?

   This question might seem ludicrous – could the answer ever be 'No'? In fact, several articles have been written based on an author's press release about their study, when the study actually didn't yet exist. For example, an influential newspaper published an article entitled 'UK chief executives earn much more than European peers' with the strapline 'Study also fails to find link between higher pay and better performance'. But there was no such study. Yet because of confirmation bias, the article was accepted uncritically and widely shared.

Sometimes a study is indeed available, but an abridged version – it may only describe the results, but not the methodology. A study claiming that responsible companies perform better would need to explain how it measures responsibility. It's critical to be able to scrutinise the methodology, because how much faith we can put in the paper's results hinges on how reliable the responsibility measure is. Chapter 4 discussed how some studies simply asked leaders how responsible they are, which is clearly dubious.

2. Is the Research Based on Actual Data?

This question might also seem ludicrous. But numerous studies aren't based on actual data, but simply asking people their opinion. A study may report that '70% of investors don't think financial incentives affect CEO performance'. That's very different from using data to study whether incentives *actually* affect CEO performance, as the studies quoted in Chapter 5 did. Certainly, surveys are useful to learn people's opinion – but influencers should recognise that they only report opinion, rather than what actually happens.

Relatedly, the data needs to actually back up the claims made by the study. One consultancy issued a press release on its study entitled 'CEO remuneration packages actively discourage innovation in UK's top companies'. But the study didn't contain any data on innovation. It gathered data on CEO pay packages, showed that they contain bonuses and *assumed* that bonuses discourage innovation.*

* It's plausible that bonuses discourage innovation for the reasons given in Chapter 5. But it's also plausible that bonuses encourage the company to get its act together and improve in many dimensions, including innovation.

3. Is It Published in a Top Peer-Reviewed Journal?

   Many studies are conducted by practitioners such as professional service firms. Practitioner studies have significant value and I've quoted many in this book. They often have better access to data than academics and are often a superior source for statistics. But academics have particular expertise in drawing relationships *between* statistics – teasing apart causation from correlation and addressing alternative explanations. Importantly, academic studies have to undergo rigorous peer review to check their scientific accuracy. This addresses not only honest mistakes in execution, but also deliberate bias, such as a pharmaceuticals company funding a report on its own drugs, or an academic claiming to have uncovered a scandal to become famous. The very top journals have the highest standards, using the world's leading specialists to scrutinise a manuscript, and reject up to 95% of manuscripts. The 5% not rejected aren't immediately accepted either; instead, their status is 'revise-and-resubmit'. The reviewers highlight concerns that the authors need to address, and the paper can still be rejected at the next round. It's not unusual for a paper to take five years to be published after its first draft. A hard slog for the authors, but it helps ensure the published results are correct. As discussed in the Introduction, a paper on pay ratios completely changed its conclusion after going through peer review and improving its methodology.

   The stringency of the peer review process is critical. That a journal calls itself 'peer-reviewed' is far from sufficient, since there's a vast range in the quality of reviewing standards. The analytics company Cabell's has a list of over 14,000 journals that it classifies as 'predatory', because they claim to be peer-reviewed when they actually aren't. Journal quality can easily be checked by looking at one of the freely available lists of the best ones, such as the *Financial Times* Top 50 journals list – you don't need to be an academic insider to do this.

Peer review isn't perfect – mistakes are made. Sometimes sloppy papers get accepted and good papers are rejected. But it's better to go with something checked than something unchecked. I've heard some influencers, who don't have experience of the peer review process, throw around the words 'publication bias' as a licence to ignore whether a paper's been published and quote whatever study they like. Their charge is that journals only publish papers that support traditional orthodoxies, such as an exclusive focus on shareholder value.

This simply isn't how the publication process works. As journal editors, we want to publish new papers that change the way people think. The main measure of journal reputation is the number of times its articles are cited. The first paper in any new area will be hugely cited; the tenth in a well-established field won't. The key reason for the 95% rejection rate at top journals isn't that most papers are wrong, but that they don't make a novel enough contribution to knowledge – they mainly rehash what we already know. Indeed, throughout this book, we've discussed many academic papers in top journals that support the idea of moving beyond shareholder value maximisation towards social value creation.

With these arguments, I'm not aiming to be an apologist for academia. There are many areas of the academic profession that can be improved. But journals not having incentives to publish new papers that challenge conventional wisdom just isn't one of them.*

* One caveat to this question is that a small number of practitioner studies may be of sufficient quality to be published in an academic journal, but don't seek such an outcome as academic publication isn't their objective. An example is studies by economics consultancies commissioned by the government or a regulator. It's critical to distinguish between studies undertaken to *inform* and studies undertaken to *advertise*. To do so, ask: *Would the organisation have*

4. What Are the Credentials of the Authors?

   Of course, every paper starts out unpublished. How do we gauge the quality of a new paper? By scrutinising the credentials of the authors. One relevant factor is the quality of their institution, which we can compare against freely available lists of the top universities. This isn't elitism, but simply a desire to use the best evidence. We'd listen more closely to a medical opinion from Mount Sinai than a hospital we've never heard of.

   It's certainly not the case that studies by top institutions are always correct and those by others are always wrong. Thus, a second factor is the authors' track record of top-tier publications, which is easy to find as nearly all academics make their CVs available on their website. Indeed, we carefully scrutinise the credentials of an expert witness in a trial. Again, this doesn't mean that well-published authors are always right. Credentials are simply *one* factor to assess when evaluating evidence, just as a company's brand name is one consideration in a purchasing decision, or an undergraduate's university is one element in an entry-level hiring decision. A useful question to ask is the following: If the same study was written by the same authors, with the same credentials and had the opposite results, would we still be willing to believe it?

   Importantly, it's critical to scrutinise whether the authors have credentials *in the relevant field*. This helps avoid the issue of 'halo effects', where a person with expertise in one field is seen as a guru in unrelated fields.

published the study if it had found the opposite result? For example, many consultancies will publish studies showing that responsible companies perform better (since making this claim is good for their brand), but not if they found the opposite. Some consultancies use their own measure of responsibility, so they have particularly strong incentives to show that their measure 'works'. Even if the answer to this question is 'no', it doesn't automatically mean that the paper is wrong, but it must be approached with caution.

For example, former GE CEO Jack Welch is widely quoted for claiming that shareholder value is 'the dumbest idea in the world'.* Welch was certainly an influential CEO at one firm, but hasn't investigated the effect of a shareholder value orientation on performance in firms in general – a question that warrants academic study rather than business leadership. Even academic researchers may be tempted to speak on issues outside their strike zone; some doctors were proclaiming miracle cures for the coronavirus, even if their background wasn't in pathology or epidemiology. That's a particular problem for responsible business – since it's a hot topic, many talking heads want to jump on the bandwagon and speak about it; since confirmation bias is rife, it's easy to make a name for yourself by saying what the public wants to hear. Therefore, we should carefully check if someone professing about responsible business has top peer-reviewed publications on the topic, rather than their expertise lying in other areas.

5. Are There Alternative Explanations?

   The fifth indicator is whether there are alternative explanations for the authors' results. Again, you don't need to be an academic insider to conduct this check, because most alternative explanations are based on common sense rather than methodological technicalities. Readers can ask themselves whether the results could be driven by *reverse causality* (does employee satisfaction improve firm performance or does firm performance improve employee satisfaction?) or *omitted variables* (did ESG stocks outperform in the pandemic because tech beat energy?). I commonly

* In addition, Welch is often quoted out of context. His full quote was 'on the face of it, shareholder value is the dumbest idea in the world'. He argued that shareholder value should be an outcome, rather than the end goal, just as in Pieconomics.

share academic papers on both sides of responsible business topics on LinkedIn. If I post an article whose findings go against public opinion, there's no shortage of comments pointing out alternative explanations – so it's certainly feasible to think of them. But if the paper confirms current thinking, it's accepted at face value.

Importantly, it doesn't take long to figure out if there are alternative explanations. The introduction of an academic paper (typically four to six double-spaced pages) should be both fully self-contained and non-technical. It aims to give all the paper's punchlines – including how it deals with alternative explanations – without readers having to delve into the actual paper and technical methodology. And this question can be asked of both published and unpublished papers. Most unpublished papers on social science are freely available at the Social Science Research Network, ssrn.com. Even if a paper is published in a journal that's behind a paywall, the pre-publication version typically remains available on SSRN.

These five questions help influencers evaluate whether research-based studies are trustworthy. We'll close with tips to help citizens discern the reliability of an influencer's article that typically cites studies in support. The first tip for citizens is the same as for influencers – to check whether a study referenced in an article actually exists.

A second, related, tip is to skim the underlying study and verify that it actually shows what the article claims that it shows. For example, the UK House of Commons Select Committee* Report on Executive Pay stated that 'the evidence is at best ambiguous on the impact of individual CEOs on company performance', with a footnote referring to the evidence submitted by 'Professor Alex Edmans' to the

* This committee is an influencer in that it recommends policy rather than directly setting it.

Executive Pay inquiry. However, nowhere did my evidence state this. My closest sentence on the 'impact of individual CEOs' was 'CEOs with high equity incentives outperform CEOs with low equity incentives by 4–10% per year, and the researchers do further tests to suggest that the results are causation rather than correlation', as discussed in Chapter 5. This suggests that CEOs do have a significant impact on firms. Since checking the original source can be cumbersome for citizens, websites such as fullfact.org do so on their behalf.

The third tip is to ask whether the article is balanced. There are two sides to almost every issue in business or economics,* so influencers who present an extreme position may have deliberately selected only the research that supports their position, and wilfully excluded contradictory evidence that they knew about, or refused to search for it. Citizens should thus be particularly wary of unambiguous phrases such as 'beyond doubt' or 'clear evidence'. We saw earlier how influencers claimed that 'the outperformance of ESG strategies is beyond doubt' and 'there is clear evidence that high CEO pay is no longer strongly associated with performance', even though neither statement is true. By being wary of one-sided opinions, not only may citizens become more informed themselves, but also discipline influencers into presenting the full picture.

For example, the Norwegian Sovereign Wealth Fund is an influencer because it's a respected investor whose lead others follow. Recall that, in April 2017, it released a position paper on CEO pay. It's since published several more on other responsible business topics. In all these papers, it presents not only the arguments for its position, but also

* There are two sides to almost every issue in social sciences, because it's difficult to prove something perfectly – as discussed, evidence is not universal. However, in the physical sciences, proof is possible and so one-sided articles may be reliable.

those against. Including the latter reinforces the Fund's credibility, as it shows it reached its stance despite carefully considering the other side, rather than blundering into it. Acknowledging potential weaknesses in your position need not display weakness, but strength.

In a Nutshell

- Citizens enjoy agency – the power to change the way enterprises operate. Few are policymakers, but all can affect policy through their role as voters. Few are influencers, but all have influence by the views they share and ignore. Almost all are investors, colleagues and customers.
- Like investors, colleagues and customers can *monitor* – choose companies based on the value they create for society – and *engage.* Colleagues at all levels can practise the attitudes of empowerment, investment and reward to others. They can manage up and be bold in suggesting and trialling new ideas. Customers can pressure enterprises to change behaviour through their purchasing decisions or providing product feedback.
- Regulation can address market failures such as externalities, redistribute the gains from pie growth and help spread best practices. However, it has limitations. By deterring errors of commission, it can exacerbate errors of omission by discouraging risk-taking. It's typically one-size-fits-all and not tailored to enterprises' individual circumstances. Thus, particularly effective may be 'comply-or-explain' provisions, and requiring disclosures to allow members to make informed decisions.
- Influencers can play an important role by drawing attention to pie-shrinking behaviour and 'naming and faming' pie-growers.
- It's much easier to gain influence by presenting only one side of an issue, and hand-picking a single story which illustrates a point starkly. But influencers' objective should be to spread

truth, by only using a story to make a general point when it can be backed up with rigorous large-scale evidence.

- Consumers of influencer opinions should beware confirmation bias, the tendency to accept views that support your own. They should place particular weight on studies published in the most stringent academic journals by researchers with strong credentials in the relevant field, and put more trust in influencers who present both sides of a topic.

Part IV

The Bigger Picture

11 GROWING THE PIE MORE WIDELY

Win-Win Thinking at the National and Personal Levels

This chapter discusses how the core ideas of this book – the power of the pie-growing mentality; the importance of errors of omission; and the principles of multiplication, comparative advantage and materiality – can be applied to wider settings beyond the role of business in society. It also acknowledges the analogues between Pieconomics and ideas that others have developed in different contexts.

We'll first start with a general principle that will be relevant to many applications discussed in this chapter.

Battle of the Sexes – the Value of Cooperation

The first hobby that I remember having as a kid was playing chess. My dad taught me from an early age and I played in my first tournament when I was 5. I enjoyed the game, but the hardest part – particularly for a 5-year-old – was losing. I'd often burst into tears after losing important games. Eventually, I learned to stop crying and played for the England junior team when I was at school. But I ditched it at university for more socially acceptable pastimes.

Yet my chess background meant that my favourite topic in undergraduate economics was Game Theory. This uses games to model real-life situations where, just like in chess, different players pursue their own individual interests. Two enterprises compete within an industry, management negotiates with a trade union or country presidents engage in a trade war. These games aren't used only in academic textbooks, but also in real life – companies sometimes use war-gaming workshops to play out potential scenarios.

Perhaps the most famous Game Theory game is the Prisoners' Dilemma, often used to model industry cartels. But another well-known game, Battle of the Sexes, is more relevant for Pieconomics. Ann and Bob need to decide where to go on date night. Ann would rather go to ballet and Bob to a fight. (Yes, economics textbooks aren't known for their political correctness.) But both prefer to go to the same event rather than to be apart. Their 'pay-offs' – their happiness from different choices – are given by the following table.

		Bob	
		Ballet	**Fight**
Ann	Ballet	5,1	0, 0
	Fight	0,0	1, 5

Each cell contains the pay-offs first to Ann, and then to Bob. If they go to different events, both get 0. If both go to the ballet, Ann gets 5 and Bob gets 1. If they both go to the fight, Ann gets 1 and Bob gets 5.

What's the best outcome? There are two possible ones – either both go to the ballet or both go to the fight. The aggregate pay-off is 6, and so going to the same event grows the pie compared to going their separate ways. Even though equality is higher under the latter (both get the same – zero), few would argue that equality is more important than creating value.

It's a no-brainer that Ann and Bob should go to the same event. The tricky question is whether this should be the ballet or the fight. They might be so caught up squabbling over how to split the pie – which event they go to – that they lose sight of the primary goal, which is to go to the same one. Perhaps as a bargaining tactic, Ann says she's already bought the ballet tickets. In Game Theory language, she *commits* to choosing 'Ballet'. The rational thing for Bob to do is also to choose 'Ballet', so that he gets 1 rather than 0 if he chooses 'Fight'.

But humans aren't always rational. Bob may view this as unfair as Ann gets a higher pay-off, so he wants to punish her by going to the fight. This punishment is successful as Ann now gets 0 – but he's also succeeded in punishing himself, and gets 0 too.

To a dispassionate outsider, Bob's behaviour seems crazy. But people choose the pie-shrinking outcome often. They're caught up in the same win-lose mentality that I had when playing chess, and so are fixated on beating the other person. By making others lose, they think they'll automatically win. But real life isn't a zero-sum game like chess. The other player isn't your opponent, but your ally. Both parties can lose and both can win, depending on whether you choose to grow the pie.

How do people actually play Battle of the Sexes? Economists have studied a richer version known as the Ultimatum Game. Here, Ann is given \$10 and offers a split to Bob. If Bob agrees with the split, both keep the suggested amounts. If Bob disagrees, both get zero. It's like Battle of the Sexes except Ann can choose a whole range of options – any number from \$0 to \$10 – rather than only 'Ballet' or 'Fight'.

What's rational is for Bob to accept *any* split. Even if Ann proposes to give \$0.01 and keep \$9.99, Bob should accept it. It's unfair, but it's better than him getting zero. But this experiment has been played thousands of times, and in practice Bob rejects even \$3.[1] He's so concerned with equality that he prefers to shrink the pie, all the way to zero, to stop Ann getting more than him.

While the Ultimatum Game is an experiment, people often play the same way in real life. It's to these settings that we now turn.

International Trade

The principle of comparative advantage in this book is based on the famous *law of comparative advantage*, pioneered by economist

David Ricardo in the setting of international trade. Assume that there are two countries, Britain and America, and two goods, televisions (TVs) and personal computers (PCs). Britain has 12 workers and America has 14. The number of goods each worker can produce is shown in the table.

	TVs	**PCs**
Britain	3	1
America	4	3

Citizens want many types of goods. A household would rather have one TV and one PC rather than two of one and none of the other. We'll capture the need for variety in a simple way by saying that Gross National Happiness (GNH) is the lower of the two items produced.

Let's first assume complete autarchy – countries don't trade with each other. Then Britain would assign 3 workers to TVs and the remaining 9 to PCs. It would produce 9 of each and its GNH would be 9.[2] America would assign 6 workers to TVs and 8 to PCs, making 24 of each for a GNH of 24. Total GNH across the two countries is 33.

Now let's allow for trade. The *law of comparative advantage* says that each country should focus on the good that it's *relatively* better at producing. The beauty of this law is that, even if a country is absolutely less productive in all goods, it will still be relatively more productive in one. Here, Britain is less productive for both items (3 <4 and <3). But it's relatively more productive for TVs. If it reallocates a worker away from PCs to TVs, it gains 3 TVs for every PC lost. If America does such a reallocation, it yields 4/3 = 1.33 TVs for every PC forgone.

So Britain should reallocate workers from PCs to TVs, where it has a comparative advantage. It switches all 12, who now make 36 TVs. America redeploys 13 workers to make 39 PCs, and keeps only one worker in the TV factory, where he makes

4. Across the two countries, there are 40 TVs and 39 PCs, and thus a combined GNH of 39. The gains from trade, in GNH terms, are 6.

Just like in Battle of the Sexes, it's not clear how to split this 6. Britain could offer America only 22 TVs in return for 14 PCs. It ends up with 14 of each item and a GNH of 14. America has 26 TVs and 25 PCs, and a GNH of 25. Britain gains 5 compared to autarchy, and America gains 1. That's like Battle of the Sexes where both go to the fight, so Bob gets 5 and Ann gets 1.

	No Trade, Production and Consumption		**Trade, Production**		**Trade, Consumption**	
	TVs	**PCs**	**TVs**	**PCs**	**TVs**	**PCs**
Britain	9	9	36	0	14	14
America	24	24	4	39	26	25

Or America can drive a hard bargain and demand 26 TVs from Britain, only offering 10 PCs in return. Britain ends up with 10 of each item and a GNH of 10. America has 30 TVs and 29 PCs, and thus a GNH of 29. So now America gains 5 and Britain gains 1 – like Battle of the Sexes where both go to the ballet.

Under both scenarios, the gains from trade are unequal. But just like in Battle of the Sexes, the most important point is that the pie has grown – both are better off than under autarchy. Now that's not to say that the countries should ignore how the gains are split – the division is still important. But the first priority should be for the countries to cooperate so that there are gains, and *then* to decide on the split.

In reality, countries sometimes have the pie-splitting mentality. Britain might see America as gaining 5 from trade, and think it must be losing 5 – it doesn't realise that it's gaining 1. Or Britain might think that, by reducing America's slice of the pie by putting up trade barriers, it will increase its own slice – not recognising that both countries' slice may fall because the pie shrinks. This is often called a 'trade war'. In August 2018, then-US President Donald Trump tweeted that '[t]ariffs are working far better than anyone ever anticipated. China market has dropped 27% in last 4months [sic]',[3] assuming that the goal of trade policy is to damage other countries. In war, it's indeed the case that making your opponent lose causes you to win.[4] But in a trade war, making your opponent lose often causes you to lose yourself.

So far, we've considered Britain as a single entity. But what matters is the division of gains not only between Britain and America, but also between different British citizens. Who in Britain actually gains from trade?

In theory, it could be all members of society. British firms in aggregate generate more sales since they now focus on the product in which they have a comparative advantage. They can pay higher wages to colleagues and return greater profits to investors. The biggest gainers may be customers. Politicians often think of trade as benefiting only the elite – companies who can sell more, and thus their bosses and investors. But it also helps ordinary citizens who have access to cheaper and better goods. America is only able to export PCs because British consumers prefer them to home-made ones. The customers who benefit from trade include not only people, but also companies who gain from access to affordable, high-quality inputs. Tariffs put domestic companies at a competitive disadvantage to foreign firms, who have free access to these inputs.

But in practice, while investors, employees and customers gain at the aggregate level, not everyone gains individually – just like, for a company, the pie may grow, but an individual stakeholder may lose. PC companies can't suddenly switch to making TVs. They may go out of business, hurting investors. Their employees also lose – while new TV companies will start up, PC workers may not have the skills to manufacture TVs, or be willing to relocate to these new firms.

These redundancies, while painful and serious, aren't too different from what happens under domestic competition. If Prestige PCs, based in London, were an inefficient incumbent, and Castle Computers in Manchester entered the market and drove it out, Prestige's colleagues would be out of a job. If they're unwilling to relocate to Manchester, and they're not employable in other London firms, they'd be jobless. That Prestige lost to a domestic rather than foreign competitor doesn't make unemployment any less painful. And companies can decline through not only inefficiency, but also changes in technology, such as Kodak losing out to digital cameras.

So the job losses from international trade are an example of a more general problem. Redundancies arise when an enterprise's products are no longer in demand, because technology or preferences have changed, or there are more efficient rivals – whether domestic or foreign. Now that doesn't make the job losses any less painful. Those unemployed due to imports aren't comforted by the fact that others have become unemployed due to technology. But it does mean that governments should prioritise solutions to the general problem, rather than treating unemployment from trade as unique. While tackling unemployment is beyond the scope of this book, policies to increase workers' redeployability (such as education, apprenticeships for the young, and retraining programmes for adults) and encourage new business formation, as discussed in Chapter 10, will help all displaced colleagues – regardless of what caused their displacement.

Employment

Pie-splitting views on international trade – that there's a fixed demand for goods and so sales by foreign firms are at the expense of domestic ones – are similar to pie-splitting views on employment. This is often known as the 'lump of labour' fallacy: there's a fixed demand for jobs, and so giving jobs to immigrants takes jobs away from domestic citizens. But the number of jobs isn't fixed. Most obviously, immigrants spend their income, which directly creates employment, and pay taxes, which gives the government resources to do so.

More importantly, while immigrants are often seen as *substitutes* for domestic workers, taking away jobs that would otherwise have gone to them, many jobs are *complements*. Hiring an immigrant in a particular role may create several new jobs that interact with this role. An immigrant project manager allows a construction company to employ domestic construction workers; immigrant construction workers allow it to employ a domestic project manager. Both types of hire create extra demand for staff in human resources or purchasing.

This doesn't mean that immigration policies should be unfettered. Substitutability is more likely to exist in professions where there's already an abundance of domestic workers. But hiring immigrants in professions where the domestic supply is scarce – such as engineering and health care for the UK[5] – is particularly likely to increase hiring in complementary jobs, as well as improve employer performance.

The 'lump of labour' fallacy applies to attitudes towards not only immigration, but also technology. A similar mentality exists – there's a fixed amount of work to be done, so any work undertaken by machines reduces the number of jobs for humans. As with immigration, there are certainly cases where technology and labour are substitutes, but they can often be complements. Leaders need to think carefully about how to redefine jobs, away from those that can be substituted by technology to those that complement it or in which humans have a *comparative advantage*, such as personal relationships. This redefinition is often tricky, but also possible.

In his 2016 TED talk, *Will Automation Take Away All Our Jobs?*, MIT economics professor David Autor notes that there were 250,000 bank tellers in the US in 1970, yet 500,000 today, with 100,000 added since 2000 – despite the proliferation of the Automated Teller Machine (ATM) from the 1970s. ATMs substitute for some tasks that tellers used to do, such as handling deposits and withdrawals. But this allows tellers to switch to more complex tasks, such as advising customers on financial products, where personal interaction and trust are important. Not only do tellers benefit from more fulfilling jobs, but the ATM also makes it cheaper for banks to open new branches. The number of bank branches in urban areas rose by 43% between 1988 and 2004, creating thousands of new jobs and offsetting the fact that fewer tellers are now needed in each branch.[6]

Japanese Deputy Prime Minister Taro Aso similarly highlighted the importance of viewing technology as help – as a partner in growing the pie, rather than a rival: 'The Western way of thinking is "robots will steal my job," but in Japan, robots will reduce the ordinary man's load.'[7] This help can involve technology doing tasks that were too dangerous for humans to do in the first place, such as cleaning up oil spills or firefighting at high temperatures – so there's no substitution. Even for highly skilled jobs, technology will make redefinition both necessary and feasible. Artificial intelligence will likely be able to diagnose cancer, but only humans can convey this news in a compassionate way, and discuss prognosis and treatment options.

For leaders to be able to redefine jobs, they need a flexible workforce. This requires both companies and policymakers to train citizens in skills that can't be replaced by technology (so that it's not a substitute) and in how to use technology (so that it's a complement that makes them more productive), as in Singapore's SkillsFuture programme. This approach views technology not only as a threat to get in front of, but also an opportunity. Autor points out that tractors, and other technological advances, severely threatened US agricultural employment around the turn of the 19th century. The US government took the radical step of introducing compulsory schooling until age 16. The substantial investment paid off in creating a highly skilled and flexible US workforce. Many industries that are the biggest employers today couldn't have been foreseen back then. Similarly, we don't know what will be the industries of the future – but we do know that general skills will help prepare our workforce for whatever they turn out to be.

The threat posed by artificial intelligence may be of a greater scale to previous technological changes, but the challenge of responding to such changes isn't new. In Autor's words, 'If you think about it, many of the great inventions of the last 200 years were designed to replace human labour.' Computers were a game-changing innovation, but they've led to jobs being redefined rather than just replaced. Moving from typewriters to word-processing software allows typists to correct mistakes, increasing their productivity and reducing demand for labour hours devoted to typing. Yet it didn't lead to typists being fired, but instead to their role being enriched to that of a secretary or executive assistant, which involves far broader responsibilities. Indeed, jobs have grown faster in industries with a high use of computers (like engineering) than those without (like manufacturing), suggesting that computers aren't simply a substitute for workers.[8]

Not every employee whose job is displaced by technology will be able to be redeployed within the firm, and so the government policies mentioned at the end of the last section, to foster external reallocation, are also critical.

Macroeconomic Policy

The expression 'grow the pie' is sometimes used in macroeconomics to argue that growing the wealth of the nation as a whole benefits citizens, particularly less affluent ones, more than redistributing wealth. Thus, policymakers should focus primarily on economic growth.

Contrary to common belief, this doesn't mean the reliance on free markets and minimal government intervention. Instead, there remains a significant role for redistributive policies to the extent that they also support growth. Free health care or university education, or subsidising these for the poor, substantially increases the productive capacity of citizens who'd otherwise be unable to afford such investments. However, this approach to macroeconomic policy would caution against redistribution for its own sake, as doing so may reduce incentives to create wealth to begin with.

While Pieconomics stresses the importance of growing the pie, it also recognises that social welfare depends not only on the size of the pie, but also its distribution. So, in contrast to 'grow-the-pie' macroeconomic policy, Pieconomics argues that redistribution for its own sake can be desirable (such as high income taxes for top earnings), even if there are disincentive effects, as long as they're not major. As we showed in Figure 2.2, a leader may prefer a smaller pie that's more evenly distributed, particularly if material stakeholders are better off.

But the most important difference is that, under 'grow-the-pie' macroeconomic policy, the pie represents wealth and a policymaker's goal is to create wealth. Under Pieconomics, the pie represents social value and a leader's responsibility is to create social value, of which profits are only one slice.

Interpersonal Dynamics

We now apply the concept of growing the pie to interactions between individuals, rather than companies or stakeholders. Perhaps the closest analogue lies in Stephen Covey's famous book, *The 7 Habits of Highly Effective People*.[9] He talks about the *scarcity mentality* which, like the pie-splitting mentality, assumes there's a fixed amount of resources or happiness to go round. If a friend achieves personal or professional success, you feel envious – perhaps thinking that there's less happiness left for yourself. If a colleague closes a deal, you fear he'll get the next promotion, not you. As political satirist P. J. O'Rourke put it, 'In this zero-sum universe there is only so much happiness. The idea is that if we wipe the smile off the faces of people with prosperous businesses and successful careers, that will make the rest of us grin.' This is linked to the 'tall poppy syndrome', where people envy others' success (a poppy who grows taller than other poppies), even if it doesn't reduce yours.

In contrast, Covey's *abundance mentality* argues that there's an unlimited amount of resources or happiness, so there's no need for envy. But a key difference with Pieconomics is that the abundance mentality assumes there are automatically unlimited resources. The pie-growing mentality stresses that larger slices are available for all, but only through hard work and cooperation.[10] Just as investors and stakeholders are allies in growing the pie rather than adversaries who maximise their share, colleagues are allies in ensuring the enterprise's success rather than competitors for promotion.

Let's say Ann and Bob are now heads of different divisions in the company Springbok, Inc. If Ann cooperates with Bob to close a deal for his division, that's like Ann cooperating with Bob to go to the fight in Battle of the Sexes. Bob gains the most because the deal increases his division's profits. But even though Ann gains less, she still gains. By bringing business into Springbok, she helps it thrive, which will give more resources for her division. Ann and Bob's primary task is to grow Springbok's pie and ensure it stays ahead of Lion, Inc., its main competitor, rather than for their division to be the best within Springbok.

In nature, a lion can't catch a springbok if it chases after it. So it waits for a herd of springboks to fight each other, and then can catch one. 'Fights' refer to actions that affect not only another division, but also the broader organisation. Bob may support a particular candidate for CEO because she's more likely to favour his division even if an alternate is of high quality. A professor may push for the hiring of a low-quality new faculty member because he's closest to her own research interest. An athlete may oppose the signing of a new team-mate because it will mean that he's no longer the star player. In all these examples, *colleagues only look at their slice*. *They don't look at the entire pie.*

A leader's responsibility is to design reward and evaluation systems that instead create win-win situations. It's important that, when Bob gets 5, Ann gets 1 rather than –1. The former will be the case if Ann has shares in Springbok, as advocated in Chapter 5, and if the evaluation system explicitly takes into account her support of Bob rather than comparing her performance against him. In contrast, new Harvard Law School students are allegedly told, 'Look to your left, look to your right, because one of you won't be here by the end of the year.' Such zero-sum statements engender a scarcity mentality.

The principles of Pieconomics also apply even if Ann and Bob are friends or acquaintances rather than colleagues. In *Give and Take*, social psychologist Adam Grant studies three types of people.[11] 'Givers' help others without doing a calculation of whether they'll eventually benefit, like a pie-growing leader. 'Takers' try to exploit others as much as possible, like a pie-splitting leader. 'Matchers' help others if they can forecast a long-term benefit, like a leader who practises enlightened shareholder value. Adam shows that givers are actually more successful in the long run – even though personal success was never the motivation for their generosity. Yet he stresses how giving shouldn't be scattered and undisciplined, just as a pie-growing firm shouldn't invest in an unfettered manner.

Mindset

In addition to relationships with others (interpersonal leadership), the ideas of Pieconomics also have antecedents in prior work on your relationship with yourself (personal leadership).

Psychologist Carol Dweck, in her book *Mindset*, talks about the *fixed mindset* and the *growth mindset* as two different attitudes to personal development. The fixed mindset views a person's abilities as anchored in genetics. He's either talented at an activity or not. If he's not talented, he's predestined to fail, so there's no point working hard. If he's talented, he's predestined to succeed, so again there's no need to work hard.

In contrast, the growth mindset views abilities as expandable through effort. This mindset is similar to the pie-growing mentality, although there isn't an analogue of how a pie is split between different members. Viewing the pie as expandable gives encouragement that all parties can gain, but also the responsibility to work together to grow the pie, rather than your own slice. Viewing your abilities as expandable through the growth mindset gives encouragement, but also the responsibility to work hard to improve them.

Yet achievement through hard work is often scorned compared to achievement through talent. Kids who work hard are labelled as 'swots' or 'try-hards', as if effort is something to be ashamed of. At my secondary school, your grades had two components: attainment, which ranged from 9 (best) to 1 (worst), and effort, where the scale was from A (best) to D (worst). The most coveted grade was a 9D as it suggested that you were a natural – you'd achieved success without having to work for it.

When I was an undergraduate, I ran for student government (known as the Junior Common Room, or JCR) at Merton College, Oxford. Not surprisingly, studying Economics, the position I went for was Treasurer. In the first General Meeting after being elected, the opening motion proposed that Merton JCR's official position be to oppose tuition fees. The JCR President normally chaired all meetings, but she was proposing the motion. The chair's duty should have fallen to the Vice-President, but he was opposing the motion. (No danger of groupthink in our committee.) The Treasurer was third in command, so I was suddenly thrust into the role of chair. I never anticipated needing to do public speaking when running for Treasurer, as I'd instead looked forward to a peaceful year of signing cheques and building Excel spreadsheets.

I was a disaster. I was too shy to chair effectively, particularly in a room of opinionated, high-spirited students – often full of spirits as well as spirit. I was so bad that in the next meeting, the students proposed a motion to create a new position, called General Meeting Chairperson. That person would chair future meetings, so the student body wouldn't have to put up with my incompetence again. The motion was defeated, but there was still an easy way out for me. While it was tradition that the highest-ranked officer would chair meetings, there was nothing in the constitution that mandated this. It was tempting to have had the fixed mindset and thought that I just wasn't a public speaker, passing the duties to the fourth in command. But I decided to work at it, even though chairing meetings was uncomfortable. I took the Chair's role many more times that year when the President and Vice-President were unavailable, and ended up semi-competent.

But still only semi-competent. Knowing that I still had significant room for improvement, but also encouraged that improvement was possible, I joined the MIT Toastmasters Public Speaking Club immediately after starting graduate school. Some classmates thought Toastmasters was pointless for a native speaker because you're either born with elocution ability or you're not – only for non-natives is there growth potential. In the first meeting, I was cold-called in an exercise called 'Table Topics', where you're asked to speak on a topic on the fly. I was asked 'What's the difference between a lady and a woman?' and gave a dismal answer because I was no good at thinking on my feet. But, despite knowing that each meeting would have a 'Table Topics' and thus the risk of being cold-called, I kept coming back.

Fast-forwarding to my first year as an assistant professor at Wharton, I attended a conference jointly hosted by Duke University and the University of North Carolina. I presented one of my research papers on blockholders. Afterwards, Duke professor John Graham (whose work we've covered in this book) came up to me and said, 'That was a great presentation. You must have worked really hard on it.' I was crestfallen. I wish he'd have said, 'That was a great presentation. You must be a natural public speaker.' I wanted John to give me a 9D grade. But that would have been false, because I wasn't a natural at all. The only way I was able to give a coherent talk was because Merton JCR allowed me to keep chairing despite my initial incompetence, because the MIT Toastmasters Public Speaking Club helped develop me, and because I'd put many hours into rehearsing, recording and playing back that very talk even though I was tempted to lie to myself that I didn't need to work on it.

Embracing Failure

A recurring theme of this book is that the desire to avoid errors of commission may lead to far more serious errors of omission. In an enterprise context, such errors forgo opportunities to create social value. A company refrains from launching a new product because it fears failure, or from implementing new technology because it will lead to job losses and a media backlash. In a personal context, such errors forgo opportunities for individual development.

Growing up in England, my main family holidays were building sandcastles on the English seaside. When I was a teenager and we had a golden retriever, we'd go to the Lake District or Yorkshire Dales, where we enjoyed long ambles. So I'd never skied before I arrived at MIT for my PhD.

Every January at MIT they have Independent Activities Period (IAP). Rather than regular classes, they put on a vast range of free lectures and workshops on extra-curricular topics. I took courses on baseball hitting and Brazilian jiu-jitsu, as well as more cerebral ones such as the Israeli–Palestinian conflict and US race relations. At the end of IAP, the Graduate Student Council runs a ski trip. I'd never skied before, but my friends were going and – buoyed by having already learned other valuable skills during IAP, such as how to put someone in a choke hold (which hopefully will never turn out to be valuable) – I decided to go. I took a beginner's class on the bunny slopes before being let loose on the rest of Smugglers' Notch, Vermont.

Being a numbers nerd, I loved to have measures of success, to see whether I was improving. The easiest measure was the number of times I fell over. I'd keep a tally of my number of falls in the morning and then have a separate tally for the afternoon. If I fell fewer times in the afternoon than in the morning, that would be improvement. If I fell fewer times on Saturday morning than Friday morning, that would also be improvement.

But I quickly devised a way to manipulate the statistics – to 'hit the target but miss the point'. The easiest way to avoid falling, an error of commission, was to ski on the easiest slopes – a far more serious error of omission, as it missed the opportunity to challenge myself. Even if I got around this by forcing myself to graduate from the green (easy) to blue (moderate) slopes, I'd quickly figure out what the easiest blue slopes were and ski on them. And even if I tried to do a 'controlled experiment', by skiing on the same blue slope and trying to reduce the number of times I fell on the way down, I'd simply take more turns to lower my speed and avoid falling. *The absence of 'failure' was how I defined success.* At the end of each day, when we were back in the condo enjoying a warming beverage, we'd ask each other how our days had been. While my friends talked about the thrill of trying out a new run or jump, even if they ultimately failed, I'd excitedly tell them that I'd fallen fewer times in the afternoon than the morning (of course, pro-rating the statistics to take into account the different lengths of the morning and afternoon sessions, like a good MIT student).

My goal when skiing was not to fall. But that's crazy. People don't take up skiing to avoid falling – they do it for the thrill of skiing. Just like a leader shouldn't define a good year as one in which she's avoided negative press coverage, or an enterprise shouldn't measure the success of a new product primarily by the absence of customer complaints. Fortunately, I finally figured out the true purpose of skiing with one day left on the ski trip. I decided to try Snowsnake, the hardest blue run I'd come across so far, which, despite its name, was covered with ice. I fell countless times that morning. But each fall taught me something – I tried to pinpoint what I'd done just before the fall to trigger the wipe-out. This feedback loop helped me get a little bit better each time until finally I could ski down Snowsnake unscathed.

The importance of embracing failure applies to far more important issues than how to get maximum enjoyment from a ski trip. Any major personal or professional development opportunity – trying public speaking, switching into a new career, applying for an internal promotion, entering your first 5k race – requires a willingness to fail. It's hard to keep secret that you've put yourself forward for an internal promotion. If you don't get it, your colleagues will know you weren't good enough. Some might think you were too big for your boots by applying for it. In a 5k race, someone has to come last, and some don't even finish – and the results are easily searchable on the internet. Just like an enterprise, a citizen should be failing to hit some of his targets, otherwise he's not setting them high enough. But as J. K. Rowling said in her 2008 Harvard graduation speech,[12] 'it is impossible to live without failing at something, unless you live so cautiously that you might as well not have lived at all – in which case, you fail by default'. That failure by default is an error of omission.

Not only is a willingness to fail valuable ex ante, but the failures themselves are valuable ex post as they allow us to learn. As discussed in Chapter 10, a negative say-on-pay vote informs an enterprise about what investors object to – just like a fall on the slopes helped me identify what error I'd just made to trigger the wipe-out. Author Matthew Syed names this mindset 'Black Box Thinking', after the black boxes in aeroplanes that record the plane's movements and cockpit conversations.[13] These boxes allow authorities to investigate the cause of a plane crash, helping to prevent future disasters.

Black box thinking is painful. Rather than taking ownership of a failure and holding yourself accountable, it's tempting to blame it on external circumstances – a behaviour known as self-attribution bias. You can blame a poor 5k time on your job suddenly becoming more hectic in the week prior. Companies like to attribute poor performance to foreign competition or 'short-term' investors.

Part of the reluctance to admit mistakes and learn from them is due to the way society views failure. We often play a game of 'gotcha' – catch others doing things wrong – and call out mistakes. As Syed argues, 'We should praise each other for trying, for experimenting . . . If we only ever praise each other for getting things right, for perfection, for flawlessness, we will insinuate, if only unintentionally, that it is possible to succeed without failing, to climb without falling.'

Even if there's no one else you can scapegoat and you know that failure is down to you, it's still unpleasant to open the black box. People cringe when watching videos of them public speaking, or listening to recordings of them learning to sing. But, as is well known in medicine, diagnosis precedes treatment. Identifying your deficiencies is the only way to eradicate them.

Malcolm Gladwell's bestseller *Outliers* is often interpreted as suggesting that racking up 10,000 hours is sufficient to master a skill. But the research by Anders Ericsson and his co-authors, which the book cites, actually has a more nuanced conclusion.[14] What matters isn't just hours spent performing the activity, but what the researchers call 'deliberate practice', which they define as an activity 'rated very high on relevance for performance, high on effort, and comparatively low on inherent enjoyment'. Deliberate practice is uncomfortable as it involves going through difficult tasks where you're likely to fail, and then reviewing your missteps. Ericsson scrutinised the diaries of violin students at a Berlin music academy, comparing the best students, who'd go on to join one of the top symphony orchestras in Germany, with average students who'd later become teachers. Surprisingly, there was no difference in the total amount of time spent on music across the two groups, which included activities such as group practice, playing for fun (alone or with others), taking lessons or performing. The big disparity was that the best students spent more time in solo practice. Other researchers found that chess-playing ability was strongly related to the amount of time of solitary chess study and unrelated to the amount of time playing chess games.[15] And what you do in solo practice time matters. Another study discovered that elite figure skaters devoted more time to difficult jumps and spins they hadn't mastered; average ones preferred the comfort of routines they'd already perfected.[16]

While I had the wrong mentality to avoiding ski falls ex ante, learning from them ex post came a bit more naturally due to my chess background. In a chess game, you keep a record of every move. So, after a game, I'd typically ally with my former adversary in learning from it. We'd replay the game and teach each other what we could have done better. When I was a kid, recording chess games was easy as you only needed pencil and paper, but recording other activities was much more difficult. We didn't have waterproof smartphones that could video your swimming stroke. Now we have the technology to record and replay our weaknesses in almost any activity, but we often lack the mentality.

Service

Throughout this book, we've stressed how enterprises should serve society – but shouldn't do so in an undisciplined manner and ignore profits. Chapter 3 introduced three principles – multiplication, comparative advantage and materiality – to guide leaders on whether to make investments in stakeholders.

The same principles can also guide a citizen in serving others. He might receive numerous requests to volunteer for non-profits, give pro bono talks or offer career advice to a friend's children. But he shouldn't ignore the impact on his own time. Just as these principles guide investment decisions when resources are limited, they can also guide people on how to serve effectively when time is limited.

Let's start with the analogue of the *principle of multiplication*. For enterprises, this means taking an action that creates more value for stakeholders than it costs the firm. Applied to service, this involves giving *gifts of unequal value* – taking an action that creates more value to the recipient than it costs you.[17] We introduce a different term because thinking about service as giving gifts changes our attitude to it. Often, service is reactive. Generous people donate when their co-workers ask for sponsorship for a charity challenge, and they lend a hand when friends ask for help moving house. But it's a different mindset to serve proactively and think what gifts of unequal value we can bless others with.

One evening at university, I had an unremarkable pizza dinner. We'd ordered one too many pizzas, so my friend Stephen asked to box it up. I thought he was going to take it home and eat it cold the next day, as many students would. But he took us on a walk round Oxford, giving slices of pizza to the homeless.

Now each slice of pizza was a gift of unequal value, worth more to a homeless citizen than a student. But that's not what this story is about. Stephen didn't just give the pizza to the homeless; he talked to them. The homeless are people we often ignore – we try to avoid making eye contact, let alone talk to them, in case they're so bold as to ask us for aid. By recognising them as a fellow human, Stephen gave them a gift of unequal value. I remember the lady he gave the final slice of pizza to. He asked her name, and over twenty years later I can remember it – Janice. Even on Janice's best days, when dozens of people threw coins into her coffee cup, maybe no one would have asked her name. Stephen did.

Many citizens gave gifts of unequal value in the pandemic. Just like a responsible leader, they asked themselves 'what's in my hand?' – what resources they had that were worth more to others than to themselves. For some, these resources were time. Citizens signed up to the volunteering platform SpareHand, matching them with vulnerable neighbours who they could do grocery shopping for. For others, these resources were money. One friend advance-purchased 100 coffees from his local coffee shop, supplying them with a liquidity lifeline. For others still it was words, which are often seen as vacuous compared to 'hard' actions or financial contributions. But telephoning someone who is self-isolating alone, or giving a sincere thank you to an overworked delivery driver, was as powerful as Stephen asking Janice her name.

The pie-growing mentality is again key to such behaviour. Good citizens help others when asked – they'll assist a friend moving house or sponsor a colleague's half marathon. Great citizens actively think about how they help without even being asked, constantly being on the lookout for ways to grow the pie and engaging in problem-finding rather than just problem-solving.

Let's now turn to the *principle of comparative advantage*. We often think that front-line activities, where you get your hands dirty, are the ultimate form of service – such as helping in a homeless shelter. But as stressed in Chapter 8, excellence is the best form of service, and we're most likely to be excellent in activities we have a comparative advantage in. If you're skilled at bookkeeping, managing a homeless charity's accounts may be more effective than serving in the shelter.

Finally, the *principle of (intrinsic) materiality* highlights the importance of serving stakeholders that we're particularly passionate about. While this may seem obvious, it's easy to be drawn into issues due to their severity or public perception. A homeless shelter may seem more worthy than your school's charitable foundation, but the latter may be more material to you if you feel a tight bond with your school.

Applying these principles might seem formulaic for something such as service, which should be natural and from the heart. But doing so creates freedom. You have the liberty to turn down service requests without any sense of guilt, recognising that there are other people out there more talented and more passionate than you in these causes. Doing so allows you to focus on the sweet spot, where the three principles overlap and you have a profound effect in helping others in an area you care deeply about.

Shaping Culture

While CSR typically focuses on 'do no harm' by reducing negative externalities, one theme of this book has been the importance of 'actively doing good' by creating positive externalities. A second topic has been the power of agency – the ability of individual citizens to influence even large corporations. These two themes are linked – the acts of service discussed in the previous section can have a multiplicative effect by changing the atmosphere and inspiring others to do the same.

In April 2020, shortly after the UK went into lockdown due to the pandemic, Captain Sir Tom Moore started to walk laps of his garden to raise money for the National Health Service. He hoped to reach £1,000 by his 100th birthday 24 days later, but ended up surpassing £30 million. And more than that, his efforts inspired a nation and encouraged others to fundraise themselves, or help out by buying groceries for vulnerable neighbours. On a smaller scale, hearing that a friend or colleague signed up to SpareHand encouraged others to do the same.

What caused this? It's unlikely that everyone used to be selfish and then suddenly became selfless in the pandemic. Instead, the actions of a small number of citizens unleashed the inherent, but sometimes dormant, altruism in others. One person inspiring even a few friends into acts of service led to them influencing their own contacts, eventually creating a tipping point.

This idea can apply to many settings beyond the pandemic. A citizen can 'be the thermostat, not the thermometer' – shape culture rather than simply reflect it, just as a thermostat controls the temperature while a thermometer measures it. Some companies seem cut-throat and competitive, and the culture is so deeply rooted that it appears impossible to change. However, it's unlikely that all, or even most, employees are actually cut-throat. Instead, there's likely a 'silent majority' who'd like to be collaborative, but they're indeed silenced by the behaviour of a few senior executives. But the actions of even a junior employee may be able to activate this silent majority.

In an investment bank, perhaps the most mistreated department is Creative Services, sometimes known as Graphics. Analysts (the lowest rank of banker) give them handwritten mark-ups of PowerPoint presentations to implement – for example, to turn some data into pie charts. Often analysts shout at them for not doing what they wanted – even though it's usually their fault for not explaining it clearly enough. If I received high-quality work from Creative Services, I'd call up the front desk, ask to speak to the graphic designer who worked on my job and thank her. I didn't aim to do this ostensibly but, because I was so junior, I didn't have my own office – instead, my desk was in the middle of the floor. So other analysts heard me, and started to thank Creative Services themselves. Thus, even the most junior person in a department may unexpectedly have power to influence culture.

Career Choice

A pie-growing enterprise is driven by purpose rather than profits, yet ultimately becomes profitable by doing so. The same approach can be applied to choosing your career. By selecting a vocation that serves a purpose rather than one that's lucrative, a citizen can ultimately become not only more fulfilled, but also more financially successful. This final section is primarily aimed at readers about to start their career or contemplating a career switch. But it may also be of value to those who don't intend to change jobs, but have the flexibility to weight different priorities in their current position.[18]

We've used Apple as an example of a pie-growing company driven by purpose. Yet arguably the most famous speech by Steve Jobs, Apple's founder, was on personal purpose. As he explained in a 2005 graduation speech at Stanford University: 'You can't connect the dots looking forward; you can only connect them looking backwards. So you have to trust that the dots will somehow connect in your future. You have to trust in something – your gut, destiny, life, karma, whatever.

This approach has never let me down, and it has made all the difference in my life.'

One way to make career decisions is to reduce them to an instrumental calculation. When deciding a job after university, think about not only that job's current salary, but also how it may open the door for future positions. Taking a job in fintech may pay a lower starting salary than joining an investment bank, but the future upside could be higher. When deciding which non-profit board to join, think about which one will boost your profile the most, based on the public visibility of the non-profit and the clout of the other board members. In other words, you map out your future career – your future dots, with each one being a stepping stone to the next.

But this approach doesn't always work in practice, because it's very difficult to see where a stepping stone will lead to next. Jobs instead advocated the counterintuitive, and seemingly short-sighted approach, of stepping onto the stone that just feels right at the time. The stone may simply be beautiful to stand on, even though you don't know where it will lead. As Viktor Frankl wrote in *Man's Search for Meaning*: 'Don't aim at success. The more you aim at it and make it a target, the more you are going to miss it. For success, like happiness, cannot be pursued; it must ensure, and it only does so as the unintended side effect of one's personal dedication to a cause greater than oneself or as the by-product of one's surrender to a person other than oneself.'[19]

The idea of choosing a career based on purpose is well known, almost to the point of becoming clichéd. It also appears unrealistic and impractical. It seems unrealistic because, while it preaches well from the pulpit when you're the Apple CEO and a multi-billionaire, most people have families to support and loans to repay. They can't cheerfully ignore financial motives in a carefree pursuit of purpose. But we'll show that some lucrative careers, maligned by the public, can also be deeply purposeful. Following your purpose may seem impractical because many people don't know what their purpose is.

But we can turn this idea into something concrete and actionable by using the same framework we introduced in Chapter 8 for defining an enterprise's purpose.

Recall that an enterprise's purpose involves two elements – *who* it exists for, based on the principle of materiality, and *why* it exists, based on the principle of comparative advantage. These two elements also apply when discerning a citizen's purpose.

The *who* is relatively easy to decide. Business materiality doesn't have an analogue for individuals, but intrinsic materiality does – which stakeholders a citizen is particularly driven to serve. A lawyer might view refugees as more important than companies and so enter human rights rather than corporate law. Someone with a heart for the environment might work for a charity, go into politics or join a company with a material impact on the environment and change it. But the *who* still leaves many questions unanswered. Let's say you've defined the *who* as children. There are many ways of serving them: paediatrics, teaching and social work. The *why* is more complex, and what we'll focus on.

The *why* is based on the principle of comparative advantage, which involves both talent and passion. The former is relatively easy to identify, the latter far more difficult. 'Pursue your passion' seems as nebulous as 'serve a purpose' – how can you do this if you don't know what your passion is? For some careers, passion might be obvious. We can easily imagine how Roy Vagelos might have been inspired when he heard Merck chemists talk about developing drugs at his family's diner, and chosen a career in science. But for other industries such as food delivery and transport, the passion may be less obvious – even though, as discussed in Chapter 8, these industries can create substantial value for society.

Again, we can create a framework to break the idealistic advice to 'pursue your passion' into something concrete. Let's say you've decided that the *who* is to serve enterprises, because you believe they can be a force for good in society (intrinsic materiality). What's the way you'll serve them? We'll illustrate this framework using finance and consulting careers, rather than working directly for a company, because these careers are particularly viewed as non-purposeful.

This framework involves three questions. The first question is: *Where do you see yourself in ten years' time?* Now this seems as unoriginal as the idea of 'pursue your passion'. Most people think they know the answer – perhaps Managing Director of an investment bank, Partner at a consulting firm or Principal of a private equity fund. But this question doesn't ask you where you see yourself in terms of your job title. It asks what will make you tick, what will wake you up in the morning, what your days will be like. Because a career, if it's to be truly fulfilling, isn't about what you do; it's about who you are. Many people do get to the top. But many haven't taken the time to ask this question before they start out, so they reach the summit and realise they've climbed the wrong mountain.

Let's make this concrete. Say you'd like to be Managing Director of an investment bank or Partner at a consulting firm. That's your job title. Who you are is a trusted advisor. Your clients will come to you with their biggest problems. Perhaps they're in financial difficulty and ask you whether they should issue equity, raise debt, cut the dividend, sell a division or put the entire company up for sale. They trust you to give the advice that's best for them, rather than what will earn you the highest fee.

Only go into investment banking or consulting if being a trusted advisor is who you are. Perhaps you're the person who friends turn to when they need candid advice on an issue. You have a reputation for telling them what they need to hear, not what they want to hear, and keeping it confidential. And you love serving your friends in this way. Or, in a study group at university, you were the one willing to have tough conversations with other group members who weren't pulling their weight. Others find these conversations awkward, but they're second nature to you. Then you're the sort of person who should go into banking or consulting.

Or say you'd like the job title of private equity Principal. Who you are is an investor, someone who finds undervalued assets. During the day, these undervalued assets are businesses that are unloved by their current owners – so much so that they want to sell them. You see potential in them that no one else sees. You're willing to put your money where your mouth is and invest in them. And you put in more than just money, but also the time and effort to turn them around. Outside of the office, these undervalued 'assets' might be people – the unemployed who you can invest in by funding a job-coaching programme, or local children who you can support by endowing a scholarship at a school. And you don't just throw money at them, but get your hands dirty by serving as a school governor. In an amateur sports team, you might be willing to coach a new player who doesn't immediately hit the ground running, rather than benching her or making her feel unwelcome so that she quits the team. All these investments take patience, which not everyone has – but many of the best investors, like Peter Lynch and Jeff Ubben, are willing to take long-term perspectives.

Only become a private equity investor if being an investor is who you truly are – if your passion is uncovering undervalued assets (both businesses and people) and working with them to fulfil their potential. If your passion is more finding undervalued assets than turning them around, you might be more fulfilled running a mutual fund, and exercising stewardship through monitoring rather than engagement.

The second question is: *What do you do in your spare time?* What you voluntarily choose to do conveys what you're passionate about. This question might seem unrealistic, since many citizens like to play sport or music, but are unlikely to become professional athletes or musicians. But pastimes are more informative than you might think.

The most common question that I get asked by students interested in finance is whether to start on the sell-side or the buy-side. To most people, the buy-side is the place to be. When

I was in investment banking, the dream was to be called by a headhunter who'd move you into private equity. In sales and trading, you longed for the day when you'd be approached by a hedge fund. And the buy-side is the right place for many people. But there are far more people whose purpose is on the sell-side than commonly thought, because their passion is selling, and this is revealed by their pastimes.

Some business school students lead treks to their home country over the holidays, giving up the chance to explore a new land. Why? Because they love selling their country. Others captain sports teams, where they teach the activity to newcomers. Teaching has many similarities to selling – explaining complex concepts in clear language and making it engaging.

Others still might not captain sports teams, but they may play in one, or play in a band. This involves an element of 'tribalism' – being part of a small team, where you truly care about every team member, and you take your tribe on the road with you. Bruce Springsteen was once asked what continues to motivate him, as he's already sold millions of records and played Madison Square Garden countless times. He replied that it was being on stage with Clarence Clemons, his saxophonist. When Clarence plays a sax solo, he's proud simply to share the stage with him – even if Bruce is silent and getting none of the applause at that moment. As Bruce said in his eulogy of Clarence, 'Standing next to Clarence was like standing next to the baddest ass on the planet. You were proud, you were strong, you were excited and laughing with what might happen, with what together, you might be able to do.'

And that's what you get on the sell-side. Just like a band going on tour, or a sports team playing in an away game, on the sell-side you take your team – your tribe – to a client to deliver a pitch. One day you might head that team, and not give the entire pitch yourself, but choose an analyst or associate to present part of it. She nails it. You get the same pride as Bruce did when he was just passively watching Clarence play his solo.[20]

The third question is: *What are your values?* Values are what you centre your life around, how you aim to touch the lives of others and what you'd like to be remembered by. In *The Road to Character*,[21] David Brooks calls these 'eulogy values', since you'd like them to be read out in your eulogy – in contrast to 'resume values' that can be put on a CV. Then, having clarified what's important to you, you can find a career that roughly lines up with these values. As Harvard economist Greg Mankiw wrote, 'The secret to a happy life: find out what you like to do, and then find someone who will pay you to do it.'

Now that might seem completely unrealistic. There's a popular view that the most lucrative careers are the most valueless ones, but this is an unfair caricature as we've discussed. There are many lucrative careers which line up with several eulogy values, just as an enterprise that serves society can still be profitable.

The value 'I will always be trusted to tell the truth' lines up with an advisory vocation. One of the potential downsides of a career in banking or consulting is that it's hierarchical. But for people with the value 'I will always respect authority', this is an attraction, not a downside, as they appreciate a clear chain of command. That's why my students with military backgrounds have typically liked the hierarchical aspect of advisory careers. But others, who have the value 'I always want the freedom to be my own boss', might find this career difficult at the start.

In Stephen Covey's book *The 7 Habits of Highly Effective People*, Habit #2 is 'begin with the end in mind'. Covey recommends not only deciding on your purpose, but also writing it down in a personal mission statement. Oprah Winfrey's is: 'To be a teacher. And to be known for inspiring my students to be more than they thought they could be.' Virgin Group founder Sir Richard Branson's is: 'To have fun in [my] journey through life and learn from [my] mistakes.' Other mission statements, including many by ordinary people, can easily be found online for readers who'd like additional examples for inspiration.

Just like an enterprise's purpose involves trade-offs, so should a citizen's. The mission statement must be short and can't contain everything. Anything left out of the mission statement is deprioritised by default. But the more concise the mission statement, the more it helps with Covey's Habit #3, 'first things first', which is about time management and prioritisation. So personal purpose can guide not only a career switch, but also what duties to focus on in your current position. If everything is in your mission statement, it provides no guidance on prioritisation – just like if an enterprise's purpose contained all stakeholders.

I define my professional purpose as 'to use rigorous research to influence the practice of business'. This is a commitment to disseminate as well as create knowledge, and to disseminate others' research rather than just my own. But it's also a commitment not to do certain things, such as responding to media requests for comment on general economic topics. Even if I can come up with something semi-intelligent based on broader economic intuition, and even if the media outlet is prestigious, it's precluded unless I have specific research expertise. It also means that I can't go to as many academic conferences and seminars as in the past. While I enjoy them, there just aren't enough hours in the day to be able to interact with businesses as well. My co-authors might just as effectively be able to present our joint work, and my comparative advantage might lie elsewhere.

Purpose is what binds together the members of an enterprise and inspires them to go above and beyond what's required in the contract. It encourages them to create value for society and contribute to human flourishing, without doing an instrumental calculation of whether they'll ultimately benefit – but the enterprise typically ends up more profitable as a result. And purpose is what inspires a citizen to view a job as a vocation, pursued because of an intrinsic calling rather than to earn a living. Yet being fuelled by purpose ultimately leads to greater success. He doesn't see his job as work, but an opportunity to use his talents to solve problems that he's deeply passionate about, and so he goes above and beyond what's required by the employment contract. Purpose is aspirational, but not nebulous, and both enterprises and citizens can ask themselves concrete questions to find out what their purpose is – and then put it into practice.

In a Nutshell

- Game theory shows that, while cooperation can lead to all parties being better off, the gains from cooperation may be unequal. Concerns with equality may lead to a player rejecting cooperation and shrinking the pie, even if he is worse off as a result.
- Many real-life situations are win-win. The other player should be seen as your ally, not your opponent.
- The *law of comparative advantage* states that all countries can gain from international trade – even less productive ones. But concerns that the gains are split evenly can lead to countries restricting trade. Other countries reciprocate, and all countries end up worse off.
- Like trade, technology has the potential to either cause substantial job losses or grow the pie for all, including workers. Doing so requires leaders to redefine jobs away from those that are substituted by technology to those that are complemented by it, and governments to fund lifelong education.
- In interpersonal dynamics, cooperation to improve company performance typically benefits all divisions, even if some gain more than others. It's a leader's responsibility to design reward and evaluation systems that create win-win situations for colleagues and encourage the collaboration necessary for pie growth. Outside of a work setting, 'givers' who help others are more successful in the long run.
- Just as the pie-growing mentality sees the pie as expandable, the *growth mindset* sees your skill set as augmentable – but only through deliberate practice.

- Success shouldn't be defined as the absence of failure. In contrast, we should expect failure if we are avoiding errors of omission and setting goals high enough, and can use the learnings from failure to grow.
- In service, the *principle of multiplication* advocates giving *gifts of unequal value*, worth more to the recipient than it costs the giver. The *principle of comparative advantage* means that citizens need not always occupy the most front-line roles. The *principle of materiality* suggests serving on issues that matter most to the citizen rather than those seen as most worthy by the public. Together, these principles give freedom to selectively choose service activities rather than feeling pressured into accepting all requests.
- An individual has much more power to shape culture than commonly thought. One person's actions can activate the 'silent majority' – others that have similar values but previously felt they were in the minority. A citizen can view himself as a thermostat that affects the temperature, rather than a thermometer that passively reflects it.
- Citizens should choose a career based on purpose and see financial rewards as a by-product, just like enterprises. As with enterprises, purpose depends in part on intrinsic materiality and comparative advantage, of which passion is a source.
- Passion is not a nebulous concept, but can be made concrete by asking three questions: where you see yourself in ten years' time (in terms of not what you do, but who you are), what you do in your spare time and what your values are.

CONCLUSION

We started this book by acknowledging the severe crisis that capitalism faces. In the eyes of millions of citizens, it's a rigged game. Corporations exist to line the pockets of executives and investors, paying scant attention to worker wages, customer welfare or climate change. Those lucky enough to be running businesses or investment funds see no need to change, as they're protected by market power, and can further entrench themselves by lobbying. Even worse, many see no responsibility to change, as they delude themselves that their social responsibility is to maximise profits.

That's why we have a crisis. Citizens and politicians can't just hope for the system to reform itself – many believe it's inherently broken. They argue we need a new system, and so there are serious proposals to overthrow capitalism as we know it by breaking up or nationalising large companies, regulating executive pay and share buybacks, and wresting the control of businesses away from shareholders.

But such reforms risk stifling the many positive contributions that enterprises make to society. Viewing capitalism as the enemy may be electorally popular, and mobilise voters around a common adversary, but throws away the substantial opportunities to partner with business to harness it for social good. It also ignores the crucial role that profits play, in providing ordinary citizens with a return on their savings, funding an enterprise's investment in its workers or encouraging a leader to swing for the fences on a new idea. So what we need is a solution that works for, and involves, *both* business *and* society.

That's what this book has been about. It's shown that such a solution exists – and importantly it lies within the current system, so doesn't involve taking a wild bet on the unknown. It's backed up by the rigorous evidence in the most stringent peer-reviewed journals, and complemented by concrete examples of how it can be successfully put into practice, rather than being an abstract idea. So, in the light of the major challenges that both capitalism and society face, we have genuine hope.

This solution is the pie-growing mentality. When an enterprise is run with the primary purpose of creating value for society, it isn't sacrificing profits and redistributing a fixed pie. Instead, it expands the total value that it creates, benefiting investors as well as stakeholders. Indeed, this approach 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 regulation or public unrest. 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.

The pie-growing mentality is freeing, as companies can make long-term investments without having to justify them by calculating their profit impact – a calculation that's often futile because this impact is hard to predict. But it's also focused, rather than a free-for-all. We've provided principles that leaders can use to discern which projects to undertake and which to rein in. Purpose isn't just a lofty mission statement, but provides a clear direction to help navigate difficult decisions. It's a commitment for leaders to follow through with action, even if it involves closing down a profitable division, and hold themselves to account by reporting on progress.

Just as a pie-growing enterprise aims to create value for all of society, so all of society has a role to play in instilling the pie-growing mentality in enterprises. Investors can play a major role through stewardship – having a deep understanding of a company's long-term value, sticking with it when others are rushing for the exit, but also not being afraid to sell or engage if it's mortgaging its future, regardless of how enticing short-term profits are. Employees have both the power and responsibility to ensure that purpose filters through to ground level and to make innovations of their own. Customers can walk away from a company, no matter how attractive its products, if they don't share its values. Citizens can influence policymakers to take an evidence-based approach to reform that considers the benefits of business as well as its costs.

Major change is already happening. Even though there are some high-profile cases of pie-splitting companies, a careful look at all the evidence shows that many others are quietly creating value for all members. Enterprises who treat their employees as colleagues, genuinely implement sustainability policies or invest in their material stakeholders end up more profitable in the long run. Those who make their leaders long-term owners deliver greater value to both shareholders and stakeholders. Investors who vote for proposals aimed at benefiting stakeholders end up themselves benefiting.

So any company or investor that embraces the pie-growing mentality isn't swimming against the tide or going it alone. They're instead riding on the tailwinds of evidence and joining a much broader movement of peers taking very seriously their responsibility to society and attempting real change. They don't need to put their trust solely in statistics and regression coefficients, but can take guidance and learn from aspirational examples. We saw how Merck – as early as the 1940s – developed penicillin to save people's lives, even though there was no clear profit stream at the time, and now donates ivermectin annually to 300 million of the world's poorest citizens suffering from river blindness. We learned how Vodafone pioneered a mobile money service to the unbanked, lifting 196,000 Kenyans households out of poverty. We observed how Barclays shut down a £1 billion revenue stream and CVS Health stopped selling a $2 billion product because they were inconsistent with their purposes.

These may seem lofty examples to follow. Not everyone has the power to develop a Nobel Prize-winning medicine, launch a new technology or close an entire business line. But pies can be grown with incremental, but continuous, sprinkles of flour. The New Belgium Brewing Company started by simply acknowledging its negative environmental impact, which inspired its colleagues to think of ways to mitigate it. Marks & Spencer reported its impact on various stakeholders and set itself targets, which united stakeholders around a common cause. The Weir Group didn't change its purpose statement or business model, but instead recognised the importance of rewarding its leaders according to the long term – and at the same time allowed all its colleagues to share in its success.

Beyond these examples, there are large and influential organisations allowing enterprises and investors to share best practice, develop frameworks to shape discussions and reforms, and collaborate on implementing change at an industry- or economy-wide level. Focusing Capital on the Long Term has established a roadmap to guide conversations on long-term issues between companies and investors. The Purposeful Company has applied the best academic evidence to devise practical reforms to corporate governance, executive pay and stewardship. The new Value Reporting Foundation is harmonising frameworks and standards for the reporting of social performance. The UN Principles for Responsible Investment Collaboration Platform, the Canadian Coalition for Good Governance and the UK's Investor Forum help shareholders engage collectively for the common good, rather than viewing each other as a benchmark to be beaten. The New Citizenship Project works with companies to mobilise their customers as citizens. Resources are increasingly abundant and momentum is strong.

Leaders of today's companies are in a privileged position, as technology and their global reach give them more power to create social value than arguably ever before. Investors running today's funds have larger pots of capital and stronger shareholder rights than ever before, to hold companies to account for delivering both purpose and profit. And citizens have greater agency than ever before, with our ability to rally campaigns or provide public feedback on a company – or, at a personal level, to seek win-win in our interactions. It's up to all of us, together, to use this power to create a form of capitalism that works for all of society. We have the evidence to back us, the examples to inspire us and the tools to put it into practice. Let's make this vision a reality.

ACTION ITEMS

This section provides practical suggestions for acting on the ideas of this book. I've categorised them into ideas for leaders, boards, investors and citizens. Since many of the book's principles apply across several members of society, some ideas appear in more than one place, and ideas in different sections may still be relevant for a particular member.

Leaders

Define the Purpose of Your Enterprise

- Describe why your enterprise exists – its reason for being and the role it plays in the world – guided by the principle of comparative advantage. Explain who your enterprise exists for – which stakeholders are the first among equals – guided by the principle of materiality.
- Ensure that the purpose is focused and selective – that it does not try to be all things to all people, but acknowledges the inevitability of trade-offs and its role in helping navigate them. Recognise that a purpose can be powerful by what it leaves out.
- Seek input from colleagues and external stakeholders, such as customers. Once a purpose is formulated, ensure that it is clear, but not rigid, allowing it to evolve in response to changing conditions.

Communicate the Delivery of Purpose

- Formulate a broad set of metrics that track whether your company is serving its purpose. Set long-term targets for

each metric and report on progress. Consciously decide not to track certain metrics if they may be manipulated or misleading.
- Use narrative reporting to add meaning and context to the numbers. For example, explain why certain metrics are off-target and the remedial actions taken; supplement headcount and turnover data by describing your company's efforts to recruit, retrain and train high-quality colleagues.
- Extend beyond impersonal, one-way reporting to personal, two-way communication. Hold meetings with investors and 'town halls' with employees and external stakeholders, so that all can keep you accountable for the delivery of purpose, as well as share their ideas.

Embed Purpose into Your Enterprise

- Scrutinise whether the enterprise's strategy is consistent with its purpose. Does every major product or service truly create value for society, and does its production cause unnecessary harm to some stakeholders? Does it still have a comparative advantage in each business or instead own them for legacy reasons?
- Align the firm's operating model and culture with its purpose. Be uncompromising about the quality of processes particularly central to the delivery of purpose. Verify that cultural fit plays an important role in hiring, promotion and retention decisions.
- Track how employees, teams and projects are performing on purpose-related dimensions. Ensure this information enters significantly into employee evaluation and reward. Make this data available to colleagues to empower them to make better decisions.

Cultivate a Spirit of Excellence and Innovation

- Ensure that the enterprise serves society not only through ancillary 'CSR' activities, but primarily through excellence in its core business. Allocate headcount, financial resources and your time to the businesses where your company has greatest comparative advantage and affects its most material stakeholders.

- Apply standards of excellence to investment decisions. Stop existing projects, and do not start new ones, if the financial and societal returns are only mediocre. Reallocate the capital to your core business or, if all good investment opportunities have been taken, pay it out to investors.
- Recognise the seriousness of errors of omission. Continually strive for improvements and take risks on untested ideas – particularly if they serve a societal need and even if the revenue stream is not yet clear. Ask 'what is in my hand?' – what resources and expertise does my enterprise have and how can we use them to serve society? Ensure colleagues have the freedom to innovate without requiring excessive approvals or fearing failure.

View Stakeholders as Partners in the Enterprise

- Empower employees with decision-making authority and be comfortable that this may lead to errors of commission. View them as sources of ideas rather than as simply ways to execute your ideas. Mobilise the citizenship potential of customers – for example, by actively seeking their input or working with them to reduce your environmental impact.
- Invest in workers' skills and well-being. Anticipate which colleagues are likely to be displaced by technology or competition, and proactively retrain them. Monitor employees' mental and physical wellness and take pre-emptive action if needed. Create a culture where all managers, including you, internalise the effect of extra work on their team.
- Consider giving shares to all employees, so that they become financial partners in the company and enjoy the fruits of its success.

Boards

Own the Enterprise's Purpose

- View purpose as the responsibility of the full board. If the enterprise has a purpose statement, consider asking all board members to sign it.
- Consider establishing board sub-committees responsible for major issues relevant for the firm's purpose, such as innovation, human capital or environmental impact.
- Ensure substantial time on the meeting agenda is allocated to purpose, and that strategy away days are anchored to purpose.

Monitor the Enterprise's Delivery of Purpose

- Require management, when presenting any major decision for approval, to explain how it is consistent with the firm's purpose. Critically evaluate this alignment.
- Verify the enterprise's purpose statement remains relevant today, given its current comparative advantage and the materiality of its different stakeholders, rather than being a legacy.
- Scrutinise the metrics the company is using to measure progress, and ensure these are the relevant ones. Have conversations with leaders beyond the metrics – what is behind the trends, and what dimensions they are particularly seeking to improve. Ask for examples of where purpose has caused them to make different decisions.

Make Leaders Long-Term Owners

- Pay executives with equity that they must hold for the long term, including after their retirement. Verify that the holding periods are appropriate given the industry cycle and the length of time it takes for a leader's actions to fully affect the stock price.
- Watch out for potential short-term behaviour – errors of omission such as the failure to launch

new projects, or errors of commission such as cutting investment – in periods where the CEO has significant equity vesting.

- De-emphasise complex bonuses based on quantitative targets, and consider removing performance conditions for equity that may lead to short-termism.

Engage Routinely with Investors

- Regularly meet with investors as a matter of course, not just in times of crisis. View investors as a source of ideas, rather than only a source of challenges to respond to. Ensure that some meetings take place without executives, to allow investors to express their candid opinions on leader performance.
- Hold 'Stewardship & Strategy Forums', jointly with executives, that can be attended by all large investors. Ensure these events are focused on long-term factors such as strategy, innovation and human capital development.
- Actively seek investors that align with your purpose, and consider giving investors a say-on-purpose vote. If so, ensure that this vote is only one outcome of a broader dialogue with investors on purpose.

Understand the Business at Ground Level

- Walk the 'shop floor' of an enterprise, through structured visits, to talk with employees at different levels and in different locations. Learn what inspires and frustrates them about the company.
- If the enterprise has retail customers, make unannounced visits to a retail location to understand the customer experience first-hand.
- Supplement personal visits with the insights of stakeholder panels that capture the perspectives of key stakeholders, such as customers and colleagues, more broadly. Ensure the insights learned translate into action.

Investors

Since investors, like boards, monitor enterprises, many of the action points for boards also apply to investors. In addition, since investors are enterprises themselves, many of the action points for leaders are similarly relevant. This section provides additional ideas tailored to investors.

Define Your Purpose and Approach to Stewardship

- Define your purpose – how you aim to generate long-term returns to savers – and your approach to stewardship. Recognise that more stewardship is not necessarily better; instead, ensure that your approach to stewardship is aligned with your purpose and comparative advantage.
- For engagement, clarify your key engagement priorities and how you intend to pursue them – for example, through voting, private meetings or public activism.
- For monitoring, highlight the dimensions of performance that you will particularly scrutinise. Formulate a divestment policy for what will cause you to sell a holding.

Embed Stewardship into the Investment Process

- If the fund is actively managed, ensure that every position is a conviction holding – whose long-term story you either believe in or believe you can turn around – rather than held because it's part of the benchmark.
- Pay fund managers with significant stakes in their fund, which they must hold for several years.
- Devote substantial resources to stewardship and integrate them into the investment process. Ensure that voting and engagements are jointly led by the stewardship team and fund managers rather than delegated to the former.

Communicate the Delivery of Stewardship

- Select metrics that are relevant to your stewardship policy (such as your voting record, including frequency of votes against house policy and proxy advisor recommendations) and report them. Consciously choose not to report certain metrics if they may be misleading, and explain why you are not doing so.

- Undertake narrative reporting – for example, how you are ensuring that stewardship is integrated into the investment process and how fund managers are incentivised. Provide case studies of engagement or divestment.
- Hold regular meetings between asset owners and asset managers to discuss stewardship performance. Ensure that asset managers understand asset owners' particular stewardship objectives and expectations.

Practice Informed Voting

- Consider formulating a house voting policy, informed by a stakeholder roundtable or advisory committee, and publish it. Anticipate the situations where the house policy may not be applicable, and ensure that the policy is not automatically followed in these circumstances.
- Develop a policy for the use of proxy advisors. Ensure that their recommendations are only one input into the vote, particularly if strategic judgment is required. Understand proxy advisors' evaluation methodologies, to know when to be particularly cautious of their recommendations.
- View the vote as only one engagement tool and part of a broader process. Express concerns to management before a proposal is put on the table, rather than only voting against it after the fact. Communicate the reasons for your vote to management and, if appropriate, to the public.

Engage Routinely with Executives and Directors

- Regularly meet with executives and directors as a matter of course, not just in times of crisis – but ensure such meetings are purposeful rather than simply 'activity'. Use these meetings to have a two-way dialogue on long-term factors, to both provide insights and remain informed about them. Refrain from micromanaging the enterprise.

- Involve other investors in engagements, viewing them as partners rather than a benchmark to be beaten. Consider joining a collective engagement organisation if available. Participate in industry-wide engagements – for example, to encourage all companies in a sector to report certain metrics.
- Have an escalation mechanism for when engagement fails, such as divestment or public confrontation. Ensure that it is used only as a last resort, but also that it is used when appropriate.

Monitor a Company's Long-Term Value

- Ensure that trading decisions are based not on short-term earnings, but an assessment of an enterprise's long-term value. Use ESG metrics to build the case for an investment, but not to be the case. Recognise that many key dimensions of social performance can't be quantified, and supplement data with meetings with management.
- Ensure that retaining a stake in a company is an active, rather than a default, decision. Evaluate whether it is creating long-term value for society, and either engage or divest if it is not.
- Consider forming an external advisory committee, to help evaluate intangible factors that require specialist expertise. Use these insights to inform both investment in specific stocks and general themes, such as which sectors to overweight and avoid, and what topics to prioritise in engagement.

Citizens

As Colleagues, View Yourselves as Having Agency, Regardless of Your Position

- Empower, invest in and reward employees that report to you. Even if you are the most junior worker in your team, practise these attitudes when interacting with other departments.

- Recognise that you have far more agency than you may think. Resist the temptation to default to your formal job description and be bold in suggesting and trialling new ideas. Manage up: question why something is done in a particular way, and whether it can be done better or not at all. Make your superiors aware of other work and non-work demands on your time to reduce the risk of burnout.
- Be willing to leave (or not to join) a company that fails to match your values and is unresponsive to engagement.

As Customers, Adopt a Citizen Rather than Consumer Mindset

- Decide on your values and ensure they have a significant effect on your purchase decisions. Use values comparison websites and apps to facilitate this.
- View yourself as being a member of the enterprise and part of a customer community. Provide constructive feedback, including suggestions for improvement, to companies or customer review websites. Consider joining campaigns to change a company's behaviour.
- Engage in responsible ownership of a product after purchase – for example, by participating in company initiatives to recycle or repair damaged products.

Keep Informed Using the Best Available Evidence

- Evaluate a company (for example, as a potential customer or employee) using a pie-growing, rather than pie-splitting, mindset. Consider not how much investors or executives earn, but whether these earnings are a by-product of creating value for society.
- Be mindful of confirmation bias. Recognise that there are two sides to (almost) every issue, and actively seek arguments or evidence contradicting your viewpoint. Place greater faith in balanced rather than one-sided opinions.

- Beware of the phrase 'research shows that . . .'. Check whether a study has been published before believing it. If so, see if the journal features on a list of the most rigorous publications or instead a blacklist. If not, examine the credentials of the authors, such as the quality of their institution and their track record.

As Regulators or Voters, Engage in Diagnosis before Treatment

- Before passing or supporting a regulation, investigate whether a problem is large-scale or confined to a few high-profile cases. Critically evaluate large-scale evidence using the above guidelines.
- Consider whether a potential policy has been implemented elsewhere, and examine the most rigorous evidence on its effects. As a voter, support politicians that take an evidence-based approach.
- Contemplate whether a regulation might lead to companies engaging in manipulation to satisfy it or refraining from innovation to avoid violating it. Assess whether the regulation would help all firms create social value or would be counterproductive for some, given their particular circumstances.

Practise the Principles of Pieconomics in Everyday Life

- Seek 'win-win' outcomes in negotiations or interpersonal dynamics. Recognise that a gain for your counterparty or acquaintance need not come at your expense.
- Be aware that your abilities are not fixed, but can be grown through intentional and uncomfortable practice. Be willing to fail ex ante, and review your failures ex post.
- In service, seek to give gifts of unequal value, which are worth significantly more to the recipient than they cost you. Have the confidence to turn down service requests that do not satisfy the principles of multiplication, comparative advantage or materiality.

Appendix A

Chapter 3 illustrates the *principle of multiplication* with a deliberately simple example of Apple investing in a gym. This Appendix explains how the principle can be applied to much more complex cases. It uses a framework described by Chris Addy, Michael Collins and Michael Etzel of the social impact advisory firm Bridgespan, and Maya Chorengel of The Rise Fund, in a *Harvard Business Review* article and accompanying case study.[1] It has six steps, which we'll illustrate using the same *hypothetical* numbers in the article/case for two programmes run by EverFi, an education technology company that Rise invests in. These are AlcoholEdu, a programme to deter alcohol abuse among college students, and Haven, which educates students on reducing sexual assault.

1. *How Many Citizens Will It Impact?*

   AlcoholEdu: 2.2 million students.

   Haven: 2.6 million students. Assume an equal split among men and women.

2. *Estimate the Social Benefits to These People*

   Here, you use the findings of studies that estimate the effect of initiatives. The ideal study is a 'Randomised Control Trial' (RCT) which compares people 'treated' by an initiative to an untreated 'control group', and whether you're treated or not is random. An example is the study by Brian Krogh Graversen and Jan van Ours, considered in Chapter 10, where eligibility for a job activation programme depended on a citizen's birthday.

AlcoholEdu: an RCT found that the programme reduces alcohol-related incidents by 11%, corresponding to 2.2m × 11% = 239,350 fewer incidents. A trickier step is to estimate the lives saved. The National Institutes of Health find that 1,825 college students die each year from alcohol-related causes, out of 12 million students – a 0.015% death rate. Thus, 239,350 fewer alcohol-related incidents should save at least 239,350 × 0.015% = 36 lives.*

Haven: a study found that an in-person sexual assault course reduced sexual assault by 19% for women and 36% for men. 10.3% of college men and 2.5% of college women experience sexual assault each year. So, this corresponds to 1.3m × 10.3% × 19% = 25,869 fewer female assaults, and 1.3m × 2.5% × 36% = 12,029 fewer male assaults. Total: 37,898 fewer assaults.

3. *Estimate the Economic Value of These Social Benefits*

The next step is to turn these social outcomes into an economic value. Putting a dollar value on outcomes such as lives and sexual assaults seems cold, but is necessary. Otherwise, you can't compare the social return to projects that save lives and reduce sexual assaults with projects that improve childhood literacy or female empowerment.

AlcoholEdu: The US Department of Transportation estimates the value of a life as \$5.4m.** So, 36 lives saved are worth 36 × \$5.4m = \$194m.

Haven: The National Institutes of Health estimate the health, legal and economic costs of an assault at \$16,657. So, 37,898 assaults saved are worth 37,898 × \$16,657 = \$632m.

* This is a lower bound because the death rate from college students involved in alcohol-related incidents is likely higher than for college students as a whole.

** One may think that the value of life is infinite. However, it's not: we consciously take actions that reduce life expectancy because of economic or intrinsic benefits – e.g. play dangerous sports, take a job in a higher-crime city or country, and don't set all speed limits to 20 mph. An infinite value of life would mean that every decision is driven by the sole purpose of maximising life expectancy.

4. *Adjust for Uncertainty*

The above calculations are based on the findings of prior studies. However, those studies may lack *internal validity*: they may only show correlation, not causation, particularly if participation in a programme is a choice rather than random. For example, someone choosing to take a sexual assault programme is likely taking other steps to reduce the risk of assault, and so you can't attribute reduced assaults entirely to the programme. Or, they may lack *external validity*: the prior studies may be on a different country, setting (urban vs rural) or somewhat different programme.

Knowing how much to 'haircut' the estimated benefits by, if internal or external validity is imperfect, is an art rather than a science. The framework has six criteria for internal and external validity that you give a subjective score to. Summing up the scores:

AlcoholEdu has a score of 85%, because it uses an RCT. The score is not 100%, since the RCT only showed that the programme reduced alcohol incidents, not deaths. Thus, the probability-adjusted benefits are 85% × \$194m = $\underline{\$164\text{m}}$.

Haven has a score of 55%. The score is lower, since the study was not an RCT – participation in the programme was a choice. In addition, it was an in-person programme, whereas Haven's is online. Thus, the probability-adjusted benefits are 55% × \$632m = $\underline{\$348\text{m}}$.

5. *Estimate Terminal Value*

The above calculations estimate the programme benefits for the next five years. However, the benefits may continue beyond that five-year period, known as the programme's *terminal value*.

To calculate terminal value, you assess the likelihood that the benefits (both people impacted (Item 1) and the impact on these people (Item 2)) will continue undiminished after five years. The project is given a discount ranging from 5% to 25% based on this qualitative assessment. Let's say there's reasonable uncertainty for both projects, so a discount of 20% is warranted. Then, the terminal values are calculated as follows:

AlcoholEdu: the benefit in year 5 is estimated as \$47.7m. (Note this is not simply \$164m (from step 4) divided by 5, since the benefits ramp up over time.) Thus, the benefits for the next five years are $47.7 / 1.2 + 47.7 / 1.2^2 + 47.7 / 1.2^3 + 47.7 / 1.2^4 + 47.7 / 1.2^5 =$ \$143m.

Haven: the benefit in year 5 is estimated at \$94.7m. The terminal value is $47.7 / 1.2 + \ldots + 47.7 / 1.2^5 =$ \$283m.*

6. *Sum Up the Benefits and Compare to the Cost*

AlcoholEdu: \$164m (first five years, from step 4) + \$143m (terminal value, from 5) = \$307m.

Haven: \$348m (first five years, from 4) + \$283m (terminal value, from 5) = \$631m.

You then compare these totals to the cost of each programme to assess whether the principle of multiplication is satisfied.

Clearly, the calculations require some assumptions. But, standard NPV, which is practised all the time, also requires assumptions. Just as with standard NPV, for a social NPV calculation you can do a sensitivity analysis to examine the effect of different assumptions.

* Technical Note: Bridgespan/Rise's methodology incorporates the 20% discount by using a 'discount factor' of 1.2, as if 20% were the cost of capital. I would do so in an alternative way. The cost of capital should only be affected by systematic risks – if the benefits of the programmes varied with the state of the economy, which they're unlikely to. Even if The Rise Fund were risk-neutral, it would still take into account the fact that the benefits may not continue, so it's not a 'risk factor' that should change the denominator. Instead, the discount should be used to 'haircut' the numerator, just like the uncertainties in point 4. Thus, I would calculate $47.7 \times 0.8 + 47.7 \times 0.82 + \ldots + 47.7 \times 0.85$. See Chapter 9 in Richard Brealey, Stewart Myers, Franklin Allen and Alex Edmans, *Principles of Corporate Finance* (New York: McGraw-Hill Education, 2022).

Appendix B

This appendix is an extension to Chapter 9, providing further detail on collective engagement frameworks.

The UN Principles for Responsible Investment Collaboration Platform promotes collective generalised engagement on ESG issues – such as improving carbon disclosure, implementing anti-corruption policies or not sourcing minerals from conflict zones. Member investors post an issue on the platform that they want to engage with a particular company about, and invite other members to support them. This may involve signing joint letters to companies, supporting shareholder proposals or combining forces in dialogues with management. Elroy Dimson, Oğuzhan Karakaş and Xi Li studied 1,671 collective engagements and found that successful ones increased return-on-assets and sales growth.[1] This echoes the findings of their earlier paper, discussed in Chapter 6, that environmental and social engagements by a large investor improved profits and the stock price. While the engagements in both studies aimed to create value for stakeholders, investors benefited also.

Another vehicle for collective generalised engagement is the Canadian Coalition for Good Governance (CCGG). There are two main differences with the UN platform. The CCGG focuses on governance issues (such as implementing clawback provisions or say-on-pay votes) rather than environmental or social ones. And it's the CCGG itself, rather than members, that leads the dialogue with companies.[2] Craig Doidge, Alexander Dyck, Hamed Mahmudi and Aazam Virani found that the formation of the CCGG increased the stock prices of firms where CCGG members had large stakes and so the CCGG was most likely to engage.[3]

The UK's Investor Forum coordinates collective specialised engagement on issues such as capital allocation, strategy and productivity. Since an investor's view of these issues depends on his private information about the company, the Investor Forum has carefully developed a framework to ensure that investors don't accidentally share private information.[4] Similar to the CCGG, it's the Forum (rather than investors) that leads the engagement, and often investors don't know which other investors are collectively engaging with them.

For example, in July 2015, the Investor Forum represented 12 investors in the UK retailer Sports Direct, together owning 33% of the independent shares, who were concerned about its governance and employment practices. Collective engagements are usually private. But due to lack of progress, in August 2016, the Forum publicly demanded an independent review of these practices, which Sports Direct agreed to the following January. Investors were then concerned that Sports Direct's working practices might be widespread across the clothing sector, sparking an industry-wide engagement.

In addition to engagements to solve a particular problem, the Investor Forum encourages dialogues between investors and companies as a matter of course. Executives often lament that, in earnings calls and annual general meetings, discussions typically concern short-term profit – but they can do something about this. The Investor Forum recommends that companies hold 'Stewardship & Strategy Forums' with their large investors to discuss long-term issues; a sample meeting agenda is available on its website. For example, Rolls-Royce's 2016 event discussed its research initiatives, new customer offerings and plans to reduce senior headcount. These are similar to the CEO Investor Forums discussed in Chapter 8.

Investors can also collaborate outside of formal coordination mechanisms. In May 2018, LGIM brought together 60 global asset managers and asset owners, with combined assets under management exceeding $10 trillion. This group published an open letter in the *Financial Times* demanding that the oil and gas industry do more to meet the Paris Agreement commitments on climate change.

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Chapter 5

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13 Amy K. Dittmar, 'Why Do Firms Repurchase Stock?' (2000) **73** *Journal of Business* 331–55. Excess capital is measured by either cash holdings or cash flow in excess of investment opportunities.

14 Alon Brav, John R. Graham, Campbell R. Harvey and Roni Michaely, 'Payout Policy in the 21st Century' (2005) **77** *Journal of Financial Economics* 483–527.

15 Venture capital funds receive 23.2% of their financing from corporate and public pension funds, 12.6% from family offices and 30.8% from miscellaneous investors (such as endowments, insurance companies and investment banks), all of whom have significant holdings in public equity. The remainder of venture capital financing is provided by private equity funds, which themselves are held in part by other institutional investors. Andreas Kuckertz, Tobias Kollmann, Patrick Röhm and Nils Middelberg, 'The Interplay of Track Record and Trustworthiness in Venture Capital Fundraising' (2015) **4** *Journal of Business Venturing Insights* 6–13.

16 Huaizhi Chen, 'Capital Redeployment in the Equity Market' (2018).
17 Fried and Wang, 'Short-Termism and Capital Flows'.
18 www.selectusa.gov/financial-services-industry-united-states.
19 Joseph W. Gruber and Steven B. Kamin, 'Corporate Buybacks and Capital Investment: An International Perspective' (2017).
20 Fried and Wang, 'Short-Termism and Capital Flows', with updates to 2019 provided by the authors.
21 Amy Dittmar and Jan Mahrt-Smith, 'Corporate Governance and the Value of Cash Holdings' (2007) **83** *Journal of Financial Economics* 599–634.
22 Wei Li and Erik Lie, 'Dividend Changes and Catering Incentives' (2006) **80** *Journal of Financial Economics* 293–308.
23 S&P Global, 'S&P 500 Buybacks Decline 55.4% to $88.7 Billion; Significant Reductions Expected to Continue in Q3 2020' (15 September 2020).
24 Murali Jagannathan, Clifford P. Stephens and Michael S. Weisbach, 'Financial Flexibility and the Choice between Dividends and Stock Repurchases' (2000) **57** *Journal of Financial Economics* 355–84.
25 Benjamin Bennett, J. Carr Bettis, Radhakrishnan Gopalan and Todd Milbourn, 'Compensation Goals and Firm Performance' (2017) **124** *Journal of Financial Economics* 307–30.
26 Alex Edmans, Vivian W. Fang and Allen H. Huang, 'The Long-Term Consequences of Short-Term Incentives' (2021).
27 'Stock Buybacks and Corporate Cashouts', speech by Robert J. Jackson (11 June 2018).
28 The last repurchase transaction was made in May 2007.
29 Heitor Almeida, Vyacheslav Fos and Mathias Kronlund, 'The Real Effects of Share Repurchases' (2016) **119** *Journal of Financial Economics* 168–85.

Chapter 8

1 'M-Pesa Documentary', https://youtu.be/zQo4VoLyHe0.
2 Vodafone launched M-Pesa through Safaricom, Kenya's leading mobile network, in which it held a 40% stake.

3 Tavneet Suri and William Jack, 'The Long-Run Poverty and Gender Impacts of Mobile Money' (2016) **354** *Science* 1288–92.

4 UNICEF (2017), https://data.unicef.org/topic/child-health/pneumonia/ and https://data.unicef.org/topic/child-health/diarrhoeal-disease/.

5 Sandy Cairncross, Caroline Hunt, Sophie Boisson, Kristof Bostoen, Val Curtis, Isaac Fung and Wolf-Peter Schmidt, 'Water, Sanitation and Hygiene for the Prevention of Diarrhoea' (2010) **39** *International Journal of Epidemiology* i193–i205.

6 Larry Fink's Letter to CEOs, 2019.

7 PwC and AIESEC, 'Tomorrow's Leaders Today' (2016).

8 Deloitte, 'The 2016 Millennial Survey: Winning over the Next Generation of Leaders' (2016).

9 Gallup, 'How Millennials Want to Work and Live' (2016).

10 This US subsidiary later became an independent company in 1917 and is the same Merck discussed in Chapter 1 (known officially as Merck & Co. in North America and Merck Sharp & Dohme (MSD) elsewhere). The former parent, still headquartered in Germany, is known as Merck KGaA.

11 Merck saw other pharmaceuticals firms as collaborators in researching penicillin production, not competitors, and had agreed with Squibb and Pfizer that the three of them would share any findings. Sharing its findings with Squibb and Pfizer was consistent with this agreement. However, other firms, upon such a major discovery, may have tried to find a loophole to back out of the agreement. In addition, Merck shared its findings with other firms not part of the original agreement, such as Abbott and Lederle.

12 www.historynet.com/penicillin-wonder-drug-world-war-ii.htm. This figure is the estimated number of soldiers treated by penicillin between D-Day and the final German surrender.

13 Paul Gompers, Will Gornall, Steve Kaplan and Ilya Strebulaev, 'How Do Venture Capitalists Make Decisions?' (2020) **135** *Journal of Financial Economics* 169–90.

14 Jordan Crook, 'Warby Parker, Valued at $3 Billion, Raises $245 Million in Funding', *TechCrunch* (27 August 2020).

15 Such a statement may have been meaningful around the time that Friedman was writing, given that many believed that a company should serve only investors. Nowadays it's much more widely accepted that a company has a responsibility to stakeholders, and so a statement is only meaningful if it's specific about which stakeholders it aims to particularly serve and how it intends to serve them.

16 Craig Groeschel Leadership Podcast.

17 Claudine Gartenberg, Andrea Prat and George Serafeim, 'Corporate Purpose and Financial Performance' (2019) **30** *Organization Science* 1–18.

18 Clarity from management is measured by the questions 'Management makes its expectations clear' and 'Management has a clear view of where the organisation is going and how to get there'.

19 The Sustainability Accounting Standards Board provides standards for what non-financial information should be disclosed and is focused on reporting to investors. The Global Reporting Initiative provides both principles and standards and is focused on reporting to stakeholders.

20 Alex Edmans, Mirko Heinle and Chong Huang, 'The Real Costs of Financial Efficiency When Some Information is Soft' (2016) **20** *Review of Finance* 2151–82.

21 Ernstberger *et al.* (2015) find that the EU Transparency Directive led to firms reducing investment, improving operating performance in the short term, but lowering it in the long term. Kraft *et al.* (2015) find that the transition from annual to semi-annual, and from semi-annual to quarterly reporting in the US led to a decline in investment. Jürgen Ernstberger, Benedikt Link, Michael Stich and Oliver Vogler, 'The Real Effects of Mandatory Quarterly Reporting' (2017) **92** *Accounting Review* 33–60; Arthur G. Kraft, Rahul Vashishtha and Mohan Venkatachalam, 'Frequent Financial Reporting and Managerial Myopia' (2018) **93** *Accounting Review* 249–75.

22 Laura Starks, Parth Venkat and Qifei Zhu, 'Corporate ESG Profiles and Investor Horizons' (2018).

23 'Following the Footprints', *The Economist* (2 June 2011).
24 Focusing Capital on the Long-Term, 'Driving the Conversation: Long-Term Roadmaps for Long-Term Success' (2019).
25 KKS Advisors and CECP, 'The Economic Significance of Long-Term Plans' (2018).
26 For say-on-pay, the policy vote is typically binding – companies can't pay leaders amounts that don't follow policy. A binding vote is feasible because it's easy to assess objectively whether actual pay follows a particular policy. For say-on-purpose, the policy vote would be advisory, as it's difficult to assess objectively whether a company has followed the policy (for example, improved colleague livelihoods by a 'sufficient' amount).
27 Oliver Hart and Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' (2017) **2** *Journal of Law, Finance, and Accounting* 247–74.
28 Employees volunteer to be considered for appointment as an ethics correspondent, alongside their regular job. They are typically quite senior, to ensure they have the trust of both leaders and colleagues, and spread across all company roles.
29 Lucian A. Bebchuk and Roberto Tallarita, 'The Illusory Promise of Stakeholder Governance' (2020) **106** *Cornell Law Review* 91–178. Aneesh Raghunandan and Shiva Rajgopal, 'Do the Socially Responsible Walk the Talk?' (2020).
30 Lynn S. Paine, 'Sustainability in the Boardroom', *Harvard Business Review* (July–August 2014).
31 Financial Reporting Council, 'Corporate Culture and the Role of Boards: Report of Observations' (2016).
32 Unlike the director of a public company, I have no legal liability. The legal liability of worker directors would have to be carefully considered by any company contemplating voluntarily adopting them.
33 Frederick W. Taylor, *The Principles of Scientific Management* (New York and London: Harper & Brothers, 1911).
34 Schmidt's real name was Henry Noll.
35 Wells Fargo 2010 Annual Report.

36 Daniel M. Cable, *Alive at Work: The Neuroscience of Helping Your People Love What They Do* (Cambridge, MA: Harvard Business Review Press, 2018).

37 *Forbes*, 'Why New Belgium Brewing's Employees Once Turned Down a Bonus to Invest in Wind Power Instead' (15 December 2015).

38 Scott E. Seibert, Gang Wang and Stephen H. Courtright, 'Antecedents and Consequences of Psychological and Team Empowerment in Organizations: A Meta-Analytic Review' (2011) **96** *Journal of Applied Psychology* 981–1003.

39 While widely attributed to Saint-Exupéry, this quote only appears in one American translation of his 1948 book Citadelle; the original French translates slightly differently.

40 Gary S. Becker, *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education* (University of Chicago Press, 1964).

41 While some employers fund Masters of Business Administration degrees, in return they require the worker to return to the firm for a minimum length of time afterwards to ensure a return on investment.

42 Amy Goldstein, *Janesville: An American Story* (New York: Simon & Schuster, 2017).

43 Katherine Baicker, David Cutler and Zirui Song, 'Workplace Wellness Programs Can Generate Savings' (2010) **29** *Health Affairs* 1–8.

44 Joel Goh, Jeffrey Pfeffer and Stefanos Zenios, 'The Relationship between Workplace Stressors and Mortality and Health Costs in the United States' (2016) **62** *Management Science* 608–28.

Chapter 9

1 The 2009 Walker Review into the UK financial crisis concluded that: 'The atmosphere of at least acquiescence in high leverage on the part of shareholders will have exacerbated critical problems encountered in some instances . . . [E]ven major fund managers appear to have been slow to act where issues of concern were

identified in banks in which they were investors, and of limited effectiveness in seeking to address them either individually or collaboratively.'

2 As of late 2017, nine jurisdictions have explicit national stewardship codes: in Europe (Denmark, the UK), Asia (Hong Kong, Japan, Malaysia, Taiwan, Thailand) and Africa (South Africa, Kenya). The EU Shareholder Rights Directive requires institutional investors to publicly disclose their stewardship policy or explain why they don't have one.

3 More formally, these are known as 'sell-side equity analysts' as they typically work for investment banks that 'sell' trade ideas to investors. This contrasts with 'buy-side equity analysts' who are in-house analysts within an investor.

4 An actively managed fund that instead aims to create value through asset allocation across sectors, or a smart beta fund that aims to create value through quantitative strategies, will justifiably hold many stocks. However, these funds don't claim to add value through individual stock selection.

5 Ajay Khorana, Henri Servaes and Lei Wedge, 'Portfolio Manager Ownership and Firm Performance' (2007) **85** *Journal of Financial Economics* 179–204.

6 Christopher P. Clifford and Laura Lindsey, 'Block holder Heterogeneity, CEO Compensation, and Firm Performance' (2016) **51** *Journal of Financial and Quantitative Analysis* 1491–520. They study mutual funds with 'fulcrum fees', where the annual management fee increases if fund performance exceeds a benchmark.

7 Survey respondent to the UK Investment Association's 2016 Stewardship in Practice survey.

8 BNP Paribas, 'The ESG Global Survey 2019: Asset Owners and Managers Determine Their ESG Integration Strategies' (2019).

9 Lucian A. Bebchuk, Alma Cohen and Charles C. Y. Wang, 'Learning and the Disappearing Association between Governance and Returns' (2013) **108** *Journal of Financial Economics* 323–48.

10 David R. McLean and Jeffrey Pontiff, 'Does Academic Research Destroy Stock Return Predictability?' (2015) **71** *Journal of Finance* 5–32.

11 While MSCI bought KLD, the KLD dataset is now a legacy database called MSCI KLD Stats. The ESG ratings that MSCI now provides use a different methodology from KLD.
12 Florian Berg, Julian Kölbel and Roberto Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings' (2020).
13 Stephen R. Covey, *The 7 Habits of Highly Effective People* (New York: Free Press, 1989).
14 Deniz Anginer and Meir Statman, 'Stocks of Admired and Spurned Companies' (2010) **36** *Journal of Portfolio Management* 71–7.
15 The November 2018 'Stewardship in Practice' survey by the UK Investment Association reported that 35% of asset managers always inform management of the reason for voting against or abstaining, 60% do so sometimes and 6% never do so.
16 John Lorinc, 'Stephen Jarislowsky Has Every Right to Say "I Told You So"', *Globe and Mail* (25 October 2002).
17 David Benoit, 'BlackRock's Larry Fink: Typical Activists Are Too Short-Term', *Wall Street Journal* (16 January 2014).
18 Paul Singer, 'Efficient Markets Need Guys Like Me', *Wall Street Journal* (19 October 2017).
19 Ian R. Appel, Todd A. Gormley and Donald B. Keim, 'Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism' (2019) **32** *Review of Financial Studies* 2720–74. Success is measured in a number of ways – the campaign leading to a settlement with management (and the number of board seats that the settlement gives to the activist), takeover defences being removed and the firm being sold to the activist or a third party. Prior studies showed that these outcomes increase firm value.
20 In 2016, the UK Investment Association reported that 72% of asset managers disclose votes publicly, of which 62% don't include the rationale for voting, 7% always include it and 31% include it where it voted against management, abstained or voted in favour, but the issue was controversial.
21 Nadya Malenko and Yao Shen, 'The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design' (2016) **29** *Review of Financial Studies* 3394–427. The study uses a regression

discontinuity to identify causation – it's not that a flawed pay proposal leads both ISS to give a negative recommendation and also investors to vote against.

22 Peter Iliev and Michelle Lowry, 'Are Mutual Funds Active Voters?' (2015) **78** *Review of Financial Studies* 446–85.

23 National Investor Relations Institute, 'The Case for Proxy Advisor Reform' (8 November 2017).

24 Ana Albuquerque, Mary Ellen Carter and Susanna Gallani, 'Are ISS Recommendations Informative? Evidence from Assessments of Compensation Practices' (2020).

25 Vanda Heinen, Christopher Koch and Mario Scharfbillig, 'Exporting Corporate Governance: Do Foreign and Local Proxy Advisors Differ?' (2018).

26 The second flaw is that ISS's methodology is not size-adjusted. Small companies typically pay their CEOs less, and also typically outperform large firms, so the lack of size adjustment leads to a negative relationship between pay and performance. For further detail, see Tom Gosling, 'Shareholding Provides the Key for Linking Pay to Performance', *LinkedIn Pulse* (24 October 2017).

27 See Willis Towers Watson's Schedule 14A filing on 31 May 2017 for details of the errors.

28 The 2003 Global Analyst Research Settlement requires firewalls between the equity research and corporate finance divisions of an investment bank, and prohibits equity research analysts' pay being linked to corporate finance revenues. It aims to prevent analysts being biased towards companies who give the bank corporate finance business.

29 Dean Starkman, 'A Proxy Advisor's Two Sides: Some Question Work of ISS for Companies It Scrutinizes', *Washington Post* (23 January 2006).

30 Tao Li, 'Outsourcing Corporate Governance: Conflicts of Interest within the Proxy Advisory Industry' (2018) **64** *Management Science* 2951–71.

31 The proxy advisory industry is already taking voluntary steps to address the above concerns through its Best Practice Principles

for Shareholder Voting Research Providers, which stress the need for adequate resourcing and to manage conflicts of interest. However, they don't adequately recognise the role played by proxy advisors in stewardship. Even if a proxy advisor has a large headcount and is free from conflicts of interest, it may use one-size-fits-all recommendations.

32 Kent L. Womack, 'Do Brokerage Analysts' Recommendations Have Investment Value?' (1996) **51** *Journal of Finance* 137–67.

33 Thomas J. Lopez and Lynn Rees, 'The Effect of Beating and Missing Analysts' Forecasts on the Information Content of Unexpected Earnings' (2002) **17** *Journal of Accounting, Auditing, and Finance* 155–84.

34 Steven R. Matsunaga and Chul W. Park, 'The Effect of Missing a Quarterly Earnings Benchmark on the CEO's Annual Bonus' (2001) **76** *Accounting Review* 313–32.

35 Stephen J. Terry, 'The Macro Impact of Short-Termism' (2017).

36 Eli Amir, Baruch Lev and Theodore Sougiannis, 'Do Financial Analysts Get Intangibles?' (2003) **12** *European Accounting Review* 635–59.

37 Jie (Jack) He and Xuan Tian, 'The Dark Side of Analyst Coverage: The Case of Innovation' (2013) **109** *Journal of Financial Economics* 856–78.

38 Pessimistic might be defined as being below last quarter's level, or the same quarter last year.

Chapter 10

1 These included a combined CEO and Chair, over-boarded directors, non-independent audit and compensation committees, and numerous CEO pay issues.

2 E. Scott Reckard, 'Wells Fargo's Pressure-Cooker Sales Culture Comes at a Cost', *Los Angeles Times* (21 December 2013).

3 Boris Groysberg, Eric Lin and George Serafeim, 'Does Financial Misconduct Affect the Future Compensation of Alumni Managers?' (2020) **41** *Advances in Strategic Management* 293–321.

4 For a step-by-step guide on how an individual household can calculate its carbon footprint and take steps to reduce it, see Tom Gosling, 'Facing Up to the Truth of Our Carbon Footprint', *LinkedIn Pulse* (6 May 2019).

5 The cleaners were not directly employed by HSBC, but by the contract cleaning company OCS. HSBC changed the terms of its contract with OCS, allowing for this pay rise.

6 Over 2013–15, UK FTSE 350 companies that garner less than 80% of votes receive an average of 71% support. One year later, the average vote for the same companies was 88%. Source: PwC, 'Executive Pay in a World of Truthiness: Facts and Myths in the Pay Debate' (2017).

7 Matthew Syed, *Black Box Thinking: The Surprising Truth about Success* (London: John Murray, 2015).

8 Kevin J. Murphy and Michael C. Jensen, 'The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation' (2018) **3** *Journal of Law, Finance, and Accounting* 189–242.

9 The November 2016 Green Paper on Corporate Governance asked respondents for their views on binding say-on-pay. The government's August 2017 response to the Green Paper consultation reported that only one-third of respondents supported this option.

10 Ricardo Correa and Ugur Lel, 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation around the World' (2016) **122** *Journal of Financial Economics* 500–20.

11 This is SEC Final Rule IA-2106. It does allow investors to intentionally refrain from particular votes if they have a good reason. The example they give is 'casting a vote on a foreign security may involve additional costs such as hiring a translator or traveling to the foreign country to vote the security in person'.

12 The inquiry found: 'The company's shareholders suffered from an absence of reliable information and were . . . unable to exercise sufficient influence on the board to change its direction of travel.'

13 Nancy L. Rose and Catherine D. Wolfram, 'Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation' (2002) **20** *Journal of Labor Economics* 138–75.

14 Knowledge of pay design matters because the appropriate level of pay will depend on its structure. For example, if the CEO is given shorter holding periods, she should be paid less.
15 PwC, 'Making Your Reporting More Accessible and Effective' (2015).
16 The EU Transparency Directive (effective 2007) required EU companies to issue Interim Management Statements during the first and second halves of a fiscal year. They didn't need to contain a full set of financial statements, but could involve qualitative reporting – thus, from 2009, Unilever's Interim Management Statements omitted quarterly earnings. The 2013 EU Transparency Directive Amending Directive removed the requirement for Interim Management Statements from November 2015. Some countries (e.g. the UK) implemented this change earlier.
17 Currently, UK law allows a director to be barred for 'unfit conduct' such as 'allowing a company to continue trading when it can't pay its debts, not keeping proper company accounting records, not sending accounts and returns to Companies House, not paying tax owed by the company, using company money or assets for personal benefit'. However, failure to show regard to stakeholders is not classified as 'unfit conduct'.
18 'Economists' Statement on Carbon Dividends', *Wall Street Journal* (17 January 2019).
19 SkillsFuture@sc was Standard Chartered's voluntary add-on to the Singapore government's SkillsFuture programme. As a result, Standard Chartered employees could not only use the government's S$500 credit for a SkillsFuture course, but also take one of the bank-sponsored courses.
20 It also funds projects to improve firms' international competitiveness.
21 Benjamin G. Hyman, 'Can Displaced Labor Be Retrained? Evidence from Quasi-Random Assignment to Trade Adjustment Assistance' (2018).
22 Brian Krogh Graversen and Jan C. van Ours, 'How to Help Unemployed Find Jobs Quickly: Experimental Evidence from a Mandatory Activation Program' (2008) **92** *Journal of Public Economics* 2020–35.

23 Hong Ru and Antoinette Schoar, 'Do Credit Card Companies Screen for Behavioral Biases?' (2019).

24 Efraim Benmelech, Nittai Bergman and Hyunseob Kim, 'Strong Employers and Weak Employees: How Does Employer Concentration Affect Wages?', *Journal of Human Resources* (forthcoming).

25 See the UK Competition and Markets Authority, 'Annual Plan 2019/20' (2020) and OECD, 'Competition Policy: Promoting Efficiency and Sound Markets' (2012). For an academic literature review, see Mark Armstrong and David E. M. Sappington, 'Regulation, Competition, and Liberalization' (2006) **64** *Journal of Economic Literature* 325–66.

26 Share options also counted, and have similar issues to performance shares.

27 Florian Heider and Alexander Ljungqvist, 'As Certain as Debt and Taxes: Estimating the Tax Sensitivity of Leverage from State Tax Changes' (2015) **118** *Journal of Financial Economics* 684–712.

28 Alex Edmans, 'Short-Term Termination without Deterring Long-Term Investment: A Theory of Debt and Buyouts' (2011) **102** *Journal of Financial Economics* 81–101.

29 Frédéric Panier, Francisco Pérez González and Pablo Villanueva, 'Capital Structure and Taxes: What Happens When You (Also) Subsidize Equity?' (2012).

30 For example, the UK Corporate Governance Code requires the board to designate one of the non-executive directors as a 'senior independent director'. Sometimes a company chooses not to comply, and explains that this is because several non-executive directors have recently been appointed, and it wants to give them time to settle into their roles before choosing one.

31 The genesis was UK Chancellor of the Exchequer George Osborne asking Sir Charlie Mayfield in 2015 to investigate the UK's productivity problem in depth.

32 Examples include Steve Mariotti's *An Entrepreneur's Manifesto* (West Conshohocken, PA: Templeton Press, 2015) and David Storey's *Understanding the Small Business Sector* (Andover: Cengage Learning, 1994). See also Berger and Udell (1988) for an academic study of the

challenges faced by small enterprises and ways to promote their growth. Allen N. Berger and Gregory F. Udell, 'The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle' (1998) **22** *Journal of Banking and Finance* 617–73.

33 The European Investment Bank runs a European Investment Fund. It doesn't provide financing directly, but through intermediaries. For example, it invests in venture capital funds and banks, and provides loan guarantees.

Chapter 11

1 Werner Güth, Rolf Schmittberger and Bernd Schwarze, 'An Experimental Analysis of Ultimatum Bargaining' (1982) **3** *Journal of Economic Behavior and Organization* 367–88.

2 Moving a worker to PCs would reduce the number of TVs – and thus GNH – below nine; moving a worker to TVs would have an analogous effect.

3 4 August 2018.

4 Even if you win a war, it may be that you lose overall because of the resources used in doing so.

5 See the UK Visa Bureau's 'UK Shortage Occupations List'.

6 James Bessen, 'Toil and Technology' (2015) **52** *Finance & Development* 16–19.

7 Nyshka Chandran, 'Japan, Unlike the West, Is Not Scared of Robots Stealing Jobs, Deputy Leader Says', CNBC (4 May 2018).

8 James Bessen, *Learning by Doing: The Real Connection between Innovation, Wages, and Wealth* (New Haven, CT: Yale University Press, 2015).

9 Stephen R. Covey, *The 7 Habits of Highly Effective People* (New York: Free Press, 1989).

10 Covey's Habit 4, 'Think Win-Win', does stress the importance of working collaboratively to create value in negotiations.

11 Adam Grant, *Give and Take: A Revolutionary Approach to Success* (London: Weidenfeld & Nicolson, 2013).

12 'The Fringe Benefits of Failure and the Importance of Imagination'.

13 The boxes are actually coloured orange, to aid in their recovery after a crash.

14 K. Anders Ericsson, Ralf Th. Krampe and Clemens Tesch-Romer, 'The Role of Deliberate Practice in the Acquisition of Expert Performance' (1993) **100** *Psychological Review* 363–406.

15 Neil Charness, Ralf Th. Krampe and Ulrich Mayr, 'The Role of Practice and Coaching in Entrepreneurial Skill Domains: An International Comparison of Life-Span Chess Skill Acquisition' in K. Anders Ericsson (ed.), *The Road to Excellence: The Acquisition of Expert Performance in the Arts and Sciences, Sports, and Games* (Mahwah, NJ: Erlbaum, 1996).

16 Janice M. Deakin and Stephen Cobley, 'A Search for Deliberate Practice: An Examination of the Practice Environments in Figure Skating and Volleyball' in Janet L. Starkes and K. Anders Ericsson (eds), *Expert Performance in Sports: Advances in Research on Sport Expertise* (Champaign, IL: Human Kinetics, 2003).

17 The idea is also similar to the concept of 'things of unequal value' in Stuart Diamond's negotiations book *Getting More*. In a negotiation, you should offer a counterparty something that's worth more to him than it costs you, so that you can ask for something in return. However, service is not about getting more from others, but giving more to others. Stuart Diamond, *Getting More: How You Can Negotiate to Succeed in Work and Life* (New York: Random House, 2012).

18 Some elements of this section are inspired by a speech entitled 'How to Have a Successful and Meaningful Career' by Professor Andrew Metrick, one of the most celebrated professors at Wharton, in his final lecture before he left to go to Yale. It's also part of a talk called 'Fulfilling Careers and Full Lives' that I give in the final lecture of my core finance course, and available at http://bit.ly/fulfillingcareers.

19 Victor Frankl, *Man's Search for Meaning* (Boston, MA: Beacon Press, 2006).

20 On the buy-side, like any job at the start, there's selling involved as you have to sell your ideas to your superiors. However, once you

get to the top, there are no more superiors to sell to, only occasional 'sell' meetings with investors. Someone whose passion is selling might not find as much fulfilment when she reaches the summit.

21 David Brooks, *The Road to Character* (New York: Allen Lane, 2015).

Appendix A

1 Chris Addy, Maya Chorengel, Mariah Collins and Michael Etzel, 'Calculating the Value of Impact Investing'. *Harvard Business Review* (January–February 2019).

Appendix B

1 Elroy Dimson, Oğuzhan Karakaş and Xi Li, 'Coordinated Engagements' (2021).

2 The UN Collaboration Platform does have its own team that directly leads a small number of engagements; however, most engagements are investor-led.

3 Craig Doidge, Alexander Dyck, Hamed Mahmudi and Aazam Virani, 'Collective Action and Governance Activism' (2019) **23** *Review of Finance* 893–933.

4 The framework also allows investors to collectively engage without being viewed as acting in concert, i.e. collaborating to launch a takeover bid for a company. Doing so may require them to make regulatory filings or even make a bid.

INDEX