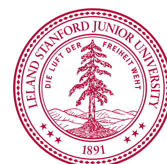

STAKEHOLDERS AND SHAREHOLDERS

ARE EXECUTIVES REALLY "PENNY WISE AND POUND FOOLISH" ABOUT ESG?

BY DAVID F. LARCKER, BRIAN TAYAN, VINAY TRIVEDI, AND OWEN WURZBACHER

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INTRODUCTION

Currently, there is much debate about the role that non-investor stakeholder interests play in the governance of public corporations. Critics assert that the shareholder primacy model—the idea that the primary purpose of an organization is to maximize value for investors—is flawed because it encourages managers to adopt a myopic view of profit generation that forgoes the investment necessary for the long-term sustainability of the company and overlooks costs created by the company's activities that are borne by society (externalities). These critics argue that greater attention should be paid to the interests of non-investor stakeholders and that by investing in initiatives and programs to promote the interests of these groups, the corporation will create long-term value that is larger, more sustainable, and more equitably shared among investors and society.[1] This concept is known as ESG (environmental, social, and governance) investing.[2]

Advocacy for a more stakeholder-centric governance model, however, is based on assumptions about managerial behavior that are relatively untested. For example, little information is available about the degree to which executives currently incorporate or ignore non-investor stakeholder interests in strategic planning and investment decisions. Furthermore, little is known about the views that these executives have about the relative costs and benefits of ESG activities in both the near and long terms.

Are executives really as "penny wise and pound foolish" as critics assume?

PRESSURE TO INCORPORATE STAKEHOLDER INTERESTS

Pressure has been growing on large, publicly traded U.S. corporations to incorporate stakeholder interests into their long-term strategic planning. This pressure comes from multiple fronts:

- *Money flowing into ESG investment funds*. In 1995, less than $1 trillion was invested in money managers and institutional investments dedicated to sustainable, responsible, and impact investing in the U.S. By 2018, that number exceeded $12 trillion.[3]
- *ESG-related proxy proposals*. The number of shareholder-sponsored proxy proposals that require companies to address ESG-related considerations has generally increased over the last decade. Furthermore, the percent of shares voted in favor of these proposals has also increased (see Exhibit 1).
- *Institutional investors*. Large institutional investors that had previously taken passive stances on ESG-related issues have become more assertive. For example, BlackRock engages in an annual letter writing campaign to encourage portfolio companies to incorporate stakeholder needs into their business planning, Vanguard engages with companies through what it calls "quiet diplomacy" to understand stakeholder issues, and State Street launched a public campaign to pressure companies with all-male boards to increase gender diversity.[4]
- *ESG metrics*. Data providers use survey data and publicly observable metrics to rate companies along a variety of stakeholder dimensions. This data is sold to institutional investors to inform investment decisions or is used in magazine rankings. Examples of data providers include MSCI, HIP ("Human Impact + Profit"), and TruValue Labs. Examples of published indices include Barron's 100 Most Sustainable Companies, Bloomberg Gender Equality Index, Ethisphere Institute's Most Ethical Companies, and Newsweek Top Green (see Exhibit 2).
- *Employee activism*. Employees of some companies have become more vocal expressing their views to management on environmental or social issues. In the last year, employees at Microsoft protested the company's involvement in the development of weapons technology for the U.S. military, employees at Amazon wrote a letter urging management to take more aggressive efforts to reduce climate change, and Google employees staged a worldwide walkout over the company's handling of sexual harassment allegations against a former senior executive.[5]

EXECUTIVE VIEW OF STAKEHOLDER INTERESTS

Despite these pressures, corporate executives need to make rational investment decisions for both the short and long terms. To understand the role that stakeholder interests play in corporate planning, we surveyed over 200 CEOs and CFOs of companies in the S&P 1500 Index.[6] We find that companies do not adopt a shareholder-centric governance model that is as extreme as current critics suggests, that many companies pay significant consideration to stakeholder interests, particularly those of their employee base, and that most do not agree with the prevailing assumption that addressing stakeholder concerns requires an economic tradeoff between the short and long terms.

CEOs and CFOs claim that stakeholder interests already play a considerable role in the management of their companies. Eighty-nine percent believe it is important or very important to incorporate the considerations of these groups in their business planning; only 3 percent believe it is slightly or not at all important. Furthermore, most (77 percent) do not believe that shareholder interests are significantly more important than stakeholder interests. Instead, most assign some level of parity in weighing the interests of these two groups, and almost all (96 percent) are satisfied or somewhat satisfied with the job their company does to meet the interests of their most important stakeholders (see Exhibit 3).

When asked to assess the relative impact of ESG activities today and in the future, only 12 percent believe addressing stakeholder interests requires a short-term cost in order to generate long-term value. This finding directly contradicts the standard narrative that companies do not invest in ESG activities because they are unwilling to incur a temporary hit to profitability. Instead, most respondents believe either that investing in ESG activities is costly in the short run and will continue to be costly in the future (37 percent), or that investing in these activities generates immediate benefits that will continue into the future (28 percent). The remaining respondents (24 percent) believe ESG activities have little cost or benefit in either the short or long term (see Exhibit 4).

Given their satisfaction with the work they do to address stakeholder interests and their assessment of the relative costs and benefits of these initiatives, it is perhaps not surprising that CEOs and CFOs view with suspicion institutional investors who advocate that they "do more" for stakeholders. Respondents in our survey, for example, generally agree with the sentiments expressed by BlackRock CEO Larry Fink in his annual letter to portfolio companies, but his words appear to have very little impact on corporate activity. For example, a large majority (82 percent) agree with Mr. Fink that companies have a responsibility to address broad social and economic issues.[7] They also agree with him (69 percent) that companies face pressure to maximize short-term pressure at the expense of long-term growth.[8] However, the vast majority (87 percent) of CEOs and CFOs say his letter does not motivate them or only slightly motivates them to evaluate or implement new ESG initiatives.

This might be because executives believe they are already doing a satisfactory job of incorporating stakeholder concerns into their corporate planning. One respondent commented that his company was already "implementing extensive ESG initiatives and would have done so without the letter." It might be because they are circumspect of Mr. Fink's motivation. According to another respondent, "I think it's all marketing." Or, it could be that ESG investment can only be profitably achieved in a more narrow scope of activities than Mr. Fink recommends:

> *To the extent addressing social and economic issues is in the long-term interest of our business we will do so. We're not going to tilt at windmills that have nothing to do with our business, but we will invest in employee comp and benefits, in reducing our environmental footprint, and in addressing human rights policies.*

Finally, it might be that companies are not responsive to activism by their largest investors because they do not believe their shareholder base as a whole cares about stakeholder interests. Only 43 percent of CEOs and CFOs believe their overall investor base cares about stakeholder interests, while 38 percent believe they do not (see Exhibit 5).

Still, companies acknowledge having a problem communicating the scope and value of the work they do to address stakeholder needs. Only half (50 percent) believe their stakeholders understand what the company does to meet their needs. A third (33 percent) believe institutional investors understand what the company does to meet stakeholder needs, and a paltry 10 percent believe the media does.

WHY THIS MATTERS

1. Public companies face considerable pressure to advance the interests of their stakeholders through investment in a broad range of environmental and social activities. What is the real cost of these initiatives? What is the real long-term impact? Is it true that companies are not investing sufficient capital into these activities because they have a myopic view of the relative short- and long-term costs and benefits? Or are executives currently making rational choices about ESG investment?
2. The survey data in this Closer Look suggests that many corporate executives are satisfied with the work they do to

meet the needs of their most important stakeholders. However, they do not believe they are currently getting recognition from the stakeholders themselves, their investor base, and the media. How do companies signal to constituents that they take ESG activities seriously? Some companies publish environmental, climate, sustainability, and human capital reports. Are these documents informative? Does anyone read them?

3. There are a large number of data providers that rate companies on their environmental, social, or corporate responsibility performance. These providers rely on a mix of publicly available and self-reported data. How accurate are these ratings?[9] Are the inputs they rely on the correct ones? Are these ratings predictive of future performance and outcomes? Can ESG measures be standardized?[10]
4. What information do boards of directors receive about the ESG activities of their companies? How quantitative is this information? Do boards understand the short- and long-term impact of these activities? Do boards believe that ESG investment is beneficial for the corporation? ■

[1] Examples of non-investor stakeholders include employees, trade unions, customers, suppliers, local communities, government and regulatory agencies, and the public at large.

[2] For a description of ESG investing, see Brandon Boze, Margarita Krivitski, David F. Larcker, Brian Tayan, and Eva Zlotnicka, "The Business Case for ESG," Stanford Closer Look Series (May 23, 2019). See also, Hester M Pierce, "Scarlet Letters: Remarks Before the American Enterprise Institute, SEC Commissioner Hester M. Pierce, Washington D.C.," (June 18, 2019), available at: http://m.mondovisione.com/media-and-resources/news/scarlet-letters-remarks-before-the-american-enterprise-institute-sec-commissio/.

[3] US SIF Foundation, "Sustainable and Impact Investing—Overview," 2018.

[4] See BlackRock, Larry Fink's Letter to CEOs," available at: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter; Vanguard, "Vanguard's Voice on Societal Risks," available at: https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/voice-on-societal-risks.html; "Vanguard Should Say More on How It Influences Companies: Founder," *Reuters* (January 14, 2015); and Amy Whyte, "State Street to Turn Up the Heat on All-Male Boards," *Institutional Investor* (September 27, 2018). For a summary of the growth and potential impact of these three institutional investors, see Lucian Bebchuk and Scott Hirst, "The Specter of the Giant Three," *Boston University Law Review* (forthcoming 2019).

[5] "Microsoft Workers Demand It Drop $480 Million U.S. Army Contract," *Reuters* (February 22, 2019); Emma Newburger, "More Than 4,500 Amazon Employees Push for Action on Climate Change," *CNBC* (April 11, 2019); and Daisuke Wakabayashi, Erin Griffith, Amie Tsang, and Kate Conger, "Google Workers Worldwide Walk Out Over Handling of Harassment," *The New York Times* (November 2, 2018).

[6] See Rock Center for Corporate Governance at Stanford University, "2019 Survey on Shareholder versus Stakeholder Interests," (June 2019).

[7] Respondents were asked: "In the letter, Larry Fink writes: 'Society is increasingly looking to companies, both public and private, to address pressing social and economic issues. These issues range from protecting the environment to retirement to gender and racial inequality, among others.' Do you agree with this statement?"

[8] Respondents were asked: "In his letter, Larry Fink also writes that: 'Companies must navigate the complexities of a late-cycle financial environment including increased volatility, which can create incentives to maximize short-term returns at the expense of long-term growth.' Do you agree with this statement?"

[9] For a critical response to an ESG rating, see Barrick, "Response to MSCI ESG Rating Report—September 2018," available at: https://barrick.q4cdn.com/788666289/files/sustainability/Response-to-MSCI-ESG-Rating-Report.pdf.

[10] The Sustainability Accounting Standards Board has attempted to standardize measures of ESG. See https://www.sasb.org/.

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The Stanford Closer Look Series is dedicated to the memory of our colleague Nicholas Donatiello.

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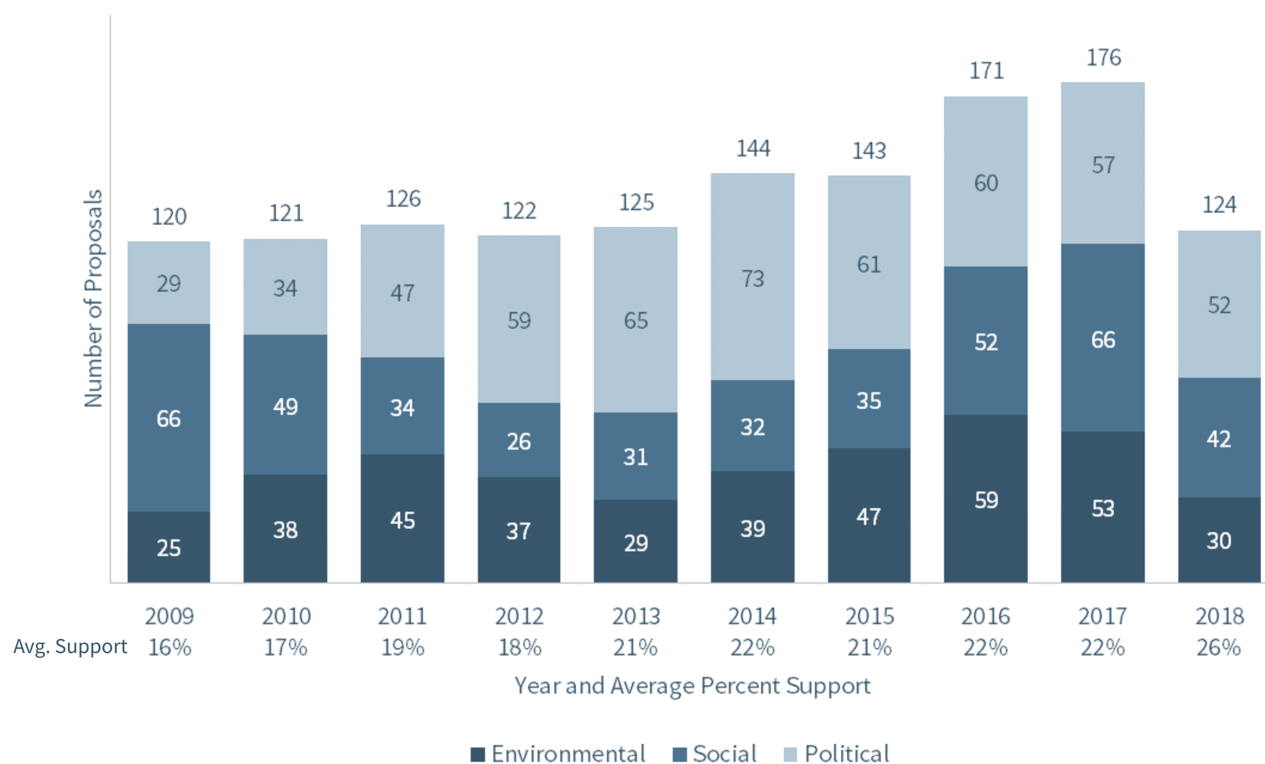
EXHIBIT 1 — SHAREHOLDER-SPONSORED PROXY PROPOSALS



Note: According to Sullivan & Cromwell, the decline in shareholder-sponsored proxy proposals in 2018 was the result of higher direct engagement between companies and sponsoring shareholders.

Source: FactSet. Calculations by the authors. See also, Sullivan & Cromwell, “2018 Proxy Season Review” (July 2018).

EXHIBIT 2 — ESG RATINGS AND INDICES

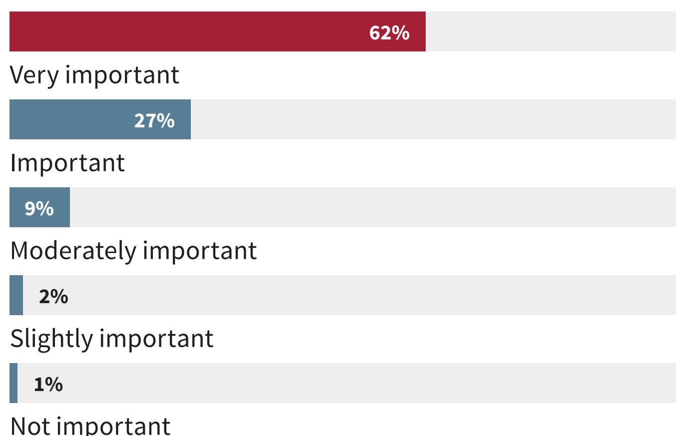
Data Provider	Inputs	Sample Categories	Highly Rated Companies
MSCI ESG	37 key issues 1000+ data points 100+ specialized data sets Company disclosure Media sources	Climate change Pollution and waste Human capital Product liability Social opportunities Corporate behavior	Microsoft Ecolab Apple 3M Accenture
HIP	>2 dozen metrics Multiple data sources	Health Wealth Earth Equality Trust	Advanced Micro Devices HP Intel Medtronic Biogen
TruValue Labs	26 categories (from SASB) 1M data points, monthly 300,000 ESG signals 115K data sources Media, NGO, watchdogs, journals, Twitter	Environment Social capital Human capital Business model Leadership / governance	Unilever Nextera Energy Ecolab BorgWarner Mahindra and Mahindra

Index Provider	Overview	Methodology	Highly Rated Companies
Barron's 100 Most Sustainable Companies	Analyzes 1,000 largest publicly held companies, measured by market capitalization with headquarters in the U.S.	Based on public data and ESG ratings data: shareholder, employees, customers, planet, and community	Top 5 companies 2018: Best Buy Cisco Agilent Technologies HP Texas Instruments
Bloomberg Gender Equality Index	Distinguishes global companies committed to transparency in gender reporting and advancing women's equality in the workplace.	Company voluntary disclosure in four areas: Company statistics Policies Community engagement Products and services	Includes the following (2019): Accenture Cisco JPMorgan Chase Robert Half Visa
Ethisphere Institute Most Ethical Companies	Recognizes companies for exemplifying and advancing corporate citizenship, transparency, and the standards of integrity.	Companies self-report data in five categories: Quality of ethics programs Organizational culture Corporate citizenship Governance Leadership and reputation	Includes the following (2019): Colgate Palmolive Ecolab Hasbro Microsoft Visa
Newsweek Top Green	Assesses environmental performance of the world's largest publicly traded companies	Based on public data and ESG ratings data: Transparency Objectivities Public availability of data Comparability Engagement Stakeholder inclusion	Top 5 companies 2018: Cisco Systems Ecolab Hasbro PG&E Corp Seal Air Corp

Source: Research by the authors.

EXHIBIT 3 — RELATIVE IMPORTANCE OF STAKEHOLDER AND SHAREHOLDER INTERESTS

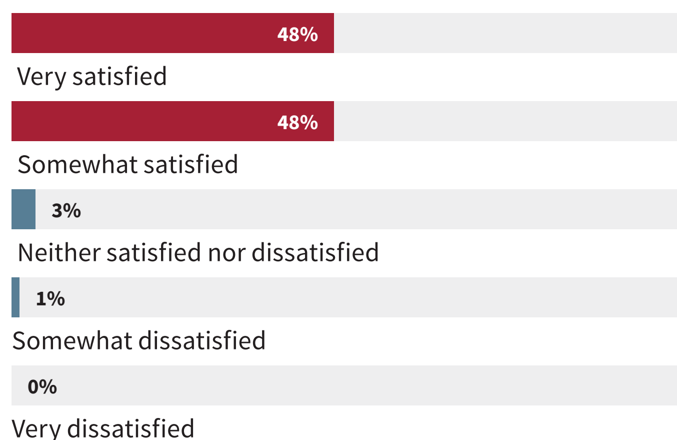
Generally speaking, how important is it that your company consider the interests of non-shareholder stakeholders (such as employees, local communities, the general public, etc.) as you pursue your business objectives?



Note: Some percentages in questions do not total 100% due to rounding.

In general, how important are stakeholder interests relative to shareholder interests in the long-term management of your company?

How satisfied are you with the job your company does to meet the interests of these stakeholders?



Source: Rock Center for Corporate Governance at Stanford University, "2019 Survey on Shareholder versus Stakeholder Interests," (June 2019).

EXHIBIT 4 — SHORT- AND LONG-TERM IMPACT OF ESG ACTIVITIES

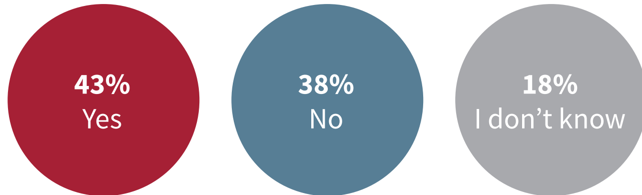
What is the financial impact to your company of meeting the interests of these stakeholders?
(Respondents requested to select one answer for the short-term impact and one answer for the long-term impact.)

		Long-term impact		
		High or moderate cost	Little or no cost or benefit	High or moderate benefit
Short-term impact	High or moderate cost	37%	4%	12%
	Little or no cost or benefit	5%	10%	5%
	High or moderate benefit	0%	0%	28%

Source: Rock Center for Corporate Governance at Stanford University, "2019 Survey on Shareholder versus Stakeholder Interests," (June 2019).

EXHIBIT 5 — INSTITUTIONAL INVESTOR VIEW OF STAKEHOLDER INTERESTS

Do you believe that your largest institutional shareholders really care about the interests of these stakeholders?



Yes, because they know it is important to our success.

They care a lot about employees and customers, much less about other stakeholders.

They portray themselves as caring a lot for stakeholders, but whether they really do is unclear.

It depends which side of the investment house. Portfolio managers understand the conflicts with shareholder interests. The governance side does not.

Source: Rock Center for Corporate Governance at Stanford University, "2019 Survey on Shareholder versus Stakeholder Interests," (June 2019).