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the purpose of corporations

A tale of two theories

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

Milton Friedman, 1970[1]

Society is demanding that companies, both public and private, serve a social purpose … Companies must benefit all of their stakeholders, including shareholders, employees, customers and the communities in which they operate.

Larry Fink, BlackRock, 2018[2]

[1] Friedman M. "A Friedman Doctrine," *New York Times*, September 13, 1970, available at https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.

[2] Fink L. "A Sense of Purpose (Letter to CEOs)," 2018, available at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

In a seminal article written for *The New York Times Magazine* in 1970, Milton Friedman, one of the most influential economists of the 20th century, made the famous pronouncement above. More than any other theory of corporate purpose, the version Friedman espoused — and emphasized by many since — has underscored the last half century of business and investment. Corporate management and investor actions have focused almost exclusively on increasing shareholder returns as the primary goal and determinant of corporate success. The doctrine is referred to commonly as the **shareholder wealth maximization theory** (SWM or simply "shareholder theory").

Increasingly, however, this theory is being challenged. Larry Fink, head of the largest asset manager in the world,[3] proclaimed in his 2018 letter to CEOs that companies must "serve a social purpose." Embedded in Fink's statement is the idea that companies exist to fulfill many obligations. Beyond maximizing shareholder returns, firms need to create value for their employees (frequently proclaimed by many employers to be their most valuable assets), their customers (without whom no company could survive) and society at large (which provides the legal and economic foundations upon which companies are built).[4] Fink's statement was recently echoed by the Business Roundtable (BRT), a group of US CEOs representing companies with over US$7 trillion in collective revenues. The BRT declared in a high-profile statement that shareholder primacy is a thing of the past, emphasizing instead that "each of our stakeholders is essential."[5]

These statements can be described as aligning with **stakeholder theory**, the primary challenger to SWM. Stakeholder theory considers corporations to be compelled to enhance value for all of their stakeholders, rather than just maximize returns for shareholders.

In this paper, we explore the tension between the two theories, with a focus on the challenger, its drivers, its adherents and its potential implications. We then explore methods of potentially reconciling the two theories.

In a forthcoming Part II of this series, we emphasize the role of asset owners in shaping the shareholder-versus-stakeholder debate. This debate has broad implications for how investors operate and the markets in which they operate, how capital pools are governed, how investments are analyzed and priced, and how value is ultimately created for beneficiaries. With this exploration, we aim to document the trend toward "business as unusual" we see unfolding in industry and investing. We also aim to empower investors to address the implications of this trend in their portfolios or to get more involved in the promotion of stakeholder views as desired.

[3] BlackRock's total assets under management stood at US$7.4 trillion as of January 2020. See: https://www.pionline.com/money-management/blackrocks-aum-hits-new-record-743-trillion.

[4] There is an important distinction to be made here. Value-creation is not always best measured in financial terms or by market prices. For further exposition on this topic, see Ambachtsheer K. "The Ambachtsheer Letter," January 2019, available at KPA-advisory.com.

[5] Business Roundtable. "Business Roundtable Redefines the Purpose of a Corporation to Promote 'an Economy That Serves All Americans,'" August 2019, available at https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

Comparing shareholder theory and stakeholder theory

The table below briefly summarizes the two theories and their central underpinnings.

Figure 1. Competing theories of corporate purpose

	Shareholder theory	Stakeholder theory
Description	• Argues that shareholders of a company are the primary group to which the company is responsible, and therefore the duty of the firm is to maximize shareholder returns	• Stresses the interconnected relationships between a business and its customers, suppliers, employees, investors, communities and even society at large • Argues that firms should create long-term sustainable value for all stakeholders, not just profits for shareholders • Arguments for are made on moral and financial grounds[6]
Measures of value creation	Total return to shareholders, including cash distributions, non-cash distributions and equity appreciation	"Balanced scorecard," including measures of financial results, environmental impact, social impact and stakeholder satisfaction
Compliance focus	Legal	Ethical and legal
Seminal business management texts	"Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure"[7]	Strategic Management: A Stakeholder Approach[8]

[6] Adapted from multiple sources, including http://stakeholdertheory.org/about/, accessed July 21, 2018. A distinction should also be made between normative stakeholder theory, which argues for a stakeholder approach on moral grounds, and instrumental stakeholder theory, which argues that a stakeholder perspective is actually best for company financial performance and therefore also best for shareholders. This salient distinction is explored further in the final section of this paper.

[7] Jensen MC and Meckling WH. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Volume 3, Issue 4 (1976), pp. 305–360.

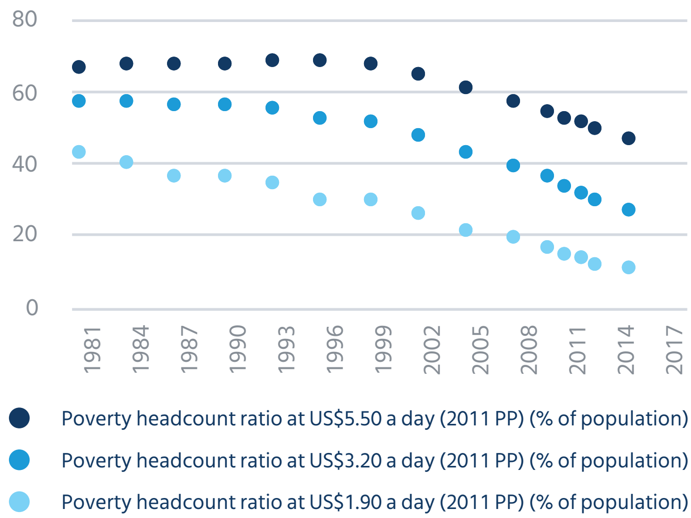
[8] Freeman RE. *Strategic Management: A Stakeholder Approach*, Cambridge: Cambridge University Press, 1984.

A half century of dominance — The good, the bad

For the majority of the past 50 years, both companies and investors have focused largely on SWM. This has meant a focus on higher profit margins and, in this regard, SWM can be deemed a success.

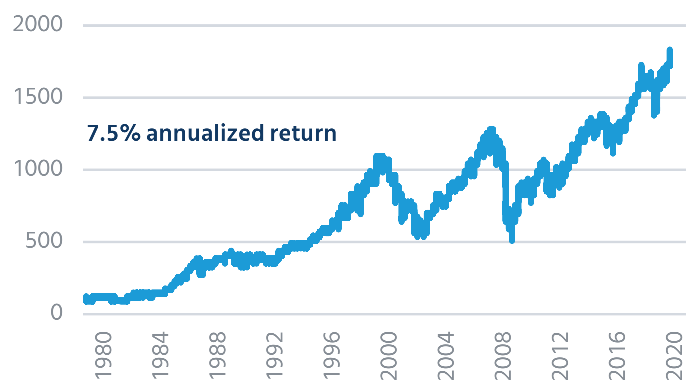
Corporate margins have improved steadily since the 1970s, with improved governance, tighter expense management and technological innovations contributing to productivity gains, stronger economic growth and falling consumer inflation. This has rewarded equity market investors over time — global developed market equities have returned around 7.5% per annum since 1980 (see Figure 2b). During this time, the proportion of the global population living in poverty has fallen precipitously (see Figure 2a), bringing with it a number of concurrent benefits in the form of improved health outcomes, longer life expectancy and lower infant mortality.[9]

Figure 2a. Decline in global poverty rates



Source: World Bank

Figure 2b. MSCI World Index value

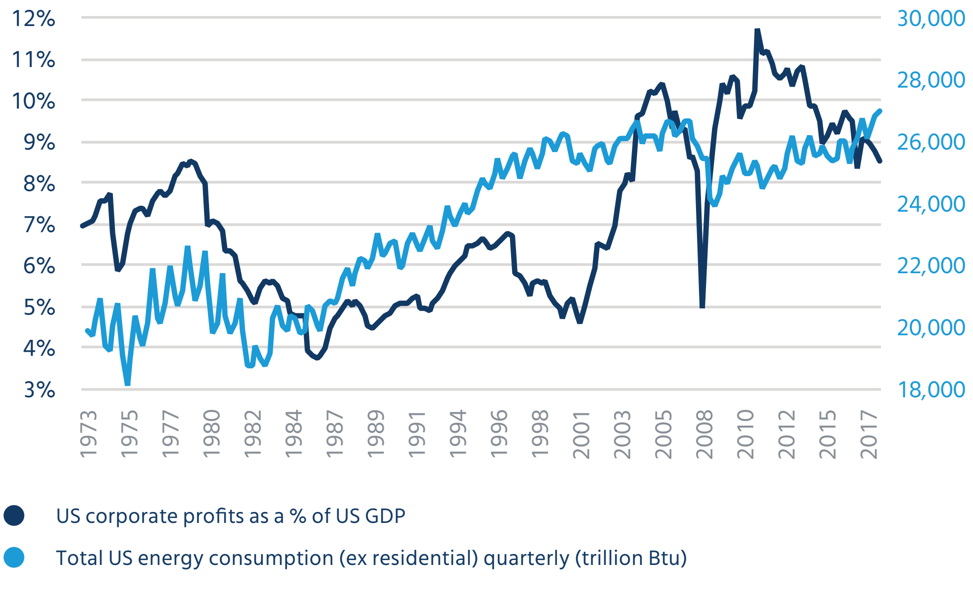


Source: Capital IQ

[9] For comprehensive data and compelling visualizations demonstrating the benefits of overall economic growth to a variety of social outcomes, see www.gapminder.org/tools.

At the same time, however, the global distribution of wealth has widened, with many of the gains accrued by the wealthiest subset of the population.[10] This trend tends to be more pronounced at the national level, nowhere more so than in the US, where the share of corporate profits relative to GDP has trended higher since the early 1990s. Globalization and technological innovation have likely been the primary drivers, although SWM probably helped establish the conditions for these trends to flourish. In addition to wealth inequality, SWM has coincided with a steady increase in energy usage — two trends that are contributing to populism and climate change, respectively (see Figures 3a and 3b).

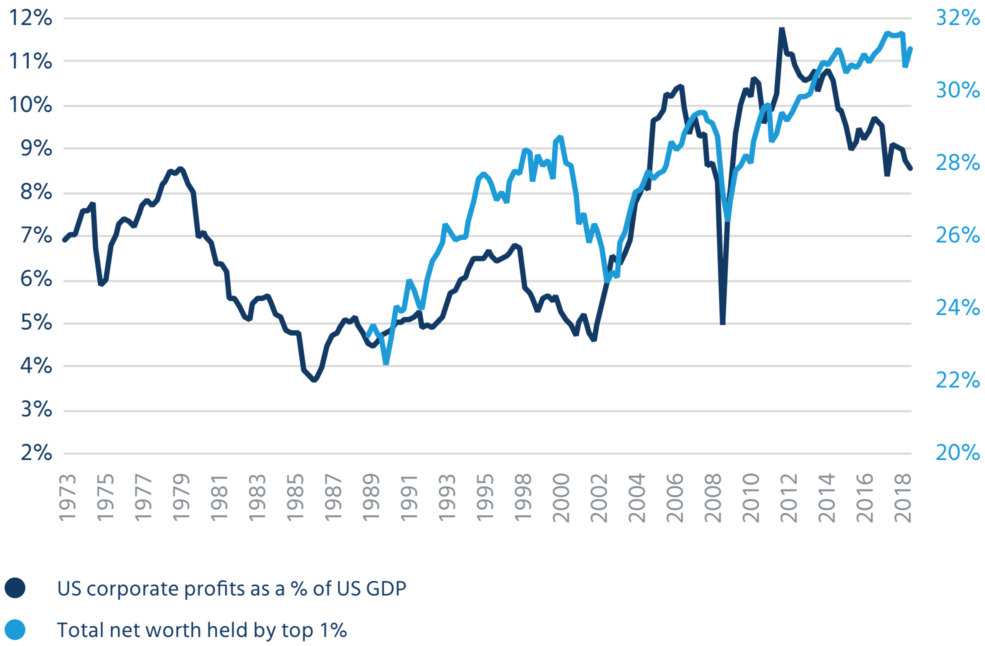
Figure 3a. US energy consumption versus corporate profits



Source: FRED and EIA

[10] World Inequality Database, available at https://wid.world.

Figure 3b. US wealth inequality versus corporate profits



Source: FRED

Furthermore, we've seen a number of examples of value-destructive corporate behavior that have resulted from a misapplication of SWM. At a company level, environmental or social disasters can too often be attributed to corner-cutting risk-management processes for the sake of maximizing short-term over long-term profits. At a market-wide level, big business and politics need each other, but this can all too easily descend into "crony capitalism." The massive build-up of leverage in the financial system in the early 2000s was likely amplified by a desire among bank executives to maximize short-term profits and bonuses, which ultimately contributed to the global financial crisis and an extreme example of shareholder wealth minimization.

What each of these examples highlights is that the interpretation and execution of SWM is primarily at issue. Much as the problem with religious extremism is the extremism, not the religion, problems resulting from SWM are the approaches taken in the pursuit of wealth maximization, not necessarily the theory itself. Such examples, however, accompanied by resulting shifts in regulation and consumer sentiment — including concerns over the environment — have been turning the tide in favor of alternative interpretations of corporate purpose, ones that typically involve a broader stakeholder perspective.

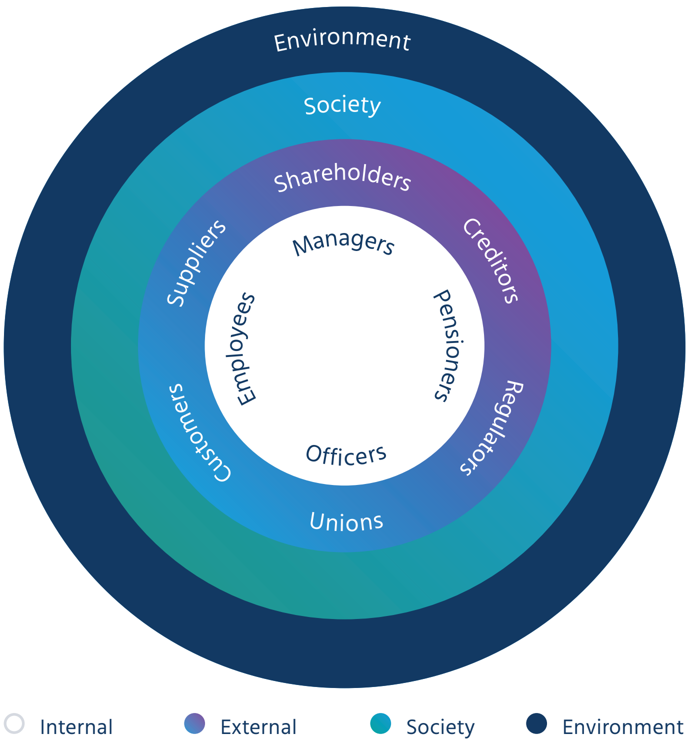
A broader stakeholder perspective — A secular trend in business and investment management

Some of the negative outcomes from the past half century are driving new ways of thinking about the role of business in society. Most of these new ideas recognize that corporations have a raft of internal stakeholders (employees, management, board members, etc.) and external stakeholders (suppliers, customers, regulators, etc.); they also exist by virtue of access to natural resources (that is, the environment) and within a construct that allows for corporate formation in the first place (that is, society) (see Figure 4). Mismanagement of any of these stakeholder relationships can lead to a loss of trust and/or value. This has become especially apparent as the internet, social media and other technological advances have continued to magnify individual voices and highlight corporate and investor practices — the good and the bad.

Adoption of a broader stakeholder perspective is, in part, being driven by the sustainable business movement, which requires the consideration of stakeholder needs beyond those of shareholders to achieve environmental or social goals. The spectrum of sustainable business management approaches is wide. Sustainability commitments often start with some form of corporate philanthropy, generally dispersed as part of a marketing budget, and evolve over time into something increasingly central to the business model.[11] For the most advanced sustainable businesses, sustainability considerations inform the mission of the organization and lie at the heart of the business's long-term strategy (see Figure 5).[12]

Some organizations — notably Certified B Corporations — are taking their commitment to sustainability even further and modifying their legal governing documents to require their boards to consider the impacts of their decisions on workers, customers, community and environment. There are currently more than 2,900 Certified B Corporations in 60 countries around the world.[13] These stakeholder-oriented business initiatives, once niche, are now starting to move into the mainstream, as evidenced by the recent BRT announcement.

Figure 4. Stakeholder model of a company



[11] The inference here is that the primary motivation of this giving is to enhance brand awareness, not to be philanthropic or achieve an environmental or social outcome.

[12] This is also sometimes referred to as "shared value," a management strategy in which companies find business opportunities in social problems and company leaders focus on maximizing the competitive value of solving social problems. See www.hbr.org/2011/01/the-big-idea-creating-shared-value.

[13] Certified B Corporations, available at https://bcorporation.net.

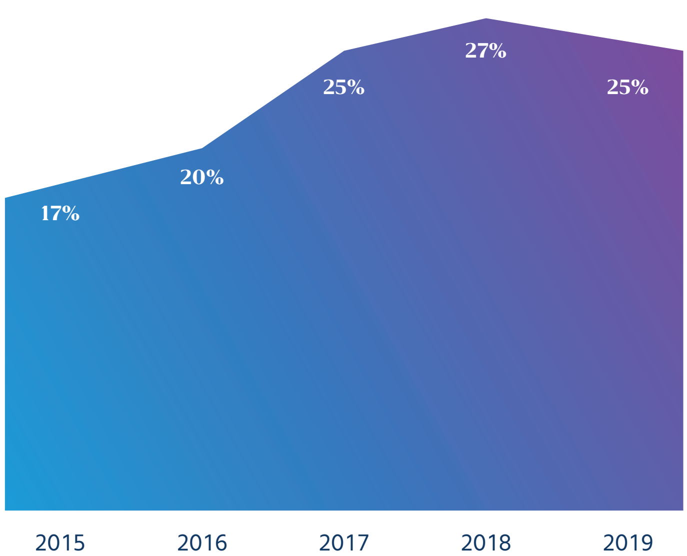
Figure 5. Spectrum of sustainable business management approaches

Source: Mercer; World Business Council on Sustainable Development (WBCSD)

Larry Fink's comments in his 2018 letter to CEOs are emblematic of a broader shift in views regarding the purpose of corporations, particularly in the investor community. Asset owners and managers controlling over US$80 trillion in assets have now signed the United Nations Principles for Responsible Investment (UNPRI),[14] indicating that they seek to integrate environmental, social or governance (ESG) issues into investment analysis and decision-making processes (Figure 6b). The impact companies have, and have had, on the environment and society around them is being given greater significance in company assessments. Valuations increasingly rely upon intangible assets, such as brand equity, reputation and an engaged workforce, all of which can be eroded quickly by mismanagement of ESG issues.[15] Investors of all kinds are steadily increasing their support for environmental and social proxy resolutions filed at public companies, encouraging them to pay closer attention to, for instance, climate change risks and opportunities or diversity policies and other human capital management practices (see Figure 6a).

Figure 6a. Growth in support for environmental and social resolutions

Percentage of overall shares voted "for"



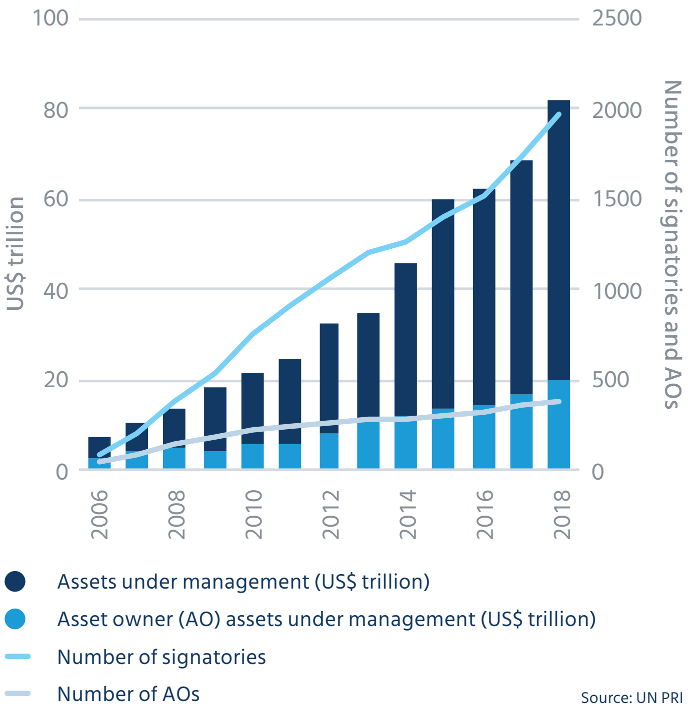
Source: PwC and Broadridge [16]

[14] United Nations Principles for Responsible Investing, available at https://www.unpri.org/pri/about-the-pri.

[15] Knutson T. "Investors Are Right to Consider ESG Risks, Says New Report by Corporate Governance Association," Forbes, July 2018, available at http://www.forbes.com/sites/tedknutson/2018/06/22/investors-are-right-to-consider-esg-risks-says-new-report-by-corporate-governance-association.

[16] Note: "Overall shareholder support for social and environmental proposals decreased from 27% in 2018 to 25% in 2019 (the first decline in support over the last five years). Given that engagement between institutional shareholders and companies has increased, it is likely the decline in average support could be related to discussions outside of the proxy process." See https://www.broadridge.com/_assets/pdf/broadridge-proxypulse-2019-review.pdf.

Figure 6b. Growth in UNPRI signatories



Source: UN PRI

The examples above speak to the growing convergence of largely voluntary top-down (investor-led) and bottom-up (company-led) activities that are driving a stakeholder orientation among businesses and in capital markets.

It is worth noting that, in some jurisdictions, a broad stakeholder perspective is the legally enforced norm. In Germany, for instance, supervisory boards of large companies are required to have the same number of employee and labor union representatives as they do other stakeholder representatives. This requirement naturally leads to a stakeholder governance orientation, as conflicts of interest can and do arise between employees and shareholders that need to be resolved at the board level.

Long-termism — Reconciling apparently contrary views

One of the outcomes often associated with a shareholder focus is short-termism. However, this is primarily an issue for public companies and their equity investors and has much to do with the market environment and regulatory framework in which they collectively operate. There is nothing in SWM that intrinsically encourages short-termism, and indeed many private firms tend to take a longer-term approach than their public counterparts.

Similarly, literature on stakeholder theory rarely specifies a time horizon for evaluation, although addressing the aims of multiple stakeholders and achieving environmental or social goals may only be possible over the long term. In recognition of the tension between these theories, several attempts have been made to reconcile their seemingly contradictory aims from different angles:

- “Normative” stakeholder theory argues that companies have a moral imperative to consider the impact of their actions on a variety of stakeholders, not just shareholders.

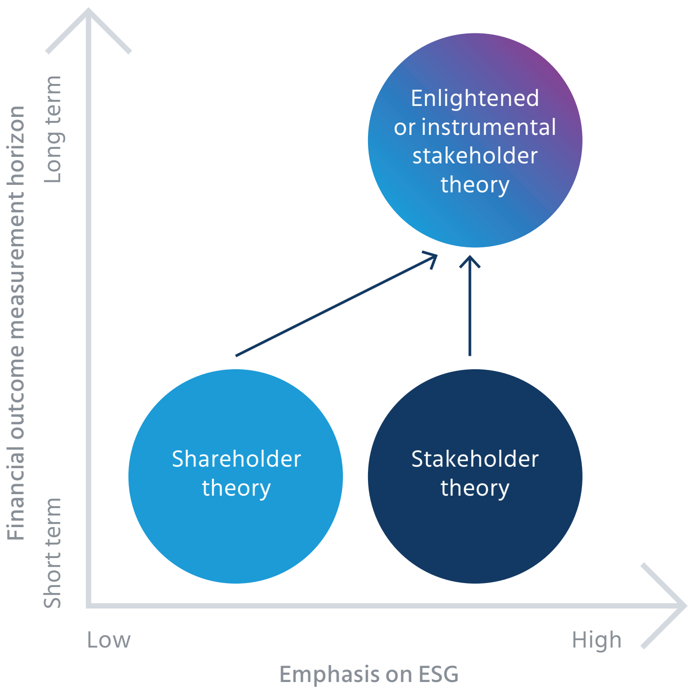
- “Instrumentalist” stakeholder theory, on the other hand, argues that a stakeholder orientation actually leads to better outcomes for shareholders because firms behave in a manner that is “trusting, trustworthy and cooperative, not opportunistic,” building better long-term relationships with suppliers, employees and the like, leading to a competitive advantage.[17]

“Enlightened stakeholder theory” — a concept proposed by Michael C. Jensen, notable for his role in establishing SWM as the predominant theory many decades ago — posits that a stakeholder approach to management is important, but the ultimate arbiter of its success should be the long-term market value of the firm. The emphasis here on long term “recognize[s] the possibility that financial markets, although forward looking, may not understand the full implications of a company’s policies until they begin to show up in cash flows over time. In such cases, management must communicate to investors the policies’ anticipated effect on value, and then wait for the market to catch up and recognize the real value of its decisions as reflected in increases in market share, customer and employee loyalty, and, finally, cash flows.”[18]

[17] Jones T. “Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics,” *Academy of Management Review*, Volume 20, Issue 2 (1995), pp. 404–437.

[18] Jensen MC. “Value Maximization, Stakeholder Theory, and the Corporate Objective Function,” *Journal of Applied Corporate Finance*, Volume 14, Issue 3 (October 2001), pp. 8–21. Jensen also refers to “enlightened value maximization.”

Figure 7. Reconciling apparent conflicts: Lengthening time horizon and focusing on financial outcomes



In assimilating these attempts, it appears the framing of SWM and stakeholder theory as wholly separable options represents a false dichotomy. As in many cases, a hybrid approach may be best — recognizing the importance of stakeholder relationships to long-term shareholder value. Furthermore, though the role of companies and investors in society ought certainly to be an integral consideration for policymakers and society at large, in the current business environment, it may be difficult for individual companies or investors to determine and/or be prescriptive about the "morality" of stakeholder approaches. Stated otherwise, extending time horizons and putting aside conversations about the moral imperative reconciles the tension between SWM and stakeholder theory (see Figure 7). The focus then shifts to maximizing long-term returns by allowing investments in stakeholder relationships, which may appear costly in the near term.

A need arises then to measure the value of these stakeholder relationships. Today, this need is met by the thoughtful assessment of ESG factors. Indeed, a growing body of empirical research shows that companies better at managing ESG issues important to non-equity stakeholders tend to produce better long-term financial outcomes for equity (and other asset class) investors.[19]

Importantly, determining success in the enlightened stakeholder model relies on measurement of the same financial outcomes considered material in SWM (for example, share price), though with consideration taking place over a longer time horizon. This model also acknowledges the potential for ESG factors to manifest as financial factors over the long term. In this regard, ESG impact assessment is of significant importance in an enlightened stakeholder approach, as ESG issues are key drivers of maximizing financial value.

Based on the above, it is clear that a transition to a more stakeholder-oriented approach to business and investment management is underway. Though the speed and ultimate extent of this transition is difficult to determine, investors would be well-advised to stay abreast of this trend and explore how it might impact their portfolios. Some investors (for example, those with a strong commitment to sustainability) may wish to support the expansion of stakeholder views via shareholder/policyholder engagement or other avenues. In Part II of this paper, we will explore the ramifications of a stakeholder approach for asset owners in more detail.

[19] For instance, see the meta-analysis here, which shows that more than 90% of primary studies demonstrate a non-negative relationship between ESG factors and company financial performance: https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917.

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