COMMENT

A WELFARE FUNCTION FOR SHAREHOLDER ENGAGEMENT: RECOGNIZING PROFIT FOR WHAT IT IS

by Frederick Alexander

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Madison Condon's *Externalities and the Common Owner* (ECO) plays an important role in the growing literature around shareholder activism aimed at increasing portfolio returns, regardless of individual firm effects. The article raises important questions of political economy, power distribution, and anticompetitive activity. In this Comment, I introduce key terminology for discussing these issues, and then reframe several issues raised by the article.

I. Proposed Definitions

Defining terms can go a long way toward establishing common ground for discussion and helping to properly frame critical questions.

Alpha. The relative financial return of a residual security (typically common stock) or a portfolio of residual securities compared to the average return of a security or portfolio with similar volatility over a fixed period.

ESG integration. The shareholder practice of exercising corporate governance rights and otherwise engaging with a portfolio company in order to improve the company's internal governance and social and environmental impacts, all with a goal of increasing the company's shareholder value.

Beta activism. In contrast to ESG integration, the shareholder practice of exercising corporate governance rights and otherwise engaging with portfolio companies with the goal of improving their impacts on society and the environment and, consequently, on the absolute return of diversified portfolios. Effective beta activism may result in reduced alpha for some companies.

Beneficiaries. The human beings who benefit from shares held by shareholders, including the owners of mutual funds, workers in retirement plans, citizens in sovereign wealth funds, foundations and endowments, insureds in insurance company assets, and retail shareholders themselves.

II. Framing the Issues

A. What Are the Costs of Shareholder Primacy?

As ECO points out, there is an efficiency-based rationale for shareholder primacy, or the idea that companies should maximize shareholder value: the use of profits is a good heuristic for value creation. This idea of the "invisible hand" is deeply embedded in folk economics, but profits do not equal value creation when negative externalities exist or markets are otherwise imperfect.[1]

Any discussion of the cost of abandoning shareholder primacy must reckon with costs as well as benefits by examining the threats to the long-term health of the economy that come from unrestrained profit-seeking. A recent study estimated that in 2018, listed companies produced $4.1T in profits globally and more than $2.2T in social costs, suggesting that the heuristic is off by at least a factor of two.[2] The cost may be even greater because profits can come at a cost to the climate, biodiversity, ocean health, clean water, diversity, equality and other valuable systemic factors not captured in the study. The annual value we receive from the endangered global ecosystem is greater than global GDP.[3] As Duncan Austin says:

1. *See, e.g.*, Kaushik Basu, Beyond the Invisible Hand: Groundwork for a New Economics 10 (2011) (explaining the First Fundamental Theorem of Welfare Economics as the strict conditions under which the invisible hand conjecture holds).
2. Andrew Howard et al., *SustainEx: Quantifying the Hidden Costs of Companies' Social Impacts*, Schroders (Apr. 11, 2019), https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf.
3. Duncan Austin, *Greenwish: The Wishful Thinking Undermining the Ambition of Sustainable Business*, Preventable Surprises (July 22, 2019), https://preventablesurprises.com/wp-content/uploads/2019/07/2019-07-19-Greenwish-Essay.pdf.

> more of the environmental and social exchanges that shape our wellbeing may be unpriced than priced, yet we increasingly steer by the priced exchanges only.[4]

While research has measured the potential cost of climate change,[5] antimicrobial resistance,[6] racial injustice,[7] growing inequality,[8] and other costs that companies externalize in pursuit of profit, greater understanding of the relationship between shareholder value and externalized costs is necessary for policymakers, investors, labor leaders, and other economic power holders to make better decisions. Even with clarity that it is socially beneficial for shareholders to engage in beta activism, there is work to be done in defining the most effective interventions.

B. Countervailing Managerial Power

It may be argued that externalities are best regulated by government, not shareholders, because, as ECO notes, (1) shareholders do not share identical interests with the full polity and (2) the concentration of power in large asset managers may be risky.

One important question is the extent to which shareholder governance can reduce externalities where government fails, such as those failures discussed above. One obvious difference is jurisdictional; companies can arbitrage laws by moving operations and tax situs, resulting in a governmental race to the bottom, whereas capital markets cross borders, potentially preventing such arbitrage. Legislation and regulation are also subject to political pressures from corporate managers that shareholders may not feel as strongly.

It is also important in the power analysis to consider the alternative. If corporate power is not held by shareholders, where is it? I would argue that it resides in corporate C-suites, where managers' investments are concentrated in the equity of a single company and thus much less-aligned with the economy overall. Power is also concentrated in hedge, venture, and private equity funds, where managers are rewarded in a manner that sacrifices beta for alpha.

Finally, the idea that power concentrates at the largest money managers, like BlackRock, State Street, and Vanguard, must be closely examined. These are, after all, service providers. Larry Fink's famous letter is as much a marketing document as a directive to portfolio companies. These asset managers are competing for clients, and any ESG mandates they attempt to impose on companies are part of their attempts to satisfy the institutional and retail investors they are trying to attract and maintain. In this sense, large asset managers may reflect a semi-democratic process.

In sum, the question is not whether shareholders are an ideal proxy for the public interest, but whether they are better than, or an important countervailence to, the power that resides in corporate managers and financial system intermediaries, as well as a complement to the power that resides in political bodies.

C. Can Purported ESG Integration Effectively Meet Systemic Threats and Systematic Risk?

ECO notes that shareholders might characterize beta activism as ESG integration and that corporate managers might disguise beta-focused strategies as alpha-producing under the business judgment rule. This blurring of lines is intended to eliminate the tension between the desire of shareholders to maximize portfolio values and the desire of corporate managers to maximize firm values.

It is important to ask whether this attempt to find common ground impedes necessary progress. It seems highly unlikely that companies with (1) significant sunk costs in business models that do not account for planetary and social boundaries or (2) profit opportunities involving extensive cost externalization will always be able to "do best by only doing good." Some examples provided in ECO illustrate the gap. For instance, the article points to long-term emission target reductions based on historical emissions, but these may fall short of what must be done to reach Paris alignment, which is more likely to require immediate milestones to allocate fair shares of our limited carbon budget.

The same issue is illustrated by the increasing focus on the use of disclosure standards created by the Sustainability Accounting Standards Board. While these have been celebrated by some of the world's largest shareholders and are being increasingly employed by companies, they are only designed to measure environmental and social impacts affecting shareholder value at the reporting company.[9]

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4. *Id.*
5. *See, e.g.*, Matthew E. Kahn et al., *Long-Term Macroeconomic Effects of Climate Change: A Cross-Country Analysis* 5 (Int'l Monetary Fund, Working Paper No. 19/215, 2019), https://www.imf.org/-/media/Files/Publications/WP/2019/wpiea2019215-print-pdf.ashx:

   > Our counterfactual analysis suggests that a persistent increase in average global temperature by 0.04°C per year . . . reduces world real GDP per capita by more than 7 percent by 2100 . . . [A]biding by the Paris Agreement, thereby limiting the temperature increase to 0.01°C per annum, reduces the loss substantially to about 1 percent.
6. *See, e.g.*, Olga B. Jones et al., *Drug-Resistant Infections: A Threat to Our Economic Future* 56 (The World Bank, Working Paper No. 114679, 2017), http://documents1.worldbank.org/curated/en/323311493396993758/pdf/final-report.pdf ("In the high antimicrobial resistance-impact scenario, the world will lose 3.8 percent of its annual GDP by 2050, with an annual shortfall of $3.4 trillion by 2030.").
7. *See, e.g.*, Dana M. Peterson & Catherine L. Mann, *Closing the Racial Inequality Gaps: The Economic Cost of Black Inequality in the U.S.*, Citi Glob. Perspectives & Sol. (Sept. 2020), https://www.citivelocity.com/citigps/closing-the-racial-inequality-gaps/.
8. *See, e.g.*, Heather Boushey, Unbound: How Inequality Constricts Our Economy and What We Can Do About It (2019).
9. *Exploring Diversity & Inclusion in the SASB Standards*, Sustainability Accounting Standards Bd. (Sept. 28, 2020), https://www.sasb.org/blog/exploring-diversity-inclusion-in-the-sasb-standards/ (treating data on race and gender as material in only 13 or the 77 industries for which the SASB establishes disclosure standards, even though racial and gender injustice in

Consequently, this disclosure regime does not assist shareholders attempting to fill in any gap between ESG integration and beta activism.

D. The Distinction Between Beneficiaries, Shareholders, and the Trustees Between Them

ECO points out that a shareholder with concentrated ownership at a company or in an industry may have an economic motive consistent with externalizing costs, just as a manager at a company would. While this is true, the analysis should be done from the perspective of the beneficiaries, not the shareholders. Given the benefit that investors obtain from diversifying to eliminate idiosyncratic and industry risk—the central insight of Modern Portfolio Theory—it seems likely that most investors with fiduciary obligations would be quite diversified, even if some money is assigned to concentrated positions at hedge funds or similar vehicles.

In determining the calculus from the perspective of beneficiaries, it is also important to recognize that, in addition to interests in portfolios, they have both individual interests and community interests. Indeed, for many, if not most, people who have interests in a retirement or mutual fund, or who benefit from foundations or endowments, the most important financial asset is a job; companies' effects on access to good jobs, training, and education is more important to many beneficiaries than financial return. And feelings of obligation toward members of communities large and small is important as well. There is no doubt that, if asked, many beneficiaries who profited from the conditions that led to the loss of life at Rana Plaza or the *Deepwater Horizon* environmental disaster would gladly return the profit attributable to those losses in order to change outcomes.

The fact different beneficiaries have different interests in these issues cannot justify ignoring them, because ignoring the trade offs is itself a choice. If a company or portfolio manager maximizes company or portfolio value by externalizing costs, and if the ultimate beneficiaries of that company or portfolio have other financial interests, careers, people, and issues they care about affected by those costs, then the manager is trading off their interests for the interest of the hypothetical beneficiary whose interests are fully aligned with those of the company or portfolio.

E. The Possibilities of Guardrails

Even accepting that beneficiaries and overall economic efficiency could be better-served if shareholders took better account of externalities, ECO notes that it is unclear how managers could put the idea into practice without losing the value of profit maximization as a corporate purpose tool.

How can we ask managers of individual companies to balance profit, pollution, inequality, job quality, and other social issues? They are deeply incommensurate. Moreover, decisions to forgo a practice at one company may be futile if others can exploit the opportunity, and this possibility may lead to a prisoner's dilemma equilibrium of everyone making the choice that provides the worst outcome.

The solution may be guardrails—rules that shareholders can apply equally to all companies—to reduce externalities by imposing baseline rules around emissions, worker treatment, racial injustice, and other issues. With these rules in place to limit cost externalization, managers can return to value maximization within these parameters, a modified shareholder primacy that (1) addresses the agency concerns and (2) fulfills the pricing and allocation function that competition plays in a free market.

F. Distinction Between Price Collusion and Beta Activism

ECO raises the concern that if shareholders work to improve beta by reducing externalized costs, they might also work together to improve the return of competitors through price collusion. More theoretical work needs to be done to ask if this is a false equivalency.

The fundamental insight of beta activism is that some companies must be asked to sacrifice financial return that comes from externalizing costs, thereby harming other companies in diversified portfolios. In a universe of three companies, for example, Company A might be required to sacrifice $100 in profit it makes by polluting the environment if each of Companies A, B, and C would suffer a $50 reduction in value from that pollution. This would mean shareholders as a group would enjoy a $50 increase, which perfectly diversified shareholders would enjoy proportionately, while a shareholder concentrated in Company A would lose. Note that even though concentrated holders receive, on average, the same increase in expected returns, they also experience increased volatility. That is why beta activism relies on the diversification of portfolios.

The calculus for price collusion is different. For three airlines, A, B, and C, price collusion will raise the value of all three companies, so diversified and concentrated shareholders have the same motives.[10] If shareholders vote and engage with a goal of maximizing profits, then the earnings and projections of a company engaging in collusion are more likely to lead to votes that support management. It is true that a concentrated owner may feel the prisoner's dilemma pressure to be the first to defect from a collusion

any industry can harm the social fabric); *SASB Conceptual Framework*, Sustainability Accounting Standards Bd. (Feb. 2017), https://www.sasb.org/wp-content/uploads/2020/02/SASB_Conceptual-Framework_WATERMARK.pdf ("SASB standards address the sustainability topics that are reasonably likely to have material impacts on the financial condition or operating performance of companies in an industry.").

10. While it is true that there will be less volatility for a shareholder with equal interests in all three during a collusion scheme that does not appear to be different from the reduced volatility experienced by a diversified holder in an initially competitive situation; indeed, that is the point of diversification—receiving the same expected return with less volatility.

scheme in order to capture market share as a first mover, but that is simply a question of finding a mechanism to ensure compliance, in which all three firms perform better on a risk-adjusted basis. This is very different from the beta activism question, which requires actual sacrifice of return from some firms.

The mechanism that common ownership provides for beta activism—the active direction of companies to sacrifice returns that rely on cost externalization—is clear. It is less clear what mechanism in support of price collusion is made available by common ownership. It would be something like managers of each company being comfortable that if the cartel fails because rival firms break the consortium, shareholders will not punish the non-defecting firms for losing market share. This feels much more attenuated than enforcement of beta activism. Moreover, because diversified shareholders rely on an expanding economy and the success of a broad array of businesses, they would seem less likely than concentrated owners to favor collusion in an industry if it raises business costs and reduces economic productivity.

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With increasingly indexing markets, concentration, and externalized social and environmental costs rising, distinguishing common owners' promotion of responsible practices from welfare-shrinking price collusion is critical for economics, law, and finance. ECO is an important contribution to the field.