WHITE PAPER

# The Heart and Soul of Corporate America

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Fifty years ago this past September, Nobel Prize-winning economist, Milton Friedman, published an essay in the *New York Times Magazine* titled **A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits.** The Friedman Doctrine provided the intellectual foundation of the principle of maximizing shareholder value that has guided corporate and investor behavior since the late 1970s. Opponents of this doctrine, however, argue that it has led to excessive focus on short term corporate earnings, increased income inequality, soaring and unreasonable executive compensation, low levels of investment in research and capital spending, and declines in corporate philanthropy. Last year, 181 CEOs signed a new Business Roundtable statement summarized as follows: "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders." At the same time, there is a growing movement among investors and corporations to focus on what is known as ESG or Environmental, Social, and Corporate Governance that are the three central factors in measuring the sustainability and societal impact of an investment or company. So, are we witnessing a tectonic change in corporate values that will lead to major changes in behavior? There is a great deal of debate on this question. Some believe that the Business Roundtable statement is largely cosmetic; others argue that government, rather than corporations, must address society's ills. A third group believes there has actually been a permanent change in the ethos of corporations and investors. It is much too early to gauge the impact and staying power of these ideas, but the outcome will have important ramifications for every American.

## The Friedman Doctrine

In his 1970 essay, Friedman argued that the goal of management is to maximize return to stockholders, who can then decide for themselves in what social initiatives to take part in. Specifically, he wrote, "Insofar as an executive's actions in accord with his social responsibility reduce returns to stockholders, he is spending their money. Insofar as his actions raise the prices to customers, he is spending the consumer's money. Insofar as his actions lower the wages of workers, he is spending their money." Friedman's position was supported by Harvard economist Michael Jensen, in a 1976 article titled Theory of the Firm in which he asserted the primacy of maximizing profits to shareholders. In a 1990 article titled CEO Incentives: It's Not How Much You Pay, But How, Jensen then argued that management's interests should be more closely aligned with those of shareholders by including a significant amount of stock options and other equity based incentives in executive compensation packages. Friedman and Jensen's views were then institutionalized in a 1997 statement by The Business Roundtable as follows: "The foremost duty of management and of boards of directors is to the corporation's stockholders. The interests of other stakeholders are only relevant as a derivative of the duty to shareholders." Since that time, this overall line of thinking has become the mainstay of corporate governance and of Wall Street expectations. And, to the extent that a given public company has not sufficiently focused on maximizing shareholder value, activist investors have quickly imposed that discipline.

## Forty Years of Maximizing Shareholder Value

Following Friedman's essay in 1970, it took at least a decade for the focus on shareholder value to become more or less universal. So, I will present a number of statistics that illustrate the experience of various corporate stakeholders since 1980. However, it is important to point out that economic outcomes are the result of a complex series of variables of which the singular focus on shareholder value is but one.

First, shareholders fared very well realizing an annualized return of 12% that compares with the long-term return of just over 9%. Once again, it isn't fair to attribute this wonderful outcome solely to the practice of the Friedman Doctrine because this period was also characterized by declining

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inflation and interest rates, a generally healthy economy, and low initial valuations. Interestingly, corporate profits grew at a 5.7% annual rate during this period as compared to the 6.4% annual rate since 1947, the period for which government data is available. So, it isn't at all clear that the intense focus on shareholder value actually improved profitability. What about the complaints that managements are focused on short-term earnings and stock price to the detriment of expenditures on research and development as well as capital expenditures? In aggregate, corporate profits have increased 9.4-fold since 1979; whereas, R&D and capital-spending expenditures rose 8- and 7-fold, respectively. So, while they have indeed lagged the growth in profits, it doesn't appear that these two categories have been starved for funds. Another criticism is that corporations have cut back on philanthropy, but corporate philanthropy rose from .7% of pre-tax income in 1978 to 2% in 1986, only to decline to .9% by 2004, where it remains today.

The area of greatest controversy is the compensation of executives versus the broader range of employees. Since 1979, the real or inflation-adjusted earnings of the average worker has increased by a total of 8.1%, which represents an annual growth rate of .2%. In other words, the living standard of the average worker has only improved slightly since the late 1970s. In contrast, CEO compensation, after adjustment for inflation, has increased **1000%** over the same period. One commonly-cited metric is the compensation of the CEO as a multiple of that of the average worker and that statistic has increased from 29.8 in 1978 to 287 in 2018. By the way, this statistic has been as high as 368 in other years, largely due to equity-based compensation. This disparity in income growth is one of the key factors in the overall problem of inequality in the U.S.

## Pressure for Change

The singular focus on shareholder return is now being challenged on many fronts. Endowments, foundations, state pension funds, and other large pools of capital are placing pressure on their investment managers to incorporate what is known as stakeholder capitalism in their investment and proxy-voting decisions. Even prior to this pressure, some large investment management firms, such as Vanguard and Blackrock, were outspoken on this issue. And, most corporations are engaged as well, although skeptics suggest that it is solely in response to pressure rather than a change in values. In any case, there is a burgeoning industry of firms that evaluate, grade, and report on each public corporation's actions with respect to issues such as diversity, sustainability, governance, and compensation. Additionally, investors who do not have the internal resources to evaluate these issues, are increasingly relying on the ratings supplied by these organizations when making proxy decisions.

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## Stakeholder Capitalism

The Business Roundtable (BRT) is an advocacy organization, consisting of more than 200 CEOs of major corporations. The BRT conducts research and advocates for policies designed to spur job creation, improve U.S. competitiveness, and strengthen the economy. Alex Gorsky, CEO of Johnson and Johnson and Chair of the BRT's Corporate Governance Committee, summarized the new statement on the purpose of a corporation as follows: "It affirms the essential role corporations can play in improving our society when CEOs are truly committed to meeting the needs of **all stakeholders**." Jamie Dimon, CEO of JP Morgan Chase, wrote, "Building shareholder value can only be done in conjunction with taking care of employees, customers, and communities." Specifically, the signatories of the statement committed to:

- Delivering value to their customers
- Investing in their employees
- Dealing fairly and ethically with their suppliers
- Supporting the communities in which they work
- Generating long-term value for shareholders
- Engaging with shareholders effectively and with transparency

While these commitments represent a marked change from the singular focus on shareholders, the ESG movement in general as well as several major investment firms have greatly expanded upon the Business Roundtable view of corporate responsibility. In particular, they are focusing on diversity and climate change, which were not specifically addressed in the Business Roundtable statement.

Most notably, Blackrock CEO Larry Fink penned an open letter to CEOs in 2019 that he titled A Fundamental Reshaping of Finance. Blackrock is the world's largest asset manager with responsibility for approximately $7.5 trillion in assets, thereby making it the largest shareholder of many public companies with the associated voting power. Fink's summary statement is that "a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders." His primary focus is on climate risk, which he believes now equates to investment risk, but he addresses a variety of other issues, including the diversity of a company's workforce, the sustainability of its supply chain, and efforts to protect customers' data. In terms of specific actions, Fink stated that Blackrock has placed sustainability at the center of its portfolio construction and risk-management process and will be exiting investments with high sustainability-related risk. He also called on CEOs to improve disclosure with respect to these issues.

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Specifically, Blackrock is asking that each company in which it is a shareholder:

- File a report according to the guidelines of the Sustainability Accounting Standards Board (SASB), covering a wide range of issues from labor practices, to data privacy, to business ethics
- File a disclosure on the company's climate-related risks in line with the standards of the Task Force on Climate-Related Financial Disclosures (TCFD)

Fink acknowledges the burden of this level of reporting, but it seems likely that all public companies are rapidly moving in this direction and a widely-accepted format, such as those offered by the SASB and TCFD, will make the data more comparable. He also asserts that there is a direct benefit to this level of disclosure in that companies that champion transparency and demonstrate responsiveness to stakeholders should attract investment capital more effectively.

While Blackrock has not established specific goals, targets, or timelines, Fink stated that they are increasingly disposed to vote against managements and boards when companies are not making sufficient progress. To give teeth to that statement, Blackrock voted against 4,800 board members at 2,700 companies in 2018. While it focuses on similar issues, Vanguard has chosen a slightly less public approach in which its Corporate Governance Team actively but quietly engages with corporate managements.

## Are We There Yet?

There seems to be virtually universal agreement that the policy of maximizing shareholder value has created significant inequities and distortion in our economy, but it is not at all clear that stakeholder capitalism is the new standard or is even a viable alternative.

First, the Ford Foundation funded a study published in September of 2020 that found that signatories of the Business Roundtable statement were no more likely than the average company to elevate social

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### Important Notes And Disclosures

concerns to the same level as profits during the Covid-19 pandemic. They were just as quick as other companies to lay off employees and many did not reduce executive compensation commensurate with the pay cuts that were applied to the larger workforce. This has caused a number of observers to suggest that many companies that have made bold ESG statements are simply engaging in a public relations effort.

Second, a major concern is whether activist investors, who control a great deal of capital, will allow corporations to engage in stakeholder capitalism. Similarly, will some shareholders seek legal relief accusing management of squandering funds that should have been directed to dividends or stock buybacks?

A more fundamental question is whether stakeholder capitalism is actually workable. Specifically, maximizing shareholder value is relatively straightforward because there is a single variable to optimize - the company's stock price. In contrast, stakeholder capitalism requires tradeoffs between competing interests inevitably leading to tension and likely sub-optimal results. There is genuine concern that companies will be difficult to lead without a clear and simple objective.

An alternative approach that some find very appealing is what is known as *customer capitalism*. The idea is that the primary function of any company is to attract customers, and all corporations that devote their energy and resources to that objective will be able to treat all of their stakeholders handsomely and equitably.

For whatever it is worth, my own view is that shareholder maximization is dying and it will be replaced by a different brand of capitalism that will recognize the needs of multiple constituencies. I'm not smart enough to figure out exactly what form it will take, but I think we are at a critical point in history in which our society will demand a more equitable and inclusive economy. I sit on two company boards, and while this is a small sample size, I can say that these issues are very much front of mind, and there is a genuine determination to implement a broader view of the purpose of the corporation.

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