

Alex Edmans – Professor of Finance

Why do businesses exist?

- To earn profit? or to serve a purpose?
- For shareholders? or for society, customers, employees and the environment?

Well the conventional view is exclusively to earn profit. And that's not as narrow-minded as it sounds.

Because to earn profit, a company is forced to care about society. It has to make high-quality products or customers will stop buying. It has to treat its work as well or they'll leave. And it can't pollute the environment or its brand will be hurt.

Indeed leading economist Milton Friedman once famously wrote:

“The social responsibility of business is to increase profit. So just head to the land of profit and you'll get all of these other decisions rights.”

But this theory assumes that you can calculate the effect that ethical behavior has on your profits. In practice, you can't reduce every decision to a mathematical calculation.

Take Marks and Spencer, the UK high street store now. Former Chairman Simon Marks... he had a policy where all top management had to walk around the shop floors to see first-hand how customers and workers were being treated.

And one day, back in the 1930s, on one of his own visits, Simon sees a shop assistant faint. And he's concerned. He wants to find out why. And it turns out that her husband's unemployed and she's not eating, so that her family can.

So the very next week, Simon introduces nutritious meals for all staff at nominal prices.

Why?

Well, Milton Friedman would say, 'Do a calculation. If I provide nutritious meals, this many workers are not going to faint. So I'm going to make this much more money.'

There's obviously no way you can calculate that number.

Instead Simon's thinking was different, "I'll provide nutritious meals even if it costs me a bit, because I care about my workers. I want to make them eat well. And because it goes above and beyond, Marks & Spencer has an excellent reputation for quality and that in turn leads to profit."

So that's the second view which is called '**Corporate Social Responsibility**'.

Now you might see it's a bit tree huggy and out of touch. But it's actually not too different from the first view. It agrees that profit is good. But profit is only a by-product. It's not the end goal. Instead businesses exist...

- to serve a purpose,
- to make products that transform customers' lives for the better,
- to provide employees with a healthy and enriching workplace, and
- to preserve the environment for future generations

...even if you can't calculate the bottom-line impact of doing so. And if you do that, profits will come naturally.

So take George Merck, the former President of Merck Pharmaceuticals. His mindset wasn't, 'How can I make as much money as possible selling drugs?' It was, 'How can I use science to save people's lives?'

Now back in 1942, Penicillin was still a new drug. It hadn't been made outside the lab before as it was too expensive. But George takes a punt and Penicillin becomes available... made by Merck, a first company for the first time.

Now this is a photo of Ann Miller. A thirty-three old woman. She lives in New Haven. Her husband's Ogden Miller, the athletics Director of Yale University.

And on March the 14th 1942 and lies dying in a hospital bed, stricken with *Streptococcal septicaemia*, which she's caught after suffering a miscarriage. Her fever struck 104 to 106 for 11 straight days, and everything the doctors have tried has failed. Until Penicillin.

Ann becomes the first American ever to be treated with penicillin and it saves her life.

The very next morning, her temperatures back down to normal and she makes complete recovery. She goes on to having three sons and she lives until 90 years old.

And Merck then shared the secrets of how to make Penicillin with its competitors, so that they could do so, also saving thousands of lives in World War II.

As George Merck said, *“We try never to forget that medicine is for the people. It is not for the profits. The profits follow. And if we remember that they have never failed to appear.”*

So just serve a purpose and the profits will follow.

Nice idea. If it were true. But where’s the evidence?

Well that’s what I set out to gather. I wanted to test whether socially responsible firms actually perform better or instead distracted from the bottom line?

But how do you measure social responsibility?

Well I chose to look at employee well-being. Now that’s not the only dimension that’s important – there’s customers and the environment. But I chose employee well-being because there’s a particularly good measure out there. The list of the hundred best companies to work for in America, now published every year by Fortune magazine.

So this list is available from 1984, so I have tons of data and it’s also very thorough. It looks at not only quantitative factors such as pay and benefits, but also qualitative factors like trust and management, pride in your jobs, and camaraderie with your colleagues.

So I study the effect of being a best company to work for on future stock returns.

But how do I know whether good stock returns are down to employee well-being? It could just be your industry happens to perform well, or some other factor?

So to isolate the effective employee well-being, I control for what industry you’re in, for firm size, for growth opportunities, of past returns, and a whole list of other characteristics.

And as we all know correlation doesn’t imply causation. So I do a number of further tests to suggest that it’s employee well-being that causes good performance rather than good performance allowing a company to spend on employee well-being.

It took four years to complete this study to verify the robustness of the results and to rule out alternative explanations.

So what did I find?

I found that the hundred best companies to work for in America delivered stock returns that beat their peers by two to three percent per year over a 26-year period. Simply put, **companies that treat their workers better, do better.**

And this fundamentally changes the way that management should be thinking about their workers. You might think, isn't it obvious that companies do better if their workers are happier? But it's not obvious, because treating your workers well is costly.

Take Costco, the American supermarket chain. So Costco pays its workers USD 20 per hour. That's nearly double the national average of USD 11 and it gives 90% of its employees' health care. That's expensive.

Indeed a stock analyst quoted in Businessweek said, "Costco's management is focused on employees to the detriment of shareholders." Why would I want to buy a stock like that?

Indeed the conventional view is that a pound paid to your employees is a pound taken away from shareholders. So pay your workers as little as possible and work them as hard as possible — just like a great football manager can squeeze that little bit extra out of his players.

I tried to get Alex Ferguson but I couldn't find him shouting at his own players. Only at referees.

So under this view, employee well-being is a bad sign because it suggests that you're allowing your workers to slack off. Indeed before my current life of poverty, I used to be an investment banker. You'd like to see a photo of my oak-paneled corner offices. That's my empire.

So as you can see from the microwaveable ready meals in the bottom corner, I was a Junior Analyst. And one day in the office, the Vice President catches me laughing and he says, "Alex! Do not laugh when you're in the office. I'm banning you from laughing."

I said "Why?"

He said, "Because if you're too happy, the Managing Director will think that I am not working you hard enough."

But the result suggests instead that treating your employees well actually pays off in terms of firm value. Indeed Costco's former CFO Richard Galante said, *"From day one, we've won the business with the philosophy that if we pay better than average, if we provide a salary that people can live on, have a positive environment and good benefits, we'll be able to hire better people. They'll stay longer and be more efficient."*

So Thanksgiving is the biggest public holiday in America. Everybody's free to go shopping but not at Costco. Because Costco is closed on Thanksgiving and other major public holidays. Even though doing so sacrifices tons of profits.

Why? Because Costco's management believes that its workers should be spending these holidays with their families. And this concern for workers is not at the expense of profit. Profits have topped two billion dollars in each of the last two years.

And while my study focuses on employee well-being, research by my LBS colleague, [Anna Yano] and many others have shown that other dimensions of social responsibility also improve firm value.

And these findings are incredibly freeing, because this means as managers, we can act responsibly without doing a calculation, without expecting anything in return, to do things for intrinsic and not instrumental value. Because even though financial awards were not the motive for acting ethically, they typically manifest anyway.

Caring about society is not at the expense of profit; it supports profit.

The results of implications not only for managers, but also for investors — which nearly everybody in this audience will be. Now as investors, you have the power to put your money into companies that reflect what you would like to see in this world.

Now the conventional view is that if you invest in ethical stocks, you have to sacrifice some returns. But the results suggest there's no sacrifice. Investors can both do good and do well. Investing in companies that are socially responsible, at least for their workers, pays off in higher returns.

Indeed **The Parnassus Endeavor Fund** pursues exactly this 'employee well-being' strategy. And over the 10 years, since its inception, it's beaten the market by 4% per year.

And more broadly, the results suggest a new way of thinking, in the criteria we use to pick stocks.

Now it's tempting to look at price earnings ratios and profits and dividends. You can easily look them up on Yahoo Finance. But because this data is so easy to gather, everyone else is gathering it. So it doesn't give you a competitive advantage.

Indeed some of the most important, I mention of a company's value, its corporate culture, its customer loyalty, its innovative capability, simply not captured in financial numbers. So we should look beyond the short-term and the quantitative and look to the long-term and the qualitative.

Now just because social responsibility can't be quantified doesn't mean it can't be measured. Indeed, there's many thorough measures out there. So just like the best companies list measures employee

well-being, so TruCost and Sustainalytics, measure environmental sustainability. And Asset4 and Calvert have a whole host of sustainability measures.

So put your hands up in the audience, if you've heard of all four of these companies! I don't see a single hand up in a very intelligent audience of 500. So you're thinking who? But that's precisely the point.

Most people haven't heard of these measures because they're often glossed over in favor of financial numbers. So because most investors are ignoring this information, if you gather this information, it will give you a competitive advantage.

Indeed perhaps because the market is so short-termist, perhaps because the market is so focused on the numbers, perhaps because of the market like that stock analysts in Businessweek wrongly think that employee friendly companies are tree-hugging... I find that it takes the market four to five years before the benefits of employee well-being fully show up in the stock price.

So you could buy those best companies three years too late and still earn financial returns. So think long-term value, not short-term numbers.

And similarly, we shouldn't dump stocks at the first sign of trouble, right. Because investing in your workers costs money today, the benefits take four to five years to appear. So we dump the stock because it's missed this quarter's earnings target. We pressure managers to focus on the short term.

Now it's your responsibility as investors to support management's pursuit of the long term by looking to the long term yourselves.

Indeed Unilever Chief Executive, Paul Polman — he stopped reporting quarterly earnings to allow him to focus on the long term and this is why they're a major force for sustainability – for example, designing shampoos to use less water.

And one of their long-term investors is **Alliance Trust**. They've been around for a hundred and twenty seven years and some families who held Alliance Trust shares back in 1888, still hold them today in 2015. That allows them to think long-term value not short-term numbers and be one of the leading investors in social responsibility.

And that's not at the expense of returns; they've increased their dividend every single year since 1967. And if you had 100 pounds of Alliance Trust stocks back in 1888 with dividends reinvested that would be worth 18.5 million pounds today. If this were to scale that green bar would be through the roof of this building.

So back to my original question. **Why do businesses exist?**

- To earn profits? or To serve a purpose?
- For shareholders? or For society, customers, employees and the environment...?

Well what's the answer? The answer is yes.

But how can you answer 'yes' to a multiple-choice question?

Because it's not multiple choice. It's not either/or, it's not zero-sum. It's both/ and.

Businesses exist to serve a purpose and by doing so, and only by doing so will they generate profits in the long run.

To reach the land of profit, follow the road of purpose.