Purpose, profit and ESG with Alex Edmans – Part One
Baringa's Climate and Sustainability Trailblazers Podcast

Emily Farrimond [00:00:00] Welcome to our Climate and Sustainability Trailblazers podcast with me, Emily Farrimond. Today, I'm delighted to be joined by Alex Edmans, professor of Finance at London Business School and author of Grow the Pie: How Great Companies Deliver Both Purpose and Profit, which is also a Financial Times Book of the Year. Welcome, Alex, and thank you for joining us. And can I say how delighted we are to have you on the podcast? I have to say that I think I am a super fan.

Alex Edmans [00:00:29] Well, thank you so much, Emily. It's really great to be here as well. I really appreciate the opportunity to share my views on these really important topics.

Emily Farrimond [00:00:35] So let's get started. I wanted to start by learning a little bit more about you. Could you tell us about your personal and professional interest in climate and sustainability?

Alex Edmans [00:00:43] Well, thanks, Emily, that's a great first question because I do lots of these podcasts, but few people ask me about the personal angle. I think you could obviously overanalyse this, but I think personally I've always been attracted to things with long term consequences. So, the very first hobby I ever had was playing chess. I started that when I was five years old. I eventually played for the England junior team. And so that's something where you want to look many moves ahead. You want to look at the long-term consequences of your actions. Then I started playing music. I had piano lessons also from when I was five. Again, that's something where there's short term pain. You'd rather be playing football than doing piano practice. But in the long term, you have a skill that you can enjoy for the rest of your life. And then I got into sports, and that's something which has continued. So, I'm really passionate about health and fitness. And again, with that, you will be training for a particular event that's time taken away from something else. It might be physically exhausting when you're doing the training, but afterwards this leads to long term benefits. And so, then when I became an academic, when I started my Ph.D. at MIT, I wanted to look at what drives a company's long-term success. And notice here, I was interested in sustainability from a company profitability angle. Now, I understand that many people think about sustainability because they care about wider society, and obviously that is also a motive. But that for me was not my primary driver. I wanted to think about what makes a company successful. And so, to me, some of this polarisation in the US with Republicans being anti-sustainability seems bizarre because, to me, sustainability makes a company sustainable. It's profitable for the long term and this led me to my first work looking at the value of employee satisfaction for long-term performance. A company that treats its workers well is not just being humane, it's being commercially savvy and it's generating higher shareholder returns than its peers.

Emily Farrimond [00:02:44] Fantastic. Thank you for sharing that with us. That was fascinating. I just wanted to start with a broad question really around purpose. So, you talk a lot about the importance of businesses having focused purpose. Can you just elaborate a little bit more on what you mean when it comes to the importance of purpose?

Alex Edmans [00:03:05] Certainly. And I think it's really good to have a serious definition as to what it means because everybody bandies around the word purpose nowadays, companies are always trying to claim that they have a purpose. And when they do that, they think about purpose being altruism. Let's serve wider society, let's serve customers and workers and stakeholders and the environment and suppliers and so on. That sounds great, but it's actually unrealistic because there might be trade offs. So, one trade off potentially is between shareholders and stakeholders. But even if we ignore profits, there could be trade offs between different stakeholders. If we shut down a polluting plant, then that's good for the environment, but it's bad for workers. So certainly, purpose should be about serving wider society. A person's purpose should be to have a life that positively impacts others, but you should also serve society in a focused way. So, if I think about what the word purpose means in the English language, if I do something on purpose, I do it deliberately and similarly for a company it could choose to serve society in a particular focused way. So even though climate change is the world's biggest threat, maybe that should not be the focus of every single company, maybe part of your purpose, or maybe your main purpose, should be financial inclusion. So that also positively contributes towards society. But when there's many people, particularly in the global south, who are unbanked, maybe that's the biggest way in which you can serve. We don't want to tick every single box. If we try to tick every single box, then we might be spread too thinly and too diluted.

Emily Farrimond [00:04:47] I think that's a very interesting and relevant point. I think when we're talking to our clients, they often look at the SDGs and feel that they need to be able to tick off all 17 of them rather than being quite thoughtful about where they can drive the most benefit through a select few SDGs.

Alex Edmans [00:05:05] So that's a really important point, Emily, because who are the SDGs for? These are goals to be achieved at a country level. So, a country can achieve the SDGs, even if one particular company might address numbers one, eight and fifteen, if there's another company which aren't addresses two, seven and nine and so forth, it can be that as a country we achieve these 17 really important goals. But that doesn't require every individual company to tick every box.

Emily Farrimond [00:05:34] Yeah, absolutely. And I think we're starting to touch on it there anyway. But I'm just interested in your thoughts around the interplay between purpose, sustainability and ESG.

Alex Edmans [00:05:46] Yeah so this also is important because those three words that you mention are three words which are often used interchangeably, but there might be quite important differences between them. So, ESG, or environmental, social and governance, to me at least as I see it currently practised, is pursuing ESG factors to improve particular ESG metrics. So, you might reduce carbon emissions, you might increase employee wages or reduce the CEO to worker pay gap, or you could increase gender and ethnic diversity in the boardroom. And these are absolutely not bad things to do, but often the motivation to do them is instrumental. It's in order to boost ESG metrics. But I see purpose as creating value for wider society, even if it's something that we can't immediately put in ESG metrics. For example, it might be what matters in terms of diversity is not just demographic diversity, but cognitive diversity. So, I would count as diverse because I'm an ethnic minority, but maybe somebody who is from a very different socioeconomic background than me, maybe he would add more diversity than I would to a team, even though he might be a white male. Or what might matter is not just the diversity of who you bring in, but inclusion. So, the inclusiveness of corporate culture. And if you improve that as a company, you might not take any boxes, but you do it because you think it's the right thing to do. And one might think things are similar with the environment. Obviously, climate is really, really important, but a lot of focus might be on climate change mitigation. How can we cut carbon emissions or how can we fund renewable energy? Not so much climate change adaptation. How can we invent crops that can grow in warmer temperatures or even environmental factors beyond climate? So now we do recognise the importance of biodiversity, but that was something that some companies were already recognising many years before this was in play and they had to do it because people were looking at it. There were some companies who thought about this intrinsically because they saw that this was a way in which they impacted society. So, I talked about ESG, I talked about purpose. Sustainability, I see more in the same breath as I would do purpose. So, creating sustainable organisations, those are ones that are going to be there for the long term. And that requires, yes, hitting ESG metrics, but it also means doing things which don't fall under a specific ESG label or can't be measurable. So, through pursuing a purpose, you create a sustainable organisation.

Emily Farrimond [00:08:35] Fantastic. Thank you for sharing your thoughts on what I know for many at the moment is a complex quagmire of different definitions around purpose, ESG and sustainability. You touched on it a little bit there, but we are starting to see business prioritise ESG initiatives specifically when there is stakeholder pressure and that really can come from a number of competing voices really across NGOs, investors, regulators and customers. I think we're finding, particularly for our clients in financial services, they're seeking to understand how they can better respond to stakeholder pressure, specifically on ESG and climate, around some of the lending that they're doing in segments such as oil and gas. I'd be really interested in your views about how they need to try and balance those different stakeholder pressures.

Alex Edmans [00:09:28] Yeah, this is an important question, I think one which is sometimes somewhat misunderstood. So often financial institutions will think, "well, my goal is to have a net zero portfolio". However, what our goal should be is to have a net zero economy, and that might not mean having a net zero portfolio. So, the way in which I can move towards a net zero portfolio is if I was to sell all of my oil and gas equities, but if I sell that, then somebody else buys from me. So, I think first we should try to understand, what are the correct mechanisms in order to achieve the change that we want. And it might not actually be divestment. Why? A couple of reasons. Number one, if I sell, somebody else buys, and it might be better for me to hold and engage with the company by saying I will lend to you or hold your stock, but the only way I will continue to renew my loan or continue to hold my stock is if you meet these particular targets or maybe you meet your own targets, but I would like to make sure that you actually hold to the plan that you've committed to. The second issue is that often we think, well, how do we create a green portfolio? Let's move out of brown stocks and into green stocks. But identifying what is green and what is brown is actually very difficult. So, with fossil fuels, we might say, well, automatically they're brown because they are emitting a lot of carbon, but we often use green and brown not just for climate but for social value generally. And one might say that in 2023, fossil fuel companies do still create social value because we don't have enough renewable energy sources to meet the world's demand for energy. So, there are many countries, particularly developing countries, who do need industrialisation in order to improve living standards. So, the UK was able to benefit from the industrial revolution, which caused a lot of pollution, a lot of forced labour, which we would now abhor if another country was to do that, we benefited so why can't it be that potentially other countries benefit. I also mention that there are many people who rely on this sector for jobs. We talk about stranded assets, but there could be human stranded assets if indeed these industries are shut down and people are not easily able to find other jobs. So, is it definitely the case that fossil fuels are brown? Not necessarily. So clearly, the bar for any financial services client to invest with a fossil fuels company should be higher than, say, financial services or pharmaceuticals. But should this bar be infinite? I would say not necessarily. If you are investing in a market leader which is really transitioning and putting its plans into practice, I think you might still be somebody who should be investing in those companies.

Emily Farrimond [00:12:24] Thank you. I'm also interested to understand your thoughts around how investors can gain greater confidence and transparency around their investments in greener portfolios, assets and activities, to support them in really genuinely feeling comfortable and confident that those green assets are indeed green.

Alex Edmans [00:12:49] Well, I think I might first challenge the question a little again Emily, is that should they even have confidence that they want green investments because green investments might not mean greening the economy? If I'm just buying these green stocks from somebody else and I'm buying and somebody else is selling, I'm not actually providing net capital to the company. It might actually be better to have brown investments and to engage with those brown companies to make them greener. So, I think first, it's not automatically the case that investors should want to have as green a portfolio as possible, because the only way that you can decarbonise your portfolio is if you carbonise somebody else, because somebody needs to buy the stock that you've sold. And that you might think, who's buying fossil fuel stocks? It might be investors who care even less about climate change, so they're willing to allow that company to pollute as much as possible if doing so increases returns. But then let's say we do want a green portfolio for some reasons. I would like just to ask, or read in a prospectus if I don't have direct access, what does the fund mean by green? So, some will evaluate green in an absolute basis, some will think about the direction of travel. So, the Financial Conduct Authority has come up with this label called Sustainability Improvers, where they actually see a role to be had by funds which are looking at companies with a positive direction of travel. What does green mean? Does it mean just climate? Does it mean other environmental issues, so there's local pollutants like ozone or sulphur dioxide or nitrous oxide, which might be important? Does it mean social? And what does social mean? Is it just diversity or is it provision of financial inclusion? So, because green can mean so many different things to different people, which is fine because different people have different social objectives. I would like to understand what a fund is investing in, and often this might be said in the fund prospectus. One very simple check that you could have is to look at the holdings. So, on any broker, Hargreaves Lansdown which is my broker, I can go to any fund, I can look at the top ten holdings by company name, I can look at top ten sectors, I can look at top ten geographies. So for me, if green might actually mean investing in a lot of developing countries and I see the holdings are in the UK and in the US, then for me that wouldn't be green, whereas for somebody else, green would be to be investing in climate change or clean energy even within the UK and US, and that would be fine for them.

Emily Farrimond [00:15:20] Thank you. That was a great challenge and I feel like you asked and answered that. So, I think that's given our listeners much to think about on that topic. Moving on, you discussed at length how you feel the most irresponsible business practice is a business' failure to innovate. You cite Kodak's failure to invest in digital cameras and its subsequent bankruptcy, which led to 150,000 job losses and clearly impacted many families and livelihoods. I'd be interested in you sharing your thoughts on how businesses can better manage and more effectively deliver on both short-term priorities versus long term strategic and innovative goals.

Alex Edmans [00:16:02] Thank you for highlighting this point. So many people view sustainability as 'do no harm'. So don't cheat on taxes, don't pollute the environment, don't mistreat your workers. And obviously that is that is really important. Don't get me wrong. I highlight the importance of that. But any listener would have known that before giving up their time to listen to this podcast. So, for me, the real key bit of sustainability is actively doing good, actively creating value even if there was no outside pressure to do this. I often use the example of Vodafone launching M-PESA to lift hundreds of thousands of households out of poverty in Kenya by giving them access to mobile money. And so that was something where it didn't improve any ESG metric, it didn't reduce their carbon footprint or increase their board diversity, but that's something which created a lot of value for wider society. And then simply, what is the worst thing that a company can do for society? Not pollute or not cheat on taxes, but actually just being an ineffective company. As you mentioned, Kodak, this led to a huge amount of job losses and a huge amount of savings being destroyed. So how do we manage this challenge? First ,we need to acknowledge knowledge that this is an important challenge and there's not going to be a silver bullet that I'm going to give. But I will say that this challenge is not unique to sustainability or ESG. This challenge is here for any company for which innovation is important, which is virtually every company. Every company nowadays needs to innovate to keep ahead of the competition. And so, to me, this is why I view ESG as it should not be seen as separate from other business practices. I have this recent paper called the ‘End of ESG’ saying that we should apply similar principles to ESG like we would do to mainstream business practices, so we will tackle ESG just like any other type of innovation. So, well, what are the ways in which to make innovation successful? First is the horizon of incentives. So to ensure that the CEO, but also senior managers are tied to long term performance. So this might be through being given shares that they can't sell for five, seven, ten years. Number two will be communication with shareholders. So, there are many companies who will say, well, actually our quarterly earnings are not the metric by which you should evaluate me. So, Unilever, which is a leader in sustainability, when Paul Polman took the job, he said, I'm going to stop reporting quarterly earnings because this is not going to be giving a true picture of our results. Number three is there's many things that we can do to promote innovation within companies. So this will be not just diversity, that is important in terms of cognitive diversity, but what are the processes in place that we can foster in order to encourage innovation, inclusiveness, rebel ideas, dissenting viewpoints and so forth. And then I'd say number four, with innovation, it's useful to have or be willing to run with lots and lots of new ideas. So, the most truly innovative things, maybe 90% plus will fail. So that's true of new drugs, for example. And so, we want to cast the net really widely. We would like to have a culture where we can try things and fail. But if things are appearing to fail, that we have the confidence to pull the plug early. So great venture capitalists or great innovators, they'll pursue lots of ideas, but if they see that an idea is not succeeding, rather than throwing good money after bad and being unwilling to admit a mistake, they will actually cut this. So, if you think about X, which is Google's moonshot factory, they will actually give bonuses to people who find flaws, which will lead to whole ideas being nixed. And why is that useful? Well, it means that the resources will then be reallocated to the couple of ideas which are really going to be successful. But also, I am more willing to propose a really crazy idea if I know the culture will be that if there's a flaw, then people will find that out so it's not just on me to find everything that might go wrong with this. So, a great car has not just an accelerator pedal, but a brake pedal, and the more effective the brake pedal, the faster you could push on the accelerator pedal, because you know that if there is an issue that you can slam on the brakes.

Emily Farrimond [00:20:30] Fantastic. And given we're in the midst of the transition to a low carbon economy, I'm interested in your guidance to companies that need to make significant investments in innovation, such as clean technologies to enable their future business growth.

Alex Edmans [00:20:46] I would say that this is one of the areas in which actually the challenges have gone down over time. I won't say that the challenges are zero, but because there has been a lot of recognition from investors that, number one, this is not only good from a social standpoint, but number two, it's good from a financial standpoint, because if indeed we see the government action, maybe there'll be a global carbon tax at some point which will push us towards clean energy, then anybody who's a leader in this will be generating a significant amount of returns. So, what does this mean? Well, for company, often what you might be able to do is project financing. So even if you are overall a brown company, can you ring fence a green development and just raise financing for that? Sometimes it may well be that some companies would split up into traditional practices and the clean energy practice. But even if you don't demerge this, can we achieve project finance so that people who are willing to finance clean, green projects just by themselves, and you will often be able to raise that financing at an attractive rate of return.

Emily Farrimond [00:21:50] Thanks for listening to part one. With so much to discuss on this topic, we'll pick up the conversation in part two.