Responsible Investing

What Is It, Does It Work, and How To Do It?

Alex Edmans, London Business School
www.alexedmans.com | @aedmans

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I. What is Responsible Investing?

The Washington Post

Disney's CEO made 1,424 times as much as his employees. An heir to the Disney fortune thinks that's 'insane.'

- Robert Iger was paid $66m. Disney market value rose $75b in prior month
  - $130 vs. $24 when Iger became CEO in 2015
  - TSR 578% vs. 140% for S&P 500
- 70,000 jobs created
- Top-quality products[1]
  - Avengers: Endgame had largest-ever North American debut
  - Integrated creative engines of Marvel, Pixar, and Lucasfilm while reviving Disney's studio and theme parks
  - Disney+ subscription has blunted Netflix and Amazon threat

AFL-CIO

More for Them, Less for Us

$13.9M

The average compensation for an **S&P 500 CEO** last year.

361

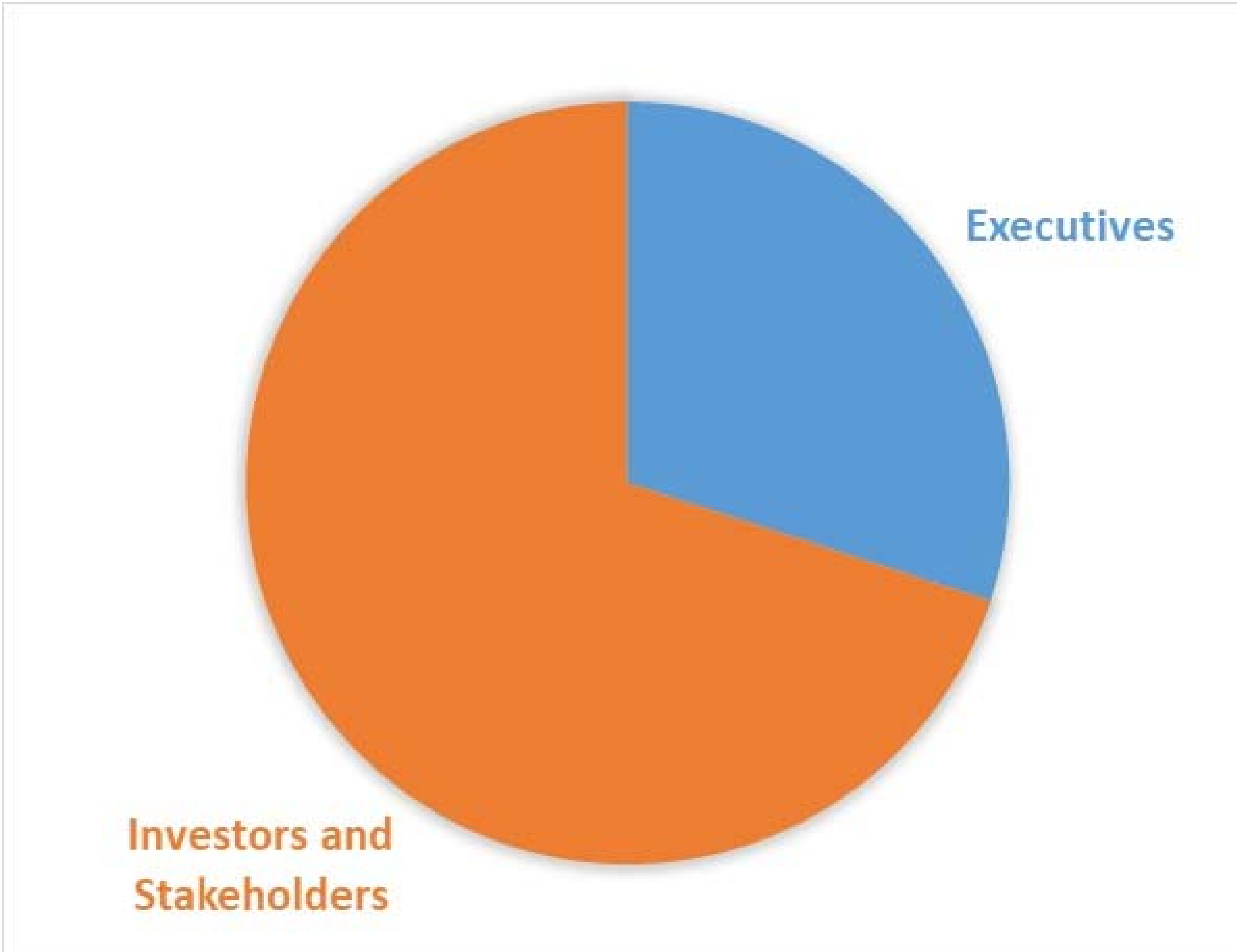
Times more the average **S&P 500 CEO** made last year compared to the average U.S. rank-and-file worker.

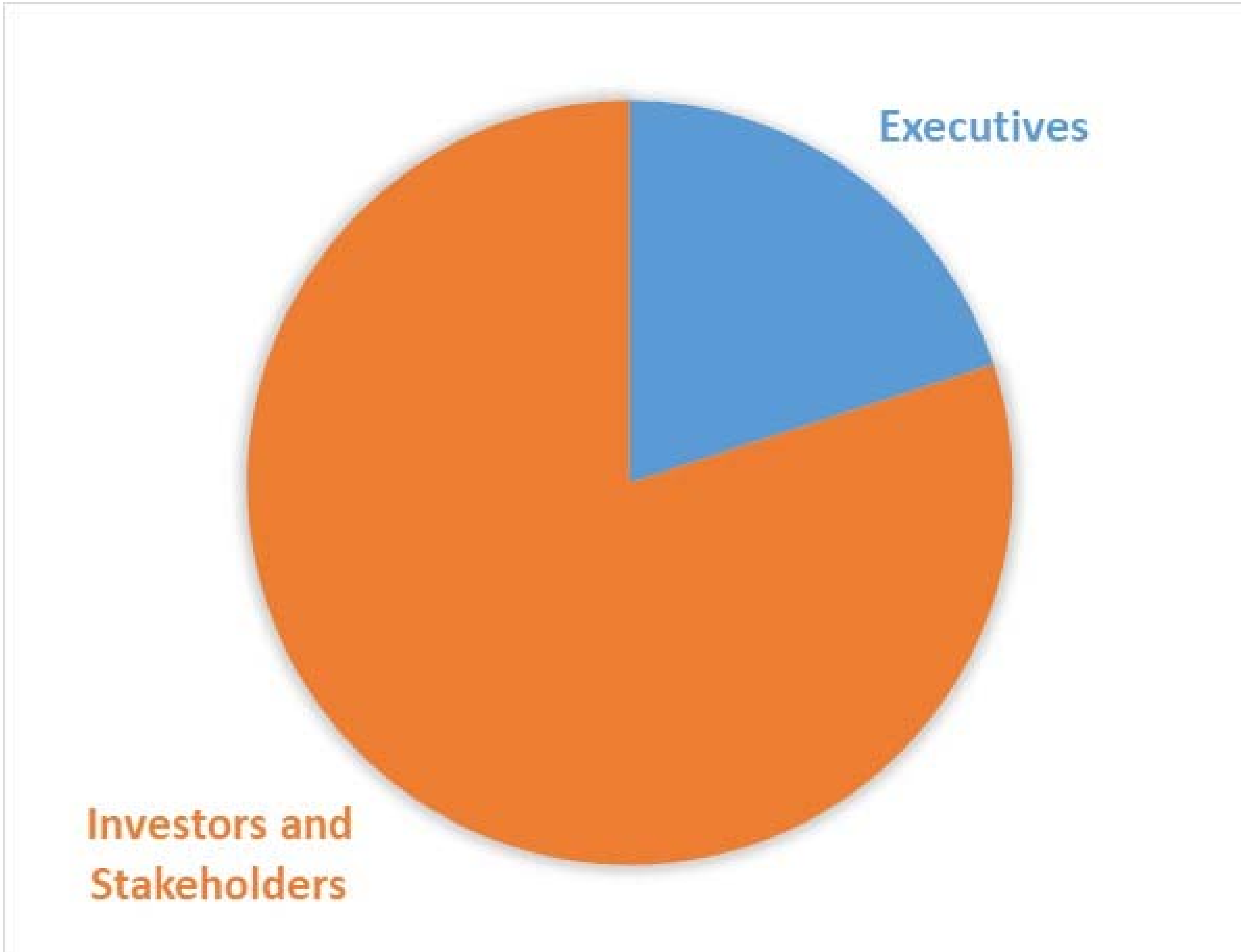
4,987

Times more the **CEO** of Mattel made last year compared to the pay of its median employee.

791

Times more the average **S&P 500 CEO** in the retail industry made last year compared to the average median pay of their employees.


Executives
Investors and Stakeholders


Executives
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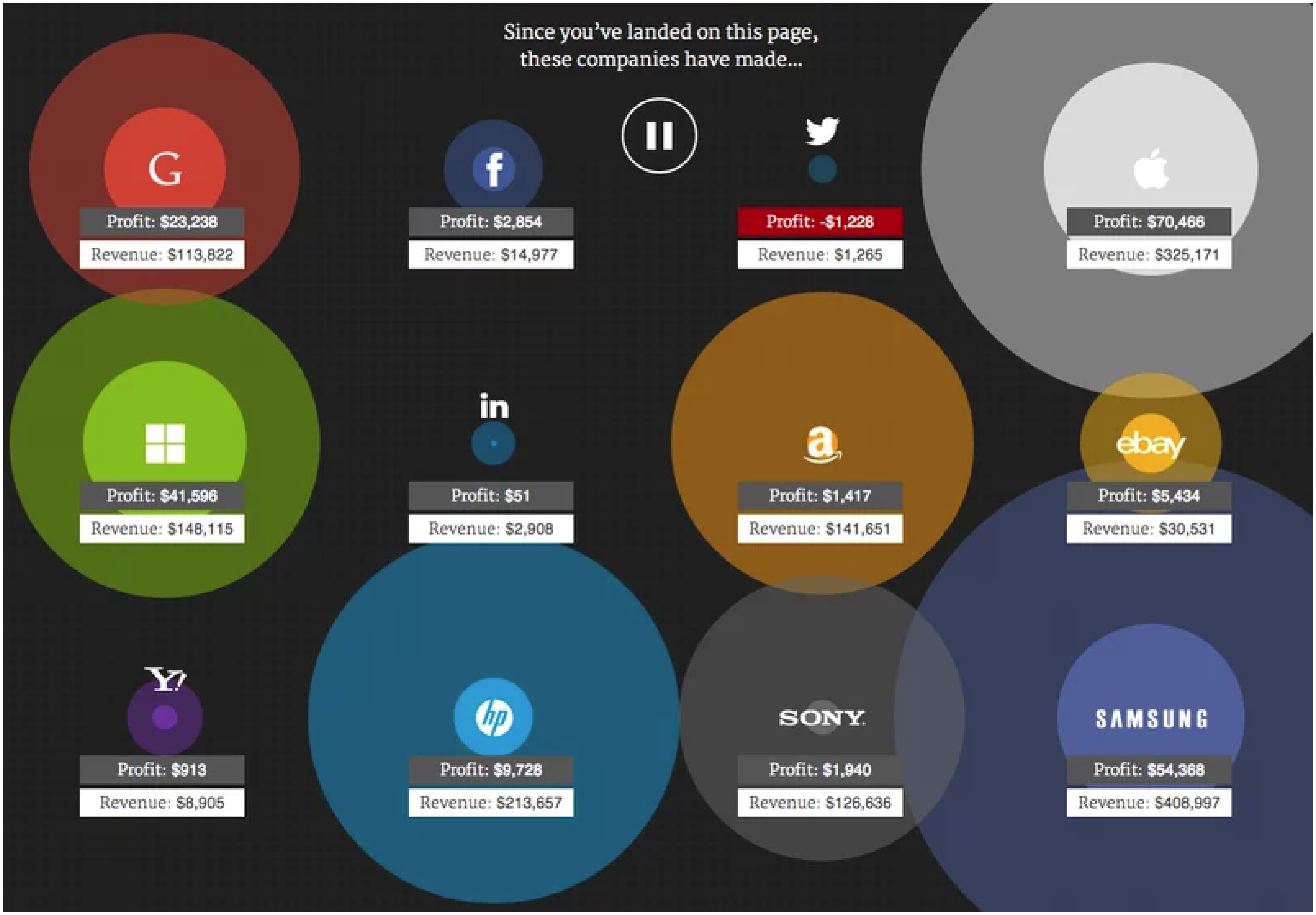
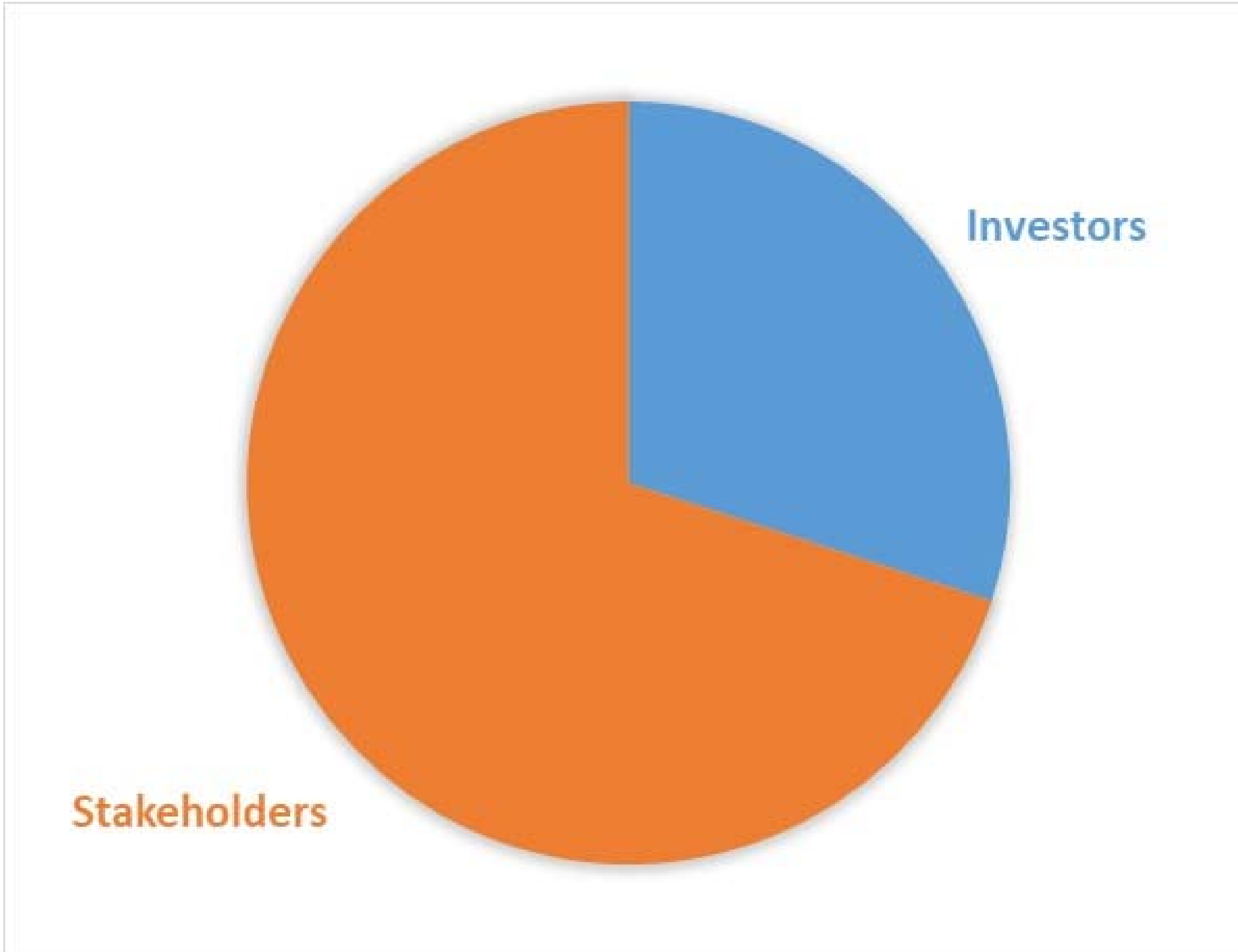
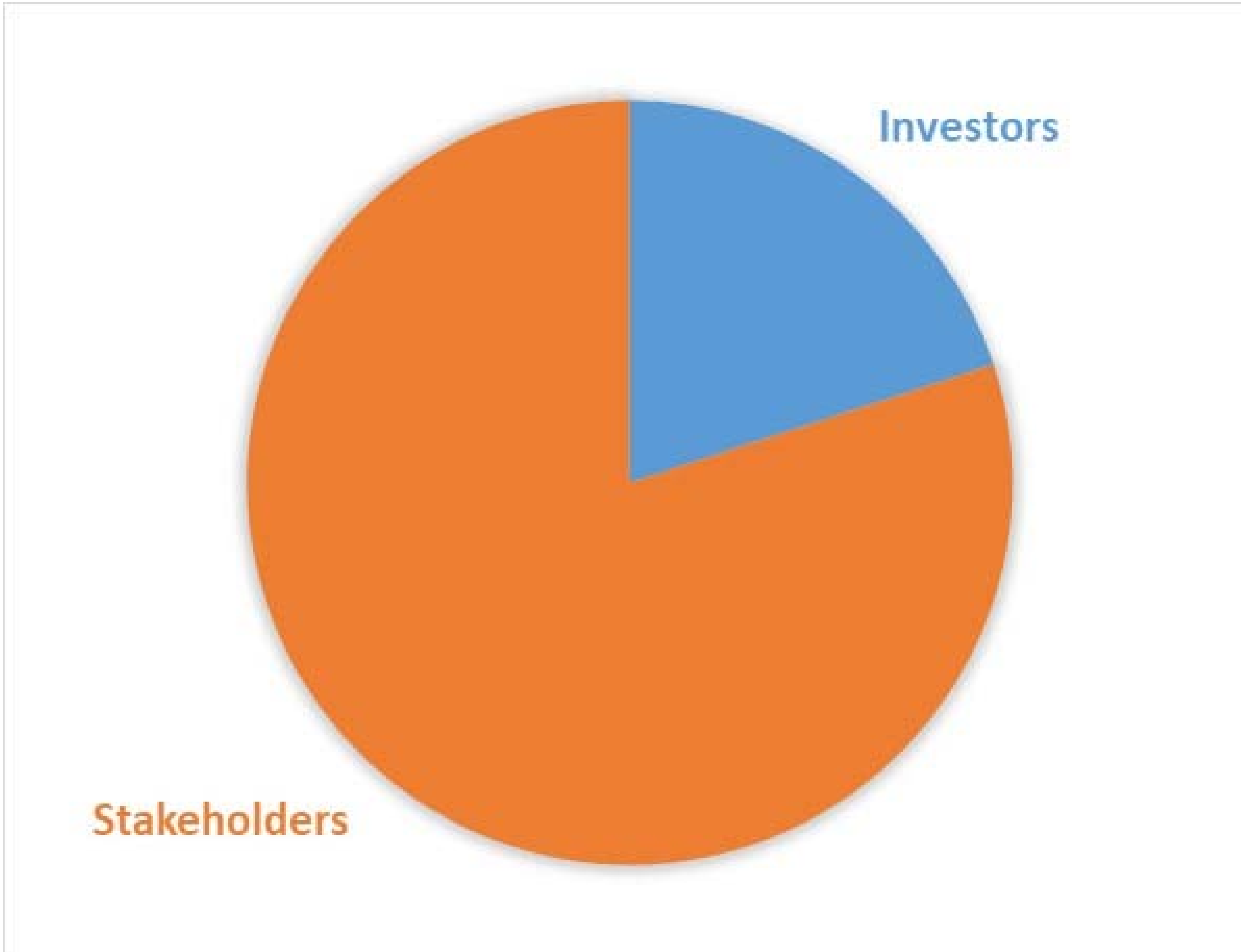
TIME

Every 60 Seconds, Apple Makes More Money Than You Do in a Year




Investors
Stakeholders


Investors
Stakeholders

Launch of Sony Mavica (1981)

Kodak’s Patented Digital Camera (1975)

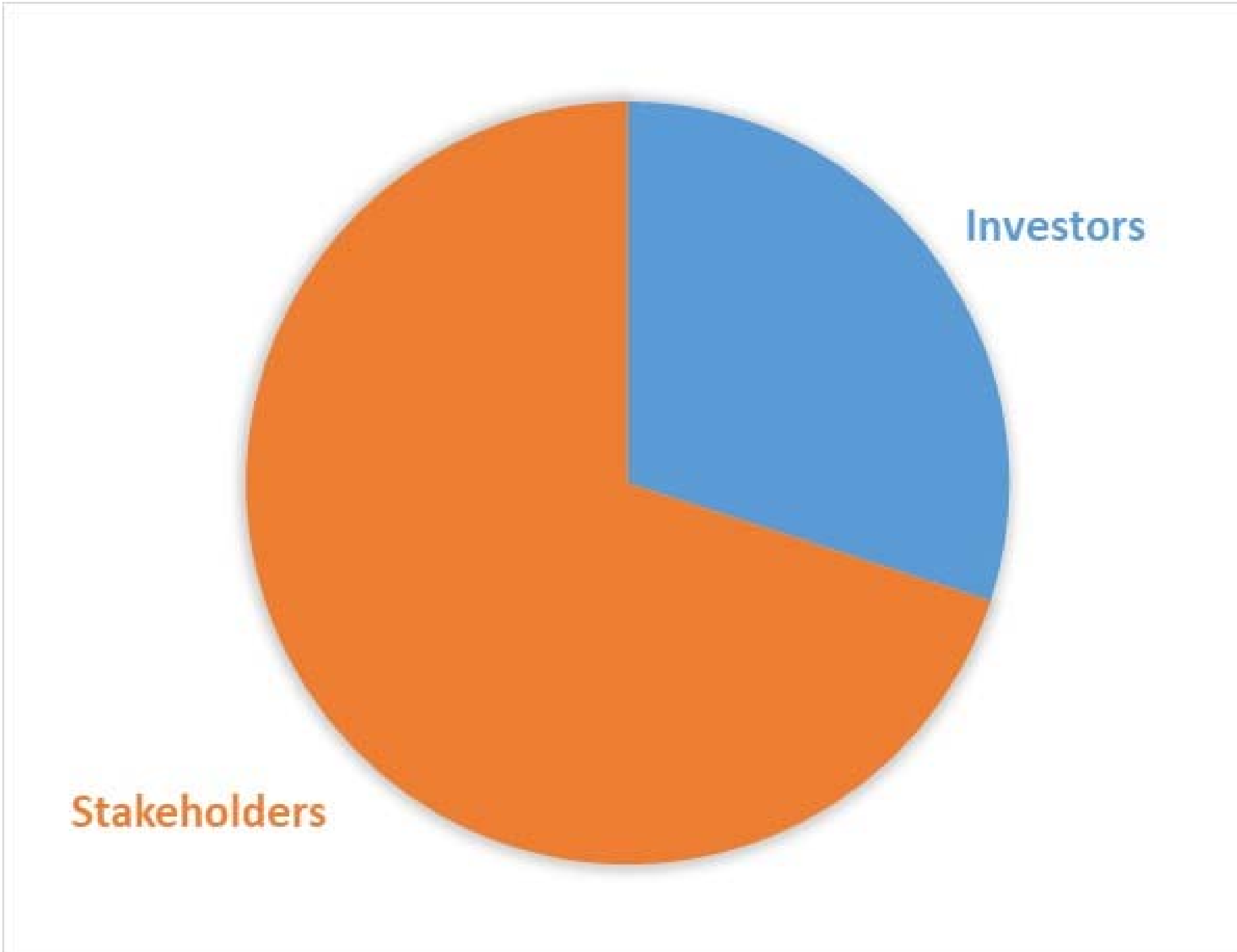
Kodak's (Non) Response

- Clear market leader in film. Sales crossed $10 billion, nearly all from film
- Study by head of market intelligence, Vince Barabba, predicted digital would replace film, but in 10 years
- "The company just never got around to developing the technology, because the money to be made from its traditional business of old-fashioned photographic film was so much bigger"[1]

1. University of Pompeu Fabra case study

Kodak: The Aftermath

- Went bankrupt in 2012, a disaster for society
  - Worth $31 billion in 1997
  - Employed 145,300 in 1988
- Rarely thought of as irresponsible investing
  - No errors of commission
  - Investors, executives didn't steal from other stakeholders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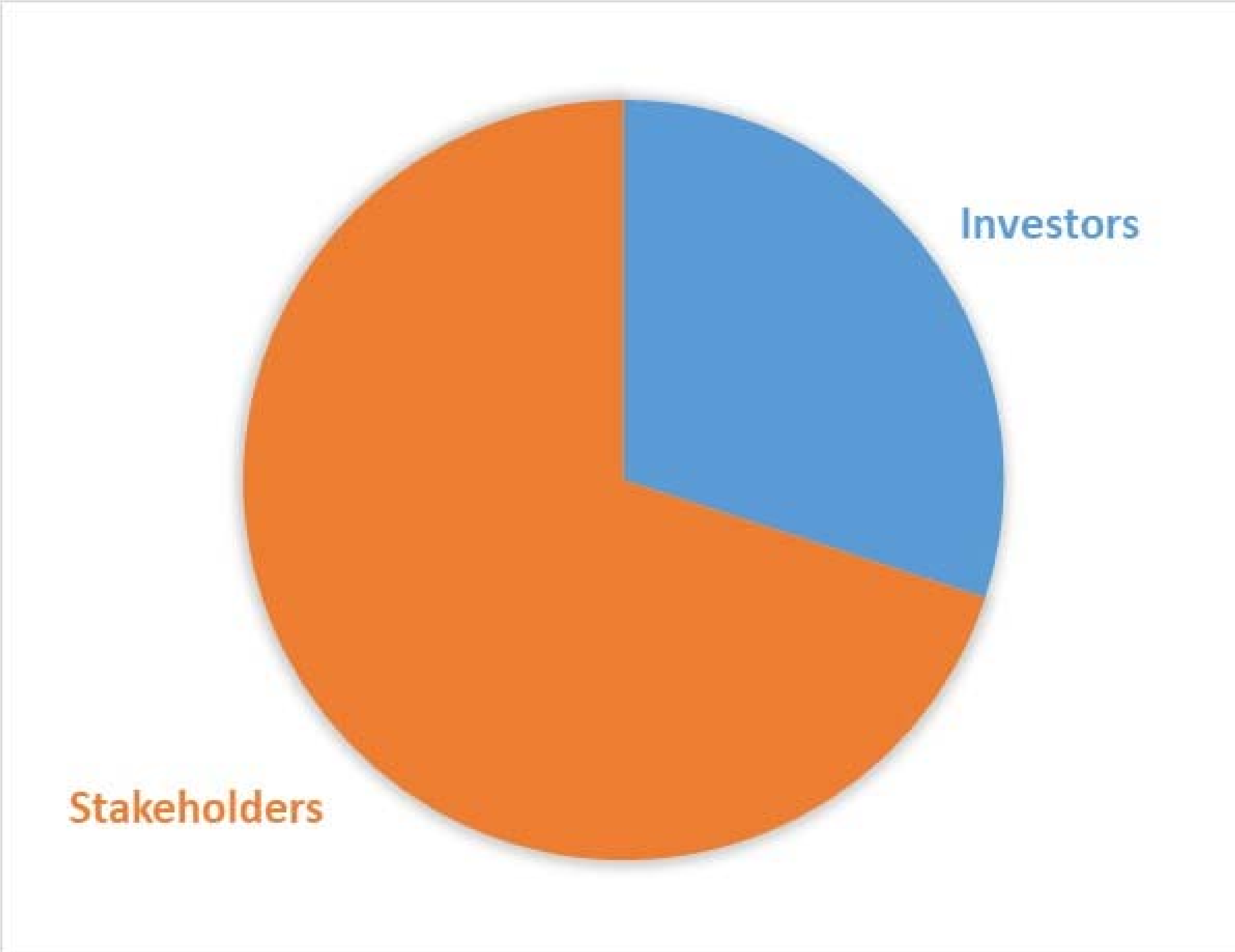
Investors
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How Is This Different From Traditional Investing?

- Friedman (1970): "The Social Responsibility of Business is to Increase Profits"
  - Instrumental vs. intrinsic
- A responsible business *creates profits through creating value for society*
- See https://promarket.org/2020/09/10/what-stakeholder-capitalism-can-learn-from-milton-friedman/

II. Does It Work?

Beware Confirmation Bias

- People accept “evidence” if it confirms what people would like to be true
  - TED talk: “What to Trust in a Post-Truth World”
- A particular issue with responsible investing
  - Opponents of shareholder capitalism
  - Advocates of ESG investing

Forbes

- “Companies that excel in their sustainability and responsibility programmes outperform their peers financially.”
- “That is the premise of a new report, and it is an accurate one, *judging by many conversations with those interested in better business, better corporate governance and a sustainable future*."

Corporate Governance

- 24 governance provisions from Investor Responsibility Research Center:
  - E.g. staggered board, golden parachute, poison pill
- Gompers, Ishii, and Metrick (2003): Well-governed firms beat poorly-governed firms by 8.5%/year over 1990-1998

Evidence is Not Universal

- Giroud and Mueller (2011): only matters in non-competitive industries
- Contract manufacturer Pemstar went public in 2000; IBM was largest customer
  - Teamed up to open manufacturing operation in Brazil and share know-how
- Johnson, Karpoff, and Yi (2015): Takeover defences increase going-public value if and only if large customer, dependent supplier, or strategic alliance[1]
- Optimal governance isn't one-size-fits all

Corporate Governance: Towards Causality

- Investor proposals to improve investor rights, board structure, or voting procedures increase stock price by 2.8% (Cunat, Gine, and Guadalupe, 2012)
  - Acquisitions and investment fall, but long-term firm value rises

Executive Compensation: Pay Ratios

- BlackRock wrote to 300 UK companies saying it would only approve salary increases for CEOs if worker wages rose by same amount
- Portland City Council in Oregon imposes extra 10% (25%) tax if ratio exceeds 100 (250)
- Trades Union Congress Parliamentary submission: “A second study … found that firm productivity is negatively correlated with pay disparity between top executive and lower level employees”

ELSEVIER

Journal of Banking & Finance

Volume 37, Issue 8, August 2013, Pages 3258–3272

The determinants and effects of CEO–employee pay ratios ☆

Olubunmi Faleye[a, 1], Ebru Reis[b], Anand Venkateswaran[a, 2]

Show more

http://dx.doi.org/10.1016/j.jbankfin.2013.03.003

Highlights

- We study the determinants and effects of the relative compensation of top executives and lower-level employees.
- We find that CEO–employee pay ratios depend on the balance of power between the CEO and ordinary employees.
- We find that employees do not perceive higher pay ratios as an inequitable outcome.
- We do not find a negative relation between relative pay and employee productivity.
- We find that firm value and operating performance both increase with relative pay.

Executive Compensation

- Firms with high equity incentives beat those with low equity incentives by 4-10%/year (Von Lilienfeld-Toal and Ruenzi, 2014)
- Returns are increasing in managerial discretion
  - Low institutional ownership
  - CEO is founder
  - High sales growth
  - Weak external governance
  - Weak product market competition
- Note: this is not about quantum
  - Importance of using the right data

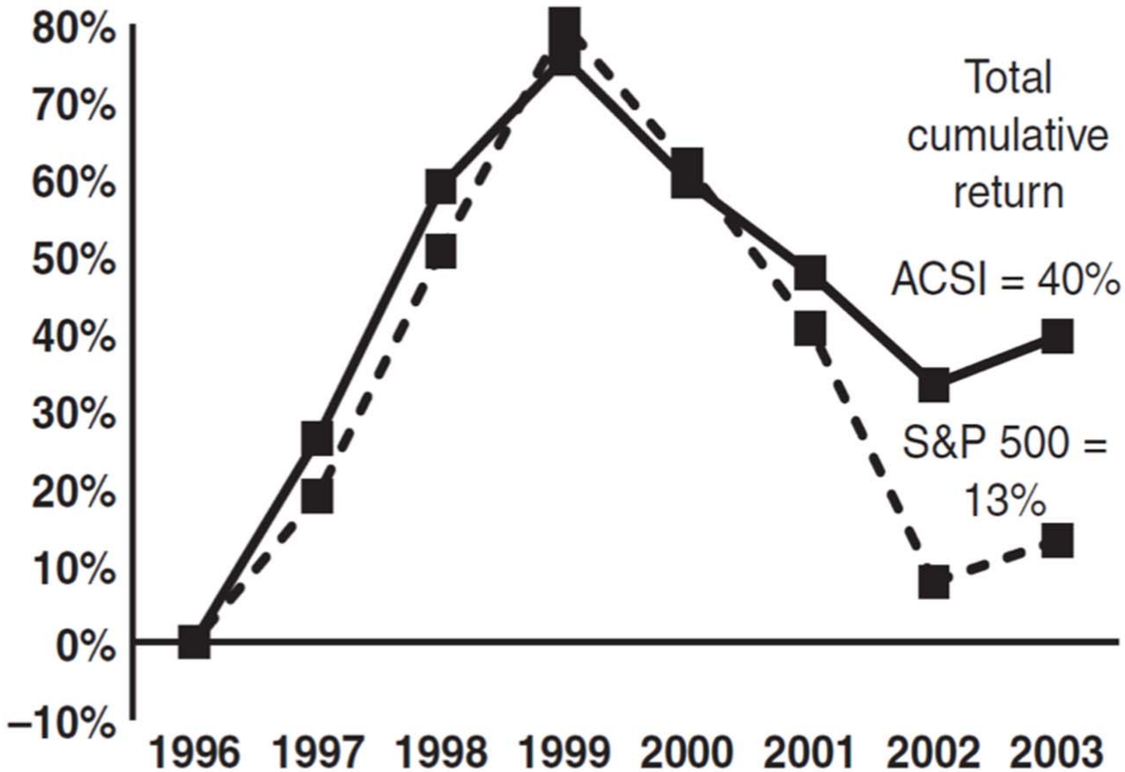
Executive Compensation (cont'd)

- Edmans, Fang, and Lewellen (2017): vesting equity linked to cuts in investment (R&D, capex)
- Flammer and Bansal (2017): long-term compensation improves
  - Return on assets, net profit margin, sales growth
  - Innovation (number, quality, novelty of patents)
  - CSR (environment, customers, society, esp. employees)
- Surveys: Edmans and Gabaix (2016); Edmans, Gabaix, and Jenter (2017)

Employee Satisfaction

- Edmans (2011, 2012): "100 Best Companies to Work For in America" outperformed peers by 2.3-3.8% over 1984-2011
  - Associated with positive earnings surprises
- Stock market takes 4-5 years before it fully incorporates the value of employee satisfaction
- TEDx talk, "The Social Responsibility of Business" (http://bit.ly/csrtedx)

Customer Satisfaction



Fornell et al. (2006)

Eco-Efficiency

Portfolio	α
High-ranked companies	
(full period)	3.98%*
	(1.93)
Low-ranked companies	
(full period)	–1.08
	(–0.55)
Difference portfolio	
Full period	5.06*
	(1.86)

Derwall, Guenster, Bauer, and Koedijk (2005)

Innovest
Strategic Value Advisors

III. How To Do It?

Traditional RI

- Exclusionary / screening: exclude a stock if it doesn't tick a particular box, e.g.
  - "Sin" industry (tobacco, alcohol, gambling)
  - Low board diversity
  - High pay ratio
  - Poor treatment of workers
- Include a stock if it does tick a particular box
  - Then make investment decision primarily based on financial factors

Disadvantages of Traditional RI

- Quantitative measures are easy to manipulate
- Ignores strategic context. Certain ESG factors may not be material
- Focus on pie splitting rather than pie growing (e.g. pay ratios)
- Focus on "do no harm" rather than "actively do good"
- Limitations may be why the average ESG fund doesn't outperform

Integration

- Consider ESG factors alongside financial factors
- “Net Benefit Test”: Does the company provide a net benefit to society?
  - Holistic approach: “bads” can be outweighed by “goods”
- Considers excellence: not a traditional ESG factor, but a key determinants of societal contribution
- Considers materiality

Decision Making Under Responsible Business

- Principle of multiplication
- Principle of comparative advantage
- Principle of materiality
  - "Our purpose is to serve customers, workers, suppliers, the environment, and communities while generating a returns to investors"
  - Engie's closure of Hazelwood
  - Purpose is why an enterprise exists – who it serves, its reason for being and the role it plays in the world

		Extractives & Minerals Processing	Financials	Food & Beverage	Health Care	Infrastructure
Dimension	General Issue Category	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand
Environment	GHG Emissions					
	Air Quality					
	Energy Management					
	Water & Wastewater Management					
	Waste & Hazardous Materials Management					
	Ecological Impacts					
Social Capital	Human Rights & Community Relations					
	Customer Privacy					
	Data Security					
	Access & Affordability					
	Product Quality & Safety					
	Customer Welfare					
	Selling Practices & Product Labeling					
Human Capital	Labor Practices					
	Employee Health & Safety					
	Employee Engagement, Diversity & Inclusion					

Sustainability Accounting Standards Board Materiality Map

The Importance of Materiality

- Khan, Serafeim, and Yoon (2016):
  - ESG data from KLD (now MSCI ESG)
  - Firms that score high on all issues outperform by 1.5%/year, insignificant
  - Firms that score high on material issues and low on immaterial issues outperform by 4.83%/year

Questions for Management

Purpose

1. What is your enterprise's purpose? How did you come up with this purpose, and what have you intentionally omitted from it?
2. What leading and lagging indicators do you use to measure whether purpose is being put into practice?
3. What steps have you taken to embed purpose internally – both in the C-suite/boardroom and at ground level – and communicate it externally?
4. Can you give examples of recent decisions that were driven by purpose and would not have been made if your objective were shareholder value?

Questions for Management

Excellence and Innovation

5. Can you give examples of excellence that you have pursued in areas not clearly linked to shareholder value?
6. What innovations have you recently undertaken that increase the value you create for society?
7. What are your main sources of comparative advantage and what are the ways in which you are deploying it?

Questions for Management

Stakeholders and Trade-Offs

8. Who do you view as your most material stakeholders? What are the strengths and weaknesses in your relationships with them and your plans for improvement?
9. How do you manage trade-offs between different stakeholders? Can you give examples of recent trade-offs that you have had to make?
10. How do you decide which investments in stakeholders to turn down? Can you give examples of recent decisions where commercial necessity outweighed social desirability?

IV. Further Reading

Further Reading

- "Grow the Pie: How Great Companies Deliver Both Purpose and Profit"
  - www.growthepie.net contains updates after book was completed