Discussion synthesis

Building trust as boards make long-term strategic investment decisions

> 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 of the game, which is to say, engages in open and free competition without deception or fraud.
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> —Milton Friedman[1]

> [When asked] to disclose the costs of Apple's energy sustainability programs, and make a commitment to doing only those things that were profitable[,] Mr. Cook replied – with an uncharacteristic display of emotion – that a return on investment (ROI) was not the primary consideration on such issues. "When we work on making our devices accessible by the blind," he said, "I don't consider the bloody ROI." It was the same thing for environmental issues, worker safety, and other areas that don't have an immediate profit. The company does "a lot of things for reasons besides profit motive. We want to leave the world better than we found it. … If you want me to do things only for ROI reasons, you should get out of this stock."
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> —Tim Cook[2]

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Many observers of large companies insist that directors and top executives of those companies make decisions like either Milton Friedman or Tim Cook. According to one director, *"It was a real journey to prepare for this meeting. I started very much in the Milton Friedman camp and ended up closer to the Tim Cook camp. I reflected on the experience of 10 boards – being an engineer, I wanted data. I also interviewed an activist friend who surprisingly was not pure Milton Friedman. It's all baked into how you run the company."*

On April 27, 2017, a group of thinkers and actors in the capital markets met in Boston to launch an investigation into how large companies make fundamental strategy choices, using investments that enhance a firm's environmental, social, and governance (ESG) performance as a window into the decision-making process. The meeting was sponsored by High Meadows Institute, which is focused on the role of business responsibility and leadership in building a 21st century social contract that can ensure sustainable economic and social progress in a global economy and society. See Appendix A for a list of participants.

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[1] Justin Fox, "The Social Responsibility of Business Is to Increase … What Exactly?," *Harvard Business Review*, April 18, 2012.

[2] Steve Denning, "Why Tim Cook Doesn't Care About 'The Bloody ROI'," *Forbes*, March 7, 2014.

The meeting focused on large public companies with distributed equity shareholding, thus excluding family firms and companies like Alphabet, in which a few people control most of the votes. In undertaking investments in ESG improvement, infrastructure, or other areas with uncertain, long-term payoffs, these larger public firms face real governance challenges. The directors can be forced to choose between strengthening the company's long-run future or satisfying shareholders who may be looking for rapid returns. Shareholders in these firms also face choices. Some equity investors, dissatisfied with a board's choice to invest in ESG, for example, can vote with their feet, selling their shares to others. But a growing percentage of investors own shares in index funds and other instruments with fixed portfolios. Unable to divest, these investors have more of an incentive to agitate for change within individual companies or to align with themselves with agitators.[3]

This document synthesizes the perspectives and ideas raised in the meeting and in conversations leading up to it. It centers on three themes:

- **Corporate leaders insist on a business case for ESG investments**
- **Companies face challenges when making any long-term investment**
- **Building trust between the board, management, and investors**

Corporate leaders insist on a business case for ESG investments

In the course of multiple interviews and several hours of conversation, we heard no support for purely disinterested corporate philanthropy, such as a grocery chain funding a free hospital with no anticipated benefit to the business. One participant said, *"With regards to the social agenda – there is no management team and board out there that does anything that is not in the best interest of the business. There is no 'doing good' on its own just yet. The idea of boards 'doing good' for no apparent benefit to the company just does not exist."* Others agreed that legitimate corporate philanthropy must have a business case.

ESG issues are becoming more prominent as a topic of conversation, participants said. One pointed to a few reasons for this: *"There are so many drivers of ESG: investors are changing, pension funds want these factors considered, SOX and other regulations, millennials, diversity, and certain events or scandals."* Another participant elaborated, *"Industry is a very important variable in deciding whether to include ESG in a strategy. One of my boards included it because it was in our interest to do so – we made sure we were not sourcing certain controversial materials from suppliers. But there needs to be a tangible reward for ESG efforts – financial or otherwise."*

Most participants saw the possibility of complementarity between ESG performance and economic performance. One participant went so far as to say, *"There is no real trade-off if being socially responsible is in line with your business model."*

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[3] In the meeting and in this summary, we have used the framework outlined in Albert Hirschman's *Exit, Voice, and Loyalty* (Harvard, 1970). The basic idea is that a consumer, investor, employee, or other member of an organization who is unhappy with the benefit the organization is delivering can either end the relationship (exit) or attempt to improve the situation by communicating the complaint or proposal for change (voice).

In calling for a business case for every ESG investment, participants seemed to side with Milton Friedman: long-term investment that creates public good must be aimed at some strategic, value-creating goal. They identified several ways in which an economic case could be made for ESG investment: It could burnish the firm's reputation, making it more attractive to customers or employees. It could increase the likelihood of loyalty in the event of a customer service or public relations problem. It could stave off regulatory intervention. It could also lead to a direct financial payoff: for example, a low-carbon supply chain might take time and investment to create, but could end up being cheaper to operate. Or, as some analysts have claimed, ESG investments could reduce operational risk and therefore lower share price volatility.[4]

Companies face challenges when making any long-term investment

Although participants insisted that a business case was necessary for ESG investment, and that such a case could often be formulated, they rejected the idea that long-term investment, including ESG, could be made without trade-offs. Even when a solid business case is assembled, ESG investments can be risky and costly in the short term. Even though a recent, highly publicized study asserts that "long-term-focused companies surpassed their short-term-focused peers" in average revenue, earnings, economic profit, market capitalization, and job creation,[5] participants pointed out that the payoff of an ESG investment may be uncertain or delayed by several years and that a good long-term result could require depressed near-term profits. One said, *"I am very skeptical that good behavior or good results on ESG will save performance – you can't use that as an excuse for not hitting your returns."* Another added, *"If you have a 50% decline in profits, you can't raise your hand and say, But I am a good corporate citizen – that will not stop the reaction to your stock."* And one concluded, *"There is tension. I won't say boards don't look at the long term, because they do, but sometimes you make those decisions and you are taking a bet – and sometimes you pay the price of short-term reaction."*

Directors and other participants noted the following challenges:

- **ESG investment returns can be difficult to measure.** Participants agreed that it can be difficult to link ESG investments to profitability and nearly impossible to conduct controlled experiments proving their effect. The operational and financial benefits of a low-carbon supply chain can in some cases be documented and even audited, but it is never easy to quantify the reputational benefits and customer goodwill gained through broader ESG efforts.

- **Unhappy investors can sell before benefits are realized.** Perhaps the most difficult trade-off participants face is that even when investors advocate for long-term spending on initiatives like ESG, they may become disappointed with declines in short-term profit and can exit, driving down the stock price. One participant noted, *"Investors are the decision-makers. It's possible that some will exit when we disagree and this will happen because there are different views about what brings about maximum value."* Another participant

[4] See, e.g., Joseph R. Shaposhnik, "ESG Investing: A New Approach," *Viewpoints*, TCW, March 25, 2016.

[5] Dominic Barton, Joseph L. Bower, Sarah Cliffe, James Manyika, Sarah Keohane Williamson, and Lynn S. Paine, "Managing for the Long Term," *Harvard Business Review*, May-June 2017.

made the important point that some investors do not have the option to exit: *"It's different for the index fund managers out there. They are stuck."* And one participant shared a recent experience: *"We were building a new company and we had weak infrastructure. We missed a quarter because of it and we were deemed the 'disaster du jour.' So we told shareholders we would fix this and build up our infrastructure and miss a few quarters – and then we were the disaster of many jours."*

- **Investors turn to activism.** Another potential reaction to near-term profit declines is that investors voice their agitation and push for the removal of directors or management. One participant said, *"There is no homogeneity with investors. They each have a very distinct point of view. Investors believe without question that they are the owners of the business – whether you like it or not, they think they have a say in how the company should be run. They view boards as stewards of the company – it's very different from how they view management. The vote is what matters; it's their only way of expressing a point of view on a whole variety of topics."*

Building trust between the board, management, and investors

The discussion identified a lack of trust as the link between all the challenges companies face when they consider making long-term investments, including in ESG. How does a board know that a proposed ESG investment will create value and is not a vanity project on the part of the CEO? How do investors gain the same confidence in the board? When an investment's payoff is hard to measure, how can everyone trust that it has been a good one? Trust issues can arise between management and a board, and between a company and its investors. Participants identified several factors that have contributed to the breakdown of trust:

- **CEO compensation.** One participant asserted that high levels of executive compensation can undermine investor trust in a board. *"CEO compensation is part of the need for transparency. It has gotten so large that investors believe boards have lost control over their ability to mandate a reasonable package. So, if they lost control of that, they must have lost control of it all,"* one said.

- **Transparency.** The issue of transparency surfaced several times in the course of the discussion, but participants viewed it as a double-edged sword. At one level, transparency can enhance trust. One participant said, *"There has been a perception that there is a breach of trust between shareholders and management. In general, shareholders think the board condones or lets management get away with a lot that shareholders don't like. To the extent that transparency helps shareholders understand that that is not the case – that management is management and the board is the board and there is no buddy system – that will help you get lots of positive reinforcement from the shareholder base. They really just want to be heard, but if there is no transparency, they make assumptions that could be very wrong – but how else will they know unless transparency is provided?"*

  Other participants noted that because trust must be bilateral, excessive transparency – in the form of multiple metrics and escalating demands for disclosure and assurance – can undermine it. If, for example, a board asks too many questions, or demands highly detailed disclosures, management can either cede a sense of accountability to the board or use the "forest of data" to conceal relevant information. Excessive transparency can also lead to politicization of the strategic debate. Finally, transparency regimes can surface easy-to-measure data that can crowd out more important long-term signals.

- **Corporate scandals.** Several participants identified scandals that have eroded institutional trust. A few directors brought up the recent scandal at Volkswagen, in which high-level managers and engineers colluded to cheat diesel emission tests, deluding both consumers and the US government.[6] Others pointed to the Wells Fargo scandal, in which millions of fake accounts were set up for unknowing customers, resulting in lawsuits, steep fines, and the firing of over 5,000 employees.[7] One participant said, *"There were over 700 whistleblower calls to report this shady behavior. People want to know – how were these ignored? Where was the board?"*

Over dinner, participants pointed to the need for mechanisms to rebuild trust, reducing the likelihood of premature exit and dysfunctional voice. They commented on the small number of existing case studies in how investors and boards have managed long-term, uncertain investments – in particular, those aimed at enhancing ESG performance.

Work is necessary to strengthen trust between relevant stakeholders. Participants offered a few examples of trust-building activities:

- **Making long-term investments in stages.** One participant shared a system of milestones that a company had used to monitor and manage a long-term infrastructure investment program. The investments were broken down into stages, each with distinct milestones and criteria for going further. Others noted parallels with venture capital finance, where a project moves through multiple investment stages, each involving larger total investment and reduced risk of loss. Participants noted that ESG investments, in particular, can be difficult to reverse, so that a staged approach can be useful in managing overall risk.

- **Enhancing reporting.** Participants noted that better reporting would help manage long-term and ESG investments. As noted above, the key is not simply to increase transparency and disclosure, but to make it cleaner and clearer. One participant said, *"My wish list includes a framework, dashboards to evaluate, and more insightful information – not just data dumps from management."*

- **Balancing compliance and monitoring with forward thinking.** Participants noted that some boards are facing unprecedented pressure. Regulators and the public have called for enhanced compliance and closer monitoring – of business conduct, cybersecurity, operational risk, etc. Board members who shirk these responsibilities put their own roles and careers at risk. At the same time, a board that does not engage in long-run thinking,

[6] Geoff Colvin, "Why Volkswagen's Emissions Scandal Has No End," *Fortune*, January 11, 2017.
[7] Matt Egan, "5,300 Wells Fargo Employees Fired Over 2 Million Phony Accounts," *CNN Money*, September 9, 2016.

well-framed scenario planning, and strategic succession planning can jeopardize the future of the company. In some cases, board members report that they are struggling to allocate sufficient time to meet a widening range of demands. The roles of large public company boards and their members need fresh thinking, and the profiles of future board members may see substantial changes.[8]

- **Improving engagement between boards and investors.** Participants strongly supported the idea of better communication between the board and investors. One said, *"Engagement is key. Investors expect to be heard, and if not, they will express displeasure through a vote."* Another participant agreed, stating, *"You will never make every investor happy – I don't know many boards trying to do that, but you will make some happy in some ways. The most important factor is communication. Many investors just want a voice in the boardroom. They want to know what was discussed and whether or not they agree with the outcome."* Participants noted that, as with reporting, trust will not be enhanced simply by increasing the quantity of communication between board and investor.

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As several participants noted, the process of thinking about these issues can itself be transformative and trust-building. One director added that a great deal of current board education fails to tackle the difficult challenges that surfaced in the meeting.

Further conversation, in the form of smaller discussions similar to the one conducted in Boston, and in larger groups, could surface useful clues about how best to build trust around long-term, uncertain investments.

[8] For a radical proposal on boards of the future, see Roger Martin, *Fixing the Game* (Harvard Business Review Press, 2011).

Tapestry Networks

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Appendix A: Meeting and interview participants

- Joan Amble, Booz Allen Hamilton, Sirius XM Holdings, and Zurich Insurance Group
- Ralph Boyd, Sandy Spring Bancorp
- Pam Daley, BlackRock, Patheon N.V., and SecureWorks Corp.
- Stephen Davis, Harvard Law School
- Jonathan Day, Tapestry Networks
- Carl Ferenbach, High Meadows Foundation
- Richard Fields, Tapestry Networks
- Rajiv Gupta, Delphi Automotive PLC, Hewlett-Packard Company, The Vanguard Group, and Tyco International Ltd.
- Bengt Holmstrom, MIT
- Craig Kennedy, Tapestry Networks
- Linda Fayne Levinson, Jacobs Engineering Group and NCR Corporation
- Jack O'Brien, Cabot Corporation, LKQ Corporation, and TJX Companies
- Chris Pinney, High Meadows Institute
- Tom Presby, First Solar, Inc. and World Fuel Services Corporation
- Gary Retelny, ISS Group
- Amy Sampson, Tapestry Networks
- Mary Schapiro, General Electric Company and London Stock Exchange Group
- Ted Shasta, Chubb and MBIA Inc.