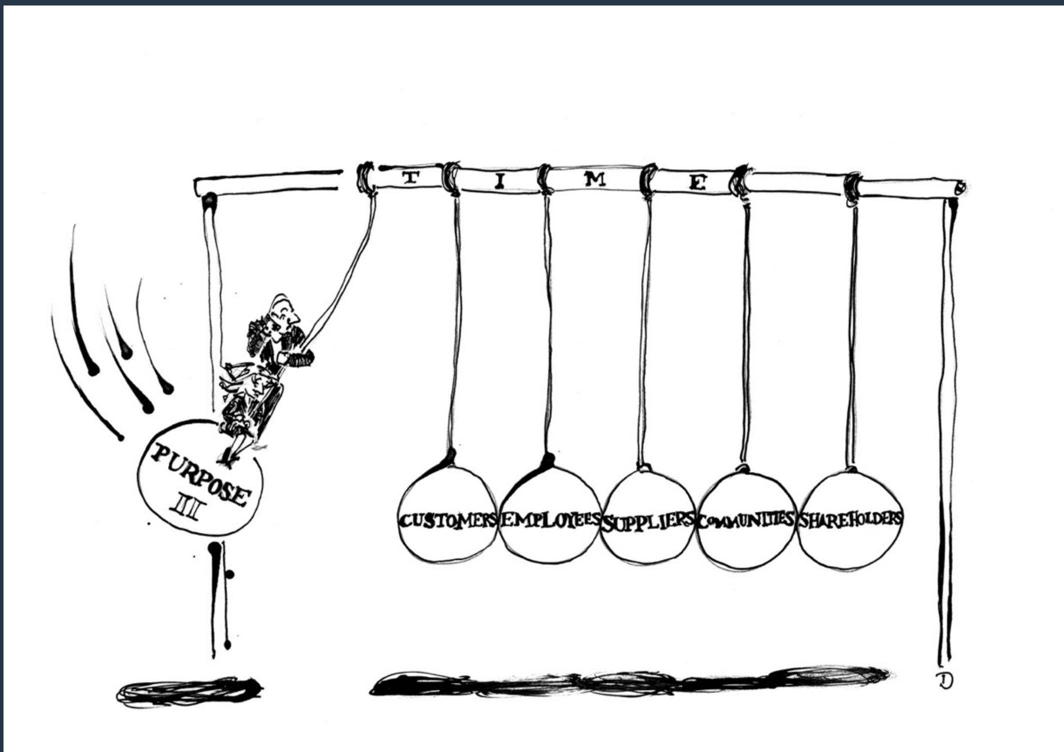
Preparing for the Impact of Purpose



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Executive Summary

The corporate pendulum is showing signs of having swung too far. The unremitting focus on short term profit maximisation has proved divisive and damaging. The world is out of balance.

Public frustration and planetary failures are now joining forces to pull businesses back to a focus on multiple stakeholders, over multiple time horizons.

Unless corporations take the lead in this move, they are in danger of either losing ground to competitors, leaving value untapped or, ultimately, being forced to shift further than they would like. The pendulum typically swings too far before settling at a new equilibrium.

Purpose provides the framework for decision making in this many tentacled world and is also a catalyst for value creation, guiding strategy and helping organisations innovate and respond to disruption.

Evidence based logic suggests that a clear purpose that is operationalised beyond the board room encourages employees to work harder, customers to remain loyal and the cost of capital to fall. Although causation is hard to establish, compelling evidence is emerging that there is no longer a trade-off between purpose and profit.

Having a clearly defined strategy that aligns with this purpose is the first step in moving along a more sustainable path; it is necessary but by no means sufficient. Operationalising that strategy through organisational change and aligning incentives such as remuneration to deliver non financial goals, is essential. As is cultural change. The power of purpose lies in motivating people around a common worthwhile endeavour which creates value for both business and society.

But in a multi stakeholder, multi time frame world, how do organisations measure how far they've travelled? If short term profit is no longer the benchmark to follow, what other metrics come into play?

Reputation provides one measure of progress. It is the canary in the coal mine.

Organisations do not own their reputation. It is the sum of others' views. In an age of radical transparency, reputation can no longer be artificially managed externally. It ultimately responds to actions and decisions taken internally which determine a corporate's character. There are no short cuts.

Which raises a number of questions; how do you evolve purpose and operationalise it effectively among all stakeholders? How do you measure and track reputation changes at a granular level among those stakeholders? How do you impact reputation most effectively from the inside out? And how can you use data and technology to predict what will happen to reputation in the future?

This paper argues that now is the time for businesses to move from a world dominated by short term shareholder maximisation – a Purpose 1 or P1 world – to one which optimises value across multiple stakeholders in multiple time frames – a Purpose 2 or P2 world.

There is demand for the move from both the public and investors, there is an urgent societal need for it and there is a business case to do so. Greater transparency on all three counts will enable businesses to judge for themselves whether any reasons at all remain as to why they would not.

Reputation: the canary in the coal mine?

Introduction

We live in a noisy world that likes to reduce complex, nuanced issues to their binary basics. Exit or Remain? Right or Left? Purpose or Profit?

But in reality the world is much less polarised. It is full of paradox, conflicting incentives and people, in all their glorious complexities. It makes definitive statements, particularly in economics, difficult to hold up to scrutiny. The issue of purpose versus profit is a case in point.

The debate over whether that trade off still exists, has been tempered or even eliminated has been building for some time. It is powered by both public demand that our corporations deliver more for society and well documented global imperatives such as environmental degradation, technological transformation and growing wealth inequality.

It is too soon to declare the trade off defunct. However, there is a compelling and growing body of evidence that suggests not only that purpose no longer demands its pound of profitable flesh, but that it actually drives better financial returns over time.

This paper draws together academic evidence, polling research and data points over more than 20 years to build the case that businesses whose strategies are actively driven by a purpose that optimises value for multiple stakeholders, perform better than those that do not.

Such evidence takes the personal out of purpose, allowing business leaders to make informed decisions for which they will be held accountable.

We argue this evidence suggests that now is the time for businesses to move from a world dominated by short term shareholder maximisation – a Purpose 1 or P1 world – to one which optimises value across multiple stakeholders in multiple time frames – a Purpose 2 or P2 world.

The question for corporates in this P2 world therefore becomes not what will generate the most money in the shortest time, but what will encourage each stakeholder to give their best? What purpose will bind all those stakeholders together? With signs that better returns are to be generated this way, it becomes a fiduciary duty.

The paper goes on to recognise the challenges of navigating successfully in this more nuanced world and argues that measuring and tracking a firm's reputation across those multiple stakeholders provides one critical management tool in evaluating progress. Reputation is the sum total of stakeholder views of a corporate's character and therefore their intentions towards that corporate, be that in terms of effort from employees, loyalty from customers, reliability of suppliers or trust from society as a whole.

With each one of those stakeholders driving value, their views on a corporate's character become critical. They also become a lead indicator that businesses cannot afford to ignore.

Changing purpose

Opinion is like a pendulum and obeys the same law. If it goes past the centre of gravity on one side, it must go a like distance on the other; and it is only after a certain time that it finds the true point at which it can remain at rest.[1]

For the last forty years or so, our understanding of business has been shaped by the Friedman doctrine[2]:

"Make as much money as possible, while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom."[3]

This itself was in part a response to the collectivist pressure that emerged post the depression era. Friedman's doctrine fell on fertile ground in the 1970s; it was clear (unlike the noise and lack of clarity of the 'rules' around the role of corporations post war) and it coincided with a move to individualism.

It was reinforced by a rolling back of regulation, particularly in financial markets, that encouraged investors to maximise returns and take on a corresponding rise in risk.

Many have argued this move to light touch regulation and the structural opportunities it created for risk taking sowed the seeds of the financial crisis, as well as hard wiring an extreme manifestation of Friedman's doctrine. Human nature provided the motive and the market provided the means, paving the way for a race to the top when it came to profits, by almost any (legal – although sometimes not even that) means. Incentives were well and truly skewed.

For the purposes of this paper we can refer to this formulation of short term profit maximisation as Purpose 1, or P1.

The P1 approach to business has been hugely impactful. For the last twenty years, the official stance[4] of America's top CEOs has been that the interests of their shareholders – the ones who benefit when the companies make money – came before the interests of anybody else they came across, whether workers, consumers, the environment, the geographical contexts they operate in, or even society as a whole.

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[1] Arthur Schopenhauer

[2] This statement by Milton Friedman (1970) in an influential article in New York Times set the pace for received wisdom in business education and practice for over four decades.

[3] Note the caveats in Friedman's statement. 'Ethical custom' implies due consideration to concepts such as implicit contracts where employees work unpaid overtime to fulfil an unexpected order or accept a wage cut during a downturn to keep the business afloat. Breaking that implicit contract through a lack of reciprocation, in the name of maximising profit, arguably violates the spirit of Friedman's dictum.

[4] As stated by the Business Roundtable in 1997, when it proclaimed that "the paramount duty of management and of boards of directors is to the corporation's stockholders." This message was repeated as recently as 2016.

This was not as grasping as it may sound; if companies focused on profits then the market would determine workers' wages, customers' prices, suppliers' contracts and all would be fair.

The machine of industrial capitalism, built on the primacy of the shareholder, has had global effects, both positive and negative. It has created enormous wealth and lifted many out of poverty, spurred innovation and provided dividend income for millions of pensioners.

However, these huge positive outcomes are being challenged; by an increasingly disillusioned public and by planetary-scale failures.

The Public Backlash

Both anecdote and evidence point to public restlessness and a huge breakdown of trust between citizen and corporate. More people are making their voices heard through protests or petitions and the media is responding, with a 66% increase in mainstream mentions of activism in the last five years.[5]

Millennials in particular are demanding change. Some 40% believe the goal of businesses should be to 'improve society'[6], they prefer to work with people and organisations that share their values[7] and almost two thirds prefer to buy goods and services from companies that stand for a shared purpose that reflects their personal values and beliefs – and are ditching those that don't[8].

Care should be taken over response bias; people may want to give the socially acceptable answer to a survey then go for the cheaper or more convenient product or service in reality. Data to back up the assertions are therefore crucial; is there evidence in sales and profit figures that shows people are doing what they say they are? We will return to this later.

The Investor Imperative

In addition to the demand for change from the public, there is additional pressure from investors. Having been indifferent for decades to positive social and environmental behaviours by the companies they invest in, they are now clamouring for information on new issues such as climate related risk, carbon policies and social impact aligned with the UN's Social Development Goals, as measures to guide the long term health prospects of a business.

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[5] Echo Research Sept 2019, *Populism v capitalism – business as a force for good?* shows that 53% of adults in the UK and 57% in the US have written to companies or the government, signed a petition or taken part in a march or protest.
[6] Deloitte *Global Millennial Survey, 2019*
[7] KPMG *Redefining the C-suite; Business the Millennial Way, 2017*
[8] Accenture *To Affinity and Beyond, 2018*

A short hand proxy for these concerns is the amount of funds being diverted into ESG indices. ESG money market funds saw their assets under management grow 15% to $52bn during the first half of 2019, versus 1% growth through all of 2018.[9] Still just a fraction of the $6tn money market sector, many are betting the upward trend will continue.

The number of investment companies that signed a commitment to incorporate ESG issues into their investment decisions had grown to 1,715 by April 2018, presenting $81.7 trillion in assets under management (AUM), up from 63 firms with $6.5 tn AUM in 2006. Institutional investors are becoming more activist too. According to the ESG research and advisory firm Institutional Shareholder Services, the share of total resolutions filed in the US focused on E&S has grown from around 33% between 2006-2010 to just over 50% by 2017. [10].

Planetary Scale Failures

A number of trends are fuelling this backlash, many of which exert influence on the corporate world regardless of public attitude. Some may be framed as external, while others may be sectoral issues, or even particular to the situation of an individual company.

For example, office services firms may have to incorporate post-carbon transition thinking into their energy choices, something they might regard as an external factor impacting their business decisions. For power stations, the post-carbon transition is not an external factor as much as the defining sectoral issue they must grapple with.

It is therefore useful to categorise the various factors that are combining to force the pendulum to swing away from shareholder supremacy as follows:

- Global megatrends
- Business trends
- Sector trends
- Company specific issues

Here is a brief description of the content of the first two categories (see Annex A for more detail)

Global megatrends

These factors are shaping the whole of society; businesses, public, governments, communities.

[9] Fitch Ratings
[10] https://her.org/2019/05/the-investor-revolution

Climate change: the defining existential crisis[11] of our age will impact every business on the planet. However, companies operating in certain industries that are seen to be causative in driving climate change (such as energy, fossil fuel financing, deforestation and agriculture) will experience massive reputational issues and huge shifts in strategy and business models.

Demographic change: the world's population is expected to grow by a billion people between 2015 and 2030, with almost all that growth coming from emerging and developing countries. At the same time, as people live longer but have fewer children, it will be the over-65s who will grow fastest.[12] Further, by 2050, one in nine people will have been forced to flee their homes due to climate change, creating one billion climate refugees by 2050.[13]

The shape of the *global economy* is changing, as fast-growing emerging economies are pushed into recession by plunging commodity prices, and global giants battle each other through trade wars. The fall in the price of oil deepens the impact of climate change through the growing use of the commodity.[14]

Scientists commenting on the loss of *biodiversity* say that we are headed towards what could be the sixth mass extinction in the history of life on earth. "The health of ecosystems on which we and all other species depend is deteriorating more rapidly than ever before," states Sir Robert Watson, chair of the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES). "We are eroding the very foundation of our economies, livelihoods, food security, health and quality of life worldwide."[15]

While globalisation has lifted many out of poverty, both *wealth and income inequality* have risen markedly in the last 40 years. Statistics abound; the share of global income earned by the richest 1% has risen to more than 20% vs 16% in 1980. In the US in 2018, the three richest individuals there had more combined wealth than the bottom 50% of Americans.[16]

These global megatrends are colliding with another major change: pervasive, rapid and constant *digital change*. Whether we talk about artificial intelligence, augmented reality, drones, blockchain, internet of things, robotics, virtual reality or massive data, we are seeing both society and business transformed by technology. PwC reports that 51% of

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[11] The Intergovernmental Panel on Climate Change features over 1300 scientists from across the world. They are forecasting a global temperature rise of between 1.5 and 6 degrees centigrade by the end of the century, compared to 1990 levels. By the end of the second decade of the 21st century, NASA's climate team says we are already witnessing rising global temperatures, warming oceans, shrinking ice sheets, retreating glaciers, rising sea levels and acidifying oceans.

[12] Population data drawn from World Population Prospects 2015.

[13] UN International Organisation for Migration (2014) report.

[14] The Energy Information Administration reported that total oil production averaged more than 80 million barrels of oil per day in 2018. The Guardian newspaper's report on major carbon emitters quotes Rystad Energy forecasts that the biggest oil companies are poised to flood markets with an additional 7 million barrels per day over the next decade.

[15] IPBES (2019) report finds that nature's dangerous decline is unprecedented, with around one million species now threatened with extinction, many within decades.

[16] Inequality.org [https://inequality.org/facts/global-inequality/]

CEOs are making significant changes in how they use technology to assess and deliver on wider stakeholder expectations.[17]

Finally, this cocktail of trends is catalysing moves to a *circular economy* where waste is minimised and products reused, thus improving their productivity. Business models are adapting vertically through the value chain, from manufacturers to retailers.

Business trends

Businesses must be prepared to act in response to the global megatrends outlined above, but they can do little to change them on their own. However, there are a number of challenges that companies must be proactive in addressing, since neglect here could be hugely disruptive for their reputations and performance.

These include: a changing regulatory environment in a number of sectors; questions around trust in business; radical transparency; shifts in power across stakeholder groups; changes in investor behaviour and governance issues.

Sector trends and company specific issues

Apart from the megatrends and general business trends that apply to all companies, there are some trends that are more specific to companies in a particular industry or sector. For example, the Sustainable Apparel Coalition[18] is creating standardised measurement tools that assess social and environmental performance in companies and their supply chains.

Other issues may be even more granular and company specific. For example, your running shoes are being boycotted by your customers, or your pilots refuse to fly your planes. For these reasons and more, nobody can hide behind a P1 focus for their business.

Understanding Value

The pressure from public and planet is causing the pendulum of opinion to swing with some force away from short term profit maximisation.

Today, companies find that they need to deal with two currents that are changing their understanding of how value flows around businesses:

- The (sometimes conflicting) needs of multiple stakeholders, rather than the easy alignment of delivering to the benefit of a single stakeholder, namely shareholders.
- The way in which an understanding of the short, medium and long term decision horizons causes deep complexity in decision-making, relative to the simplicity of managing for a single time horizon, usually the short-term.

[17] PwC (2106) for the 19th annual Ceo survey.
[18] The Sustainable Apparel Coalition has developed the Higg Index, a suite of ESG performance tools used by apparel brands, retailers and manufacturers. See https://apparelcoalition.org/

Significantly, the 181 American CEOs represented at the Business Roundtable have realigned their focus.

In its August 2019 Statement of Purpose, the Business Roundtable highlighted five stakeholders. As a group, they now seek to meet or exceed *customer* expectations, invest in *employees* and compensate them fairly, help them gain skills for a rapidly changing world, deal fairly and ethically with *suppliers* and support the *communities* in which they work. Finally, they wish to generate long-term value for their *providers of financial capital*[19].

In other words, those corporations, which represent 30% of total US stock market capitalisation between them, embody a rebalancing among stakeholders and society; businesses still need to generate a return on capital invested, but it is no longer viable to do so through a slash and burn approach that disregards all other stakeholders.

In effect, whether these CEOs perform in line with these new expectations, the lesson is clear: the P1 approach to business is looking increasingly outmoded. Its fundamental assumption, that the creation of wealth for shareholders fulfils, in its entirety, the purpose of a business, is broken. Today, companies need to address the creation (and destruction) of value across their entire value chain – which includes, but is not confined to, value in the form of profit to those shareholders.

The concept of value is not new in management circles; in the twenty years preceding January 2015, the four leading strategy journals (Strategic Management Journal, California Management Journal, Harvard Business Review and Sloan Management Review) together published 189 articles with the word 'value' in the title.[20] On average, these magazines published a new article focused on value every month for twenty years.

But whereas in practice, value has arguably played second fiddle to profit for some time, it is beginning to emerge as a serious challenger, even when there are no apparent problems for shareholders or customers.

For example, chemical companies still deliver value to their customers and shareholders through their single-use plastics products, but they destroy value elsewhere in the chain – such as through marine pollution. This holistic imperative is upending their understanding of how they create value, and who their stakeholders are. Governments could choose to make that holistic calculation more explicit by introducing penalties for marine plastic pollution; it could intervene to internalise the externality. Or the market could do it through a shift in sales.

In this new environment, where public opprobrium and planetary-wide failures are rendering the P1 approach inadequate, forward looking businesses are searching for a new purpose, which we may choose to call Purpose 2 or P2.

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[19] To read the full statement of the Business Roundtable Statement on the Purpose of a Corporation, please see https://opportunity.businessroundtable.org/wp-content/uploads/2019/09/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures-1.pdf

[20] Verdin et al (2015) state that although value seems to be the holy grail for every company, it also seems one of the most used and misused terms in management literature.

We define a P2 organisation as one making a positive contribution to society through attention to multiple stakeholders over multiple time frames.

That contribution is needed, defined, and backed up with time bound and measurable goals and targets that are intrinsic to its business strategy.

In short, this changed, evolved purpose needs to meet the broader issues predicated on addressing multiple stakeholders across multiple time horizons. Today's company needs to optimise how it creates value, rather than how it maximises profit and it needs to find ways of measuring progress towards its long-term value goal that do not rely on over simplistic metrics such as short run profits.

Strategy

Setting strategy in a dualistic world of short-term profit maximisation is relatively straightforward. Will a management decision make money or lose money? Will sales rise, will costs fall, will actions neuter competition?

Harvard Business School economist Michael Jensen argues in favour of such optimisation of one goal: "since it is logically impossible to maximise in more than one dimension, purposeful behaviour requires a single valued objective function," namely, the maximising of total market value[21].

For senior executives raised on the P1 idea, that makes perfect sense. Moreover, the tools used for measuring progress towards that single goal are equally clear - discounted cash flow, return on equity etc. – as are the incentive structures that reward performance, namely those denominated in terms of financial capital.

However, setting strategy in a multi stakeholder, multi time horizon, value maximising world is more challenging.

This very present, non-dualistic world raises a whole set of new questions. How does an organisation create value? Who benefits from this creation of value? While value is being created in one area of the business, is it being destroyed elsewhere? Who gets hurt as a result of this destruction of value? And how can progress be measured?

Value looks very different for each set of stakeholders. Managing performance in value creation requires a new statement of a company's purpose. That purpose provides the thread, the framework for decision making in the new, many tentacled world.

But it must go beyond the boardroom; having a purpose is necessary but not sufficient. Operationalising purpose will likely take structural and organisational change. A new set

[21] Jensen (2000) points out that taking into account all the stakeholders of the firm makes it impossible to keep score on performance. Hence, his preference for setting managers an unequivocal objective around value maximisation.

of incentives will have to be introduced to drive behavioural change and data identified to measure non financial progress. We return to this later.

Roger Martin, a leading proponent of integrative thinking, suggests creating an environment in which those operating it can make coherent decisions by "choosing a variable to optimise and set minimums (and maximums, if you wish) for all the other relevant variables[22]."

But even if having a singular objective is optimal for management decisions, should that objective be shareholder value maximisation? Martin argues that it should not be – maximising customer satisfaction is his preferred weapon. Vineet Nayar, the former CEO of HCL, an Indian tech giant, prefers to put employees before customers[23], as the most innovative ideas are emerging from the ground up, resulting in a better outcome for customers.

Can we trust customer satisfaction as the key metric to drive our businesses? Or should we be embracing employee engagement? What other non-financial capitals could be driving value across a business?

The table below summarises six different capitals as designated by the International Integrated Reporting Council, that together better define value:

Financial capital – the pool of funds available to an organisation or its use in the production of goods or the provision of services – this capital is obtained through financing or is internally generated
Manufactured capital – the manufactured physical assets available for use by the organisation
Intellectual capital – organisational and knowledge-based intangibles, including patents, software, systems and procedures
Human capital – the competencies, capabilities and experience of the organisation's people
Social and relationship capital – the relationships and institutions within and between communities, stakeholders and other networks intersecting with the organisation
Natural capital – all renewable and non-renewable environmental resources that the organisation uses, including air, water, land, biodiversity and the health of ecosystems.

Table 1: Capitals as drawn from Banerjee (2019) in the Oxford Handbook of Food, Water and Society

It is clear that to continue to emphasise financial performance as the variable to optimise is to misunderstand the transformation in value that has taken place over the last forty years or so. Tangible assets (as captured in a company's balance sheet) used to represent 83% of the value of S&P 500 companies in 1975, according to an Ocean Tomo study. By 2015, tangible assets only represented 16% of overall market value, with intangible assets such as good will, reputation and intellectual property driving value across the rest[24]. Clearly, to focus management attention on 16% of value, while missing the drivers

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[22] Martin (2016) argues that the argumentation around shareholder value maximisation contains an helpfully false premise that aiming to maximise shareholder value actually results in the achievement of that objective.
[23] Nayar (2010) feels that companies who claim to put their customers first, don't actually know how to deliver on that promise. By putting employees first, companies can make good on their "customers first" objective.
[24] Ocean Tomo (2017) has been carrying out a value study on intangibles and intellectual capital for a number of years.

for 84% makes no sense whatsoever. It simply affirms the continuing dominance of operating business-as-usual, even if business has changed all around us.

But if shareholder value is not the variable to optimise, does the empirical evidence suggest there is an alternative? And is the alternative better?

Moreover, which value drivers – or, from the other lens, which stakeholders – are most material for different businesses? A technology firm may derive much of its value from the intellectual capital of its software engineers and so want to focus its attention on employee retention. A consumer goods firm on the other hand may prize customer loyalty more which could be driven by perceptions of responsible business practices as much as price.

In accountancy terms, it becomes necessary to consider materiality, where an issue is deemed to be material if it becomes relevant to the economic decision-making of the users of that information.[25]

The Evidence for a Broader Sense of Value

The question of whether it pays to heed multiple stakeholders rather than just shareholders or if there is a trade off between purpose and profit is one that has occupied practitioners and academics for some years. As Colin Mayer, professor at Oxford's Said Business School, puts it, "Does doing good do well?[26]"

Mayer states that "a decisive study of a relation between responsibility and performance is the Holy Grail to which the business and financial academic community is working frenetically. But like the quest for the Holy Grail, it is proving a bit more elusive than might have been hoped."

However, while there may not be a smoking gun (yet?), the evidence is mounting that there are good relationships between company performance and non-financial drivers of value. Or, viewed through an alternative lens, between profit and purpose.

Some key studies point the way. The following are grouped where possible by stakeholders as specified by the US Business Roundtable:

Multiple stakeholders (proxied by high CSR) as value drivers:

- In a US study of 1,556 mergers, Deng et al (2013) find that those by high CSR acquirers lead to higher announcement stock returns for acquirers and for value-weighted portfolios of the acquirer and target, larger increases in long-term

[25] IFRS (2017) Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of a specific reporting entity's general purpose financial statements make on the basis of those financial statements.

[26] Mayer (2018) seeks to provide a number of solutions to the diagnosis he develops on why the corporation is failing us.

operating performance and stock returns, and higher likelihood and shorter duration of deal completion.[27]

- A study of 12,915 US companies by El Ghoul et al (2010) determined that companies with a higher CSR score exhibit lower cost of equity capital.[28]
- By combining the findings of about 2200 separate academic studies, Friede, Busch and Bassen (2015) were able to report that the business case for ESG investing is empirically well-founded. Around 90% of all the studies report a nonnegative relationship between ESG criteria and corporate financial performance.[29]
- During the financial crisis (in the period from August 2008 to March 2009), Lins et al (2017) found that high performing CSR firms earned stock returns during the crisis that were 5-7 percentage points higher compared with low performing companies.

Community stakeholders:

- Khan, Serafeim, Yoon (2015), using calendar-time portfolio stock return regressions in a study of 2,307 companies in the MSCI KLD dataset, found that the top performers on material sustainability issues outperform their peers in a range from about 3% to 8% annualised. This suggests that investments in sustainability issues are shareholder-value enhancing.[30]
- In a study of 180 US companies by Eccles, Ioannou and Serafeim (2014), companies that voluntarily adopted sustainability policies significantly outperformed those that didn't over the long-term, both in terms of stock market and accounting performance.

Employee stakeholders:

- In studying the 244 companies that featured in the 100 Best Companies to Work For list (key factor here is employee satisfaction) between 1984 and 2009, Edmans (2011) found that a portfolio of these companies generated a 3.5% value-weighted return over the risk-free rate.[31]
- Firms with employees that maintain strong beliefs in the meaning of their work experience better performance[32]

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[27] Deng et al (2013) find that companies with high CSR scores have significantly higher Tobin's q and free cash flow than firms with low CSR scores, suggesting that firms with strong performance are more active in their CSR activities (McGuire, Sundgren, and Schneeweis, 1988; Jiao, 2010). Compared to firms with low CSR scores, those with high CSR scores have higher scaled wealth-performance sensitivity of CEO compensation (Edmans, Gabaix, and Landier, 2009), are better governed (i.e., low G-index), operate in more competitive industries, and maintain lower leverage.

[28] El Ghoul at al (2010) suggest that investment in improving responsible employee relations, environmental policies and product strategies contributes substantially to reducing firms' cost of equity.

[29] Although Principles of Responsible Investment (PRI) signatories accounted for around 50% of the total global institutional assets base, Friede et al (2015) quote studies that less than a quarter of investment professional sconsider extra-financial information frequently in their investment decisions.

[30] Khan, Serafeim, Yoon (2015)presents excellent evidence on the value implications of sustainability investments.

[31] Edmans (2011) reports that this alpha is consistent with human capital-centereed theories, as well as pointing to the fact that the stock market does not understand how to fully value intangibles.

[32] George Serafeim (HBS), Andrea Prat (Columbia University) and Claudine Gartenberg (NYU (2016)]

- SAP, the German business software company, relies heavily on human, intellectual capital.[33] It has determined that every percentage point change in employee retention has a positive 55-65 million euros impact on non-IFRS operating profit. Employee engagement provides a 50-60 million euros impact and the Business Health Culture Index, which tracks to the degree to which the company's workplace culture supports well-being, work-life balance and organisational health, contributes 90-100 million euros for every percentage point change.[34]

Intellectual capital:

- Investment in R&D is usually under-priced by the market. Lev and Sougiannis (1996) reported a 4.6 excess return while Chan, Lakonishok and Souginannis (2001) found that firms in the top quintile of R&D flows earn excess returns of 6.1%.

Customer stakeholders:

- Fornell, Mithas, Morgeson and Krishnan (2006) found that a 1% change in the American Customer Satisfaction index (ACSI) is associated with a 4.6% change in market value for an individual company.[35]
- Purposeful brands outperform the stock market by 133%[36]

Social capital:

- Bloom, Sadun and Van Reenen (2012) find, in a study of almost 4000 companies across Europe, North America and Asia, that social capital (as proxied by trust) increases aggregate productivity, primarily by impacting the way the companies are structured. Companies geographically located in high-trust regions are more likely to decentralise.
- Consecutive CEO surveys by PwC suggest that regaining trust is critically important for business, with a majority of CEOs pointing to the building of a more ethical culture as the basic building block for this.

There is more work to be done in establishing causality, not just correlation, between profit and purpose. But if corporates wait until the evidence is indisputable, there is a

[33] Banerjee (2019) points to the key drivers of value creation in people-focused businesses such as tech, pharmaceuticals and financial services, as being people, ideas and relationships. He calls these the hidden capitals of a company.
[34] For more information on these and other non financial drivers of value creation, see the SAP Integrated Report 2018, available here: https://www.sap.com/docs/download/investors/2018/sap-2018-integrated-report.pdf
[35] Interestingly, news about customer satisfaction results does not move share prices according to Fornell et al (2006). At a low systematic risk, it is possible to beat the market consistently by investing in firms that do well on customer satisfaction.
[36] http://www.meaningful-brands.com/en

risk the pendulum will have swung away from them, possibly past the equilibrium point, powered by public anger and the urgency of planetary-wide failures. There is danger in simply waiting for a squall to pass.

As John Maynard Keynes famously said;

"But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."[37]

Reputation and Corporate Character

We have argued that the world has moved from a P1 state of maximising short term shareholder returns to a P2 state of optimising value for multiple stakeholders over multiple time horizons. That demands a different business model where purpose is the framework for decisions, providing a North Star in the presence of constant change and driving value across all those stakeholders. To achieve this, purpose must be executed beyond the boardroom, through appropriate organisational and incentive structures and done so with intent.

This move to a P2 world against the backdrop of our age of radical transparency, demands organisations rethink their approach to reputation.

We define reputation as the sum total of stakeholder views of an organisation. It cannot be artificially managed externally – the corporate does not own it in that sense. But it responds to actions and decisions taken internally that shape a corporate's character.

In a P2 world stakeholder views of a corporate's character therefore become critical for three reasons: they drive value, guard against risk and act as an early warning sign of trouble.

- *Corporate Character Drives Value*. Stakeholders' views towards an organisation determine their intentions towards it. If views are favourable, employees may put in more effort, customers be more loyal, suppliers more reliable and society as a whole more trusting. In other words, implicit contracts are strengthened which gives organisations a distinct competitive advantage.
- *Corporate Character Guards Against Risk*. With intangible assets such as trust, reputation, goodwill and intellectual capital colonising the balance sheet, risks are broader, more unpredictable and equally intangible. It is easy to insure against a factory fire, less so to insure against a social media fire. A robust corporate character becomes an effective risk mitigant.
- *Corporate Character Signals Trouble*. Without short term financial metrics to show progress, measuring and monitoring reputation becomes one way to extract

[37] J M Keynes *A Tract on Monetary Reform (1923)*

a signal from the noisy, messy P2 world. It is the **canary in the coal mine**, an early indicator of both success and impending failure. Tracking reputation allows management to take operational decisions before problems manifest in the bottom line for example via rising staff turnover or downward trending sales.

With reputation simultaneously a value driver, a risk management aid and an indicator of future value, it deserves rigorous, systematic attention in its entirety, at the highest level in a corporation.

In a P2 world it becomes necessary to both track what each stakeholder group thinks separately and to collate and critique that data centrally, at board level. Employee engagement can no longer be confined to the people function, net promoter scores no longer the sole domain of the sales team, investors' feedback must go beyond the investor relations team.

If managed with intent and skill, reputation gives an organisation the legitimacy it needs to implement the value creation strategies that will benefit them in the longer term.

Without this reputational air cover, business will be forever squeezed between the imperative to chase short term profits on one side versus the demand to take long term decisions on behalf of multiple stakeholders on the other.

The ability to manage reputation more effectively comes from a structured process that uses a combination of technology and human judgement to gather and assess disparate data, both internally and externally held, on stakeholder perceptions. It allows businesses to determine whether they suffer from a reputation deficit – often without even being aware of it.

For example, a firm entrenched in a P1 world may make decisions unaware of the changing context around it. It may continue to operate business as usual when customers, employees, suppliers, the community is demanding anything but.

Reputation tracking forces the hard of hearing to listen.

Call to Action

The case for purpose led organisations is not yet beyond dispute. A number of areas would benefit from additional work.

First, *more data is needed* on the relationship between purpose and profit, both from academics and practitioners, be they corporations, asset managers, private equity investors and more. But waiting for definitive causal evidence could too easily slip into an excuse for inaction.

Second, firms intent on making purpose their anchor must also *introduce incentive structures that drive non financial outcomes.* This is critical to taking purpose beyond slogan and into strategy. For example, remuneration could be linked to employee retention, customer satisfaction or paying suppliers on time, rather than only to short term profit maximisation. And they will have to be held to account through an entire business cycle if colleagues are to believe the board is committed to a P2 approach. Standard Bank, the South African financial institution, is one example of a firm that has done just that but more documented case studies are needed.[38]

Third, the *definitions of success in a P2 world will have to evolve* alongside the multi stakeholder model; it is striking that P2 measures like customer satisfaction or employee engagement are being couched in terms of the P1 metric of profit. Does investing in employee engagement create a direct link to greater customer satisfaction? Is there value to be driven by the inverse connection? Intuitively, this makes sense but evidentially it is harder to prove.

[38] In 2017, Standard Bank executives were required to report against value drivers in its Social, Economic and Environmental (SEE) impact programme. Its Remuneration Report that year included, for the first time, a breakdown of the key executive remuneration against those value drivers. To find out more about Standard Bank, please see its 2018 Integrated Report, available here: https://annualreport2018.standardbank.com/

Conclusion

This paper has attempted to make the case for an evolved purpose (P2) in an evidence based and rigorous way. It has argued the need for a value based approach in a multi stakeholder world, where reputation provides a critical early indicator of success or failure.

In doing so, it raises some key challenges for organisations:

- How are all your stakeholders – employees, customers, suppliers, the community – bound to your organisation, other than through money or a contract? What is the glue?
- Does your corporate purpose encourage all stakeholders to give their best? How do you know whether it does, how do you measure its impact?
- Do you know what all your stakeholders think of your corporate character? Does that match what *you* think is your corporate character?
- If there is a disconnect between the two, why so? How much value are you losing as a result? What fundamental actions need to be taken to close that gap?
- How are you managing your intangible assets? Which are the most material? Is intellectual, social, environmental, relationship capital best managed in your organisation via explicit contracts, or should you take a more holistic approach, recognising that each are driven by *people*?

We live in an Information Age; purpose is not something we should have to 'believe' in or not. If business leaders are given the facts around its role in value creation and its impact on reputation, they will then judge for themselves the efficacy of threading it into their organisations. The more information there is, the less personal and polarising the discussion.

The issue calls for transparency and honest debate, less guessing, more assessing.

This paper hopes to contribute to that debate.

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About Apella Advisors

Apella was established in 2019 to help organisations manage a multi stakeholder world with confidence. Our advisory skills are proven and our team is senior, combining expertise, experience and a broad and deep network. We operate a rigorous approach based on hard evidence and data, overlaid with good judgement.

We believe that an evolved **Purpose** is the guiding light that should drive **Strategy** which, when well executed, differentiates and generates an exceptional **Reputation**. The causation runs in both directions. We are interested in corporate character and how it can confer a sustainable competitive advantage.

Because all three are self-reinforcing, where some advisory firms work on strategy and some help to build reputations, we work end to end with organisations to reap those synergies. We are able to embed our consultants to ensure our advice is practical and commercially relevant.

www.apellaadvisors.com

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ANNEX A: Business trends

Issue	Fact
Shifting regulatory environment	An OECD report on regulations finds that they are "often necessary for a well-functioning, market-based, capitalist society, but they do not always live up to public expectations or achieve their social goals."[39] We are also witnessing continental differences in regulation: post 1990, the US has regulated far less aggressively than has the European Union.[40]
Trust in business	Although trust in business is growing in 21 of 26 markets reported in the 2019 Edelman Trust Barometer, many Western economies are distrustful of their companies, including Germany, United Kingdom, Spain, Japan, Ireland and South Korea.[41]
Tax handling	Policy makers and researchers have long been interested in how potential changes to the personal income tax system affect the size of the overall economy
Changes in expectations	Customers and citizens have rising expectations for businesses that they engage with. According to the Gladly (2018) study, 54% of US consumers make purchasing decisions based on customer service and 68% would pay more for products or services from a company with good service.[42] Rising expectations is about more than just customer service. Business often comes with "inherent negatives" according to Barie Carmichael, such as high demand of natural resources, or environmental hazards. "It's how a company manages these inherent negatives and work to reduce their impact that determine whether or not consumers see them as progressive minded or social pariahs."[43]
Transparency	94% of consumers are likely to be loyal to a brand that offers complete transparency, and 73% are willing to pay more for a product that offers complete transparency in all its attributes. [44]
Accountability	There is a shift away from the shareholder primacy expectation that company boards have. Accountancy Europe, the apex professional body for accountants in Europe, proposes that boards have a prime responsibility to make the economy sustainable. This requires them to transform the business model of the company to be sustainable, and make board composition fit for a (renewed) purpose.[45]

[39] OECD (2011) report on regulatory policy and governance.
[40] Oxholm (2013) argues that Europe has become the global leader in regulation, a role previously played by the United States.
[41] Edelman Trust Barometer (2019) report.
[42] Gladly (2018) study.
[43] Uzialko (2017) in an interview with Barie Carmichael, co-author of Reset: Business and Society in the New Social Landscape, Columbia Business School Publishing, 2018.
[44] Label Insight (2016) finds that consumers want more than just required product information and will be loyal to a brand that provides detailed insights.
[45] Accountancy Europe (2019) is of the view that boards have the power to transform their business and help leverage one of the greatest drivers of change: markets.

Corruption and integrity	Transparency International reports that the foundations of democracy and the rule of law are under threat given the rise of authoritarian and populist regimes around the world. "The rise of state capture and the free flow of dirty money fuels human and environmental crimes, loss of privacy and civic space, and weakens the capacity for international concerted action. " [46] Businesses supporting corrupt regimes and practices face a reputational crisis.
Long-term horizons	The greatest performance pressures on executives and directors are over a two-year horizon – unsurprisingly, 99% of earnings for the S&P 500 are spent on dividends and buybacks. Rodney Zemmel and Mike Useem, authors of Go Long, argue that the real challenge is balancing short-term decisions with long-term performance. [47] Dominic Barton proposes three essential elements for the shift to long-term thinking: a) jettison short-term orientation and revamp incentives for the long term; b) executives must infuse the business with the perspectives of major stakeholders; c) cure the ills stemming from dispersed and disengaged ownership by bolstering boards' ability to govern like owners.[48]
Governance	McKinsey studies show that the "most effective ownership structure tends to combine some exposure in the public markets (for the discipline and capital access that exposure helps provide) with a significant, committed long-term owner."[49] Where such a long-term owner is absent, boards need to step up to play that role.
Changes in investor behaviour	There is growing confidence across the investment community that assets with impressive environmental, social and governance (ESG) performance are delivering strong financial returns. The ESG Global Survey 2019 report finds that 75% of asset owners and 62% of asset managers hold more than a quarter of their funds in funds incorporating ESG[50] – in Europe this is higher than in North America. This study finds that the top drivers behind ESG integration are improved long-term returns, brand image and reputation, decreased investment risk and regulatory/disclosure demands.

[46] Transparency International (2019) announcement on the theme of their 2020 conference – Designing 2030: Truth, Trust and Transparency.
[47] McKinsey (2018) podcast interview with Zemmel and Useem.
[48] See Barton (2011) for a detailed discussion on the need for business leaders to move to a long-term orientation.
[49] Barton (2011) makes the point that CEOs too often listed to the investors and members of the media who make the most noise. In an environment where most large public companies have highly dispersed ownership, such an approach means CEOs usually end up listening to parties who are usually the most nearsighted, reinforcing the tyranny of short-termism.
[50] BNP Paribas (2019) study covers the responses of 347 asset owners and managers.