January 2022

What does stakeholder capitalism mean for investors?

THE INVESTOR FORUM

Centre for Corporate Governance

The purpose of the Investor Forum is to position stewardship at the heart of investment decision making.

The mission of the Centre for Corporate Governance at London Business School is to use rigorous research to influence the practice of corporate governance.

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FOREWORD

A growing body of opinion asserts that the current model of capitalism has failed because of an excessive focus on shareholder interests without sufficient regard to other stakeholders. Its proponents advocate an alternative form of capitalism – stakeholder capitalism.

The investor community should not underestimate the urgency of this challenge and the need for a comprehensive response. Attitudes towards business have been rapidly evolving and expectations of what constitutes responsible corporate behaviour have radically changed. To highlight just one issue, how companies and investors respond to the climate crisis and the role they play in tackling climate change and biodiversity loss represents, alongside the pandemic, the most demanding business priority of recent times.

Yet at the same time companies seeking to create long-term value for their shareholders have been an immense force for good, helping to raise billions out of poverty and enhancing the health and living standards of people across the world. The question is how to harness this force to address the future challenges society now faces.

Investors are privileged to occupy a position of significant influence on corporate priorities. At a time of huge economic and social change, it is essential that this influence is used wisely and with legitimacy, in accordance with client mandates and fiduciary duty. To understand how investors can best discharge these critical responsibilities, over the last year we have explored these issues through a collaboration between the Investor Forum and the Centre for Corporate Governance at London Business School.

Bringing together the capabilities of our two organisations with their complementary missions, we have sought to combine the rigour of the academic mindset with the practical experience of investment professionals. These have included asset managers and asset owners, investment decision makers and stewardship specialists from over 30 global institutions who are Investor Forum members. Working together, we have engaged in detailed discussions on the evidence and the contrasting implications of the shareholder and stakeholder models of capitalism. From this joint work, we have identified practical steps that investors can take to address the erosion of trust in shareholder value.

Our shared objective has been to make a practical contribution to this critical debate. Our hope is that this will strongly encourage a step-change in behaviour within the investment industry and, in turn, improve real-world outcomes.

The idea to bring together academics and investors came from Paul Coombes, Chair of the Centre for Corporate Governance and an Investor Forum Board Member, and we owe an enormous debt of gratitude to Paul for forging this collaborative effort. We would also like to thank Tom Gosling and Clare Hayes Guymer from the Centre and Tim Shanagher and Maido Richards from the Investor Forum for their tireless efforts to facilitate this dialogue and produce this report. We are, of course, enormously grateful, too, for the time, energy and significant insights from the Investor Forum members who participated in this project.

Andy Griffiths
Executive Director, The Investor Forum

Professor Alex Edmans
Academic Director, Centre for Corporate Governance
London Business School

24th January 2022

EXECUTIVE SUMMARY & INTRODUCTION

EXECUTIVE SUMMARY

Widespread loss of trust in the shareholder value model of capitalism is undeniable. Its critics argue that it should be replaced with an alternative model of stakeholder capitalism. This would, they argue, address the short-termism they see as endemic to the current model and would also address the impact of externalities, for example in regard to the environment, that the shareholder value model insufficiently incorporates or simply ignores.

Part 1 of this report explores the merits of these claims and compares shareholder and stakeholder models.

While the problems faced by society are real, rigorous examination of the evidence shows that the identification of shareholder value as their root cause is less convincing.

Specifically, charges that short-termism is inherent in the current model are not supported by the evidence. Shareholder value creation is intrinsically a long-term concept. Similarly, economists have always acknowledged the importance of externalities and the need for these to be addressed by government through law and regulations.

→ **Read more in Chapter 1.1**

Nevertheless, the force of such criticisms makes it essential to take a dispassionate look at the shareholder value model and compare it with stakeholder alternatives.

We conclude that, while there is no definitive model of stakeholder capitalism, in practice its most likely version would be a variant on the investor-owned company but with a significant dilution of existing shareholder rights. We find that this creates a high likelihood of costs to investors without any guarantee of superior outcomes for stakeholders given serious problems with accountability, dynamism, legitimacy and effectiveness of these alternative approaches.

→ **Read more in Chapter 1.2**

This finding does not let investors off the hook. The investor community simply cannot afford to be complacent.

The pressure to take far greater account of stakeholder concerns will be unrelenting. It is also the case that, in many cases, investment processes remain too divorced from the stakeholder context within which business operates today. The challenge is therefore to identify a principled and rigorous way that investors can respond to these concerns, in a manner that is fully consistent with their fiduciary duties to clients. Based on our review of shareholder and stakeholder models, we conclude Part 1 with a statement of key insights and the challenges that must be addressed by any such approach.

→ **Read more in Chapter 1.3**

Part 2 of this Report, builds on the insights and challenges established in Part 1 to identify practical actions that market participants can take.

At the heart of the necessary response is the need for a sustainable shareholder value model to guide legitimate[1] investor action.

This model requires us to revisit the proper role of investors in the investment ecosystem. While much of this can build on current best practice and adherence to the spirit of the Stewardship Code, our articulation of the sustainable shareholder value model reveals two additional insights. First, investors must do more work to incorporate stakeholder perspectives into their investment process.

1 Throughout this report we use "legitimate" in its meaning of "able to be defended or justified" rather than in the stricter sense of "in accordance with the law or rules"

Second, there needs to be a step change in securing far greater specificity of client mandates beyond narrow contractual commitments to create a shared understanding of how these stakeholder issues will indeed be taken into account.

Only on this foundation will investors have a clearly legitimate basis for determining how they will reconcile responsiveness to stakeholder issues with adherence to fiduciary duty. Just because investors can act on a stakeholder issue does not mean that they should.

→ **Read more in Chapter 2.1**

Identifying which stakeholder issues to act on is challenging for investors who are on the receiving end of multiple demands relating to a wide variety of issues.

To decide which stakeholder issues to prioritise, we propose that investors should commit to three principles against which potential stakeholder initiatives should be evaluated.

- First, the stakeholder should be material, recognizing there are several dimensions of materiality not just financial.
- Second, the investor should have efficacy relating to the issue, meaning that there should be a realistic prospect of investor action bringing about change in the real world.
- Third, the investor should have comparative advantage to take the proposed action, meaning they are well-placed to address the issue, either individually or collectively, relative to other parties.

These principles set a demanding new challenge for investors; they require disciplined effort to apply. But this is essential for demonstrating that attention to stakeholder concerns is not being achieved through sacrifice of clients' interests. Instead, they provide an integrated framework for determining where investors can establish a legitimate case for action.

Together they form a triple test: each principle is necessary but not sufficient. Any stakeholder–oriented initiative needs to pass all three tests.

→ **Read more in Chapter 2.2**

To support this triple test, we develop the concept of materiality beyond the traditional investor-focused view of financial materiality.

Materiality is a many-faceted concept that is central to many stakeholder concerns. In line with this, interest groups are increasingly seeing investor action as a channel for addressing their aims, particularly when government in seen as slow to act. This is especially the case in relation to systemic issues identified as material.

Given the complexities involved, we therefore expand our discussion of materiality in detail in Framework 2. There we bring together various perspectives on materiality that have emerged in recent years to produce a prioritisation framework that recognizes three further dimensions of materiality over and above the traditional financial view: impact materiality, reflecting a company's impact on a stakeholder; systemic materiality, reflecting issues that are market-wide rather than company specific; and intrinsic materiality, reflecting non-financial goals of investors and society.

Finally, we incorporate the dynamic nature of materiality, meaning that stakeholder issues can migrate from one category to another as knowledge, attitudes, or regulation change.

→ **Read more in Framework 2**

While these elements of materiality are not individually novel, we believe that their integration into a coherent framework for investors is a distinctive contribution of our work.

The dynamic nature of materiality across this framework encourages a focus on factors that the traditional model of shareholder value finds hard to capture. We argue for the incorporation of stakeholder insight within the investment process to inform shareholder stewardship activity.

These debates take investors into complex areas. We counsel that investors need to be rigorous and evidence-based in how they apply the frameworks we lay out. There is an ever-present risk of being seen to over-reach into the political realm or of pursuing social goals that conflict with the investor's fiduciary duty to clients.

Investors will need to develop new skills in stakeholder dialogue and horizon scanning in order to incorporate appropriate perspectives. Transparency and clear communication with clients will be essential to identify their informed preferences and ensure common understanding of how investors will act.

→ **Read more in Section 2.2**

Conclusions and Next Steps

The investor community, we conclude, has a legitimate role in addressing stakeholder issues, both within individual companies and when dealing with market-wide, systemic risk. Moreover, we argue that this can be achieved without compromising client interests and fiduciary duty. This, in our view, is exactly how investors should define their commitment to stakeholder capitalism. However, investors need to be extremely clear on their mandate for pursuing such issues and on the likely overall effectiveness of their actions.

The model of sustainable shareholder value that we advocate illustrates how the different components of the role of investors should interact to create value in a way that can serve the needs of clients and in parallel benefit society. Crucially, the model also incorporates a triple test of principles to enable shareholders to determine which stakeholder issues to prioritise.

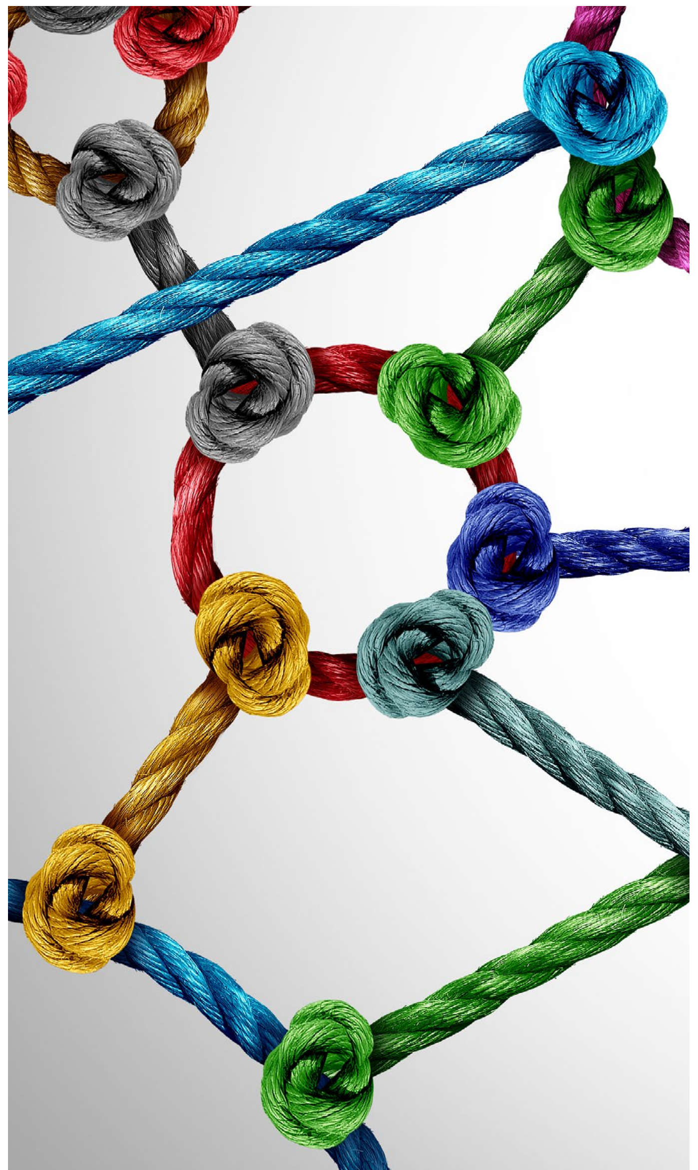
In combination, the model and the principles provide a practical approach which can help investors establish a legitimate foundation to address many of the challenges to the model of shareholder value.

This is a major undertaking. But only on this foundation will investors have a sound basis for determining how they will reconcile responsiveness to stakeholder issues with adherence to fiduciary duty.

And through that process investors can create the circumstances for shareholder value to be seen as part of the solution rather than part of the problem.

This report should be seen as a step in a process rather than the end of a process. We identify a number of practical actions that could build on the insights of this paper, for consideration and progression in 2022 and beyond.

→ **Read more in Conclusions**



INTRODUCTION

Context

Since the global financial crisis, debate has focused on whether companies have become too powerful and, through the abuse of dominant market positions, have benefitted shareholders at the expense of wider society and the environment. There are numerous examples where companies were not fully held to account nor the harm that stemmed from their behaviour fully recognised.

Pursuit of shareholder value is accused of leading to:

- **Short-termism** - to the detriment of companies' long-term health.
- **Stakeholder harm** – to the detriment of wider society.

The environment is perhaps the poster child issue for these concerns, with the accusation that shareholders have benefited from exerting an unsustainable toll on the environment, without bearing the costs of this. It is therefore no surprise that there is a growing body of opinion that the current model of capitalism has failed in large part, because of an excessive focus on financial returns without sufficient regard to other stakeholders, and that alternative forms of stakeholder capitalism should be considered.

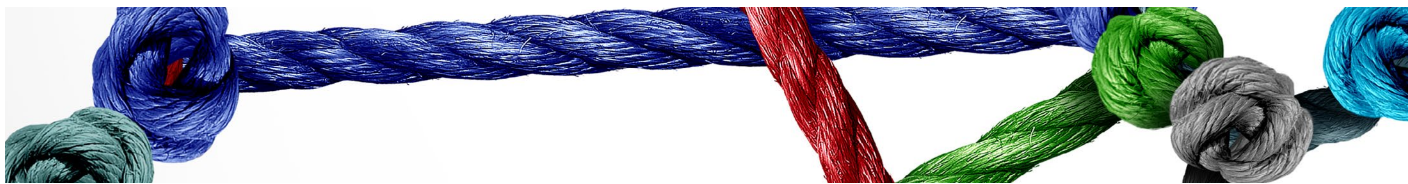
Yet at COP26 we saw the importance of business and investors, within a framework of government regulation, being part of the solution. Companies will play an essential role in developing and scaling the innovative technologies we will need to become more environmentally efficient and to function within the planetary boundaries. Investors will be crucial in reallocating capital from declining to burgeoning industries as we progress through the energy transition.

Separately, the COVID-19 pandemic has shown the extraordinary ability of companies to adapt and innovate to help mitigate the impact of the most serious public health crisis in living memory, both through the acceleration of the digital revolution and the rapid development of vaccines, testing, and therapeutics. But at the same time the pandemic has heightened concerns about haves and have nots, particularly between developed and developing nations but also within them.

What is clear is that where government and business both play their part in a synchronised fashion, extraordinary things can be achieved for society and companies can generate sustainable long-term value.

Investors are privileged to occupy a position of significant influence to ensure that the benefits of capitalism are realised and shared, and its harms mitigated.

At a period of huge economic and social change, it is essential that this influence is used wisely and in accordance with client mandates and fiduciary duty.



Our response

Given the importance of this responsibility, the Investor Forum and the Centre for Corporate Governance at London Business School have explored these issues in a highly distinctive year-long collaboration.

We have sought to combine evidence from the academic literature with the insights of 30 leading investors, including both asset owners and asset managers, in a series of workshops to explore these challenges.

Our overarching question was as follows.

Overarching question
What does stakeholder capitalism mean for investors?

Our response to this question divides into two main parts. In Part 1, we review the challenges against the shareholder value model and consider the stakeholder alternatives. It is not the role of investors to select the model by which our economy operates. But by undertaking a considered review, **we have identified a series of insights and challenges that need to be addressed if trust in shareholders' role in society is to be rebuilt.**

Part 1 questions

- To what extent are the criticisms of shareholder value justified?
- What are the implications of the stakeholder alternative(s)?
- What insights can we draw to inform the actions investors need to take?

In Part 2, we consider what shareholders can do in order to support a sustainable model of shareholder value that is viewed as part of the solution rather than part of the problem. We have consciously chosen to take an active orientation: what can shareholders do now?

There are important debates and choices about what is the right model of capitalism and the right model for decision rights within a company. Ultimately it is not the role of investors to make those choices. But what we can do is to draw insights from those debates to inform **how investors can act most effectively to help clients achieve their financial goals and deliver benefit to society within the model we have today.**

Part 2 questions

- What are the principles for how shareholders should act in a sustainable shareholder value model?
- When do investors have a mandate to act on stakeholder issues?
- How can we embed and develop the learning from this project within the investor community?

In Part 3, we set out two detailed frameworks that have emerged through the combination of academic and practitioner insight that has been central to this project. These frameworks build on the ideas set out in this report and will support investors who want to integrate those ideas into their investment approach.

Part 3 frameworks

- Sustainable shareholder value framework
- Framework for analysing materiality

In this way, through a year-long facilitated dialogue we created an opportunity for competitors to collaborate effectively to identify practical measures that might better inform our understanding of shareholder and stakeholder models of capitalism and to identify practical steps that investors can take to address the erosion of trust in shareholder value.

A distinctive approach

Throughout this project, we have combined deep practitioner insight with rigorous academic evidence and challenge, to draw conclusions about the role of investors in a business world where stakeholder perspectives are becoming ever more prominent. In bringing together two high quality organisations, The Investor Forum and the Centre for Corporate Governance at London Business School, in a year-long project, we believe we have created a highly distinctive output that both surveys the current landscape in a balanced way but also proposes practical steps forward.

Of course, of its nature this is an investor perspective. But it is one that acknowledges, and authentically seeks to respond to, the challenges placed at capitalism's door.

Capitalism has brought enormous benefits for society through companies pursuing long-term value for their shareholders.

Yet there are significant societal problems that need to be addressed and business needs to play its part. We have set out a series of practical principles to guide investor action so that pursuit of sustainable long-term shareholder value can, in the words of Alex Edmans[2], 'grow the pie' for the whole of society, not just for the benefit of a few.

Relationship with the Stewardship Code

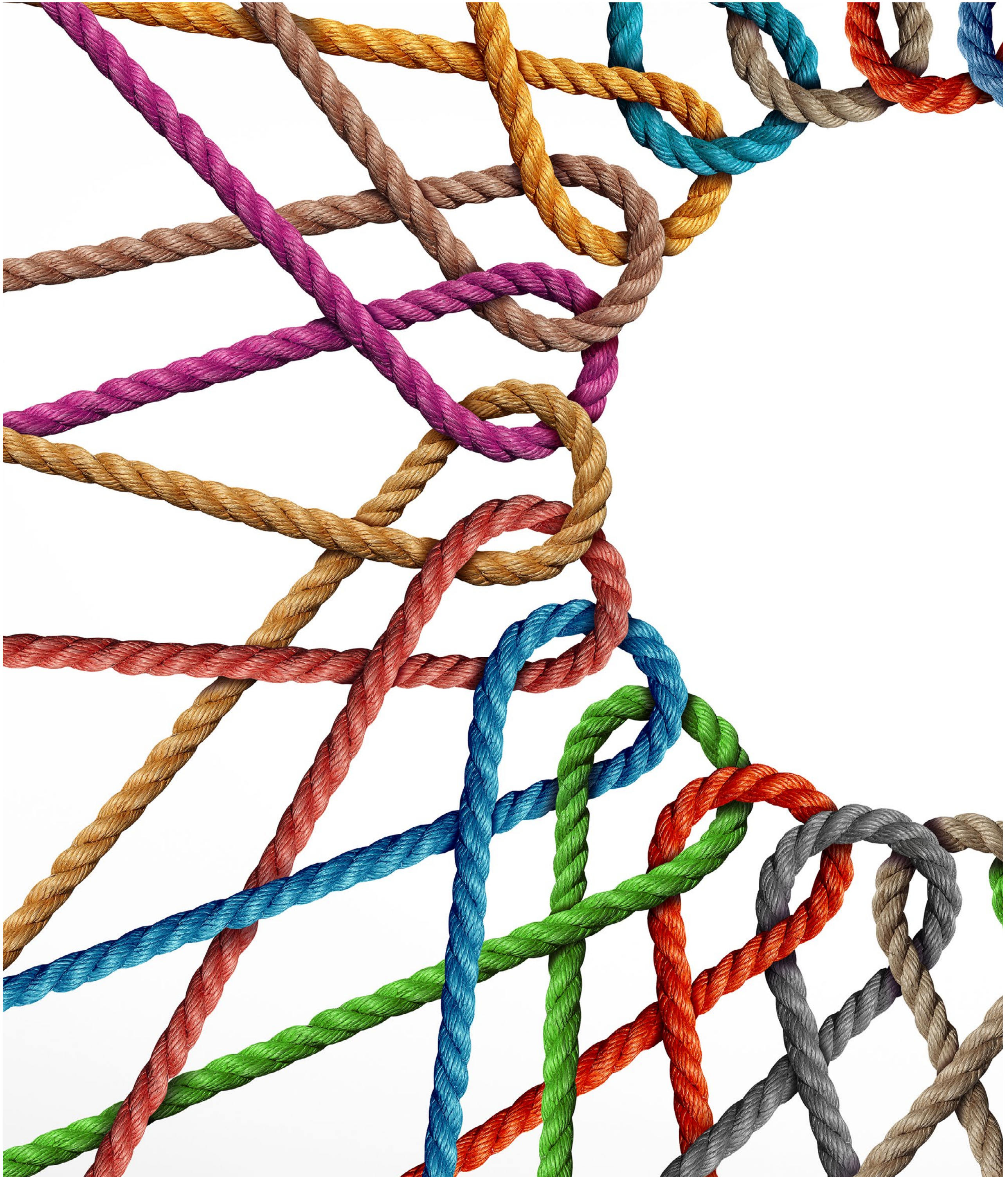
Following consultation with market participants, the FRC issued an updated Stewardship Code in 2020. This represented a significant and welcome change on the previous Code, particularly through its increased emphasis on demonstrating stewardship and communicating stewardship activity and impacts in a clear way to clients.

Our work is entirely complementary to the Stewardship Code, and is focussed upon the actions investors can take to exercise sound stewardship in a world where stakeholder considerations are taking on increased prominence. Firms that assess their investment approach against the framework we outline and use the principles we identify for prioritising stakeholder issues will be better placed to demonstrate good practice under the Principles of the Code.

But perhaps most importantly, our work provides clarity on the question of **legitimacy**: how can investors ensure that they respond to increasing calls for a broader approach to investment, taking into account stakeholder concerns, in a way that reflects their proper role versus other actors, and is consistent with client mandates and fiduciary duty. This exercise, in which investors have come together to address an issue of major importance, is in itself an example of Investor Forum members working together, to identify and respond to market-wide and systemic risks to promote a well-functioning financial system, as envisaged under Principle 4 of the Code.

2 Grow the Pie: How Great Companies Deliver Both Purpose and Profit by Alex Edmans

PART 1: REVIEW, INSIGHTS AND CHALLENGES



1.1 SHAREHOLDER VALUE REVIEWED

The key components of the shareholder value model are summarised in the box.

The shareholder value model - theory

- The organising principle of the company is to maximise long-term shareholder value and directors' duties reflect this.
- Decision rights over, for example, control and director appointments reflect shareholders' role as holders of the residual claim on the company's cashflows, ranking after employees, suppliers, debt-holders.
- Key stakeholders are principally protected by contract (employees, customers, suppliers) but must also have their interests considered by directors.
- Other stakeholders (communities, environment) may not be protected by contract; government regulation is required to address these externalities and to promote competition and transparency.
- In well-regulated, perfect markets, maximising shareholder value also maximises stakeholder welfare, thereby benefiting the whole of society.

The corporation run for the benefit of shareholders as residual financial claimants has become the dominant ownership[3] model for good reasons: it is a very efficient form for bringing together resources, especially risk capital, to meet customers' (and hence society's) needs.

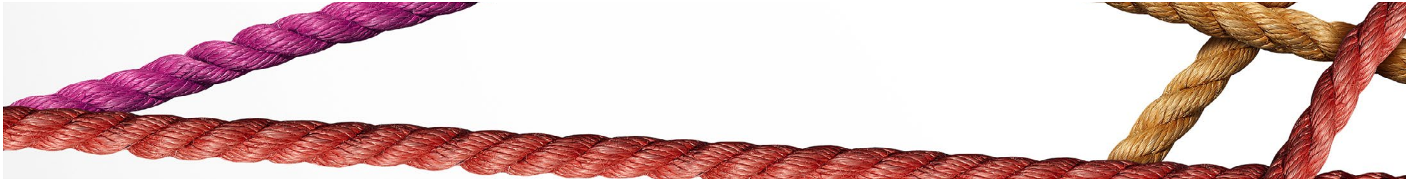
Alternative ownership models have difficulty raising equity capital and may need to fund expansion through retained earnings. Companies pursuing shareholder value have played a key role in promoting innovation, lifting billions of the world's citizens out of poverty, enhancing life expectancy and health, and improving living standards around the world.

However, there are problems in the application of the shareholder value model in practice:

- There can be a tendency to focus on what is most immediately tangible and measurable, which, at least historically, has meant financial results and current market valuations, which is particularly relevant in takeover situations.
- Conditions for markets to maximise societal welfare can break down (lack of competition, winner takes all dynamics, unaddressed externalities[4]) .
- Increasingly serious systemic issues and externalities are not being fully addressed through regulation (e.g. climate) and may be overlooked by individual firms pursuing shareholder value.
- Regulators may not be able to stand up to powerful companies effectively when needed.
- There is growing public expectation that business should help to address issues when government does not.

3 We understand the argument that shareholders do not strictly "own" the company, but use the term "ownership" as a shorthand for having the residual financial claim on the company, with associated voting and control rights - similarly, we use the term "employee owned" elsewhere in this paper

4 Corporate Purpose and Corporate Competition by Mark Roe



The problems with the shareholder value model have been long-recognised by economists. They create the case for well-resourced regulation to enhance financial and non-financial disclosure, promote competition, address monopolies, protect stakeholders and to tax or limit externalities. To be effective, markets must operate within a framework set by government. However, where government action and regulation are inadequate, economic incentives and public benefits can become misaligned, creating pressure for investors and companies to act themselves.

These problems are often conflated with two other issues that are more accurately described as misapplications of the shareholder value model:

- **Cases where the focus has shifted from the creation of long-term value as a result of misaligned and short-term oriented incentives.** These may include excessive executive pay for short-term results, too much focus on quarterly earnings rather than long-term value, and investment mandates that encourage short-term benchmark chasing.

- **Cases where the focus on profit maximisation has led to the unethical treatment of one or more stakeholder.** There have been high profile cases where companies are perceived to have gone beyond the bounds of acceptable behaviour in pursuit of profits. Such cases have related to issues such as extreme corporate tax avoidance, health and safety violations, supply chain working conditions, environmental harm, abuse of market power in pricing, customer data privacy and security, and even fraud.

We refer to these as misapplications of the shareholder value model, because they frequently harm the interests of investors themselves over the long-term. They erode shareholder value, which is a long-term concept.

Taken together, the principal criticisms come down to two main charges: that pursuit of shareholder value, whether in theory or practice, leads to short-termism at the long-term expense of shareholders and society, or to stakeholders being harmed for the gain of shareholders. We consider the evidence for these charges next.

Short-termism

The shareholder value model is widely perceived as driving short-termism, whereby the pursuit of private short-term interests of shareholders leads to the detriment of a company's long-term health. The reduction in average shareholding period, the growth in activist investment, and executive pay plans based on short-term targets are all accused of driving a focus on short-term profits and share price to the detriment of long-term societal outcomes. The most rigorous evidence suggests that claims of short-termism in the shareholder value model are seriously overstated[5].

The misunderstanding often arises from a confusion between holding period and orientation. For example, an activist investor may have a short holding period, but a clear interest in enhancing long-term value if they are to sell their stake at a profit. Company valuations are only justified based on creation of value many years and decades into the future, and so shareholder value is an inherently long-term concept. The valuation of companies in industries undergoing technological transformation is one demonstration of the long-termism inherent in share valuations.

At the same time, short-term incentives within the system do exist. Executive pay is, overall, still short-term in its design. Investment mandates and portfolio manager compensation can be aligned to short-term measurement periods. Similarly, asset owners and investment consultants frequently focus attention on quarter by quarter performance of asset managers. While investors focus on pricing big long-term strategic trends, they are sometimes less effective at pricing subtler issues such as the value of employee engagement or other changes in expenditures such as R&D.

Many of these challenges can be overcome through systematically reviewing and structuring incentives to be longer-term through the investment chain, not weakening shareholder rights.

At the same time, a focus on both short and long-term results is a necessary part of investor accountability. Distinguishing between a temporary dip in performance and the commencement of a longer decline can be challenging for asset managers and asset owners. Having a long-term perspective does not mean hanging on grimly in the face of declining performance. The counterpart of one company's innovation may well be the erosion of another company's business model.

Aligning shareholder and stakeholder value

It is often contended that a narrow pursuit of shareholder value results in costs being externalised which negatively impact the environment and other stakeholders.

The existence of true externalities cannot be denied. But stakeholder value and shareholder value are strongly aligned – to a much greater degree than is often assumed – over the long-enough term[6]. Great companies create sustainable value for their shareholders by understanding the role that positive stakeholder relationships play in creating value over the long term. There are many examples of great companies doing this within the current system. Companies will be most successful when they anticipate the long-term trends that influence consumer, employee, supplier, and regulatory behaviour.

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5 Response to the European Commission Study on Sustainable Corporate Governance by Alex Edmans, Stock Market Short-Termism's Impact by Mark Roe

6 Why Shareholder Capitalism Benefits Wider Society by Alex Edmans

But this does not mean that companies should be indiscriminate in their stakeholder actions. Indeed research shows that companies prioritising financially material stakeholders (as determined using the SASB Materiality Map®) deliver enhanced performance[7]. Those also prioritising financially immaterial stakeholders do not. Creating alignment between stakeholders and shareholders requires focus. In Section 2.2 we discuss how the concept of materiality can usefully be extended beyond financial materiality of the stakeholder on the firm to impact materiality of the firm on the stakeholder.

Shareholder value can be pursued in a short-term way, and in a way that seeks to extract value from other stakeholders as opposed to growing the pie for all stakeholders. But these approaches often backfire, to the detriment of the interests of companies and shareholders adopting this approach.

Much of the gap between shareholder value and stakeholder value can be closed by considering value creation over the long-term.

An evolution in the understanding of shareholder value

Whilst real, the problems of short-termism and stakeholder harm are not an inherent part of the shareholder value model and can substantially be addressed within the shareholder model rather than requiring its replacement.

However, some stakeholder issues are truly externalities, not reflected in shareholder value at all or only over the very long-term. Arguably it is the role of government, through the democratic process, to establish regulation or taxation to reflect the proper balance between shareholder and stakeholder interests in these cases. But governments can find it difficult to act, either because of difficulties in obtaining political consensus, or because the issue itself does not readily submit to precise regulation (e.g. qualitative issues such as corporate culture).

In these cases there is increasingly a call for business to do more. In the next section we consider how this might be achieved by incorporating stakeholder trade-offs into corporate governance through a stakeholder model. We then consider in Part 2 how and when shareholders can and should get involved in stakeholder issues within the current ownership model.

7 Corporate Sustainability: First Evidence on Materiality, by Mozaffar Khan, George Serafeim, and Aaron Yoon

1.2 THE STAKEHOLDER ALTERNATIVE

Stakeholder models of governance have a long history, but are coming to prominence again as a reaction to the perceived problems of the shareholder value model. There are many variations of stakeholder models of the corporation, but many of them are loosely sketched rather than formally designed. One of the challenges in the shareholder versus stakeholder debate is that while the status quo of shareholder value is well understood, different advocates have very different views about what a "stakeholder model" means.

Our purpose is not to survey all such models here. But we do highlight at the outset one important distinction. Any business, however owned, will seek to create value in its outputs compared with the costs of its inputs. A first order question is which stakeholder(s) share in the residual equity value created (whether in monetary form or otherwise) and which receive their economic rewards through contract. We use the term "ownership" (see note 2 on page 11) to reflect entitlement to these residual cashflow rights, which, given their relatively low security, tend to bring with them certain control rights, such as appointment of directors, a say on change of control, and so on.

Alternative ownership models

According to this definition, one view of stakeholder alternatives is organisations with different ownership structures. These could include employee-owned co-operatives, customer-owned mutuals, state entities, non-profit organisations, or some combination thereof. It is worth noting that ownership models typically assign ownership to one stakeholder group rather than multiple stakeholder groups, although individuals can appear in more than one stakeholder group (for example employee shareholders). Moreover, the dominant stakeholder may choose to share ownership benefits to create alignment with incentives (for example profit sharing).

The reason multi-stakeholder ownership is rare is that for organisations to function effectively, it is necessary to have some commonality of interest within the stakeholder group in whose ultimate interest the organisation is run (the "owners"). Joint ownership amongst a number of stakeholder groups with no ultimate decision rights for a given stakeholder group, is likely to lead to confusion and division, creating the opportunity for managers to evade scrutiny by any group. For this reason, such an ownership model is mainly the preserve of academic theory and extremely rare in practice.

The dominance of the shareholder-owned corporation

What is indisputable is that the shareholder-owned corporation became the economically dominant form for organising economic activity. As Henry Hansmann has shown[8], in an analysis that stands the test of time, the advantage of shareholder ownership is the high commonality of interest between shareholders, which allows them, to a greater degree than other owners, to lower the cost of corporate decision-making and hold management robustly to account. Other stakeholder groups tend to have significant differences of interest within the group, which can result in blunted management accountability and therefore management entrenchment. It is relatively rare for the benefits of ownership by other groups to outweigh the disadvantages, which is one reason why the shareholder-owned corporation is so dominant.

A further reason is that the shareholder owned corporation is uniquely well-suited to raise external risk capital for growth and investment, something which tends to be very difficult for alternative ownership models to achieve. The idea that shareholder ownership is less relevant for modern

8 Ownership of the Firm by Henry Hansmann

businesses created on the basis of intellectual capital is not correct. Equity capital provides a mechanism for providers of the intellectual capital to value and crystallize in monetary terms their contribution to the business, as well as creating economic signals and a currency for direction of intangible resources.

The legal framework in most jurisdictions, including The Companies Act 2006 in the UK, provides flexibility for alternative ownership models to emerge, but they have not, which suggests enduring advantages of the shareholder ownership model.

Adapting shareholder ownership

It is perhaps for this reason that most practical proposals for a more stakeholder-oriented model of corporate ownership, frequently seek to adapt rather than overthrow the shareholder ownership form[9]. In essence these approaches seek to internalise shareholder-stakeholder trade-offs to a greater degree within a company's corporate governance, as opposed to leaving these trade-offs in the realm of contract negotiation (with employees, customers, suppliers) and regulation (employment law, consumer safety standards, environmental law).

Meanwhile, shareholders remain as residual owners of the firm. This is often achieved in practice by diluting shareholder rights, or changing directors' duties, despite leaving shareholders as residual claimants.

This results in greater discretion to boards (hence management) on how to adjudicate between different stakeholder groups. Ownership is unchanged, but ownership rights are reduced.

Some common proposals are summarised in the box below[10].

Stakeholder adaptations to the shareholder model – common features

- The legal purpose of the company should be to create wider stakeholder benefits not just shareholder value[11].
- Directors' duties should reflect this broader purpose and may include features such as due diligence obligations to assess stakeholder impacts.
- Stakeholders may have formal decision rights (e.g. employee directors).
- Director discretion to prioritise stakeholder interests should be increased relative to shareholder rights - this is particularly relevant in, for example, takeover situations where stakeholder considerations may outweigh price.
- Increase in board (and hence management) discretion may be implemented via, for example, staggered boards or takeover defences.

11 See for example the UK's Better Business Act which requires benefiting society and the environment to be a corporate purpose alongside the benefit of shareholders, or Public Benefit Corporations or B Corporations which provide for specific social purposes to be included in the articles of association alongside the benefit of shareholders

9 The Purposive Transformation of Corporate Law by David Kershaw and Edmund Schuster, Policy and Practice for Purposeful Business by The British Academy

10 Ibid.

Because these are the features that most commonly make up proposals for a stakeholder model of governance, we focus our further discussion on these kinds of proposals.

What most of these proposals do is to create a "zone of insulation" for boards and managers from shareholder pressure[12]. This zone of insulation could be used to the benefit of shareholders by taking decisions that create long-term value but which myopic investors might object to in the short term. This would be a form of "enlightened shareholder value".

However, in practice proponents envisage that this zone of insulation could be used to take decisions that would prioritise other stakeholder interests over even the long-term interests of shareholders.

The rationale for this must be either that:

- The benefit to stakeholders matches or outweighs the loss to shareholders, meaning that society as a whole is better off; or
- The benefit to stakeholders does not outweigh the loss to shareholders meaning that society as a whole is worse off but presumably fairer.

Challenges and unintended consequences

Whether these stakeholder-oriented adaptations of the shareholder ownership model produce better outcomes for shareholders and stakeholders is a matter for empirical study. Overall, experience suggests that these common features of stakeholder models have problems in practice. The most serious concerns with the various proposed stakeholder alternatives fall into four categories:

- **Accountability.** Shareholders are well-placed to hold company boards accountable, whereas other stakeholders frequently are not. Reducing management accountability to shareholders, for example through staggered boards and takeover defences, is shown on average to reduce long-term firm value[13]. Yet there is little or no evidence of stakeholder benefits flowing.

  Increasing managerial discretion creates a high risk of managerial capitalism, rather than stakeholder capitalism[14]. This is particularly the case given that it is very difficult to determine whether a decision has created value for wider society, since almost all decisions will benefit some stakeholders but hurt others, and it is not clear how to weight them. As a result, it is difficult to enforce a legal purpose to create wider societal benefits.

- **Dynamism.** Stakeholder interests, whether employees, communities, suppliers, or even customers, are inherently likely to be biased towards the status quo.

  Managers who face reduced investor scrutiny are less likely to take the decisions required to enable the dynamism and change that supports economic progress. Requiring an action to create value for all stakeholders may prevent many innovations, since most will harm at least one stakeholder group. At a time when entire industries and supply chains need to be remade in response to climate change, this loss of dynamism would be highly damaging.

12 The Purposive Transformation of Corporate Law by David Kershaw and Edmund Schuster

13 The Purposeful Company Interim Report pages 50-58, Grow The Pie: How Great Companies Deliver Both Purpose and Profit by Alex Edmans Chapter 6

14 The Illusory Promise of Stakeholder Governance by Lucian Bebchuk and Roberto Tallarita

- **Legitimacy.** Many stakeholder trade-offs tend towards the political realm. Not all citizens agree on the prioritisation or valuation of stakeholder interests. Companies that use their economic power to influence these outcomes in a way that is seen as encroaching into the political realm risk undermining trust rather than increasing it.

  Equally there is a question of property rights and mandates, particularly if stakeholder considerations are prioritised at shareholder expense, through changes to company ownership ex-post and without shareholder consent.

  This is not at all to say that companies should ignore stakeholder issues. Taking stakeholders into account is a pre-requisite of sustainable value creation. But the basis of their engagement with such issues needs to be carefully thought through.

- **Effectiveness.** Models that increase board powers to allocate resources away from shareholders to other stakeholders assume that this will be done effectively.

  In practice, most issues of societal resource allocation are system issues that are very difficult to optimise at the company level, but which are precisely what markets are good at. For example, addressing climate change requires us to use a fixed carbon budget in the most effective way possible between now and 2050. Addressing inequality requires a complex connection of issues to be addressed relating to education, health, housing, competition, and social mobility. These are fundamentally systems optimisation issues which have almost no hope of being solved efficiently through the aggregation of discretionary decisions by individual boards.

Stakeholder adaptations of the shareholder ownership model: evidence

The research evidence for and against the various corporate governance adaptations outlined above are based on a trade-off between a "bonding" hypothesis and an "entrenchment" hypothesis. Under the bonding hypothesis, insulation of management from investor pressure creates the ability to commit to key stakeholders and resist short-term shareholder pressures, creating value through deepening non-contractual commitments with those stakeholders. Under the entrenchment hypothesis, management insulation from investor scrutiny leads to coasting and self-enrichment of managers rather than stakeholder benefits.

The evidence ***overall*** and on average is more supportive of the entrenchment than the bonding hypothesis. In other words...

...in most cases insulation of management is damaging to long-term shareholder interests.

Of course, this ignores any generally unquantifiable spill-over benefits to stakeholders. But the case must be made for why these aggregate benefits should be greater than the known costs to shareholders.

The evidence is not all one way[15]. There is evidence that special classes of shares can in some circumstances be beneficial for value, at least in a time-limited period after IPO. There is evidence that private equity shareholders quite often include insulation devices into company governance arrangements when bringing portfolio companies to IPO. However, what is notable is that much of the positive evidence relating to use of insulation devices such as staggered boards and dual class shares relates to structures put in place by shareholders upon IPO and can be temporary in nature.

15 The Purposeful Company Interim Report pages 50-58, Grow The Pie: How Great Companies Deliver Both Purpose and Profit by Alex Edmans Chapter 6, The Purposive Transformation of Corporate Law by David Kershaw and Edmund Schuster

Given the known research that one-size-fits-all governance structures can be counterproductive, it should not be surprising that knowledgeable shareholders in an IPO situation may on occasion determine that value is maximised by giving up certain control rights. We have also seen in certain cases that investors have supported changes in a company's legal constitution in a way that elevates stakeholder interests, famously in the case of Danone converting to become an entreprise à mission under new French legislation. However, the fact that knowledgeable investors voluntarily forsake rights in special circumstances does not of itself create a case for widespread adoption, particularly where this would involve diluting rights of existing shareholders. This is particularly the case when the evidence we have suggests that the situations where such changes are positive for value are on average outweighed by those where it is damaging.

In the interests of balance, it should be noted in a UK context that while the Companies Act is flexible in relation to ownership models, the ability to use structures such as dual class shares, differential voting rights, staggered boards, and takeover defences is (or has been) hampered in the UK by other requirements in the Companies Act, Listing Rules or UK Corporate Governance Code. By contrast, such models are available in many US states, and the US is not known for its anti shareholder-value sentiments. Given that some proposed "stakeholder" reforms relate to where regulation sits on a spectrum between UK and US practice, it should not be assumed, from a UK perspective, that any change would of necessity be detrimental.

Moreover, even without adopting formal legal changes, there are insights that can be gleaned from how different models seek to incorporate insight about stakeholder issues into corporate governance. For example, part of becoming a B-corporation requires a comprehensive corporate impact assessment to be undertaken to identify the company's impact on its stakeholders. Review of these mechanisms can give companies ideas for how they can authentically fulfil, for example, UK requirements relating to Section 172 of the Companies Act and the UK Corporate Governance Code.

No panacea

The stakeholder model, however defined, is not a cost-free alternative and has uncertain benefits. At a point in time where our economy needs a reallocation of capital and resources on an unprecedented scale, the role of investors becomes even more, not less, important. As Henry Hansmann stated in his classic analysis of ownership models:

> ***"…however poorly situated investors may be to exercise effective control, there is seldom any other group of patrons who are in a better position to assert control."[16]***

Even within the framework of shareholder ownership, governance can be tilted more towards stakeholders. In practice this is fairly modest ground to be arguing over and does not represent turning capitalism as we know it upside down. Moreover, the evidence that such changes will unleash a transformation of economic activity that would benefit society appears thin on the ground. On the contrary, on balance the evidence weighs in the opposite direction.

16 Hansmann's use of the term "patron" can loosely be translated as "stakeholder".

1.3 KEY INSIGHTS AND CHALLENGES

We have reviewed the evidence relating to shareholder and stakeholder oriented models of governance. In Section 1.1 we find that a number of these issues are a misapplication of the shareholder value model rather than an inevitable consequence of pursuing long-term shareholder value.

The stakeholder alternatives set out in Section 1.2 are neither cost-free nor obviously effective.

Our view, then, is that we need to make the shareholder value system work better rather than to discard it. This is, in any event, the sphere of action within the control of investors.

But this cannot be taken to mean that no change is required. Shareholder value has been misapplied more frequently than we would like.

The demands for a stronger stakeholder orientation have increasing force. The preceding discussion suggests that a sustainable approach to shareholder value needs to bring to the forefront three dimensions that have been underemphasised in how the shareholder value model has been applied:

- A business must fully take into account its stakeholder relationships to create long-term sustainable financial value for shareholders. This incorporates the concept of materiality and reflects the dynamic nature of materiality.
- Private owners may have non-financial goals for the businesses they control, including the fair treatment of employees and suppliers and the avoidance of environmental harms.
- The scale of business impact on stakeholders in the modern world creates systemic issues (most obviously climate change and other environmental impacts) that of themselves may affect the potential future stability of the market system.

Given the increased public interest in the role of investors in addressing stakeholder issues and incorporating client preferences into investment approaches, there is a risk of "green-washing", in the form of investors claiming credit for real-world impact that cannot be justified by evidence. Integrity relating to claims for real-world impacts will be an important part of trustworthy stakeholder-oriented behaviour by the investment industry.

Drawing together the elements of this review so far, we have identified five key insights and associated challenges.

We believe that taking action to address these challenges can make a significant contribution to rebuilding confidence in the role of investors.

Key insights and challenges

1. **Evidence suggests that the charge of short-termism is over-stated.** Shareholder value is an inherently long-term concept based on anticipated value created over many years, indeed decades, into the future.

- A short-term focus is frequently to the detriment of shareholders' long-term interests and so represents a misapplication of the shareholder value model rather than a problem with the model itself. **The challenge is to use the governance architecture and stewardship mechanisms to minimise the cases where the model is misapplied.**

2. **The alignment between the long-term interests of shareholders and stakeholders is much greater than often assumed.**

- For a business, the creation of sustainable value through mutually beneficial relationships with its material stakeholders is essential. Stakeholder benefits (harms) frequently translate into creation (erosion) of shareholder value over the long-enough term. **The challenge is to effectively embed long-term thinking throughout the investment chain in order to better align interests.**

3. **Disruption is an inevitable consequence of economic progress.** Indeed we stand on the cusp of the most urgent and significant reallocation of capital and resources in living memory as the economy adapts to climate change.

- The process of creative destruction, and investors' role in it, is essential for economic progress and continued improvements in standards of living – but that process often meets resistance from stakeholders, and on occasions shareholders themselves. **The challenge is to maintain sharp management accountability and economic dynamism while ensuring stakeholders are treated fairly and externalities are identified and fully considered.**

4. **Investors are increasingly expected to take stakeholder issues into account** both in support of long-term value creation but also to help address the systemic risks facing society and markets – particularly but not only in relation to the environment.

- Governments and shareholders each have a role to play to ensure systemic risks are addressed in the market. **The challenge is to identify which systemic risks investors can address, and how, in a manner consistent with their fiduciary duties to clients.**

5. **There has been an erosion of trust in shareholder value among wider society** and calls, in some quarters, for a move to a stakeholder model in which the interests of other stakeholders are elevated relative to shareholders. End investors and beneficiaries may have private preferences that affect how they want their money to be invested sustainably.

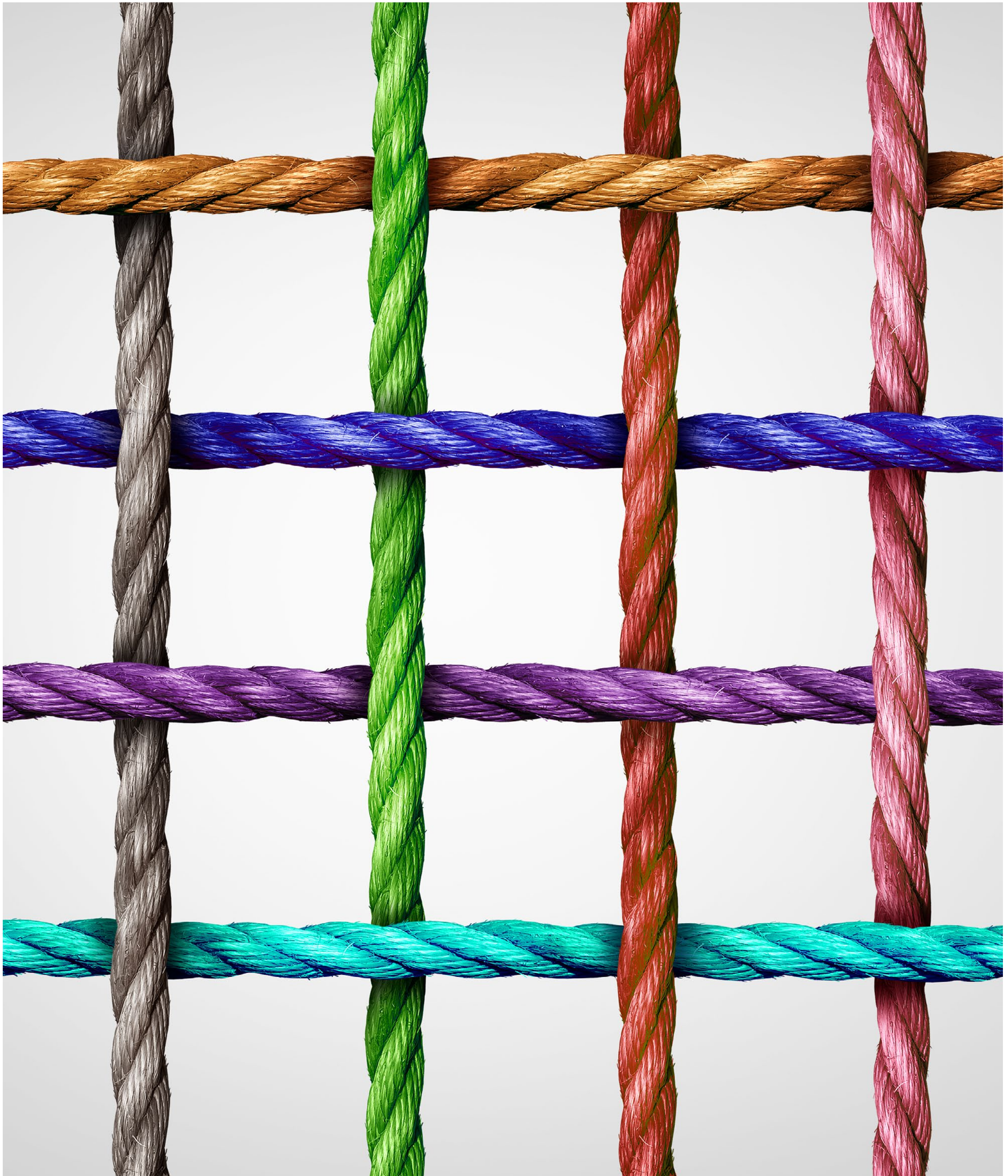
- Significant progress can be made towards a sustainable shareholder value model if investors manage their clients' money for the long-term in clear alignment with their financial and non-financial objectives. **The challenge is to create absolute clarity over mandates and fiduciary duty so that investors are viewed by society as fulfilling their role in a trustworthy manner.**

Whatever an individual's starting point in this debate we argue that there is much that investors can do to address the erosion of trust in shareholder value.

The urgent task now facing investors is to identify a principled and rigorous way that investors can respond to these concerns in a manner that is fully consistent with their fiduciary duties to clients.

We now turn to these actions in Part 2 of this report.

PART 2: PRACTICAL ACTIONS



2.1 A SUSTAINABLE APPROACH TO SHAREHOLDER VALUE CREATION

To address the insights and challenges identified in Part 1 of this report, we first revisit the proper role of investors in a sustainable model of value creation. The model set out in this section contains many components that will be recognisable to investors and which may be considered to form existing best practice in stewardship. However, reviewing the model in its entirety enables us to identify dimensions that require increased focus in today's investment environment.

The model has five dimensions to guide investor action to support the creation of sustainable long-term shareholder value.

- **UNDERSTAND** the political and stakeholder context
- **CODIFY** investor responsibilities to clients
- **MANAGE** capital in clients' interests
- **MONITOR** operation of investee companies
- **MAINTAIN** a sustainable market

This model has a number of implications for investment practice.

We argue that investors must now incorporate a much more rigorous, structured, and methodical assessment of current and emerging stakeholder issues as they seek to UNDERSTAND the political and stakeholder context.

This involves going beyond just acknowledging, for example, the major concerns that single issue pressure groups are actively seeking to highlight. Instead, it requires a much more stringent and disciplined assessment of the economic implications and their relevance to the specific portfolios that investors are managing and the fiduciary duty of investors to their clients.

Mandates and mandate discussions must move from legal and quantitative exercises to a dialogue (or, where relevant for pooled or retail funds, product descriptions) that creates clarity about how the asset manager will act in their client's interest in managing their money, enabling investors to CODIFY client objectives.

This requires difficult questions to be addressed such as the circumstances under which clients are prepared to sacrifice long-term returns in order to support particular stakeholder oriented activities that would enhance their overall welfare as a client.

Without understanding, in depth, client preferences on difficult questions such as this, there will always be an understandable temptation for investors to take decisions on the basis of their own preferences, especially if this avoids having to engage in challenging client conversations.

If a disciplined approach to stakeholder issues and mandates is already in place, investors are then empowered to engage with companies in a principled way on shareholder and stakeholder issues.

The next two levels of the ecosystem – **MANAGE** and **MONITOR** – will be recognized as existing areas of focus for good stewardship. But they will be enhanced by having a sound foundation of rigorous stakeholder analysis and robust client mandates.

This will enhance the quality of dialogue with companies, as discussions on stakeholder issues will be rooted in matters of direct relevance to the company, and to investor interests, rather than being seen as indiscriminate, as can sometimes be the case today.

Assessment of current and future materiality enables actual or potentially systemically important issues to be incorporated into the investment process to MAINTAIN market sustainability.

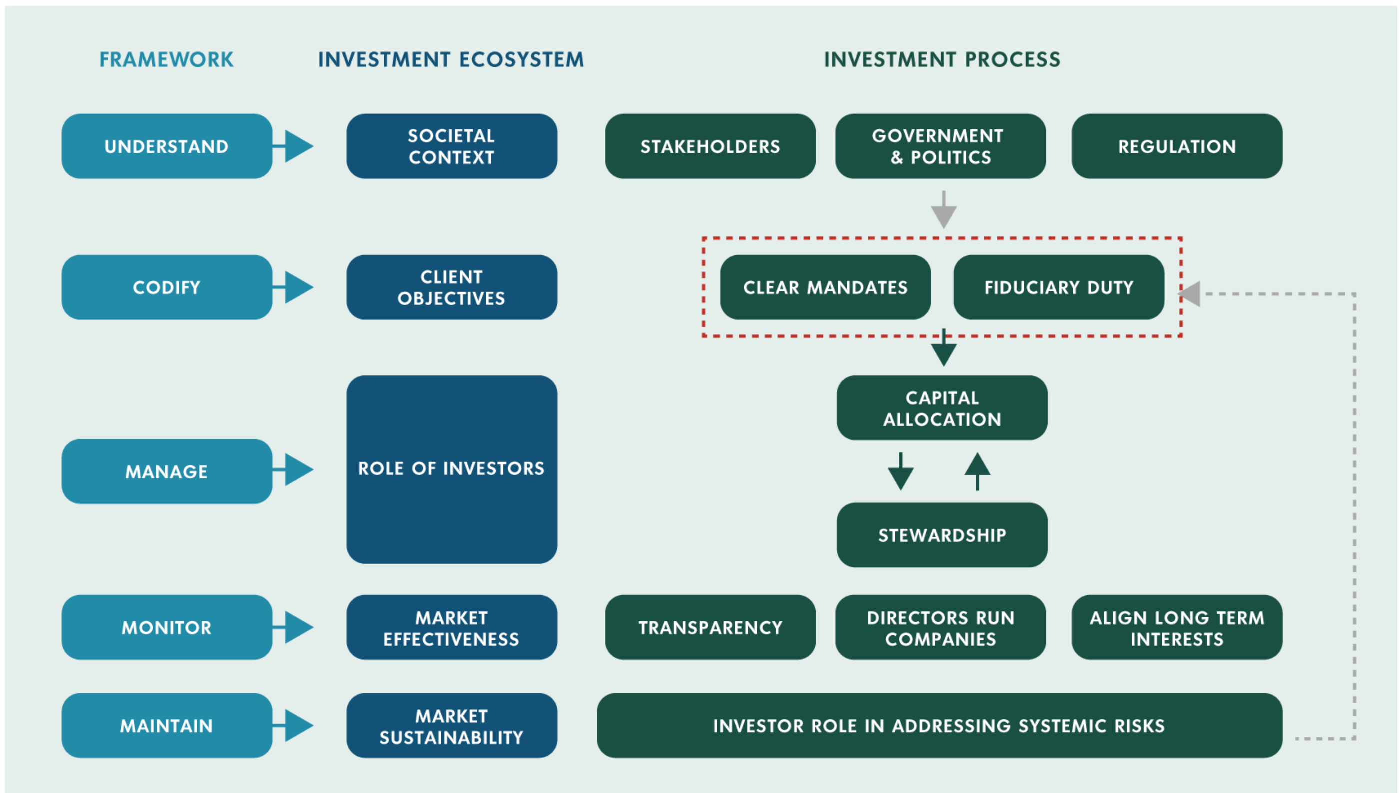
This is where there is a need for a well-structured process for analysing current and future materiality and building this into the investment process, feeding back – as the exhibit shows – into the discussion of client mandates, and even into the initial societal context.

This model is illustrated schematically below.

Different investors will choose to act at different points in the model depending on their strengths. But if all investors consider how their business model maps onto this framework, we will make significant progress towards a sustainable model of shareholder value. To assist with this, we set out in Framework 1 a series of principles, against which investors can assess their role in the investment ecosystem, their own maturity against the sustainable shareholder value approach, and areas for future focus in developing their investment model.

Relationship with the Stewardship Code

There is a high degree of complementarity between this model and the Stewardship Code. Investors that review how their investment model aligns with this sustainable shareholder value model will be well placed to fulfil their Stewardship Code obligations, with particular relevance to Principles 1, 4, 6, and 7 (see overleaf).



SUSTAINABLE SHAREHOLDER VALUE MODEL

Stewardship Code Principles

Principle 1: Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment, and society.

Principle 4: Signatories identify and respond to market-wide and systemic risks to promote a well functioning financial system.

Principle 6: Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

Principle 7: Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.

While much of this model aligns with current best practice and adherence to the spirit of the Stewardship Code, our articulation of the approach to sustainable shareholder value creation reveals three additional insights.

First, investors must indeed do more work to incorporate stakeholder perspectives into their investment process.

Second, there needs to be a step change in securing far greater specificity of client mandates beyond narrow contractual commitments to create a shared understanding of how these stakeholder issues will indeed be taken into account.

Third, in an environment where stakeholder issues are readily politicised, investors need a robust way to ensure that they are prioritising stakeholder matters in a way consistent with their proper role, aligned with client mandates and fiduciary duty.

At the heart of all of these factors is the question of legitimacy.

Precisely how to assess which stakeholder issues should be prioritised for stewardship activity is a complex issue, and the topic of the next section.

Summary

The model of sustainable shareholder value seeks to reweight the importance of historically under-represented components of the ecosystem and so requires:

- Far more disciplined analysis of actual and potential stakeholder concerns, through a structure that rigorously examines how far responding to these concerns is compatible with the creation of shareholder value and fulfilment of fiduciary duty.
- Client mandates (or fund product descriptions) that explicitly, and in real detail, specify and agree client preferences in regard to stakeholder issues on which investors will subsequently act.
- More principled engagement with investee companies on stakeholder issues that incorporate a far more disciplined approach to explaining how such investor concerns are fully compatible with shareholder value creation.
- More in-depth scrutiny of current and emerging systemic stakeholder issues that in turn feeds back into a periodic review of client mandates.

The task facing stewardship teams has become far more demanding and the need for them to be central to the investment process has greatly increased.

2.2 PRINCIPLES FOR ACTION ON STAKEHOLDER ISSUES

We have made the case that many of the challenges laid against the shareholder value model can be addressed by objectively considering how that model is applied, as opposed to discarding it for an alternative. At the same time, we have noted the centrality of stakeholder considerations to the creation of long-term value and the necessity for investors to take into account demands for change in how shareholder value is implemented.

To be achieved in a credible way, this requires investors to have a rigorous and transparent process for prioritising stakeholder issues and determining where they have legitimacy to act in a way consistent with fiduciary duty. It also requires investors to articulate their priorities clearly in consultation with clients and to establish mandates that create clarity about how investors will act.

Achieving this effectively and authentically is no small task and will require more work on these issues by investors than has been the case historically.

Investors will also need clear principles for carrying out their own prioritisation of stakeholder issues, which in turn enables transparent communication with clients, stakeholder interest groups, and the wider public. In this section we articulate a set of principles to meet this objective.

Stewardship Activity and Stakeholder Issues

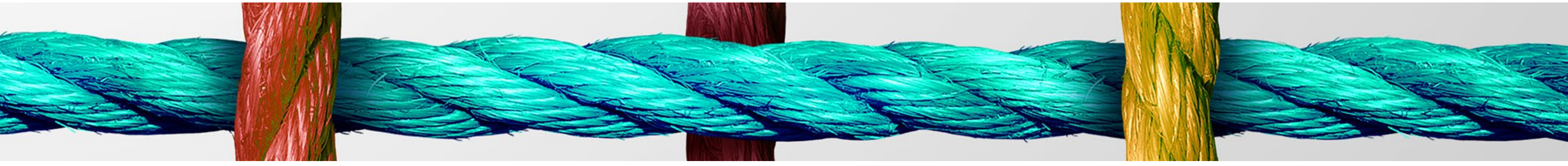
Investors, through their stewardship activity, have the ability to bring about change within their investee companies. Traditionally investors have used this power to intervene in individual companies on issues of governance, strategy, or performance in order to increase the value of the company's shares or to recover value after a corporate mis-step.

In recent decades, the focus has broadened to include market-wide improvements. For example, shareholders have driven significant improvements in corporate governance across the market over the last two decades, with evidence that this has led to improved cashflows and enhanced valuations[17]

This approach is now being advocated for a range of other issues, in particular so-called systemic issues that apply across the market. But shareholders cannot focus on every issue that is important to society. Clear principles are required to discriminate the issues on which investors should act. Risks of investor over-reach are significant, and include distraction from their core fiduciary duty to clients as well as accusations of political illegitimacy.

A fundamental insight from this work is the importance of mandate and the need for much greater clarity on the actions that clients can expect from investors. Just because investors can act on a stakeholder issue does not mean that they should.

17 Learning and the Disappearing Association Between Governance and Returns by Lucian Bebchuk, Alma Cohen, and Charles Wang



Investor principles to establish the mandate for stakeholder-oriented actions

Investors face an increasingly wide array of requests from stakeholders to raise issues with companies. Currently these requests are considered through a variety of ad hoc approaches which vary by institution and are not necessarily embedded in the investment approach. Consequently it is difficult to assess the effectiveness of stewardship activity to address the requests.

We argue that developing a toolkit to assess the competing requests would enable each investor to develop an effective action plan and would make a significant contribution towards the alignment of interests between stakeholders, shareholders and companies.

Building on the framework developed by Alex Edmans to help companies prioritise stakeholder-oriented actions[18], we propose the following principles to help investors decide on which stakeholder issues to prioritise in their stewardship activities.

INVESTOR PRINCIPLES TO PRIORITISE STEWARDSHIP ACTIVITY

18 In his book Grow the Pie: How Great Companies Deliver Both Purpose and Profit, Edmans proposes three principles: Materiality, Multiplication, and Comparative Advantage. We have extended Multiplication to Efficacy, reflecting the fact that investors operate at one step removed from the direct stakeholder actions of their investee companies, meaning that as well as considering materiality, investors should consider whether their actions will indeed bring about real world change.

Core to our argument is that investors need to establish a legitimate basis for action on stakeholder issues. All three of these principles must be met in order for stakeholder action to be legitimate in the context of investors' fiduciary duty to clients.

We discuss each principle further below.

Materiality

Materiality is a critical component of investors' mandate to act on stakeholder issues, but it is a complex and dynamic concept. There is a general recognition that the practice of responsible investment requires a notion of materiality that extends beyond the traditional definition of financial materiality at the company level.

Given their fiduciary duty to deliver strong investment returns to clients, investors should prioritise the stakeholder issues on which they act. In general, investors should only pursue action on an issue that relates to material stakeholders. As discussed shortly, this could include stakeholders on which the company has a material impact as well as stakeholders that have a material impact on the company.

The principal rationale for investors prioritising material stakeholders is a simple one of focussing resources where they can be most effective, recognising the fiduciary duty to clients. But prioritising material stakeholders has a further benefit of increasing the chances that the stakeholder action will have a long-term benefit for shareholder value.

The most straightforward case is where addressing the stakeholder issue is also shareholder value enhancing. For example, it has been shown that treating employees well leads to better long-term performance[19]. In this case, investors seeking action from an investee company on the issue are directly fulfilling their mandate to enhance shareholder returns.

However, in certain cases there may be a mandate to act where a stakeholder is one on which the company has a material impact, even if they are not as yet financially material to the company[20] – so-called impact materiality. This may be because of the dynamic nature of materiality, meaning there is a realistic prospect that the stakeholder may become financially material over time. Or it may be because there are non-financial reasons for prioritising the stakeholder's interests. For example clients may have non-financial goals and preferences for how their portfolio is managed. Finally, we note that material issues may apply at the level of the company or on a systemic basis at the level of the market as a whole.

> Carbon emissions were once not considered a material stakeholder factor in the management of business. Growing awareness of the impacts of climate change led to carbon emissions being recognised as having a material impact on the environment. Recognition that dealing with climate change will result in significant transformation of business models and growing emergence of carbon pricing in various forms changed a material stakeholder impact into a material financial impact for high emitting companies.

These are complex issues, and we have provided an integrated framework for analysing materiality in Framework 2, which goes into much more detail on these issues, drawing on various perspectives on materiality that have emerged in recent years.

A key insight is that materiality is not a static concept. Stakeholder issues that are not currently material can become so.

19 Does Corporate Social Responsibility Improve Firm Value? by Alex Edmans

20 Impact materiality is terminology now adopted by the European Financial Reporting Advisory Group, and generalises to a wider set of stakeholder issues the concept of Saliency, which was developed in relation to human rights impacts.

This requires incorporation of stakeholder dialogue and horizon scanning within the investment process to inform shareholder stewardship activity.

Efficacy

Companies can often directly affect stakeholder outcomes through their actions. For investors the line of causality is indirect: their impact comes through their influence on investee company actions. Although investors can impact real world outcomes through investee companies, there are limits to this. Investors are involved in IPOs and debt raisings. But much investor activity is in secondary markets rather than primary capital allocation.

Investors can therefore have real-world impacts through their investing activities, although they are more limited than often assumed. A review of the evidence[21] suggests that engagement is the main channel through which institutional investors drive change within organisations through the securities they hold. This can either be activist investment on a particular strategic or performance issue, or "generalised engagement" on market-wide or ESG issues.

One of the risks in relation to green-washing is investors claiming credit for real-world impact that cannot be justified by evidence, for example in some divestment or "impact" strategies.

Integrity relating to claims for real-world impacts will be an important part of trustworthy stakeholder-oriented behaviour by the investment industry.

The principle of efficacy also includes the simple concept that a stakeholder action should deliver more stakeholder value than it costs to take. This is a particularly important principle for investors to consider when they are taking actions that may reduce investor returns.

> The best academic evidence suggests that blanket sector exclusion strategies are not effective at bringing about real-world change in investee companies. Yet sector exclusions create a clear potential cost in terms of risk-adjusted returns. Investors proposing blanket exclusion strategies as an approach to addressing stakeholder issues therefore may not meet the principle of Efficacy.

Investors should only act on stakeholder issues when their actions have efficacy. The reduction of returns from mitigating action is certain and can compound over time. Given challenges over efficacy, the benefits of shareholder action are not always clear.

Comparative advantage

Just because an issue is important does not mean that everyone should act upon it. Investors, when acting on a stakeholder issue, should consider whether they are particularly well placed to address it, compared with other actors, notably government. This links to the concept of fiduciary duty. Investors are increasingly under pressure from a range of interest groups to use their powers in support of particular stakeholder issues.

21 Investing for Good by Tom Gosling, Can Sustainable Investing Change the World? by Julian Kölbel, Florian Heeb, Falko Paetzold and Timo Busch

Investors are uniquely well-placed to act to raise corporate governance standards across the market. Regulation can help, but investors are best placed to judge whether companies are putting in place the right arrangements for them. In other areas, such as income inequality, investors have a more limited role to play versus governments or employee representatives. But, even in this situation, once standards have been agreed, the power of investor scrutiny to enhance disclosure and require compliance is significant.

Regardless of the principles of Materiality and Efficacy outlined above, investors need to consider whether they are indeed the appropriate actors in a given case to act on a stakeholder issue, in light of the need to ensure that clients' resources are being used appropriately.

Comparative advantage is likely to vary by issue, by investor, based on their areas of expertise or sector focus, and by investment style.

Limitations

Interest groups are increasingly seeing investor action as a channel for addressing their aims, particularly when government is seen as slow to act. This is particularly the case in relation to systemic issues. We have seen issues identified as systemic by proponents of this approach ranging across: climate change, antimicrobial resistance, inequality, human rights, diversity, deforestation, other environmental impacts, and artificial intelligence[22]. The recent debate about the role of pharmaceutical companies in combatting COVID-19 has added vaccine fairness to this list.

As we have outlined above, there is indeed a case for investor action on stakeholder issues that extends beyond the narrow definition of Financial Materiality. However, care is needed, because not every important issue is one where investors should act, and just because investors can act does not mean they should.

It is critical that investors only act where they have legitimacy. A clear connection back to investment mandates and fiduciary duty must always be made.

It is important for investors to be rigorous in determining which issues genuinely are financially material at the company level and, in particular, at the systemic level. Interest groups frequently claim financial materiality for their issue of concern in order to create a "business case" for investor action that overcomes any concerns about legitimacy. On close examination the evidence on which such claims are based is frequently found to be lacking rigour. It is important for the purposes of legitimacy that investors undertake a thorough assessment of the quality of any evidence on which they are relying in order to designate a stakeholder issue as financially material.

Client preferences can be used as a rationale for shareholder action on stakeholder issues even where these are not aligned with long-term financial returns. It is often assumed that any stakeholder-oriented action must lead to higher long-term returns. This is not the case. In such cases it is vital that those preferences are determined in a thorough and informed way. Given the complexity of stakeholder issues and potential unintended consequences in terms of real-world impacts, managers and investment consultants therefore have a role in educating clients, as well as responding to their wishes, to ensure that decisions are informed.

Similarly it should be recognised that stakeholder perspectives are frequently characterised by a single issue focus whereas the company model offers an efficient process for balancing competing forces and creating solutions which prioritise effective outcomes. Capital is thereby allocated to the most attractive projects and market scrutiny empowers the force of creative destruction to ensure that the stock of capital is recycled from legacy operations to the most attractive projects.

22 Moving Beyond Modern Portfolio Theory: Investing That Matters by Jon Lukomnik and James Hawley

In many of these areas there is significant risk of investors being drawn into promoting activity that is fundamentally political in nature. Although investors' clients are drawn from across society, on a vote-weighted basis they are not politically representative. There is risk of investor action on stakeholder issues decreasing, rather than increasing, trust if it is seen to be focussed on the favoured issues of a wealthy elite.

Even relatively well-accepted systemic issues such as climate change create complexities for investors. Accelerating withdrawal from fossil fuel financing may benefit climate goals but impose economic costs on coal-producing communities and the countries that rely on the power they generate for poverty eradication. Even citizens who agree on the economic, social, and moral necessity of addressing climate change may weigh these outcomes differently and so have different views on the pace of change.

In this context, investors need to be careful about getting too far ahead of political consensus on the stakeholder issues they engage on. Some issues, such as climate change, have a broad degree of political consensus as to the nature of the problem and the likely solutions, and in the UK this has been reflected in legislation through the Climate Change Act. Although even here there is difference of view on the extent of the problem and whether, for example, where the optimal trade-off between transition costs and temperature rise sits.

Similarly the issue of human rights in supply chains has received democratic endorsement through the Modern Slavery Act. In certain other areas there is significant disagreement on the nature of the issue or whether it exists at all.

The role of investor (and broader business) leadership is relevant here. Business can play a role in influencing societal attitudes, as well as responding to them. This has arguably happened in relation to climate change where investor activism on the issue has made it easier for government to act. Leaders will take different positions on how far ahead of the curve of consensus opinion they position the purpose of their firm.

Summary

Investors can have a legitimate role in addressing stakeholder issues both within their investee companies and on a system risk basis. However, investors need to be extremely clear on their mandate in pursuing such issues, how it is consistent with fiduciary duty and on the likely overall effectiveness or their actions.

Because investors have acted successfully on some systemic factors (e.g. corporate governance, and to a degree climate), this does not mean that every systemic factor will be a candidate for successful investor action.

Given the scope for stakeholder issues to have a political dimension, **it is important that investors use a transparent and rigorous framework to determine those issues where:**

- they have **legitimacy to act** (in line with client mandates and fiduciary duty);
- a **capacity to achieve the targeted objectives;** and
- above all c**lear alignment between the investment objectives, the proposed stewardship activity and the client expectations.**

Consideration of the principles of materiality, efficacy and comparative advantage in a triple test, provides a strong foundation for investor stewardship activity.

A further key insight of this work is that materiality is a dynamic not static concept. Just as we discussed the implications of a misapplication of the shareholder value model, so a static analysis of materiality can lead investors to underappreciate stakeholder concerns and perspectives which in time could fundamentally impact the reputation and/or value of a company or market.

This requires a focus on factors that the traditional model of shareholder value finds hard to capture, and **argues for the incorporation of stakeholder insight within the investment process to inform shareholder stewardship activity.**

2.3 CONCLUSIONS AND NEXT STEPS

The Investor Forum established this collaborative project with London Business School in recognition of the widespread loss of trust in the shareholder value model of capitalism and increasing calls for an alternative model of stakeholder capitalism. Even a year-long project cannot do justice to the full range of issues that feature in this debate.

However, the time we have devoted, and the rigour with which we have analysed the issues, reflects the seriousness with which we treat societal criticism of the shareholder value model.

In Part 1 we reviewed the criticisms of shareholder value and compared the current model with the stakeholder alternatives. While the problems faced by society are real, the identification of shareholder value as their root cause is less convincing. We find the contention that shareholder value is inherently short-term in nature to be unsupported by the evidence. Shareholder value can be implemented in a short-term way, but this is frequently to the long-term detriment of shareholders themselves.

Stakeholder-oriented models, which in practical terms are often extensions of the shareholder ownership model but with some dilution of shareholder rights, appear to suffer from significant problems relating to accountability, dynamism, legitimacy, and effectiveness. They risk reducing scrutiny of management, without showing clear benefits for stakeholders.

So rather than framing the debate as a choice between different models, our assertion is that we need to look at the practical actions investors can take to create a sustainable shareholder value model. It is this that is, in any event, within the control of investors. Investors do need to do more.

In many cases investment processes remain too divorced from the stakeholder context within which business operates today. The challenge is therefore to identify a principled and rigorous way that investors can respond to these concerns in a manner that is fully consistent with their fiduciary duties to clients.

In Part 2 of this Report, we set out a model of sustainable shareholder value with, at its heart, enhanced consideration of stakeholder perspectives and a step up in quality of client mandates beyond narrow contractual commitments. This enables shared understanding of how these stakeholder issues will indeed be taken into account.

We have also developed a three-part test to help investors prioritise amongst the multiplicity of stakeholder issues on which they are urged to act. First, the stakeholder should be material. Second, the investor should have efficacy relating to the issue, meaning that results can be achieved at reasonable cost. Third, the investor should be well-placed to take the proposed action relative to other parties. If all three parts of the test are met then the investor may have a basis to act within the framework of their mandates and fiduciary duty.

For the purposes of this test, we have developed the concept of materiality beyond the traditional investor-focused view of financial materiality. The integrated framework, combining various dimensions of materiality that have emerged in recent years, is a distinctive contribution of this piece of work and a practical aid to investors seeking to reconcile stakeholder demands with their fiduciary duty to clients. Incorporating the dynamic nature of materiality across this framework encourages a focus on factors that the traditional model of shareholder value finds hard to capture. We argue for the incorporation of stakeholder insight within the investment process to inform shareholder stewardship activity.

These debates take investors into complex areas.

We counsel that investors need to be rigorous and evidence-based in how they apply the frameworks we lay out. There is an ever-present risk of being seen to over-reach into the political realm or of pursuing social goals that conflict with the investor's fiduciary duty to clients. Investors will need to develop new skills in stakeholder dialogue and horizon scanning in order to incorporate appropriate perspectives. Transparency and clear communication with clients will be essential to identify their informed preferences and ensure common understanding of how investors will act.

In Part 3, we have set out detailed frameworks to help investors implement the ideas set out in this report. Framework 1 sets out the dimensions of a sustainable model of shareholder value creation, against which investors can assess their own practices. Framework 2 sets out an integrated approach to materiality, to enable investors to assess whether a stakeholder issue meets the materiality principle within our three part test. This framework is a novel and important contribution of this work, which we hope investors will find useful in practice.

The investor community, we conclude, has a legitimate role in addressing stakeholder issues, both within individual companies and when dealing with market-wide, systemic risk. Moreover, we argue that this can be achieved without compromising client interests and fiduciary duty.

This in our view is exactly how investors should define their commitment to stakeholder capitalism.

However, investors need to be extremely clear on their mandate for pursuing such issues and on the likely overall effectiveness of their actions.

The model of sustainable shareholder value that we advocate illustrates how the different components of the role of investors should interact to create value in a way that can serve the needs of clients and in parallel benefit society. Crucially, the model also incorporates a triple test of principles to enable shareholders to determine which stakeholder issues to prioritise.

In combination, the model and the principles, provide a practical approach which can help investors establish a legitimate foundation to address many of the challenges to the model of shareholder value.

This is a major undertaking. But only on this foundation will investors have a sound basis for determining how they will reconcile responsiveness to stakeholder issues with adherence to fiduciary duty. And through that process create the circumstances for shareholder value to be seen as part of the solution rather than part of the problem.

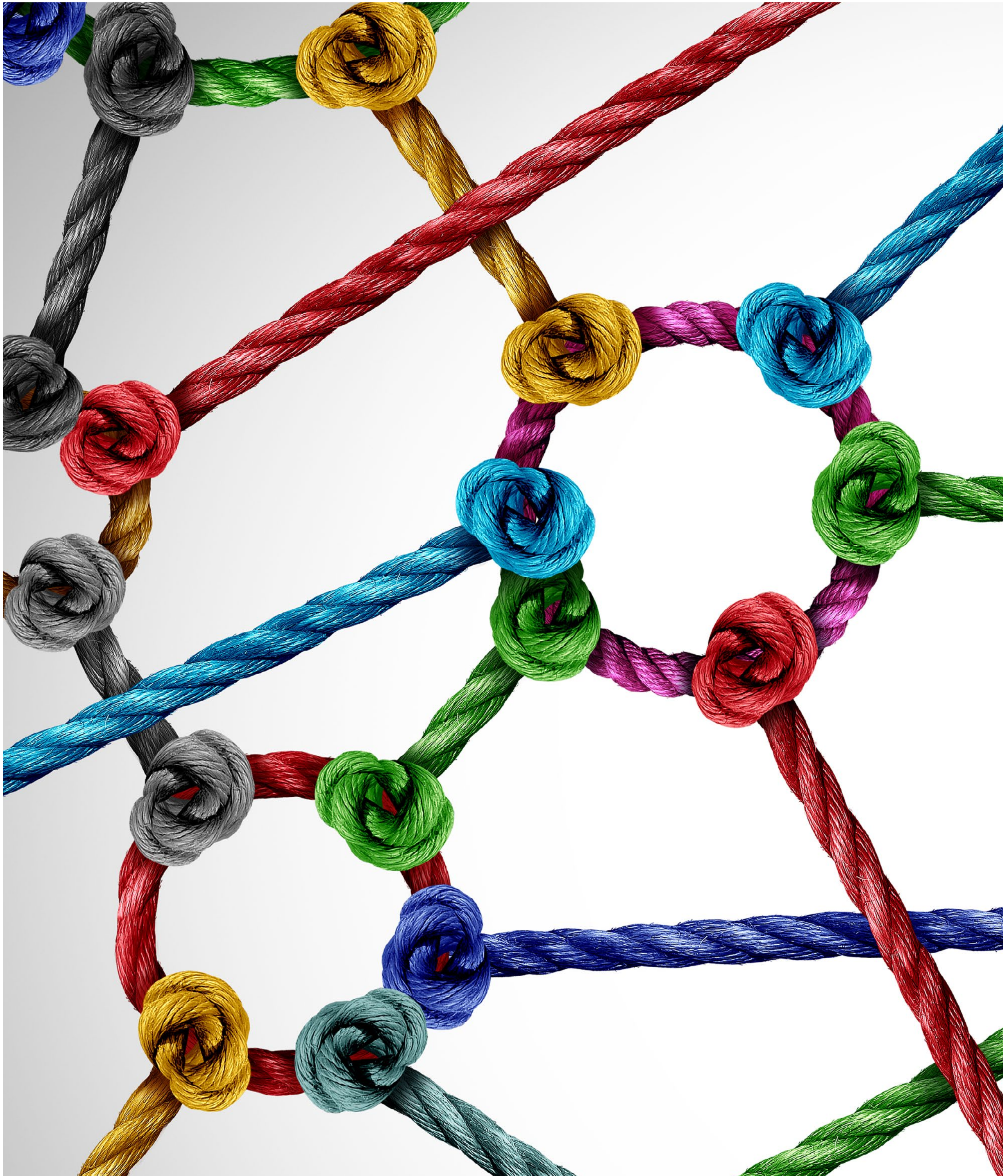
Next steps

We view this report as a step in an ongoing process of dialogue with Investor Forum members and other stakeholders on the question of What does stakeholder capitalism mean for investors?

We have identified six possible follow up steps for consideration and progression:

- Review existing work and initiatives on Model Mandates to provide practical insights to align the investment chain.
- Work with investors to develop implementation guides for the sustainable approach to shareholder value outlined in Section 2.1 and Framework 1.
- Evaluate how the proposed principles for legitimate action on stakeholder issues outlined in Section 2.2, including our extended materiality framework in Framework 2, could be embedded in the investment process:
    - Investor Forum to investigate the potential to facilitate multi-stakeholder dialogues to identify potential long-term issues which might either encourage or inhibit the creation of long-term sustainable value;
    - Examples might include issues such as the impact of Artificial Intelligence on Labour Markets, Data Privacy on consumer rights.
- Review reasonable expectations of boards in relation to both the standards, and evidencing, of stakeholder impact assessment.
- Consider how the sustainable shareholder value model and stakeholder issue prioritisation principles might be effectively integrated into the Stewardship Code.
- Consider how the model extends beyond equity and across asset classes.

PART 3: FRAMEWORKS



FRAMEWORK 1: SUSTAINABLE SHAREHOLDER VALUE

This section sets out a series of principles, against which investors can assess their role in the investment ecosystem, their own maturity against the sustainable shareholder value approach, and areas for future focus in developing their investment model.

The framework has five dimensions to guide investor action to support the creation of sustainable long-term shareholder value.

UNDERSTAND the political and stakeholder context

Investors cannot make political decisions – they must be responsive to client preferences but must work in a context set by government. An appropriate framework of law, regulation, and economic incentives is essential for a sustainable future. But at the same time the political and stakeholder context informs beneficiary preferences:

- **Stakeholder views are increasingly prominent.** Investors should be aware of the stakeholder context which encompasses both stakeholders who are material to the company, and stakeholders on whom the company has a material impact. Stakeholder impacts alone do not provide a mandate for action other than where aligned with client mandates and fiduciary duty.

- **Political decisions need to be made through the political process.** The proper boundary between political and commercial objectives should be respected. Many stakeholder actions involve trade-offs between stakeholders not just between stakeholders and shareholders and can be essentially political in nature. Investors have a mandate through the ownership rights and preferences of their clients, but they do not have a political mandate. Investors should be aware, and exercise caution, when they are acting in areas where there is not yet significant political and scientific consensus.

- **Effective regulation by government is essential to well-functioning markets.** Markets need an appropriate regulatory framework set by government to function effectively, and the existence of robust institutions and regulation is in the long-term interests of investors and their clients. Investors play an important role in advocating effective policy and institutional development and in pressing investee companies to advocate on policy constructively and innovatively and to support creation and operation of robust institutions. But investors will not be able to entirely compensate for any fundamental misalignment of economic incentives.

CODIFY investor[23] responsibilities to clients

Investors, in seeking to create value, should only act in their clients' interests. Increasingly this requires a more holistic approach and needs to be seen in terms of client's non-financial as well as financial goals. But not all stakeholder interests will be aligned with clients' interests.

Navigating these issues requires a significant step up in the quality of dialogue and level of clarity around client mandates and fiduciary duty. Whereas the political context highlights issues that may be of concern to beneficiaries as citizens, investors should only act on the basis of the clear authority expressed in informed client mandates. Pursuing stakeholder interests at a cost to clients without their consent would represent a misappropriation of property rights.

- **Asset managers need to agree clear client mandates beyond narrow contractual commitments.** Expectations need to be codified, particularly where clients want more than just financial returns.

  Many clients and beneficiaries are expressing preferences about how asset managers address stakeholder issues that extend beyond financial value. These should be reflected in investors' investment and stewardship activities.

  However, clients must be sufficiently informed and consulted, particularly about any financial consequences, and associated stewardship activity, to ensure that beneficiary wishes are indeed pursued.

- **Fiduciary duty is at the heart of the role of investors.** Investors benefit society by enabling their beneficiaries to meet their investment goals through allocating and reallocating capital to its most productive sources.

  Fiduciary duty requires that investor actions should be geared towards meeting their clients' and beneficiaries' goals. Investors cannot take decisions that they know will reduce a client's long-term returns without clear and express consent and should inform clients when they believe stakeholder actions have a cost in terms of shareholder value creation as opposed to a benefit.

  At the same time, investors should educate clients on key factors that do affect their interests. This may include impacts on financially material stakeholders, impacts on stakeholders who are not yet financially material but may become so, or stakeholder impacts that are the subject of beneficiary wishes.

MANAGE capital in clients' interests

Once the client mandate is agreed, the key role of investors is to fulfil their fiduciary duty by allocating capital and acting as stewards of those assets in line with that mandate, whatever it is. Investor action should, authentically, align with and not deviate from, the pursuit of clients' interests as expressed in the investment mandate.

- **Allocation of clients' capital is the key role of investors.** It is their unique skill and a role which generates objective results – as measured through fund performance against objectives – irrespective of the investment philosophy.

- **Stewardship is an essential capability for investors.** It is the process by which they monitor and assess investment decisions, hold companies to account where expectations are not being fulfilled, and how capital is recycled. Stewardship can help meet the interests of beneficiaries by improving outcomes at the company level and at the system-wide level.

23 Investor here may refer to asset manager or asset owner, depending on the context of the fiduciary relationship being considered

MONITOR operation of investee companies

Investors are not in a position to oversee the detailed operation of companies (micro-manage). This is the proper role of directors. But investors can, through stewardship and active ownership, hold companies to account and improve the operation of the market on a systemic basis.

- **The company model, operated with transparency, is the best model we have to assess competing and conflicting needs and to allocate resources to produce solutions.** Markets are the most effective arbiter of where resources should be allocated over the long-term, provided there is transparency in how the company is being run and its impacts.

- **Directors run companies, investors hold them to account through stewardship.** Investors do not run companies, directors do. But through engagement and other stewardship mechanisms, investors can set expectations for how directors should discharge their duties, particularly in relation to stakeholder interests.

- **Long-term orientation increases alignment between shareholder and stakeholder value.** Long-term financial returns are heavily influenced by non-financial factors material to the company, so a long-term investment outlook creates significant alignment between shareholder value and stakeholder outcomes. Such an outlook is only possible if appropriate long-term incentives cascade through the investment chain.

MAINTAIN a sustainable market

Investors help to shape the market rather than just being passive participants. It can be in beneficiaries' interests for systemic issues to be addressed whether by active owners or universal owners.

- **Investors have a role in addressing systemic issues.** Investors require sustainability and stability of the market system and so have a legitimate interest in system-wide issues, such as climate change, that may affect valuations across the market. Such issues are likely to be small in number but stewardship activity in relation to these is consistent with, and indeed part of, investors' fiduciary responsibilities.

- **Material externalities can lead to significant future risks** and so are a legitimate area of investor focus, concern and action. However, investors can only ever play a secondary role to governments in addressing major system-wide externalities.

Investors require a clear mandate to act on stakeholder issues. This is conferred by the materiality of the stakeholder, the ability of the investor to have efficacy in bringing about change, and their comparative advantage relative to other parties.

FRAMEWORK 2: ANALYSING MATERIALITY

Framework for analysing materiality

Our first principle of investor engagement on stakeholder issues is that engagement should only be carried out where the stakeholder is material. This Section sets out a framework to help investors analyse which stakeholder issues meet this principle.

Materiality can have many dimensions and has been the subject of extensive discussion in recent years. It is critical that investors have a transparent and rigorous account of materiality to guide stewardship activity. In this framework we have identified and considered five dimensions of materiality. We believe that investors need to enhance their capability to assess stakeholder issues against all five dimensions in order to guide their stewardship activity effectively.

Environmental and community impact is a **Financially Material** stakeholder issue for natural resources companies. Local damage to environment, health, and sites of cultural significance can result in direct financial fines but also loss of licence to operate from governments.

The two primary dimensions of materiality, now recognised by the European Financial Reporting Advisory Group are Financial and Impact Materiality:

- **Financial Materiality:** The stakeholder has a material financial impact on the company; and
- **Impact Materiality:** The company has a material impact on the stakeholder.

But stakeholder issues are not static, leading to the important need to consider the Dynamic Nature of Materiality:

- **Dynamic Nature of Materiality**: The boundary between Financial and Impact Materiality is fluid, and, moreover, stakeholders or stakeholder issues that are not material under either definition can become so over time.

Working conditions in the supply chain potentially **Impact Materia**l for any company. Indeed the concept of saliency as applied to human rights is an established example of analysis of Impact Materiality. The company's actions can have a material impact on working conditions both in direct operations and suppliers. These can become **Financially Materia**l for consumer goods companies through the channel of consumer preferences as has been seen in the apparel sector. The recent Xinjiang Supply Chain Business Advisory issued by the US Government shows that changes in regulation can, through the **Dynamic Nature of Materiality** result in **Impact Material** items becoming **Financially Material** even in non-consumer sectors.

These three core pillars of materiality create the initial framework for prioritising stewardship activity:

- Financial Materiality creates a direct business case for investor action, due to the direct link to shareholder value.
- Impact Materiality creates a case for careful consideration, because Impact Materiality may translate into Financial Materiality over time given the Dynamic Nature of Materiality. Impact Materiality therefore, at the least, creates a financial risk that should be considered.
- The Dynamic Nature of Materiality requires investors to consider what factors might fundamentally impact the current understanding and assessment of the situation thereby creating unexpected opportunity or risk. It has long been the practice of investors to ask company CEOs 'Finally, what keeps you awake at night?'

The **Dynamic Nature of Materiality** can also lead to recognition of new **Impact Material** issues emerging over time, which had not been previously recognised. Plastics usage is an example of an issue that exploded into prominence as a matter of consumer concern following David Attenborough's 'Blue Planet' series. This emphasises the need for horizon scanning as the materiality model is not static.

Financial Materiality can operate both at the company and system level. The discussion above has focussed on company-specific issues. But equally it can be extended to market-wide – so-called systemic - issues. Here action across the market can improve the quality and resilience of the market overall, thereby improving valuations across the board, even if there might even be negative impacts on individual companies.

- **Systemic Materiality.** An issue that has a market-wide impact on market resilience or share valuations over and above its impact on specific companies.

Climate change is an example of a **Systemically Material** stakeholder issue. If reducing the impact of climate change results in better economic outcomes, bringing net benefits across an investor's portfolio, then this can justify action on climate change even if it is to the detriment of specific heavy-emitters within the portfolio. This is in addition to any non-financial aspects arising from shareholder preferences on climate change. This has led to the emergence of collaborative engagement projects such as Climate Action 100+.

In the UK investors have used both their voting powers and their engagement muscle over an extended period to effect a number of important governance reforms including to contract termination periods, executive pay, separation of Chair and Chief Executive and so on. While a particular governance reform may not be optimal for every company, investors assess that this is outweighed by the improvement in the market as a whole, given the identified positive relationship between corporate governance and value.

Our fifth dimension of materiality recognises that there may be non-financial motivations for acting on a stakeholder issue, even if there is no Financial Materiality consideration.

- **Intrinsic Materiality:** The company has intrinsic concern for a stakeholder either because of investor preferences, the company's purpose and values, or societal norms and expectations. This intrinsic concern exists regardless of financial consequences.

Sources of Intrinsic Materiality include:

- **Client preferences.** As far back as the work of Jensen and Meckling, the role of shareholders' non-financial objectives has been recognised[24].

- **The purpose of the investment fund or firm.** For example, a firm with a purpose dedicated to reducing climate change may engage with fossil fuel firms to run down coal assets ahead of the end of their economic life. In this case the firm's stance is made clear to any clients investing with the firm and the implications are fully understood.

- **Societal expectations.** It is certainly the case that there are certain expectations and norms of behaviour, that businesses are expected to fulfil, and societal objectives that business is expected to support, even if not written down in law or regulation. To some degree societal expectations have been used as the justification for investor action on issues such as the environment, diversity, and supply chain working conditions.

24 What Stakeholder Capitalism can Learn from Jensen and Meckling by Alex Edmans

Workforce diversity is clearly an **Impact Material** stakeholder issue given the influence a company has over the make-up of its workforce. There has been a long and contentious debate over the extent to which diversity is **Financially Material.** After the murder of George Floyd in the US many businesses faced demands from employees and customers for more action on racial diversity and inclusion for moral reasons, quite separate from any financial case. Investors faced similar demands to put pressure on companies to act from their own clients. Investor action on diversity is therefore, at least in part, an example of **Intrinsic Materiality** based on investor and societal preferences.

Intrinsic Materiality is perhaps the most challenging aspect of materiality to assess given that it is frequently far easier to articulate the concern than it is to evaluate the impact.

Moreover, investors should be aware of the need for rigorous justification and assessment of client wishes when relying on Intrinsic Materiality. When the motivation of societal expectations is used, again care is required, particularly in relation to "who sets the standard" about expected behaviour? Sometimes this will be a clear matter of essential business ethics. But there is a risk of special interest groups seeking to impose their own view of the correct standard in relation to a stakeholder issue, without the balanced view of considerations that has the opportunity to arise through the political process, however imperfectly.

Over time Intrinsic Materiality can translate into Impact or even Financial Materiality given the Dynamic Nature of Materiality. Equally, the simple principle of efficient use of resources means it is unlikely that Intrinsic Materiality creates a mandate for investor action unless the stakeholder is at least Impact Material.

Establishing the legitimacy of stewardship activity

The consideration of the dimensions of materiality highlights a key insight of this work - that materiality is a dynamic not static concept. Just as we discussed the implications of a misapplication of the shareholder value model, so a static analysis of materiality can lead investors to underappreciate stakeholder concerns and perspectives which in time could fundamentally impact the reputation and/or value of a company or market.

The concept of the Dynamic Nature of Materiality provides an opportunity for investors to frame and test objectively their understanding of material factors impacting a company and its stakeholders. To effectively capture the true risks and opportunities would require investors to:

- Rigorously assess a broader range of stakeholder perspectives and societal insights to truly understand the integrity of an investment thesis.
- Review of independent data, evidence and testimony to validate or challenge corporate claims. A classic example might be 'Greenwashing' where investors would be well served to conduct enhanced due diligence to form their own opinion of risks and opportunities.
- Build capabilities in horizon scanning and scenario analysis to help identify and consider the impact of developments which do not currently appear likely to present a material impact but which could have an outsize impact on corporate reputation and/or value.

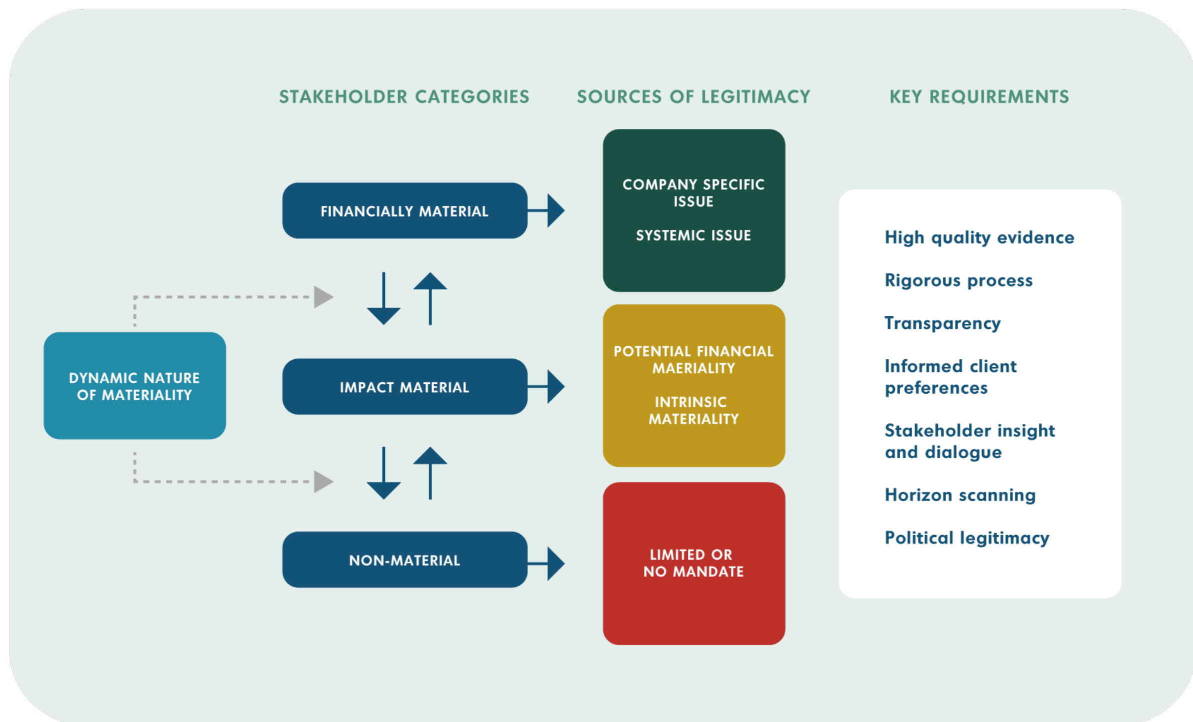
The range of corporate controversies in recent years reminds us of the crucial importance of reputation and the impact that reputation has on value when society loses confidence in a company's actions. The essence of corporate failure can typically be found deep within the financial disclosures of a company, but is often only evident in ex post analysis. In contrast loss of customer confidence, abuse of certain stakeholders or market position, or a material breach of rules or societal expectationsmay be visible in real time. Deep understanding of a company's relationships with its material stakeholders can therefore provide a practical warning mechanism for boards and investors.

Legitimacy

Given the vital importance of legitimacy, we present below a traffic-light graphic to illustrate schematically the relationship between the notions of materiality, the sources of legitimacy, and the consequent likely strength of mandate:

- Green indicates the likely presence of a strong mandate for investor action.
- Amber indicates that there may be a mandate but particular care is required to ensure action is aligned with client mandates and fiduciary duty.
- Red indicates that there is unlikely to be a mandate for investor action.

We highlight the key requirements that investors need to consider when operating this framework to both establish the legitimacy for, and inform the effectiveness of, their stewardship activity.



ESTABLISHING THE LEGITIMACY OF STEWARDSHIP ACTIVITY

End-note: the terminology of materiality

In this framework we have sought to integrate a number of distinct but complementary notions of materiality into a coherent whole. Where concepts are well-established we use the language in general usage. In some cases we have used our own terminology. These concepts have developed over time in many parallel forms and we highlight just some key reference points below.

Financial Materiality is a long-established concept and has been the basis of the work of the Sustainability Accounting Standards Board[25] since its formation in 2011.

Impact Materiality is a newer concept, but has now formally been recognised in, for example, the work of the European Financial Reporting Advisory Group (EFRAG) since 2021[26] . It is a generalisation of the concept of saliency[27], which was developed in relation to the impact of companies on human rights issues in supply chains or communities in which they work. Double Materiality is simply the recognition of the existence of both Financial and Impact Materiality.

Systemic Materiality is a term that we use to refer to stakeholder issues that are relevant on a market-wide rather than just company-specific basis. As far as we are aware this is a new term, although it is related to, for example, concepts of Beta Activism[28].

Intrinsic Materiality is a term we have taken from the work of Alex Edmans[29]. It is useful to separate issues that are related to long-term financial value from those that are pursued for non-financial "intrinsic" reasons. This distinction is important because it critically affects the nature of the client mandate and evidence required for such actions to be legitimate.

The Dynamic Nature of Materiality was brought to prominence by the World Economic Forum in a report in early 2020[30]. It can refer to how stakeholder issues that are not material at all becoming so, due to a change in circumstances. Or it can refer to issues that are Impact Material become Financially Material as a company's impact on its stakeholders is internalised through changes in regulation, consumer attitudes or other means.

25 Sustainability Accounting Standards Board

26 Proposals for a Relevant and Dynamic EU Sustainability Reporting Standard-Setting by the European Financial Reporting Advisory Group

27 Salient Human Rights Issues, by the UN Guiding Principles Reporting Framework

28 IPE Guest Viewpoint by Jim Hawley and Jon Lukomnik

29 Grow the Pie: How Great Companies Deliver Both Purpose and Profit by Alex Edmans, Chapter 3

30 Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG by WEF in collaboration with Boston Consulting Group

APPENDIX 1: METHODOLOGY AND BIBLIOGRAPHY

Methodology

In late 2020, The Investor Forum Board approved a collaboration with the Centre for Corporate Governance at London Business School to address the question "What does stakeholder capitalism mean for investors?".

The project was run by a Project Team from The Investor Forum and the Centre for Corporate Governance and a Steering Group of Investor Forum Members was formed. The content and objectives of the programme were agreed with the Steering Committee in March 2021, and the programme ran over three sessions in June, September, and December 2021 attended by representatives from over 30 Investor Forum members.

Pre-read was provided for each session by the Centre for Corporate Governance. This report was drafted collaboratively between the Investor Forum and the Centre for Corporate Governance and shared with Investor Forum members for feedback and input. It should be noted that this report does not necessarily reflect the views of every Investor Forum member involved with the project. In this way the Centre for Corporate Governance provided a framework for the discussion that combined academic rigour and challenge with the ability for members to provide practical insight.

We have sought to base insights on what can be concluded from the most rigorous academic evidence. A key role of the Centre for Corporate Governance was to draw together and feed in high quality academic insights in a way that was accessible and relevant to practitioners within The Investor Forum membership. The rigour and attention to detail of academic work means that any academic paper likely addresses a single detailed research question in a particular setting and may not by itself provide insight that is reliably actionable in the context of the real world. Indeed, the danger is that a single paper can be called upon in support of almost any point of view. Drawing practical insight therefore requires aggregation of insight drawn from a body of research over time, which may not all point in the same direction. It was the role of the Centre for Corporate Governance to provide this aggregated view.

Given the practitioner orientation and likely audience for this document, we have limited our referencing of source academic papers, unless they are particularly broad in scope and readable. In the main we have referenced summary papers and articles that themselves draw together insights on a theme from a number of high quality individual research papers. We believe that by referencing these summary articles we provide an easier route into the research literature for practitioners than would long list of source references. For the same reason we have adopted only light referencing in this document where we believe it may be of particular interest to the reader.

For those interested in direct exposure to the underlying academic literature, the Centre for Corporate Governance at London Business School has curated an extensive selection of over one hundred key research papers and articles under relevant headings relating to corporate governance and responsible business, which can be accessed here:

Centre for Corporate Governance Key Research Repository

In the bibliography overleaf we have set out some key readings that provide an entry point to key topics discussed in this paper. Many of these were shared with members over the course of the year. This is not intended as a comprehensive literature review but rather a series of access points into the academic literature for the interested practitioner.

Bibliography: Selected Readings

Short-termism

Response to the European Commission Study on Sustainable Corporate Governance by Alex Edmans

How Short-Term Activists Create Long-Term Value by Alex Edmans

Are Buybacks Really Short-Changing Investment? by Jesse Fried and Charles Wang

Stock Market Short-Termism's Impact by Mark Roe

The European Commission's Sustainable Corporate Governance Report: A Critique by Mark Roe, Holger Spamann, Jesse Fried, and Charles Wang

Alignment between shareholder and stakeholder value

How Shareholder Value Benefits Wider Society by Alex Edmans

Company Purpose and Profit Need Not be In Conflict if We Grow the Pie by Alex Edmans

What Stakeholder Capitalism can Learn from Milton Friedman by Alex Edmans

What Stakeholder Capitalism can Learn from Jensen and Meckling by Alex Edmans

Cancelling Capitalism by Christina Parajon Skinner

Corporate Purpose and Corporate Competition by Mark Roe

Stakeholder models

The Illusory Promise of Stakeholder Governance by Lucian Bebchuk and Roberto Tallarita

Policy and Practice for Purposeful Business by The British Academy

The "Value" of the Public Benefit Corporation by Jill Fisch and Steven Davidoff Solomon

Ownership of the Firm by Henry Hansmann

The Purposive Transformation of Corporate Law by David Kershaw and Edmund Schuster

Shareholderism versus Stakeholderism – a Misconceived Contradiction by Colin Mayer

For Whom is the Corporation Managed in 2020? The Debate Over Corporate Purpose by Edward Rock

The Shareholder Value Myth by Lynne Stout

Investor efficacy: the impact of sustainable investing

Investing for Good by Tom Gosling

Can Sustainable Investing Change the World? by Julian Kölbel, Florian Heeb, Falko Paetzold and Timo Busch

ESG and Responsible Investing Around the World: A Critical Review by Pedro Matos

Materiality

Dynamic Materiality and Core Materiality: A Primer for Companies and Investors by Robert Eccles

Grow the Pie: How Great Companies Deliver Both Purpose and Profit by Alex Edmans, Chapter 3

Proposals for a Relevant and Dynamic EU Sustainability Reporting Standard-Setting by the European Financial Reporting Advisory Group

Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG by WEF in collaboration with Boston Consulting Group

Salient Human Rights Issues, by the UN Guiding Principles Reporting Framework

APPENDIX 2

Investor Forum Member representatives

We would like to thank the following individuals from Investor Forum Member firms who participated in the sessions and contributed much valued insights to the discussions:

Andrew Mason (abrdn)
David Shammai (Allianz Global Investors)
Kimon Demetriades (Allianz Global Investors)
Mirza Baig (Aviva Investors)
Sandra Lawson (BlackRock)
Anne Marie Fleurbaaij (Cambridge Investment Management)
Jessica Ground (Capital Group)
Harlan Zimmerman (Cevian Capital)
Olga Hancock (Church Commissioners for England)
Ben Peters (Evenlode Investment Management)
Roland Bosch (Federated Hermes)
Michael Sayers (Fidelity International)
Edward Mason (Generation Investment Management)
Shireesh Vasupalli (GIC Private Limited)
Ashish Ray (Jupiter Asset Management)
Charles Heenan (Kennox Asset Management)
Jeanette Andrews (Legal and General Investment Management)
Angeli Benham (Legal and General Investment Management)
Alex Burr (Legal and General Investment Management)
Matthew Jowers (Majedie Asset Management)
Charles White (McInroy & Wood)
Jeremy Punnett (M&G)
Matt Evans (Ninety One)
Michael Marshall (Railpen)
Chris Anker (RWC Partners)
Jocelyn Brown (T. Rowe Price Group)
Hugo Ure (Troy Asset Management)
Paul Clark (UBS Asset Management)
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