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Stakeholders and shareholders

Why Milton Friedman got it wrong

Summary

On the 13th of September 1970, the New York Times Magazine published an article by Milton Friedman which concluded that "*the social responsibility of business is to increase its profits*".

Friedman's branding of corporate social responsibility and the consideration of stakeholder concerns in corporate executives' decision-making as "*pure and unadulterated socialism*" found fertile ground in the midst of the Cold War.

The article made Friedman the most cited New York Times author, with the article becoming one of the most academically cited newspaper articles of all time. The article has influenced academics, business and financial leaders and political discourse ever since.

With the acceleration of responsible investing and corporate responsibility initiatives, the article's 50th anniversary is a chance to reflect on the shareholder vs. stakeholder debate in academia and in practice.

Friedman received the 1976 Nobel Memorial Prize in Economic Sciences for his valuable, empirical research on a wide range of major economic issues. But his 1970 article was an op-ed in the political arena. One critic concluded that Friedman's article is "*the world's dumbest idea....It's curious that a paper which accuses others of 'analytical looseness and lack of rigor' assumes its conclusion before it begins.*" (Denning 2013).

After fifty years of academic research, investment and business experience, we categorically conclude that Friedman was incorrect. Friedman's opinion should be consigned to the history books.

Over the past nine years, DWS has published three major reports on the academic literature focused on the strong relationship between corporate financial performance (CFP) and environmental, social and corporate governance (ESG). We summarise these reports and estimate that there are now 4,000 to 5,500 academic reports on ESG and financial performance.

According to Altmetric analysis, the DWS-University of Hamburg 2015 white paper examining the link between ESG and CFP is in the top 1% of all academic research receiving media and social media attention. Citations of this white paper have appeared (along with others) in numerous reports and speeches from the United Nations, the European Commission, the Bank of International Settlements, the European Central Bank, the European Securities and Markets Authority (ESMA), the Bank of England, the US Government Accountability Office, the Principles for Responsible Investing (PRI), and the World Economic Forum. More than one hundred other banks and asset managers have also quoted our 2015 report.

We also show that maximising shareholder value is not legally required. As well, how the history of management research support the conclusion that companies should balance shareholder and stakeholder interests, not one over the other.

We find that investors, banks and companies are changing their ESG practices and policies, through growing participation in responsible/sustainable initiatives and organisations. However, significant gaps between rhetoric and action exist, for instance in asset managers' voting at companies' Annual General Meetings.

Moreover, many top ranked business schools have insufficient focus on sustainability.

A growing number of financial institutions and companies are participating in sustainability initiatives, aiming to balance stakeholder and shareholder views. They are embracing stakeholder-centric capitalism and rejecting Milton Friedman's shareholder primacy opinion.

For Institutional investors and Professional investors

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History of management research and philosophy

‘Shareholder first’ was not always the dominant framing of business purpose

Today, Friedman’s 1970 article has more than 20,000 academic citations in Google Scholar, making it his second most influential publication. His newspaper article may soon become his most cited work, overtaking his 1962 book “Capitalism and freedom”. In this book, Friedman originally formulated his thoughts on the narrow responsibility of companies: “*the only social responsibility that companies have, is that they should obey the law and maximize their profits*” (Friedman 1962, 1970).

Research and discussion on corporate social responsibility did not start in the 1970s. In fact, it has been a century-long debate about the extent of the social and environmental responsibilities of companies and other actors (Clark 1916; Bowen 1953; Ghoshal 2005; Lee 2008, Carroll et al. 2012). The overarching question is, and was, how and in which way shareholder and stakeholder considerations - the business and society relationship - can be balanced (Carroll, 1999).

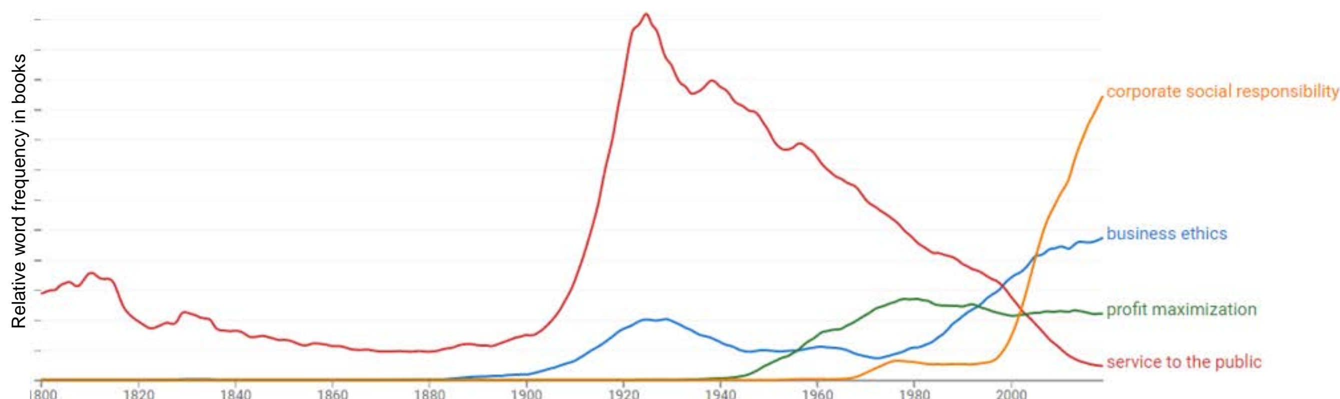
Various approaches to reconcile stakeholders and shareholders exist - even before these terms were actually coined. Carroll et al (20012) found that nearly every issue of corporate social responsibility (CSR) was being discussed in the USA by the end of the 1920s. Looking back even longer, according to the historian Moses Finley (1999), ancient decision-makers in Greece strived to maximize social status rather than profits.

Until the middle of the 20th century, the “managerial” philosophy of management dominated, with future business leaders being taught that corporations should be managed to serve shareholders, but also a wider group of stakeholders (Berle, 1954, p. 169; Carroll et al., 2012; Weiner, 1964).

Even one year after Friedman’s article, the influential US nonprofit, nonpartisan, business-led public policy organization, the Committee for Economic Development (CED), published a report on the role of stakeholders. CED concluded that the role of business managers is to be a “*trustee, balancing the interests of many*”. The CED clearly stated that short-run profits need to be traded off against long-run profitability “*within a framework that will be constructive and acceptable to society*” (CED, 1971, p. 22)

A search for keywords in books reveals that the terms “business ethics” or “service to the public” (as a previous term for social responsibility) increased steadily in academia from the first decades of the 1900s. **Figure 1** shows that “profit maximization” and related keywords are relatively young concepts that only received academic focus from the 1940s onwards.

FIGURE 1. KEYWORD SEARCHES IN BOOKS SHOW THAT USE OF THE TERM ‘PROFIT MAXIMISATION’ PEAKED IN 1980 WHILE THE USE OF CSR CONTINUES TO GROW



Source: DWS analysis, Google Ngram 2020

Business Roundtable Statement

Since 1997, the US Business Roundtable Statement on Corporate Governance wished "*to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners.*" The club of top US CEOs saw their "*paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders.*"

This statement did not change until 2019. The Business Roundtable CEOs changed their understanding on the purpose of the firm significantly: "*Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.*"

While this statement has been welcomed, a number of critics[1] have pointed out many of these companies are not living up to the spirit and ideas contained in this statement. One law firm[2] concluded that company directors can already accomplish the Statement's goals but that the Statement creates legal risk as directors will now have to document decision-making processes, particularly if certain types of stakeholders may be harmed while others may benefit.

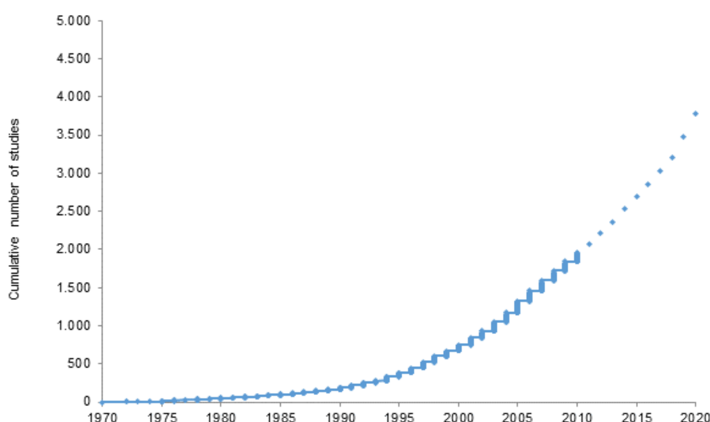
On the one year anniversary of the Statement, Oxford university professor and founding chairman of the Sustainability Accounting Standards Board, Bob Eccles[3] called for each of the companies to publish a company specific, stakeholder inclusive short Statement of Purpose signed by each of their board members. Not doing so would show the Statement as only being a public relations ploy. Harvard Law School professors[4] additionally found that only one company's support for the Statement was approved by that company's board while other companies' support for the Statement was only approved by their CEO.

The evidence for financial performance and sustainability should encourage Statement signatories and all other companies to heed the advice to publish short Statements of Purpose. This is an idea whose time has come.

The evidence for corporate financial performance and sustainability

Where Friedman went wrong: summarising academic research

FIGURE 2. NUMBER OF EMPIRICAL STUDIES TRACKING THE LINK BETWEEN ESG AND CORPORATE FINANCIAL PERFORMANCE HAS GROWN TO 4,000-5,500 REPORTS



Source: DWS Investment GmbH 2020

Since the 1970s, academics have increasingly been studying the relationship between ESG issues and CFP. In 2015, we found that around 2,250 academic studies had been published with an explosive growth in research in since the mid 2000s: with on average more than 100 empirical papers on ESG and CFP being published every year, **Figure 2.**

Today, we estimate that there are in 2020 between 4,000 and 5,500 academic reports on ESG and financial performance. On average and conservatively, we estimate that at least 200 ESG-CFP papers are being written annually.

We explain the methodology for this estimate in the appendix.

[1] See for instance Winston 2019 https://hbr.org/2019/08/is-the-business-roundtable-statement-just-empty-rhetoric
[2] Pierce 2019 https://corpgov.law.harvard.edu/2019/09/26/analysis-of-the-business-roundtable-statement/
[3] Eccles, August 2020 https://www.forbes.com/sites/bobeccles/2020/08/19/an-open-letter-to-the-business-roundtable-181/
[4] Bebchuk and Tallarita, September 2020 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3544978

Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

DWS 2012: one of the first literature surveys for investors

In 2012, DWS published one of the first reports[5] summarising this research for the investment professional audience. The 2012 report analysed more than 100 academic studies with close examination of 56 papers, 2 literature reviews and 4 meta-studies. At the time, it was believed to have been one of the most comprehensive reviews of the literature undertaken.

The 2012 report found that 100% of the academic studies agree that companies with high ratings for ESG factors had a lower cost of capital in terms of debt (loans and bonds) and equity. The report also found that 89% of the studies examined show that companies with high ratings for ESG factors exhibit market-based outperformance, while 85% of the studies show these types of company's exhibit accounting-based outperformance.

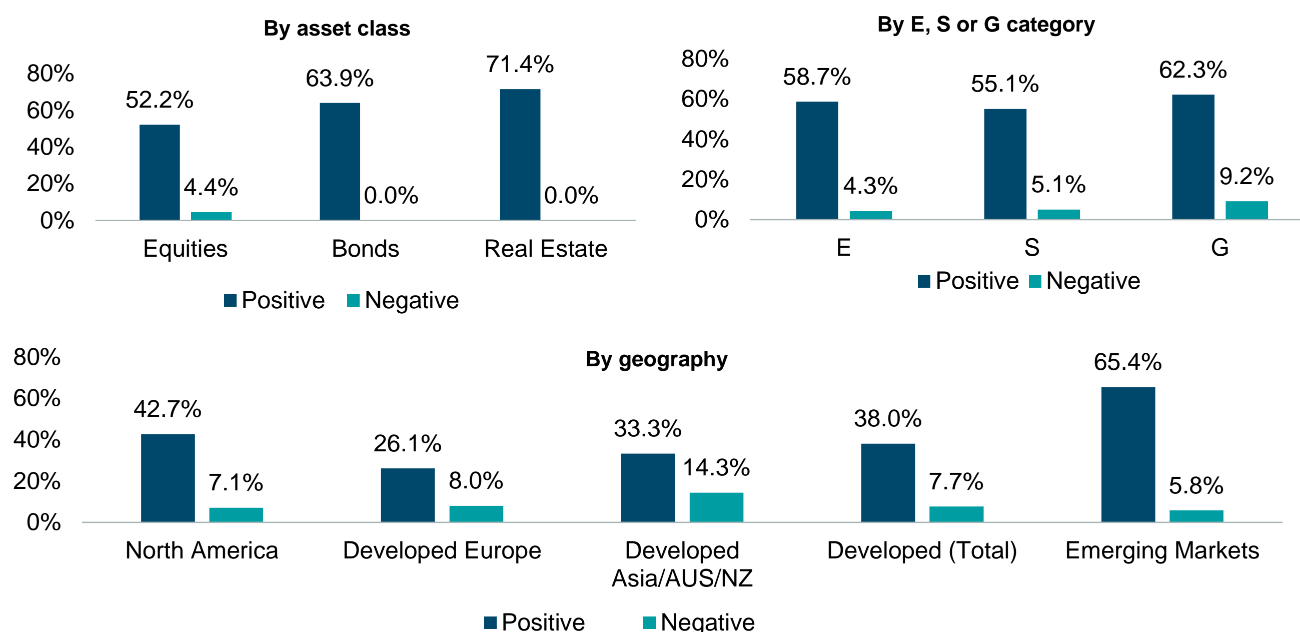
DWS & University of Hamburg 2015

In 2015, DWS in partnership with the University of Hamburg jointly published a review of the 2,250 of the academic studies published[6]. In addition, DWS also published an investor practitioner summary[7]. The 2015 report found that 90% of academic reports found a positive or neutral relationship between ESG and CFP. A positive correlation was found in 47.9% of primary studies in vote-count studies and 62.6% of meta-analyses. Only 6.9% of primary studies in the vote-count sample and 8.0% in the meta-analyses sample find a negative ESG-CFP relation, with the rest finding a neutral relationship.

The positive ESG-CFP relation holds across asset classes, regions, and the individual E, S, and G categories. A disproportionate positive relation is detected for studies focused on North America, the Emerging Markets, and non-equity asset classes like bonds and real estate, **Figure 3.**

FIGURE 3. 2015 REVIEW: ACADEMIC STUDIES WITH THE STRONGEST LINK BETWEEN ESG AND FINANCIAL PERFORMANCE

Proportion of studies with a positive or negative relationship between ESG and financial performance:



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Source: DWS Research Institute (September 2015) ESG & Corporate Financial Performance

[5] DB Climate Change Advisors: Fulton, Kahn, Sharples 2012. Sustainable Investing: Establishing Long-Term Value and Performance. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222740

[6] Friede, Busche and Bassen 2015. ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610

[7] Deutsche AWM: Friede, Lewis, Bassen and Busch 2015. ESG and Corporate Financial Performance: Mapping the global landscape https://download.dws.com/download?elib-assetguid=2c2023f453ef4284be4430003b0fbeee

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Complementary research published in 2015

It is not just DWS reviews of the ESG academic literature that came to these conclusions.

In 2015, the University of Oxford and Arabesque Partners[8] investigated over 200 of the highest quality academic studies. Their findings mirror DWS's 2012 report:

- 90% of cost of capital studies show that sound sustainability standards lower the cost of capital of companies
- 88% of reviewed sources find that companies with robust sustainability practices demonstrate better operation performance, which ultimately translates into cash-flows
- 80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance

Harvard University[9] researchers and many others also came to similar conclusions.

DWS and University of Hamburg 2018 report: Digging deeper

In 2018, DWS published follow-up analysis[10] on the 2,250 academic reports, digging deeper into understand how different ESG factors and corporate financial performance interacts, their relationships and their robustness.

The 2018 paper examined the sample of the 25 first-order meta-analyses in greater detail. We found that there has been a highly significant, positive, robust, and bilateral ESG-CFP correlation. The correlation strength is comparably high for both environmental and social factors.

We also found that corporate reputation turns out to be a key driver of corporate financial performance, followed by philanthropy. The correlation is weaker between ESG disclosure and ESG audits, policies and processes. We also observed a particularly strong ESG relationship vis-a-vis operational financial performance, highlighting that ESG affects operational efficiency and with it financial performance.

The 2018 report also examined potential biases due to methodologically weaker academic papers or papers published in academic journals focused on social issues in management. Our conclusions confirm that the business case for being a good firm are undeniable. Firms and investors can feel encouraged that potentially competing financial and stakeholder priorities can in fact complement each other.

DWS 2018: The quant road to ESG integration

Our quant investing team also published a report[11] in 2018. They found that introducing ESG criteria to an equity portfolio gives rise to implicit secondary market factor exposures (i.e. large cap bias or over exposure to certain regions) when compared with a broad market index.

The report showed that increasing ESG tilts to passive portfolios requires investors to bear a greater tolerance to tracking error. However, combining ESG screens with an active approach can add value by producing higher risk adjusted returns while fulfilling investors' ESG requirements. For a given investor, the 'right' parameters may be established through the use of quantitative analysis and simulation. It was also found that as the ESG tilt is increased above a certain level, risk adjusted returns may begin to decline when combining profit maximising strategies with higher ESG tilts.

The gap of rhetoric to action

Despite the strong evidence for integrating ESG into investment decisions, we know that there is a gap between intention and action. For instance, DWS published a report[12] examining how asset managers' ESG integration

[8] University of Oxford and Arabesque Partners March 2015. From the stockholder to the stakeholder, How sustainability can drive financial performance
[9] Khan, Serafeim and Yoon 2015 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912
[10] Friede, Lewis, Bassen and Busch 2018. https://download.dws.com/download?elib-assetguid=714aed4c2e83471787d1ca0f1b559006&wt_eid=2156993328300498196&wt_t=1599646919306
[11] DWS October 2018 The quant road to ESG integration https://www.dws.com/insights/global-research-institute/the-quant-road-to-esg-integration/
[12] DWS 2020. How best to measure asset managers credentials when it comes to ESG https://www.dws.com/insights/global-research-institute/how-best-to-measure-asset-managers-credentials-when-it-comes-to-esg/

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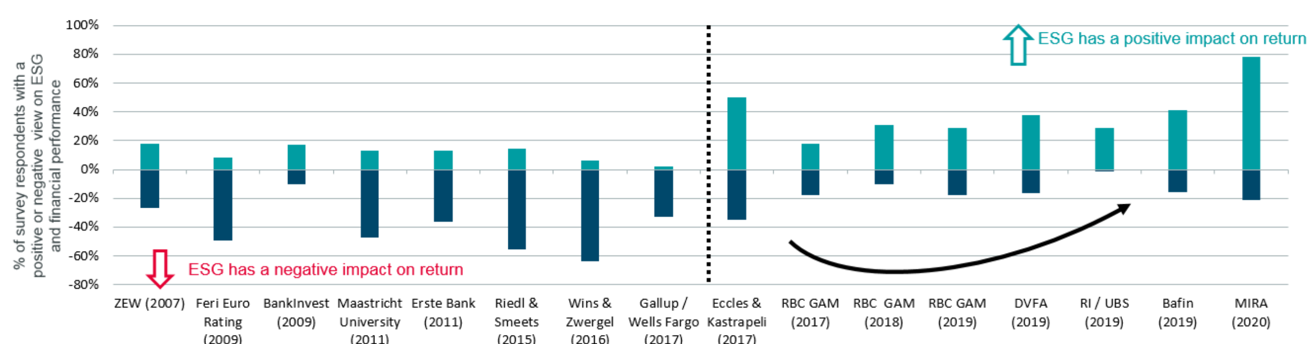
and stewardship activities may differ. We cite research from Morningstar[13] that five of the largest ten asset managers do not back up their rhetoric on ESG with action. These investors voted in favour of fewer than 12% of shareholder resolutions at company Annual General Meetings in 2019. We believe asset owners should and will increasingly hold asset managers to account for their actions in areas such as their voting track-record.

Surveys of investors show that opinions have shifted

DWS has also been tracking the evolution of opinion surveys of institutional and retail investors' views, **Figure 4.** We observe that 2017 is the year when more investors came to believe that ESG integration can lead to higher financial performance, than the number of investors believing that ESG integration leads to lower performance.

FIGURE 4. INVESTOR PERCEPTION OF ESG AND FINANCIAL PERFORMANCE IS CHANGING



Survey question: "what do you think: does ESG integration lead to higher, lower, or equal performance"

Source: DWS analysis 2020; ZEW (2007): German institutional investors; Feri Euro Rating (2009): German institutional investors; Bankinvest (2009): institutional investors from Germany, Austria, Switzerland; Maastricht University (2011): German retail clients; Erste Bank (2011): Austrian retail clients; Riedl & Smeets (2015): Mutual fund investor in the Netherlands; Wins and Zwergel (2016): German retail investors; Gallup / Wells Fargo (2017): U.S. private investors; Eccles & Kastrapeli (2017): global institutional investors; RBC Global AM (2017/2018/2019): global institutional investors, RI / UBS (2019): global institutional investors, DVFA (2019): German institutional investors, Bafin (2019): German private investors, Macquarie Infrastructure Real Assets (2020): real asset investors

Stakeholder vs shareholders in business theory, in law and at business schools

Shareholder theory

Shareholder theory advocates the primacy of shareholders against all other stakeholders. At its core it has a win-lose or trade-off logic and suggests the distinction of shareholder and stakeholder aspects. In this logic, non-shareholder-oriented management, as agents of the firm, transfers shareholder wealth to non-share-owning stakeholders and unduly tax shareholders, if it pursues stakeholder-oriented management (Jensen & Meckling, 1976). The only social responsibility that companies have is therefore formulated in such a way that they should obey the law and maximize their profits (Friedman, 1962, 1970).

Maximising shareholder value is not legally required

Shareholder primacy is often perceived as embedded in legal case law with narrow codified shareholder focused duties for directors and boards (Dodd, 1932; Hansmann & Kraakman, 2000). For instance, a 1919 Michigan Supreme Court case "Dodge vs. Ford" stated the opinion that a corporation is primarily for the profit of the stockholders and not only incidentally should benefit them. It shall not primarily act for the purpose of benefiting others (stakeholders). However, a profit maximization goal was never specified (Dodd, 1932).

[13] Morningstar, March 2020. 2019 ESG Proxy Voting Trends by 50 US Fund Families https://corpgov.law.harvard.edu/2020/03/23/2019-esg-proxy-voting-trends-by-50-u-s-fund-families/

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There is also growing research that corporate law does not require, and never has required, directors of public companies to maximize shareholder value but rather to balance all stakeholders' interests (Fisch, 2006; Stout, 2012).

In addition, the concept of shareholders owning a corporation is legally incorrect. Shareholders are not owners of the corporation, but owners of stocks which entitle their owners to limited rights like voting at AGMs and receiving dividend payments.

Moreover, shareholders are not the ultimate beneficiaries of corporate cash flows. Shareholders are only one group whose right to receive corporate cash flows (such as through dividend payments), is actually subordinate to employees, suppliers, and bond holders. Shareholders only receive residual cash flows (Ghoshal, 2005; Lan & Heracleous, 2010; Stout, 2002).

Stakeholder theory

Stakeholder theory, on the other hand, assumes that businesses are about creating value together with other stakeholders. The executives who manage the firms create value not only for capital providers, but also for customers, suppliers, employees, and/or communities.

A leading academic proponent of stakeholder responsibility is R. Edward Freeman, an American philosopher and professor of business administration at the University of Virginia[14]. Freeman writes that business should be understood as a set of relationships among such groups that contribute to the business purpose and success, and which have either the power to affect the business' performance and/or have a capital stake (Freeman, 1984).

Freeman argues that the task of firms' management is therefore to build and manage these relationships and not only paying attention to the providers of capital. Hence, the understanding of capitalism is formulated as to "putting together a deal, a contract, or a set of relationships among stakeholders so that all can win continuously over a long period of time" (Freeman, Harrison, & Wicks, 2007, p. 4).

An organization which provides mid-market executive with support, training and inspiration for 'conscious capitalism' suggests that "*Freeman is the socially responsible capitalist opposite to the more free-wheeling neoliberalism of Milton Friedman."* (Conscious Capitalism 2020).

Stakeholder theory assumes that the idea to always prioritize one particular group, such as capital providers, is flawed. This reflects "a more humanistic concept of business as a vehicle for human cooperation to realize outcomes not otherwise attainable" (Freeman, Phillips, & Sisodia, 2018, p. 7).

Embracing the stakeholder idea of creating win-win relationships among all stakeholders, including investors, could reorient significantly the opportunity set of companies, investors and increase planetary welfare overall.

Realizing that stakeholder wealth can be positively affected by good ESG performance at no measurable shareholder disadvantage (CFP), may increase investor support for ESG integration and could prove a catalyst for breaking down existing ESG integration barriers.

Evaluating business schools

Part of the reason for the perceived enforceable requirement to maximize shareholder value seems in fact not to consist of legal and economic arguments. Several studies have found that a better explanation for perceptions of maximising shareholder is found in the dominating social norms among company executives, due to a decade-long dogma in law and business schools (Ghoshal, 2005; Smith & Rönnegard, 2016; West, 2011).

With such strong and growing evidence showing Friedman's shareholder primacy opinion to be incorrect, how are business schools integrating sustainability?

We recognize and applaud that many universities are deepening their integration of sustainability in their teaching, research and operations. One methodology for evaluating business schools on sustainability was developed by CorporateKnights[15], a sustainable business publication. We conclude that business schools must

[14] https://www.darden.virginia.edu/faculty-research/directory/r-edward-freeman
[15] Corporate Knights 2019 https://www.corporateknights.com/reports/2019-better-world-mba/

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significantly step up their actions on sustainability to remain relevant to modern financial institutions and companies' business goals to integrate sustainability, to strengthen action on our many environmental and societal crises and to reflect the strong and growing literature on sustainability and financial performance.

Conclusion: Embracing stakeholder-centric capitalism

Investors', banks' and companies' sustainability commitments and actions

Perhaps there is no better rebuttal to Friedman's views on shareholder primacy than the rhetoric and actions of investors, bankers and companies which are increasingly embracing the ideas of stakeholder-centric capitalism:

- The Principles for Responsible Investment (PRI) counts 3,000+ institutional investors with USD100 trillion in assets as signatories, a significant growth since 2006.
- The more recently created Principles for Responsible Banking (PRB) was created in 2019 and now includes 180 banks from 44 countries with over USD47 trillion in assets
- More than 11,600 companies and small/medium enterprises support the UN Global Compact. CEOs from 200+ major companies with revenues of USD $8.5 trillion and 19 million employees, are members of the World Business Council for Sustainable Development.

While this is encouraging, we know that there is a gap between intention and action. However, the ESG-CFP evidence should actually encourage investors, banks and companies in strengthening and accelerating action.

We believe that the financial institutions and companies participating in these and many other sustainability initiatives, want to balance stakeholder and shareholder views. In doing so, they are embracing stakeholder-centric capitalism and rejecting Milton Friedman's shareholder primacy views.

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Appendix – Updating the estimate of the number of ESG and financial performance academic reports

We extrapolate our timeline of studies based on our previous study results until 2010 (Friede et al., 2015; Busch et al., 2018) and completely update it with a 2011-2020 primary study search. We merged subsequently the sample until 2010 with the new search results. The 2020 year to date (9 September 2020) search hits are annualized to ensure comparability.

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Our search is based on Google Scholar (GS) with the help of additional software. We search for the terms "corporate financial performance" and "corporate social performance" on an annual basis. The overlap with search results for ESG and other acronyms is very high and is only performed as additional check. The first 1000 study search hits per year based on the GS relevance algorithm are extracted. All search hits (studies) that are not quoted at least once in GS are eliminated from the further analysis. Only for 2019 and 2020 are all search hits considered without the minimum citation frequency. The remaining search hits are automatically searched by title and are only considered for the analysis if the title contains a combination of at least three of the phrases "perform", "return", "corporate", "firm", "finance" or "value". In relation to our search terms and based on a subsequent analysis via large sample checks, false positives are negligible. Based on additional sample checks and word frequency analysis of all study titles, the likely study count per year of empirical ESG-CFP studies is conservatively estimated. If the citations limitation of one GS citation is lifted and only at least two phrases match with the title, the number of estimated studies for 2011-2020 rises additionally by ~1500. Further validations and analysis is needed to further narrow the confidence interval.

It needs to be noted that the extrapolation beyond 2010 is a rough estimate and potentially far from a complete picture. In 2018 (Busch et al., 2018), we extrapolated based on our qualitatively selected sample that roughly 150 empirical ESG-CFP studies have appeared on average annually since 2015. This was already a conservative estimate as we now determine an annual average of 182-328 studies per year from 2011-2020, varying, based on the applied filter and year, from 99 to 450 per year. We apply for the chart the annual values of our most conservative estimation method.

We therefore estimate that roughly 4000-5500 empirical studies on ESG-CFP have been written from 1970-2020.

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