DENNY CENTER CONVERSATIONS
A Q&A with Alex Edmans, London Business School

Alex Edmans is a professor of finance at the London Business School and academic director of the Centre for Corporate Governance. Prior to teaching at LBS, Professor Edmans taught at The Wharton School at the University of Pennsylvania. He's received a number of teaching awards from both institutions. His most recent book, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*, was published in March 2020 and was named a Financial Times book of the month and added to FT's list of must-read books for summer. In the book, Professor Edmans goes against common wisdom and concludes that responsible businesses don't have to sacrifice profit in order to pursue social value.

This interview has been edited for length and clarity.

Denny Center: Before talking about your latest book, would you back up a step and talk about your journey to-date that led you to get interested in the topic of responsible business and to pursue related research as a professor of finance?

Alex Edmans: I studied economics and management as an undergraduate at Oxford, and why go so far back is that the management that I studied there was not just finance -- even though I'm now a professor of finance -- but it also included things such as organizational behavior, strategy, and marketing. I think that's important because responsible business is a holistic concept.

After a couple of years working for Morgan Stanley in investment banking, I went to MIT to do a PhD in finance and have been a professor of finance for 13 years now, initially at Wharton and now at London Business School. I've always been interested in responsible business. I'm not quite sure why I got interested in it, but I've always thought about the long-term and so when I started doing my PhD thesis, it was always on responsibility.

And even though now responsibility is a hot topic and that can lead many talking heads to start to write and speak about it, that might not always be based on evidence. Instead, the fact that I've worked on this for 15 years means that there's a lot of evidence that I bring to bear. And there's a lot of other researchers whose research I'm very well aware of which I can hopefully bring to this very current debate.

Denny Center: So you were thinking and writing about corporate responsibility before it was in fashion?

Alex Edmans: Yes, I wrote a paper when I was a PhD student on the link between employee satisfaction and long-term stock returns, which is perhaps my best known research article on responsible business, but at the time I didn't really have any knowledge that this had implications for responsible business. I didn't really know the term so I just wrote that paper because there was a lot of human capital theories that I studied as an undergrad on importance of human resources and the modern firm, and I wanted to test whether those theories were true (i.e., are employees really critical to a company's long-term success?). Then I was contacted by Lloyd Kurtz who runs the Moskowitz Prize for Socially Responsible Investing at Northwestern's Kellogg Business School. He said that I should enter my paper for this competition because the paper had a lot of implications for responsible investing; the idea that companies should target stakeholders rather than shareholders. I have huge thanks to Lloyd because were it not for him, I would have never realized the implications of my work for responsibility. I just thought that I was testing human capital theories.

When I went to that conference back in 2007, the investors that were there were not the mainstream investors who were speaking about responsibility (like the Larry Finks of BlackRock today). They were specifically socially responsible investors who had a social remit; their goal was not just to maximize financial returns, but to achieve some social objective in areas like climate change or diversity. What's really changed over the past 13 years is just how mainstream socially responsible investing has become. Mainstream investors whose goals might purely be financial are still thinking about responsibility because they recognize that that is not a non-financial factor; it's ultimately financial in the long term.

Denny Center: Are you saying that investors realized that in order to reach their financial return objectives, many other things should be factored in, especially when you think about returns over a longer time horizon?

Alex Edmans: That's correct. Because if you are an investor, you want something which is linked to a company's long-term value, but you also want something which the rest of the market doesn't see. For example, to buy Facebook because Facebook is the market leader in social media doesn't make sense because everybody knows that. To buy companies based on profitability and size and so on, we now have smart beta funds and computer traders doing that. But what's special about responsibility is that this is something which is intangible. It's something that computers and algorithmic traders find it difficult to assess. This is something where really active investors can have a big advantage, and that's again why mainstream investors are getting really interested in it. It's because it's something which matters for financial returns, but is ignored by the market.

And beyond that they're thinking about this not only for financial perspectives, but they recognize that their clients, savers like you and me, might look for not only financial returns from our investments but also social returns. We'd like the companies that the mutual funds invest in to reflect what we would like to see in the world.

Denny Center: Much that's published on business and society takes an existing side in the debate and works hard to support that side or point-of-view (profits over against corporate social responsibility, for example), but with your research and new book, *Grow the Pie*, it seems that you are really outlining a third way – is that right?

Alex Edmans: Yes, you're absolutely right. I wrote the book because I was a little alarmed and perturbed by the one-sided nature of the debates that we see out there.

You have some folks who like me think business should serve society, but they try to be as radical as possible. They might say "we need to scrap the current model of capitalism; companies are evil; CEOs are overpaid; investors are short term" and so forth. Now that's often not based on evidence, but it is really powerful because it confirms what many people would like to be true, those who are predisposed to be skeptical about capitalism. They think it's a rigged game, and they are inclined to latch onto any book that makes that case very strongly. Therefore, a one-sided attack on capitalism might get a lot of support.

And then on the flip side, there will be others who say capitalism is perfect; there's nothing that needs to be changed. They might say "every CEO who's highly paid fully deserves her pay…" and so there's going to be defenses on the other side. And again, if you're a defender of capitalism, you have an incentive to make your defense as strong and as one-sided as possible so that certain CEOs or investors might quote you in order to make their case.

But then when I consider the evidence, there were arguments for both sides. And let me stress: the evidence is not based exclusively on my own research (which I've conducted over 15 years), but also the research of other scholars. In some cases, CEOs might be overpaid, but in other cases, CEO pay might be justified. And what I wanted to do in the book was to take this academic research which, because it's academic and rigorous, it's often written in a very technical and dense way, and make it accessible for a general audience.

The message is that there is a third way: it's not business or society, but it's both. To use the phrase from the book, there are ways of growing the pie so that everybody benefits and, importantly, the idea that both sides, business and society, can benefit is not too good to be true. It's actually supported by rigorous evidence.

Denny Center: What misconceptions or subconscious assumptions are you calling out in the book?

Alex Edmans: The main subconscious assumption that I try to rebut is what I call the "pie splitting mentality". What I mean by that is the view that the value that a company creates is given by a fixed pie and that pie can either be given to investors in the form of profits, or to society in the form of wages to workers, or taxes to the government, or lower prices to customers. If the pie is fixed, then it's an "us versus them" mentality.

So if you're a CEO, you think that the way in which I increase profits is by exploiting the rest of society; and unfortunately, there are some companies who might pay their workers as little as possible, or who might price gouge customers like Martin Shkreli of Turing Pharmaceuticals who increase the price of drugs by 56 times. Their view is that society is there for the taking and that corporate responsibility is just fluffy and some optional extra. This is why I come to this debate as a hard-headed finance professor: to say even if your only goal is to maximize the long-term financial value of your company, you do need to take seriously how you treat your workers, how you serve your customers, and what shape your environmental record is in.

The other misconception is the pie splitting mentality from the other side. Let's say you're on the side of society. You might think well, if the pie is fixed, the only way to increase the slice for society is to cut the slice of companies. You have people proposing heavy regulation on profits, or CEO pay, or stock buybacks and dividends. This is also misguided because there are many things that companies do that can increase profits, but the increasing profits are not at the expense of society, but as a byproduct of growing the pie and serving both.

Denny Center: As you introduce the "pie growing" concept, what kind of reactions do you get from people? What lights go on for them?

Alex Edmans: The idea that the pie can be grown clicks with people, and it's not so much that they never thought of it before, but that they had some suspicions that this was indeed the case, but they didn't have the evidence to back it up. One might suspect that companies that serve society will do better in the long term, but it's difficult to gather evidence because it's difficult to measure. For example, is it correlation or is it causation? Is it that purpose leads to profit, or only once the company is profitable can it then think about purpose?

I would love to say that are my ideas were completely revolutionary and that nobody ever thought about it before, but that's not the case. It's something where people had some hunch. But the lack of data kept them actually taking the leap of faith and putting this into practice, making social responsibility and purpose front and center to the company rather than just delegating it to a corporate social responsibility department.

Corporate purpose and responsibility should be a CEO level issue, not a CSR department issue. Often when I present to companies and investors, and I introduce myself as a professor of finance, the audience does a double take because they think that the finance department is the enemy of purpose-related initiatives within the company, i.e., CSR is just a cost center, or it's a luxury during a pandemic. But in fact, the research says that any finance department with this mindset is not doing its job properly because it doesn't recognize that these factors, which are often dismissed as being non-financial factors, are actually financially material in the long term.

Denny Center: When you "long term", is having the right time horizon in mind an important part of the "grow the pie" mentality?

Alex Edmans: Yes, time frame is a critical part of the equation because in the short term, it is indeed the case that the pie is fixed. If you pay your workers more today, that is at the expense of profits today, in the short term; the idea that the pie can be grown is only true over a longer time horizon. Once you treat employees better, then maybe in a couple of years, they become more motivated and more productive; but that's more likely to happen in up to five years' time, as my research suggests.

If a company wants to think about society in the pie growing mentality, it's not just sufficient to write a nice new purpose statement. It must change the horizons with which it is rewarding its leaders. For example, pay the CEO according to the stock price over five or seven years (versus 1-3 years); also, change what the company reports on, not just financial metrics which are inherently short-term and backward-looking, but also consider stakeholder metrics which might be more forward looking (e.g., what the company is doing to develop a skilled and innovative workforce, or the number of patents the company is filing). Measures like this are important and necessary for an investor or other stakeholders because they evaluate the long-term potential of a company.

Denny Center: Let's say a CEO is new to your "grow the pie" framework and wants to put the framework into action, what can they do as a first step?

The first thing for an executive to do is to define the purpose of their organization, a focused and targeted purpose. It's important to define what purpose actually means because a purpose is a word which is bandied about a lot today. We often think that purposeful means altruistic; for example, a purposeful organization is one that cares about society, but that's not what the word purpose means. It means focused and targeted.

A purposeful meeting is one with a clear agenda. Or if I do something "on purpose" then that means I do something deliberately. It follows that the purpose of an organization can include a societal objective, but it must also be targeted and not attempt to be all things to all people. A bank might focus on transparency in their marketing with the objective of financial inclusion even though that leaves out other important issues like resource usage or climate change.

Denny Center: But what about those who say the purpose of a business is to generate a profit?

Alex Edmans: I see profit as being a by-product of serving a purpose. Unlike many critics of capitalism who think of profit as value extraction, I believe that profit is an absolutely essential element of business. And profits also play a key role in society: they are necessary to provide returns to investors; in addition, profits enable companies to invest toward future innovations like the next important cancer treatment. However, profit is not something to be pursued directly because if you pursue profit directly, you might end up unintentionally extracting from stakeholders. Instead, think of profit as a bi-product of making products that transform customers' lives for the better, or providing employees with a healthy and enriching workplace, or preserving the environment for future generations.

It's a bit like asking a child what they want to be when they grow up. Hopefully the answer isn't "I'm going to make a lot of money". It might be "I'd love to be a doctor or an entrepreneur". It's something they'd love to do. And if they do that well, they will make a great living for themselves, but it's really the career aspiration that then leads to financial security rather than financial security being the end goal.

To learn more about Professor Edmans and his work, visit https://www.growthepie.net/.