The Paradigm of Purpose and Profit

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Anu Rajakumar: As companies face increased scrutiny on Environmental, Social, and Governance issues, how can they go beyond ticking-the-box exercises to creating real value for their customers, employees, investors, and stakeholders? At Neuberger Berman, we are focused on answering these questions, which is why we formed an ESG Advisory Council whose members bring the latest in ESG expertise into the heart of our business. On today's episode, we've brought back my colleague, Jonathan Bailey, Head of ESG Investing, to chat with George Serafeim, the Charles M. Williams Professor of Business Administration at Harvard Business School, and member of our ESG Advisory Council, to share more about this topic from his upcoming book, Purpose and Profit. Now, over to you Jonathan.

Jonathan Bailey: Thank you, Anu. And thank you, George, for joining us today for a discussion on *Purpose and Profit*. George, in your upcoming book, *Purpose and Profit*, you explore how ESG has become mainstream over the past decade. Can you share more about what has changed in the world that makes thinking about sustainability so critical to investors?

George Serafeim: Thank you, Jonathan, first of all, for having me. A couple of things have actually changed in the world. The first one is that we have unprecedented levels of transparency. Years ago we would have very little actually ability to understand what's happening in supply chains, what is happening in terms of working practices, the environmental outcomes, and outputs that organizations are having, and now we have much more data. And of course, the data still needs to be improved, but we have much more data. And that data is increasingly being used both by consumers around the world, by customers asking for the impact that organizations are having, and as a result, changing their practices and their procurement processes. Both businesses observe what's happening in the supply chain, for example, of Walmart, but also individual consumers that are asking for action, but also employees critically, more and more talent is going towards organizations that are having more positive impact and people are trying to actually join and enable organizations with more positive impact.

And with that, as a result, competitiveness is changing in organizations, right? So you can actually start mapping the fundamental drivers of sustainability around regulatory practices. So, for example, we have more and more prices on carbon and more and more carbon trade systems that used to be close to zero. Now, globally around the world, we have a little bit more than 20% of global greenhouse gas emissions that have some price. We have technological changes that are enabling us to have products that might have better outcomes on consumers for example. And of course, we have changes in the market environment, as I discussed before, in terms of what customers or employees might want. And of course, legal environment changes right? Where more negative impacts might be litigated against more and more everywhere around the world. And the manifestation of that, of course, is climate litigation that we're observing, but also litigation around labor issues in the supply chain and in operations as well.

Jonathan: So all of that sort of means that you shouldn't just be ticking a box and thinking about sort of basic ESG, but really moving forwards in the way that you manage the company, right? To ensure that that focus on outcomes and those material topics is core to it. So how are great managers responding and embracing this changing world?

George: The absolute wrong approach is to think that I will hire two or three people in my sustainability department. I will publish a sustainability report and box checked. We just did it, right? And I think many organizations have actually engaged in that and they have failed to create value, failed to create impact, and failed to satisfy really the expectations of customers and investors and employees and stakeholders.

I think what we have found and actually works is to view this process as a transformation process, both from a governance perspective, really engaging the board of directors, from an oversight perspective, understanding the incentives that exist inside the organization and whether the incentives are congruent with delivering more positive outcomes and impact, and really engaging also in a pretty large-scale cultural transformation. Many of the sustainability issues could view it as a threat to the employees in the organization. You go to a consumer's good company, and you say, "You need to sell healthier products." And people are saying, "Why? What is wrong with the products that we have been selling?" Same thing for an energy company, right? In terms of like carbon emissions, for example, and so forth. So the question is how do you actually bring with you the workforce of the organization, and how do you frame actually those issues as an opportunity for innovation and growth, and also as a thread to the identity of the organization? And that cultural transformation is actually hard, it's not easy. And that's why you need really great management, great governance as part of the process.

Jonathan: So investors, at least active investors are trying to find and back those great teams and to support the transformation, but it's not easy to identify ahead of time, right, who the winners are going to be. So what is the role of investors and how should they be approaching finding these companies in these management teams?

George: Well, the first thing is that asking the right questions, right? And I think also as part of that is realizing that management attention is a very scarce resource. So you can't be asking management to be doing hundred different things. The question is what is the purpose of the organization, and is the management delivering towards that purpose, right? And when you look at organizations, for example, that have been in the news quite a bit, such as Tesla, for example, Tesla's purpose is actually very simple, right—which is accelerating the transition to sustainable energy. So the question is, are they doing that, and how effective they are in doing that? And I think from an outcomes perspective and from the impact that they're generating perspective, the question is management and governance actually enabling the acceleration and the transition to sustainable energy. And to a large extent, electrification of the mobility sector has been accelerated by Tesla. So the question is, is the purpose of the organization, the right one, are they delivering towards that purpose? And are they making a meaningful improvement in terms of some of those environmental and social outcomes that are coming with that specific idiosyncratic purpose of the organization?

Jonathan: So measuring outcomes isn't easy. And you've done a lot of work at Harvard Business School to try and measure outcomes through the Impact-Weighted Accounts initiative. Can you tell us a little bit about that and-and how you go about trying to put quantification around some of those outcomes?

George: As you said, measuring outcomes is extremely important. And let me start by saying that we have actually made a lot of progress in the ESG space of having some data. The starting point in the ESG space was no data. When I started working in this space, you would have a blank spreadsheet in front of you. And we made quite a bit of progress in terms of the data, but most of the data in the ESG space is what I call input metrics, meaning intentions, policies, practices, management systems, disclosures, targets, and this is all good, but they don't necessarily translate into outcomes. They don't necessarily translate into outcomes because you have the new year's resolution effect, which is, "Okay, I want to actually get healthier, but several months later I'm still eating unhealthy, because it's actually hard." It's part of the, I would say of the human behavior, but also you have a lot of cheap talk, right? So you have a lot of intentions that never generally translate into those outcomes in a meaningful way.

So from that perspective, if you are actually not measuring the outcomes that you're trying to transform whether this is an environmental outcome, such as, for example, reducing carbon emissions or providing more environmentally friendly products to the customers, or that is a societal outcome, such as, for example, creating products and services that have higher access and affordability or higher product safety and so forth, whatever that might be, then it's really hard to actually hold management accountable and have a sense about whether we are achieving the outcomes, one, and two, whether we're achieving the outcomes in the most cost-effective way.

And this is also what we're observing in the data that companies are-are investing $1, for example, in terms of trying to achieve the same amount of outcome, but they are generating very different actually outcomes, whether again, that is an environmental or social outcome in terms of the efficiency with which that dollar is being invested. So what we're doing at impact with accounts, we're saying there are so many different outcomes. Let's try to measure some really big ones, such as, for example, environmental outcome, employment outcome, and then product outcome to the customers.

And then asking the question, how can we measure those outcomes? And then importantly, how can we value those outcomes? And valuation of those outcomes, which means be putting a dollar term is something very, very hard, but actually, it forces people to make this deeply uncomfortable choice, which we're all making every day unintentionally and unconsciously, which is what do you value really more, right? So am I going to invest in an additional dollar to reduce my carbon emissions, to reduce my waste, or to generate an additional job, a high-quality job, improving health and safety, what am I trying to do? And I think once you have that, and you can actually do your financial impact, your environmental impact, your employment impact, your customer impact, at some point, as a society, we're going to be able to make that judgment, which is how good is this company for society? broadly speaking, I think many companies are actually having a tremendous amount of positive impacts and many companies are having a tremendous amount of negative impacts. And right now we're making those judgments on a beliefs and subjective assessment basis. Can we develop the rules and norms to start making a systematic judgment?

Jonathan: So that leads to the question of engagement versus divestment. So you take one of those companies that's on net negative in terms of the outcomes it generates. It might not be doing the quantification of that, but there's a good sense by looking at the company outside in that that's the case. What is the role of investors?

Should we be trying to explain to management teams how those outcomes are negative, encouraging them to redeploy capital to try and transform themselves, or is it unrealistic to expect that hundreds of companies from the MSCI World Index are going to be able to make that transformational journey, and instead we should just be asking for capital back and putting it into companies that we think are already bought into transforming themselves, or-or are in fact positive in their outcomes today?

George: I know it's a hotly debated topic and I think when it comes to that, the question is one of evidence, right? So you can ask the question about what is the evidence that actually divestment is generating some positive environmental or social outcome, and the answer to that is not much actually. On the other side, what is the evidence that might be generating some unintended consequences? Such as, for example, you can force actually publicly listed companies to divest, for example, some of their polluting assets, and what you find sometimes is that the operators or in the private markets are worse operators. So, for example, there's some evidence that suggests that flaring around actually energy assets increase after best-in-class operators are actually divesting from them when they have been under pressure.

Of course, that doesn't mean that divestment shouldn't be a choice that you're having, and I think a reasonable approach in my mind is one of adopting some type of minimum standards where actually you're engaging with an organization. You are articulating not only a clear theory of why this-- something needs to happen, but also about how it can happen. So instead of actually waving your finger but actually engaging with an organization and trying to help an organization about what are the tools, what are the practice, what are the learnings about how one could implement change and then setting a target?

A multi-year target about how much improvement one should expect and then with intermediate milestones, of course, and if you see no change, of course, that can be a reasonable case for divestment because one investor might say at that point there is no meaningful change that can happen in the organization because of the underlying outcomes that it generates. It exposes the investor to a financial risk that is unacceptable, but I think thinking about that, what are we trying to do and what are we trying to generate in a holistic way is really, really, important.

Jonathan: So we've talked a lot about the company's decisions and the investor decisions. Another stakeholder in this is, of course, policy and regulation and we've begun to see more disclosure requirements placed on companies around environmental, social, and governance data. The EU has its non-financial reporting directive. The SEC is proposed climate-related disclosures. Do you feel that the stepping-in of regulators is going to give us the data we need, or is there still going to be a gap between what's being proposed or required, and what investors really need to make these types of decisions?

George: I think some type of regulatory intervention is needed. Whether that will be the silver bullet, and then suddenly we're going to get the perfect data, actually, 100 years of financial reporting has taught us that this is not the case, right? So still actually we cannot get right financial accounting and financial reporting out of 100 years actually of having regulated, financial reporting, a little bit less probably, 90 years since the securities act in the United States, but there is a learning there which is over time we're actually going to improve the data. We're going to improve the measurements with an eye for several key properties.

So the data needs to be relevant. The data needs to be reliable. The data needs to be comparable, and the data needs to be timely, and right now although we have made a lot of progress in terms of sustainability metrics, and generally, it's the metrics, still, those properties are not the ones that tend to characterize. So the data that gets out pretty late in the season, the data gets to be not very comparable. In many case, not very reliable, and in some cases, not very relevant. So all of those things need to be fixed, and I think some type of regulatory intervention can be helpful in achieving those properties.

Jonathan: So just in closing, your book is coming out soon. What are a couple of takeaways for our listeners before they get a chance to read it themselves?

George: I think one of the really important messages is how the world is changing because of where we started, Jonathan, that actually many managers are saying, "But I have been so successful in the past." This and that, "Uh, how can it be that I'm missing something?" And the question is not one of defensiveness, right, about, "Oh, you're missing something," but actually trying to understand how the world is changing. And then how can you develop the management and governance systems to know how to manage the scarce resources inside an organization, right?

So that your social capital that has been given to the brands and the reputation of the organization, the human capital, and being able to attract, retain and grow people. And the intellectual capital that comes with all the innovative ingenuity that comes from the employees. The second element is also trying to understand what really motivates people. And I think to a large extent, what motivates people is really progress and change towards a better type of outcome that might be created either for themselves as employees or for the customers and really trying to create amazing products and services.

And that's another part of the book, which actually tries to understand through stories and the data that we have been observing about how people are actually engaging in this sustainability journey with an understanding that this is not easy. In many ways, it requires individuals to take both personal and organizational risk in order to achieve the transformation that we talked about.

Jonathan: Well, George, thank you so much for joining us today and sharing your insights. And I look forward to reading the book in full in the coming weeks.

George: It has been my pleasure, Jonathan. Thank you very much for having me.

Anu Rajakumar: Well, that will do it for this episode, definitely will have to keep an eye out for the book's release this summer. And to our listeners, if you've enjoyed this episode of Disruptive Forces, I encourage you to subscribe to the show via Apple Podcasts, Google Podcasts or Spotify, or you can visit our website at www.nb.com where you can learn more about ESG, our podcast, our firm and its offerings.