Stakeholder Capitalism & Responsible Investing

Augustin Landier

HEC

Stakeholders / Shareholders

Environment

Communities

Society

Shareholders

Management

Creditors

Employees

Customers

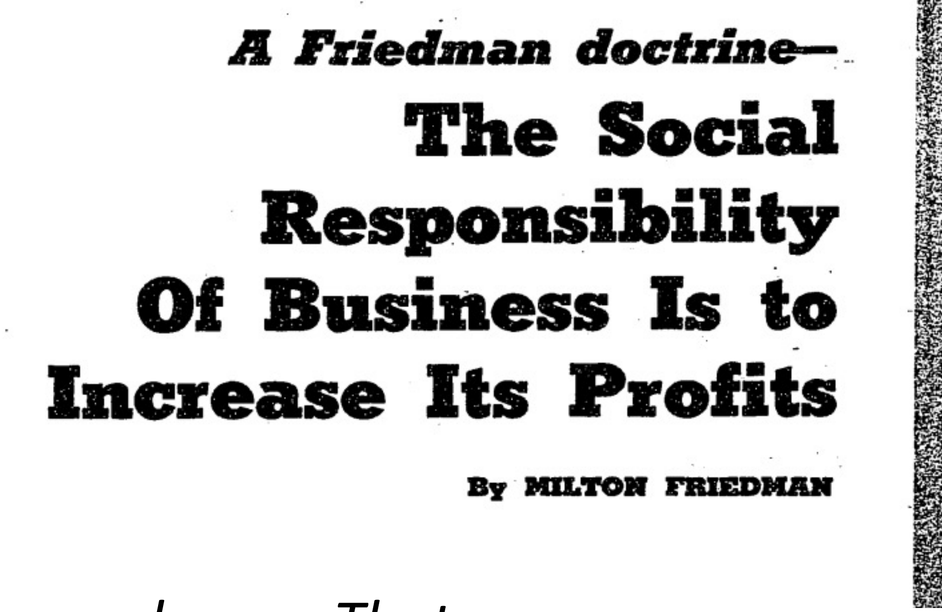
Suppliers

What is corporate governance?

- Rules allocating power to decide and defining monetary payoffs
  - Corporate decisions (investment, hiring, price-setting etc.)
- Good governance = system of rules that leads to largest total creation of economic value
  - Economic value includes externalities, such as pollution (welfare)

Shareholder value paradigm

- Milton Friedman



A Friedman doctrine—

The Social Responsibility Of Business Is to Increase Its Profits

By MILTON FRIEDMAN

- *"A corporate executive has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires ...his primary responsibility is to them."*
- *"There is one and only one social responsibility of business-to use its resources and engage in activities designed to increase its profits so long as it stays within the rules."*

1. Where does the « shareholder value » paradigm come from?

Agency problem : Separation of ownership & control

Principals = Shareholders → **Agents = Managers**

- Agency costs
  - Pervasive in economics (called “moral hazard”)
    - Examples: employees, contractors, children etc.

- Concrete manifestations:
  - Fraud (Adelphia, Enron)
  - Perks (private jets) / crazy compensation
  - **Enjoying the quiet life – status quo bias**
  - **Empire building**

Most important

Should managers be asked to maximize stakeholder value ?

- Share value maximization is a very simple target
  - Stakeholder value is much more complex
  - People disagree about what this entails
  - Bad manager may hide behind “welfare maximization” (entrenchment)

  → Stakeholderism might lead to lower accountability of managers

- Not sure why CEOs should be doing charity with shareholder money
  - Shareholders can always choose to donate their dividends

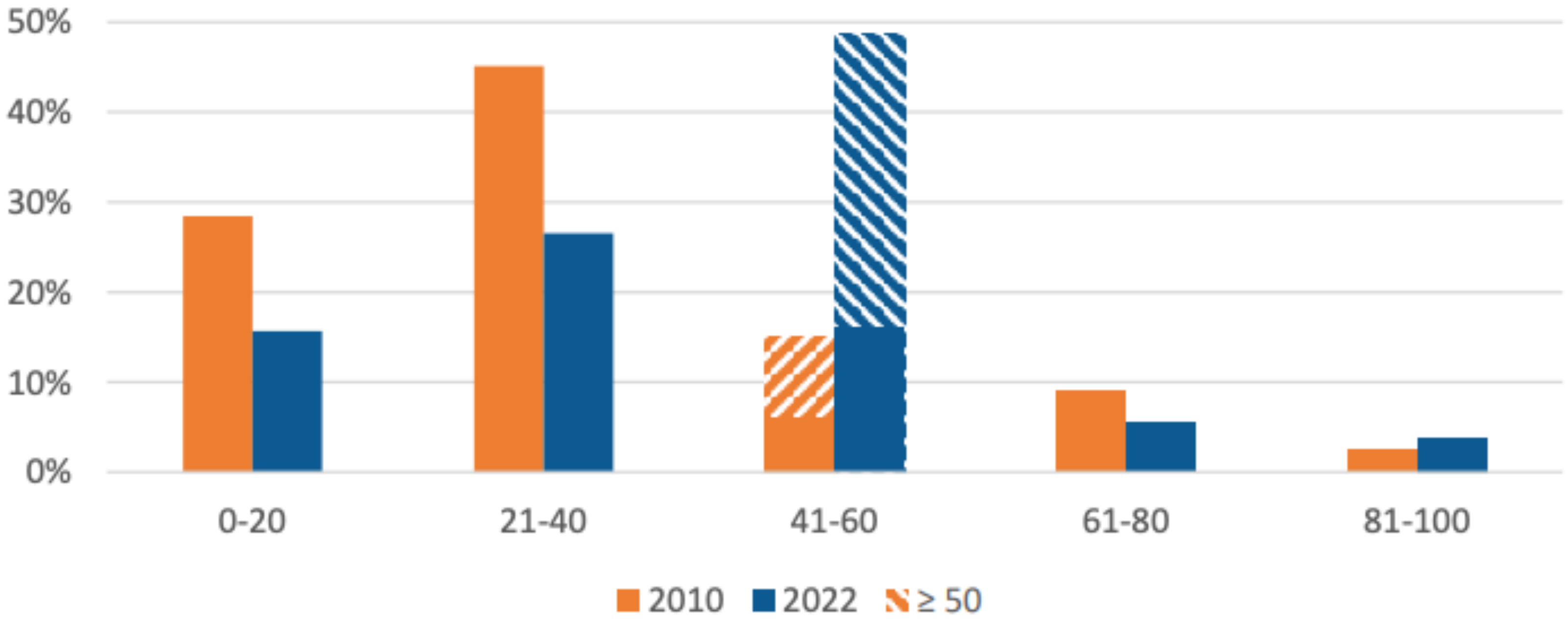
- Separation of powers in modern democracies
  - Firms maximize value
  - Government maximize welfare by setting regulation

Stakeholder value is back

- Evolution toward stakeholder value (survey of CFOs)

Figure 22. On Whose Behalf Should a Company Be Run?

This figure displays CFO responses to the following question: *In whose interests do you think a company should be run? {0 = Shareholders Only, 100 = Other Stakeholders Only}*. The orange bars display results from a Spring 2010 Duke CFO survey. The blue bars display results for the 2022 survey (March 2020 wave). Within the middle bars, the crosshatched portion displays results for scores greater than or equal to 50.



2. « instrumental stakeholder value »

- General idea: Good for business to care about stakeholders because it does in fact maximize (long-term) shareholder value

- « win-win view »: doing well by doing good

Motivations for sustainable finance

FV (dirty company)

= **NPV** (short-term dividends) + **NPV** (long-term dividends)

FV (clean company)

= **NPV** (short-term dividends) **– C**

  + NPV (long-term dividends **+** benefits from being clean)

Motivations for sustainable finance

FV (dirty company)
= **NPV** (**short-term** dividends) + **NPV** (**long-term** dividends)

FV (**clean** company)
= **NPV** (**short-term** dividends) **– C**
+ **NPV** (**long-term** dividends **+** benefits from being clean)

When the **NPV** (benefits from being clean) > **C,**
then **FV** (**clean** company) > **FV** (dirty company)

The win-win view is not in contradiction with the shareholder value view

- Milton Friedman (1970):
  - *Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds […] To illustrate**, it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community** or to improving its government. That may make it easier to attract desirable employes, it may reduce the wage bill or lessen losses from sabotage or have other worthwhile effects.*

« Instrumental stakeholderism »

- Even in the perspective of shareholder value creation, it’s useful for managers to **ask themselves if projects are aligned with societal aspirations**:
  - If they are not, **future regulations** or customer reactions will have negative long-run effects on shareholder value.
  - Complying with current regulations might not be enough: need to think about future regulations

Example: Orpea’s scandal

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NURSING HOMES SCANDAL

France to investigate nursing home network accused of putting profits ahead of quality

Issued on: 01/02/2022 - 14:10

How do firms react to negative ESG news?

- Derrien et al. (2021):
  - Use Rep-risk, data set on negative ESG incidents
- After negative ESG news, analysts (slowly) downward adjust earnings forecasts at all horizons, including long-term.
- Longer-term impact than other negative incidents (e.g. executives

changes, reorganizations).

- Driven by lower expected sales (rather than higher future costs).

Example of negative ESG shock (Rep-risk data)

Is Nutella made with nuts picked by children?

By Tim Whewell
BBC News, Turkey

19 September 2019

https://www.bbc.com/news/stories-49741675

Ferrero International SA

Sep 19, 2019

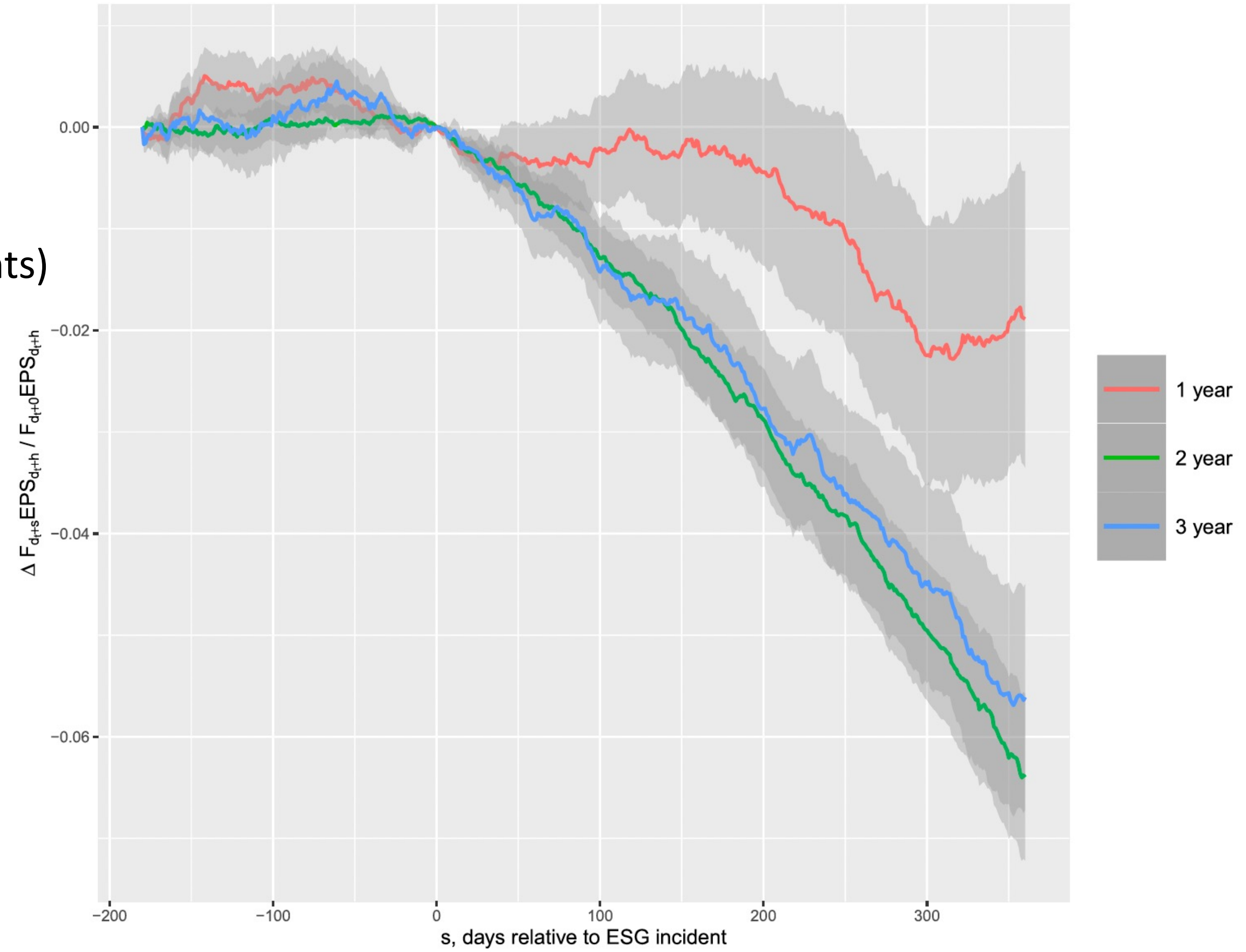
severity=2, novelty=2, reach=3

Related issues:

- Child labor
- Human rights abuses and corporate complicity
- Supply chain issues
- Violation of national legislation
- Occupational health and safety issues
- Poor employment conditions

Event study: % change in earnings forecasts at various horizons

Long-term forecasts decrease quite a lot (more than for other events)



Why would managers not spontaneously undertake clean projects that increase firm value?

- **Status-quo bias?**
- **Incompetence / lack of effort?** (lack of knowledge about climate change/ mitigation technology)
- **Short-termism**?
  - **Long-term** dividends might be overlooked by market
  - Little evidence about this however

Revival of stakeholder capitalism: why today?

- Employees/consumers have moral concerns
  - Happy employees/customers can be good for shareholder value
- Regulations are lagging (due to political economy issues): firms need to anticipate evolutions

→This is instrumental stakeholderism (no trade-off between profits and values)

- Another issue: Investors moral preferences
  - Beyond the win-win view: here, there is a trade-off
  - Cannot separate moral actions and corporate behavior: More efficient to produce clean than to produce dirty and pay a charity to clean-up

Moral firms, moral investors

- Historically, attempt to separate morals & business
  - Friedman.
  - Why not include moral goals in firms' objective?
    - It's a slippery slope (whose values will prevail?)
    - Power grab by incompetent managers (governance)
- Current trend in business, harder to separate business from morals
  - Climate change, Russia boycott, ESG investment, Disney v DeSantis
  - Cannot separate profit-making and charity-giving
  - Some is "instrumental stakeholderism": do good in order to do well
  - Some of it is genuine willingness to blend capitalism and values

Should firms guarantee reproductive rights?

Some of the female employees of a large US firm are working in states where abortion is illegal. For employees who wish to get an abortion, the firm offers to pay for out of state travel and medical expenses.

The firm will also subsidize childcare for women who wish to keep their baby [1/2 of the sample]

This new policy will be financed by [a reduction of shareholder dividend / a small reduction in wages]

How much do you support this policy?

- 56% approve
- 50% if employees pay, 61% if shareholders pay
- 84% if liberal, 53% if centrist, 20% if conservative
- Increases to 26% among conservatives if also child care support

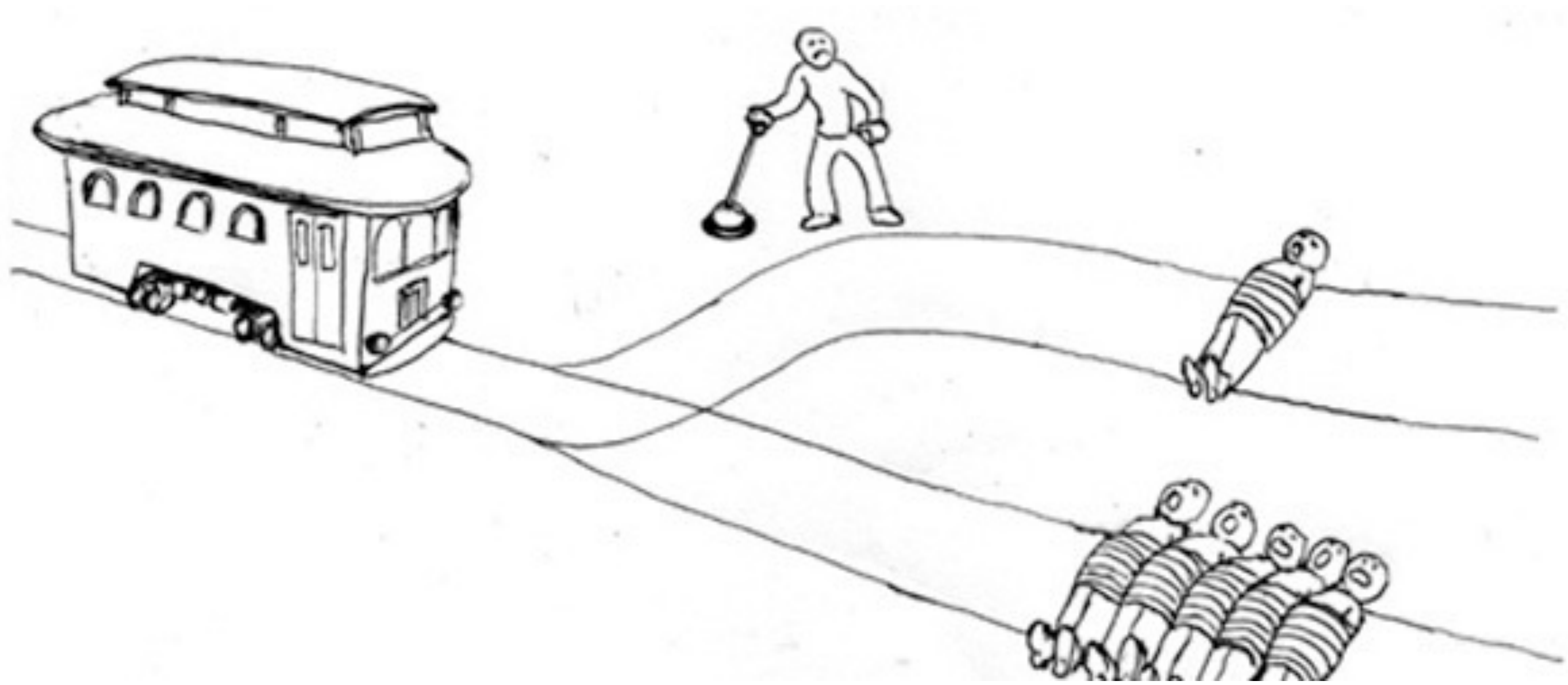
3. What do moral investors want?

- Shareholders have moral concerns
  - Matter if deviate from profit maximization: trade-off between profitsv and values

- 2 main categories of responsible investors
  1. Focus on having a good « ESG footprint » (Deontology)
  2. Focus on impact (Consequentialism)

Trolley Problem

- Trolley problem: what is the right thing to do?



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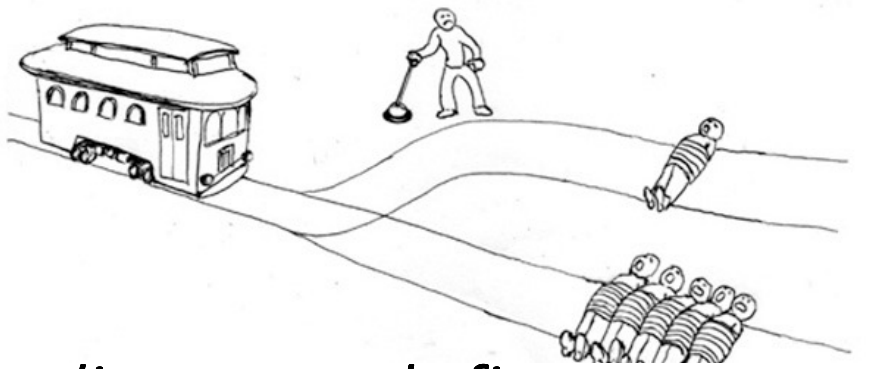
Trolley Problem



A train is speeding down a track out of control, heading towards five people; but luckily there is a track switch that can be pulled to divert the train. But, on this other track there is one person. There are two options:

1. Do not pull the switch, five people will lose their life,
2. Pull the switch, one person will lose their life.

What is the right thing to do?

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How to participate?

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1 Go to wooclap.com

2 Enter the event code in the top banner

Event code

JSZGQQ

1 Send @JSZGQQ to 06 44 60 96 62

2 You can participate

Moral theories

- Consequentialism
  - Care about the impact of action (Bentham)
  - Utilitarian (think like an economist)

  →Killing one person to save five is moral

- Deontological Ethics
  - The morality of action depends on conformity to principles (Kant)
  - Alignment of action with values: "The end does not justify the means”

Altruism

- Question asked to representative US sample
  Nick is graduating from college, and would like to help people in poor countries.
  As his first job, Nick wants to enroll as a construction worker in an NGO that builds hospitals in Africa. However, a friend tells him that he could do more good by taking a high paying job in Wall Street and giving a large portion of his earnings to this NGO. The NGO could then use the money to hire several workers instead of one.

  What advice would you give to Nick?

  1.Follow his heart and enroll with the NGO to directly be involved in charity work.
  2. Follow his friend's advice, because it is indeed more impactful.

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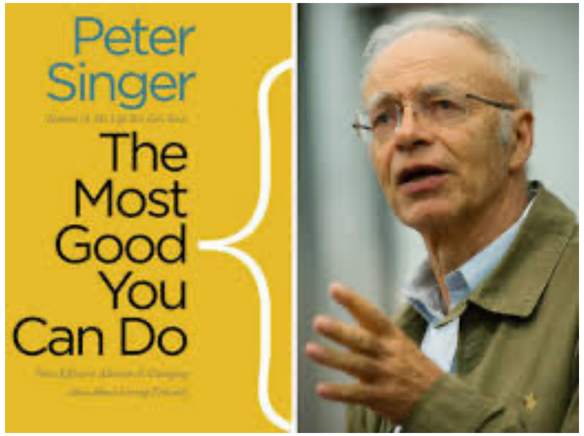
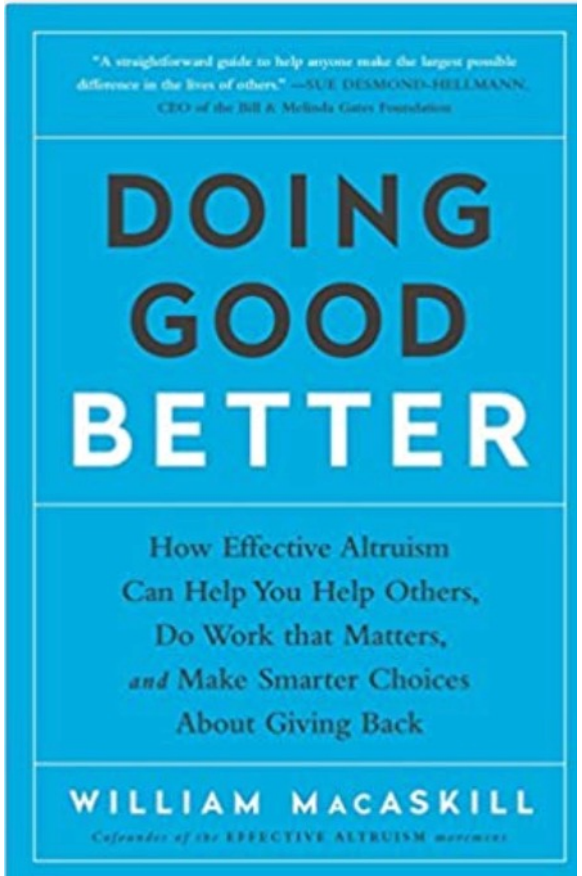
  2. Follow his friend's advice, because it is indeed more impactful.

→ 29% agree with "earning to give" (women: 23.5%)

Altruism

- Pop incarnation: effective altruism
  - Duty = maximize impact
  - “Earning to give”





Moral theories and responsible investment

- Consequentialism: Impact investing
  - *Additional*" investments and financial "*concessions*
  - Natural approach for an economist

- Deontological Ethics: Decarbonized incentives
  - Low-carbon portfolios
  - Value alignment, but questionable impact...

2 main categories of responsible investors

1. Focus on having a good « ESG footprint »: *deontology*
2. Focus on impact : *consequentialism*

Funds with good « ESG footprint »:

- This might have an impact by decreasing cost of capital of green projects (but requires large fraction of investors to behave that way, otherwise, substitutiuon…)
  - A critique is that it might lead to old energy sources being controlled by « non-responsible » investors.
  - Example of divestment of « dirty assets » or funds focussed on service industries (cf. readings)
- Example: Green indices

Measuring premium for charitable firms

- A company makes **$10** per share of profit.
- It gives **$1** per share to the Food for the Poor Charity
- It gives the remaining **$9** as a dividend to shareholders

What maximum price are you willing to pay for one share of this company?

Measuring premium for charitable firms

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- A company makes **$10** per share of profit.
- It gives **$1** per share to the Food for the Poor Charity if you buy the share but $0 if you do not buy the share
- It gives the remaining **$9** as a dividend to shareholders

What maximum price are you willing to pay for one share of this company?

Experiment data

- 1,550 participants in two batches (summers of ‘19 and ‘20)
  - 984 pass the quiz → their beliefs are “correct”

- Several experimental conditions
  - Baseline: investing has no impact
  - Impact treatment: donation only if investor buys share

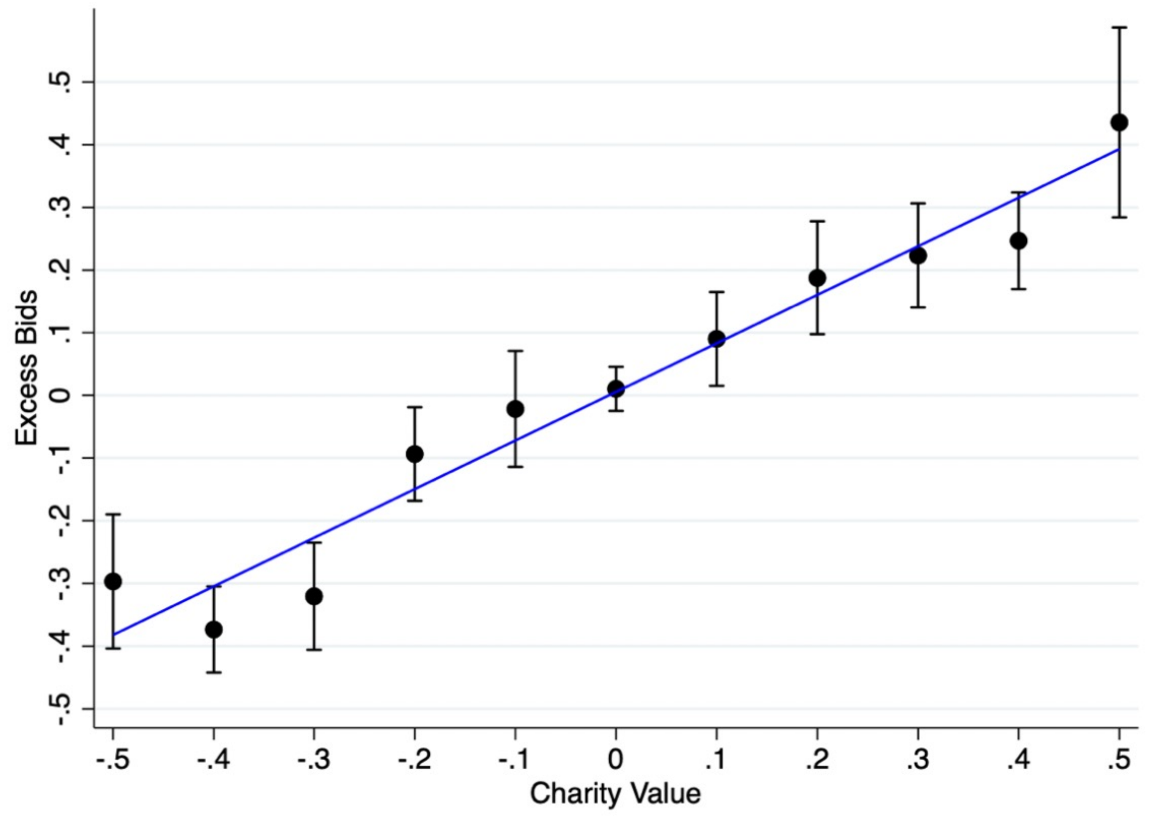
Baseline result

- Regress: $\text{Bid}_i - \text{dividend}_i = \alpha + \beta.\text{Charity donation}_i + \varepsilon_i$

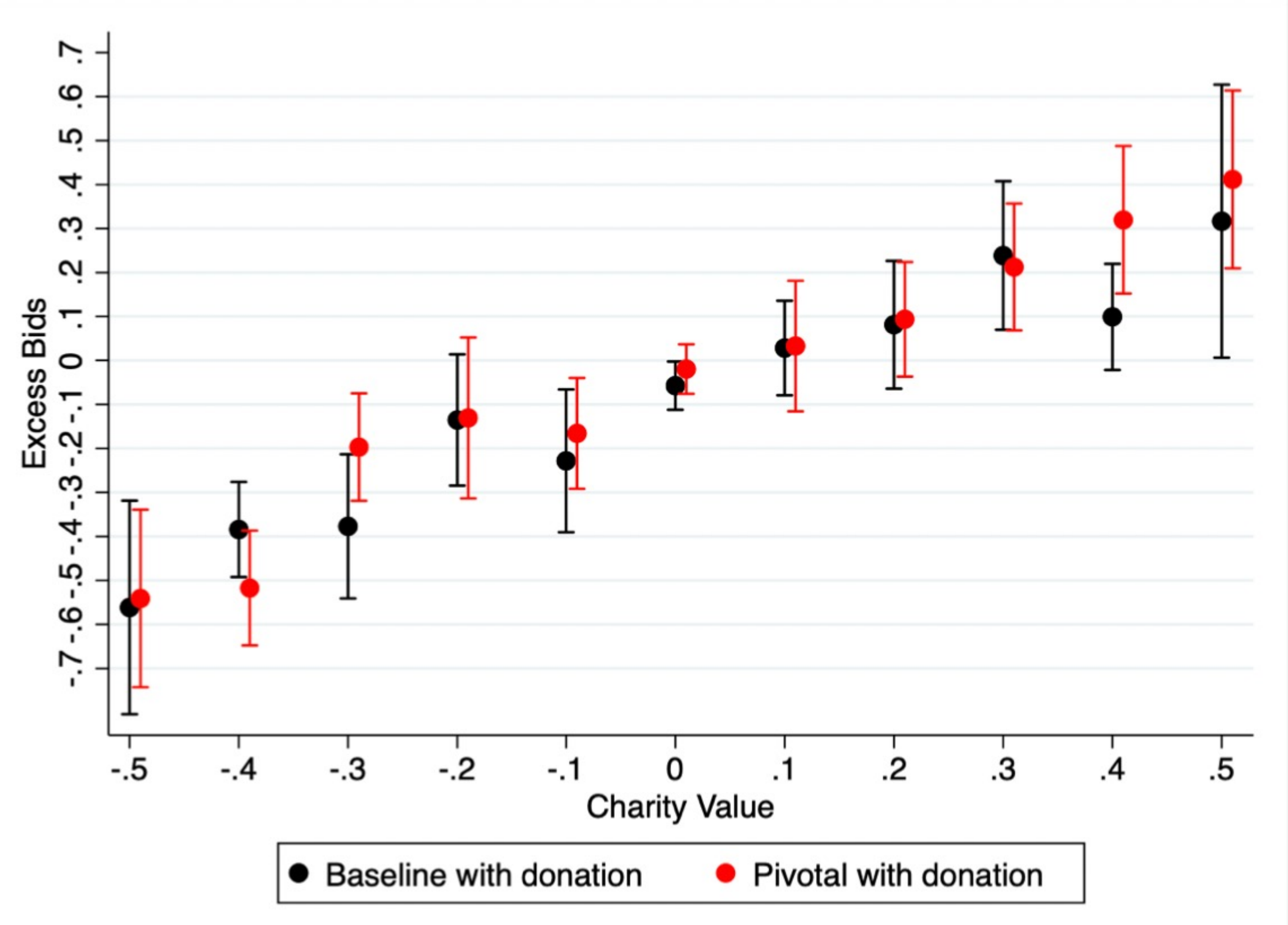
  "excess bid"

- β = "donation pass through"

- $\beta \approx 0.8$
  - Very significant
  - Remember: donation happens whether bid is successful or not



Making bid pivotal for donation ("consequentialist condition")



No difference

Wrap-up

- Donation almost fully priced
- Pivotality changes nothing
- When investor can directly donate money, they don’t

➔People not consequentialist : They are deontological

➔This justifies the development of portfolios with high ESG footprint, even if these do not maximize impact

The coordination view on ESG (Biais&Landier 2022)

- Future regulations (on CO_2 emissions) depend on whether firms do R&D efforts today
  - Ex-post, regulators have to be pragmatic (lack commitment power)
  - Current efforts by firms are not observable
- Multiple equilibria:
  - Good: Firms anticipate strict future regulation, so they invest; this makes future strict regulations feasible
  - Bad: Firms do not believe in future regulation announcements; lack of investment makes strict regulations too costly ex-post

The coordination view on ESG (Biais&Landier 2022)

- Role of ESG investors: coordinating firms on the « good » equilibrium
  - If a critical mass of firms invest, bad equilibrium disappears
- Can view impact as « eliminating bad equilibrium »
- In this view, regulation interventions and ESG investing are complementary

Takeaways

- “instrumental stakeholderism”: to maximize profits, important to make sure managers are aware of stakeholders desires

- Impact vs. value alignment are two distinct objectives for a shareholder
  - lead to different portfolios