

# Long-term capitalism is not a new idea, but it has come into sharp focus in recent years

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# A fiduciary approach to long-term capitalism

### **Key points**

- As an asset manager we are a fiduciary for our clients, who are the
  owners of the assets we manage. This role obligates us to act in the
  best economic interests of our clients. Because more than half of
  the assets we manage are in retirement savings, we are particularly
  focused on creating and maintaining value over the long term.
- To this end, we are launching a research initiative designed to better understand the ways that a company can create long-term value for its shareholders. We undertake this from an economic and financial standpoint.
- One key component of long-term value creation is the relationships between companies and their key constituents, often defined as employees, clients, suppliers and communities. We see these relationships as a series of investments. Just as companies invest in intellectual property or in plant and equipment, they can also invest in stronger relationships with these key stakeholders with the goal of generating productive and innovative employees, loyal clients, robust supply chains and supportive business environments. We think these investments are critical for creating value for shareholders over the long term.

- Conversely, we also think there is a cost associated with not making these investments. When companies fail to invest, or when their interactions with key constituents are negative, they can harm their own long-term prospects and impede value creation, as potential talent stays away, clients turn elsewhere and community or regulatory opposition limits growth.
- Our intent is to conduct data-driven research to better understand the linkages between these investments and the creation and maintenance of shareholder value over the long term. As part of this we hope to broaden the public discussion around long-term capitalism and to create a forum for engagement and dialogue among asset owners, asset managers, companies, employees, community groups, policymakers and regulators, non-profit organizations, media, academics and more.

Long-term capitalism is not a new idea, but it has come into sharp focus in recent years. Today, a wide range of voices is increasingly calling on companies to look beyond maximizing profits in the short term, and companies themselves are increasingly focusing on the benefits of engaging with their key constituents.

This focus on engagement with key constituents – principally employees, customers, communities, suppliers and governments – is in some places termed 'stakeholder capitalism,' which itself is open to many interpretations. On one end of the spectrum, sceptics see a direct conflict between the interests of stakeholders on the one hand and of shareholders on the other, suggesting that anything that is 'given' to stakeholders must be 'taken' from shareholders. On the other extreme, some of the strongest advocates of stakeholder capitalism see shareholders as one category of stakeholders among many, without a greater claim to corporate priorities than the others.

Our own point of view sits between these extremes. We start from our position as a fiduciary investor. We manage other people's money, not our own; the assets we manage are owned by our clients. As a fiduciary, we are responsible for managing these assets in our clients' best interests. Because more than half of the assets we manage are related to retirement, we are particularly focused on creating and maintaining value over the long term.

Therefore, we focus on companies' relationships with their key stakeholders as a means to create value for shareholders over the long term, above and beyond the benefits these relationships yield to stakeholders.

We see mutually beneficial relationships between companies and the employees, customers, suppliers and communities that they rely on to prosper as a prudent approach to running a business well over the long term.

Accordingly, we see long-term capitalism as a series of long-term investments. Just as companies invest in intellectual property or in plant and equipment, they can also invest in stronger relationships with key stakeholders – with the goal of generating productive and innovative employees, loyal clients, robust supply chains and supportive business environments, while at the same time reducing regulatory and reputational risk. We think that investing in productive relationships with key constituents is one of the critical ways that companies can create value for shareholders over the long term.

Conversely, we think that when companies do not make these investments, or when their interactions with key stakeholders are not constructive, they can harm their own long-term prospects and impede value creation, as potential talent stays away, clients turn elsewhere and community or regulatory opposition limits growth. Poor relationships between companies and their important stakeholders may create adverse impacts that can generate legal, regulatory, operational and reputational risks.

While we believe that stakeholder interests and shareholder value are ultimately moving in the same direction, we do not expect this to be true in every case or every industry or every region or over every time period. Understanding where and when this argument holds true and where and when it does not will be a key part of our research agenda.



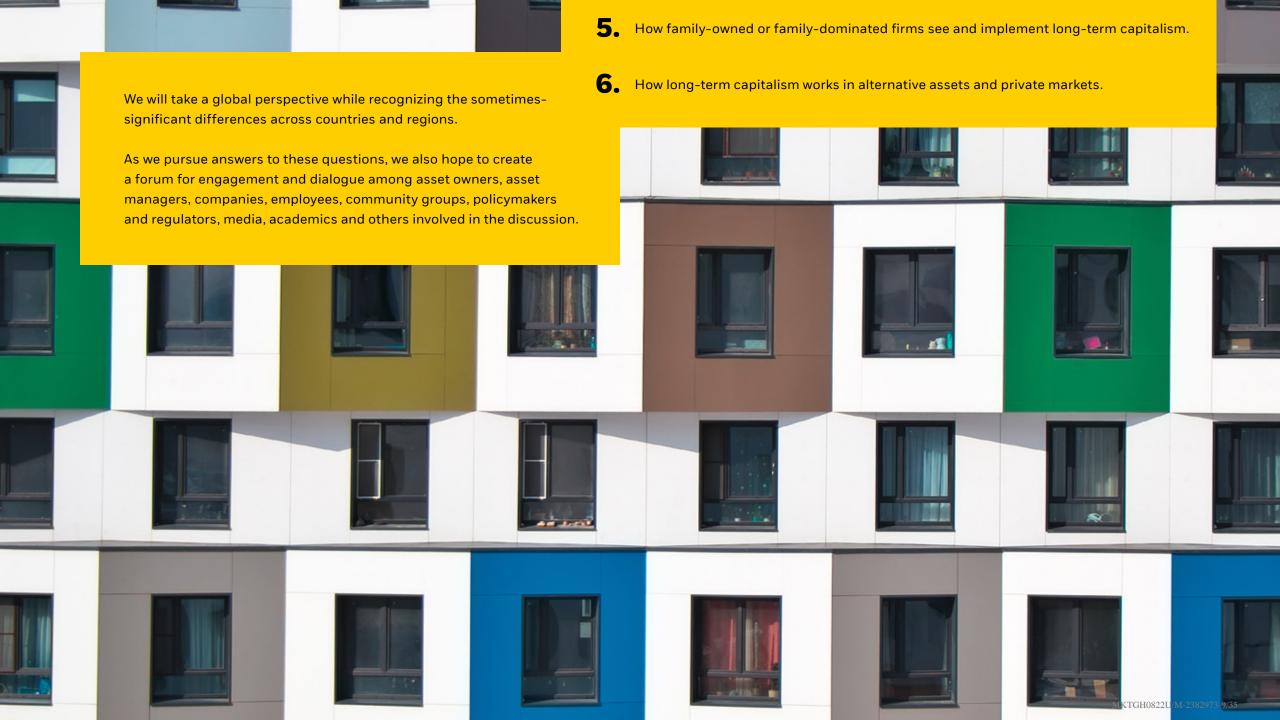
Our initial research into the foundations of long-term capitalism is meant to better understand the linkages between investments in key constituents and the creation and maintenance of long-term shareholder value.

We intend to conduct data-driven research in order to identify how different stakeholders contribute to long-term performance, and how this varies by industry and by region. We will assess the transmission mechanisms between companies and stakeholders that drive value creation and will evaluate how to measure both corporate behaviours and their impact on corporate performance. We will work to distinguish the data and metrics that are material to corporate performance from those that are merely easy to provide.

#### More specifically, we will look at questions such as:

- How investments in key constituents generate value and how we can measure their impact.
- 2. How companies can identify their material constituents and prioritize among them, focusing on investing in the relationships that will create the most value while not alienating those that may be less important for value creation but still carry the risk of value destruction.
- 3. What stakeholder-related metrics are material to a company's financial performance.
- How different types of asset owners think about long-term capitalism and how this may affect capital flows.





## **Employee sentiment and corporate culture**

We <u>find</u> that employee sentiment can be an important driver of better company performance, as workforces with better morale and satisfaction can generate higher productivity. Enhanced productivity in turn is correlated with higher returns. We assess this by collecting data from networking and employee review websites, conference call transcripts and other textual data sources, using modern machine learning (natural-language processing).

We use this data to construct signals reflecting employee sentiment and satisfaction. Digging deeper into the analysis, we find that non-monetary benefits, such as quality of the workplace, training and education opportunities, are particularly influential in determining employee satisfaction.

We find that companies with strongly positive employee sentiment and satisfaction outperformed companies with low employee sentiment and satisfaction consistently from 2017-2021. Excess returns have historically been driven both by out performance by companies with the most satisfied employees and by under performance by companies with the least satisfied employees.



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Source: BlackRock Systematic Research, Vertical knowledge, as of December 2021. BlackRock analysis of employee sentiment as of December 2021. The chart shows cumulative absolute returns (stock price) for companies with the highest and lowest employee sentiment within the MSCI World universe (2017-2021).



# Why a company's investments in its key stakeholders matter for longterm value creation

# In the broadest sense, everyone who interacts with a company in any way becomes a stakeholder.

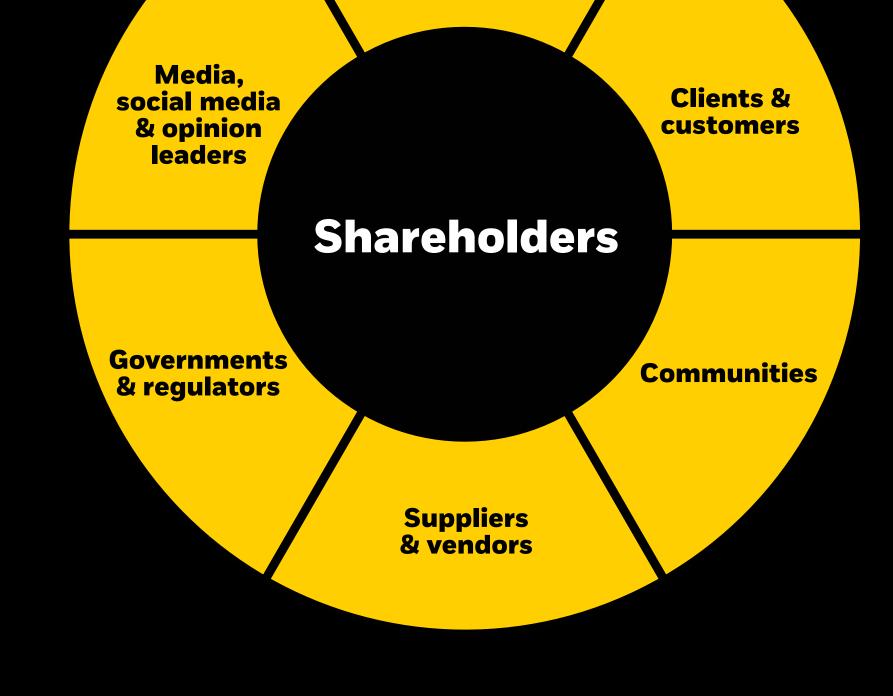
The most obvious ones are employees, clients, suppliers and governments, whose interests must be taken into account nearly every day. Other groups, such as the media, NGOs and academics, have fewer direct interactions but still can play an important role in shaping a company's reputation and social license to operate. Some aren't so tangible: when it comes to communities and the environment, for example, companies may recognize their important concerns but not have direct points of contact through which to address them.

All these groups can affect a company's reputation and success. But not all of them are material to a company's operational, reputational and financial performance, especially over the long term. Their relative importance will vary by industry and is likely to shift over time. And there are likely to be competing interests across groups of key constituents, which companies will need to balance and prioritize.

# Stakeholders & shareholders

Stakeholders





### For most firms, material constituents include:

## **Employees**

### Employees are the most obvious and in many industries the most critical category of stakeholders.

From an employee's standpoint, good compensation, benefits, working conditions and opportunities for career advancement can generate greater loyalty, more innovation and higher productivity. From an employer's standpoint, investments in employees can reduce turnover, improve hiring, raise productivity and strengthen client relationships. Conversely, dissatisfied employees are sources of reputational risk, while high turnover raises hiring, training and retention costs, reduces productivity and sends a negative signal to clients and investors.

# Clients & customers

### Clients care about well-made products and services, competitive prices and good customer service.

Beyond this, many clients also value the non-financial attributes of the goods and services they consume. Fair-trade commodities are an illustration. Focusing on social or environmental attributes and the company's role in the wider community may generate higher sales and greater brand loyalty; it can also provide an offset for higher prices and potentially an opportunity for better margins. Dissatisfied clients can drive reputational risk and declining market share, especially in competitive industries, and can weigh on hiring.

## Communities

### Communities matter at both the micro and the macro level.

At the micro level, investments in local communities can help to develop future customers, strengthen the talent pool for hiring and bolster a corporate brand. On the negative side, neglect of local concerns about jobs, pollution, traffic, property prices and the local environment can generate operational risk as well as reputational risk that extends far beyond that specific community. At the macro level, corporate approaches to taxes, lobbying and data privacy can generate reputational and legal risk, potentially leading to fines, antitrust scrutiny, unfavourable legislation, activity restrictions and higher tax bills. Concerns around climate change and the environment more broadly also play into community relations.

# Suppliers & vendors

### Suppliers are increasingly subject to scrutiny on issues around labor and environmental standards.

Supply chains can pose risks both upstream (reputational damage) and downstream (the potential loss of business from unhappy clients). This is true not only in input-intensive industries like consumer products, but also in sectors that rely more heavily on intellectual property. From a consumer standpoint, it does not matter how many intermediate steps exist in the supply chain, and how difficult oversight may be: if a company sells a product, it is responsible for any problems in production.

## Governments & regulators

Governments have the power to set standards, enforce regulation, challenge business decisions, make antitrust determinations and more.

They differ from other stakeholders in that their demands must be met, under penalty of law.

# Media, social media & opinion leaders

These groups may not have direct relationships with companies in the way that employees and suppliers do.

But they can still be seen as relevant stakeholders because they have the ability to influence a company's reputation and its social license to operate. Damaging and lasting reputational risk can arise from interactions that might in the past have been locally confined and quickly forgotten – particularly in the age of social media. This means that companies will need to invest resources in pinpointing and building relationships with diverse voices – some of whom may come from unlikely places and who may not be on companies' radar screens until a problem has already surfaced.

### Vignette 02

### **Employees**

It is increasingly recognized that diversity in the workforce fosters innovation, creativity and more robust decision-making. Diversity among employees creates a stronger talent pool and is linked to lower employee turnover and stronger financials. To evaluate one element of diversity, we look at the share of new women employees, which captures companies' most recent decisions and so can be seen as a forward-looking stance on diversity policies, talent recruitment and new commercial opportunities.

We compare the performance of companies with the highest proportion of new women employees against that of companies with the lowest proportion. Companies with the highest proportion of new women employees outperform, while the performance of companies with the lowest proportion has been roughly close to the market.

In addition, we have done preliminary analysis on the EEO-1 survey data collected by the US Equal Employment Opportunity Commission. As voluntary disclosure expands, this data is becoming the gold standard for workforce diversity data on race, ethnicity, gender and job categories. Our early work on a small sample in the IT sector also suggests that companies with higher gender and ethnic diversity tend to have higher rates of employee satisfaction, which in turn could be associated with better performance, as discussed above.

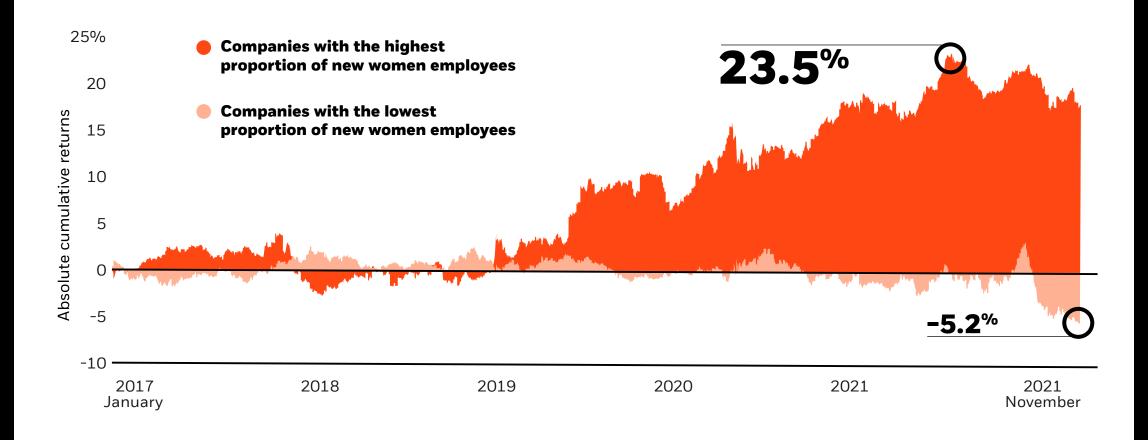


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Performance of companies with highest and lowest share of new women employees



Source: BlackRock Systematic Research, Asset 4, as of December 2021.

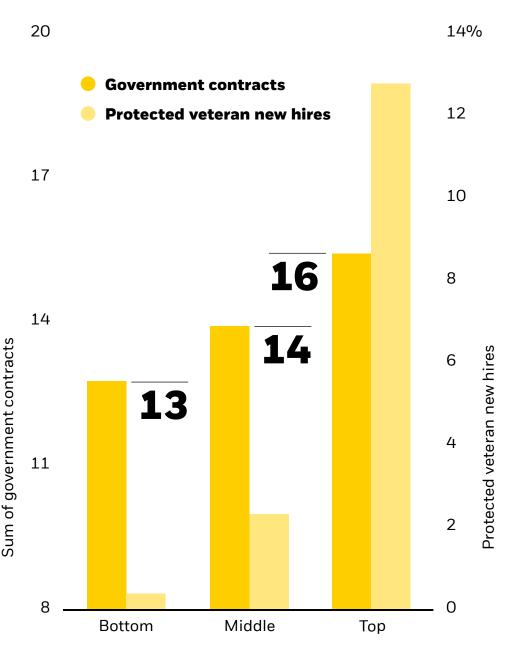
BlackRock analysis of the impact of new women employees on firm performance as of December 2021. The chart shows cumulative absolute returns (stock price) for companies with the highest and lowest proportion of new women employees within the MSCI World Universe (2017-2021).

# Firms hiring protected veterans have gained more government contracts

Government contracts across firms hiring protected veterans (US) (Firms grouped by % of protected veteran new hires).

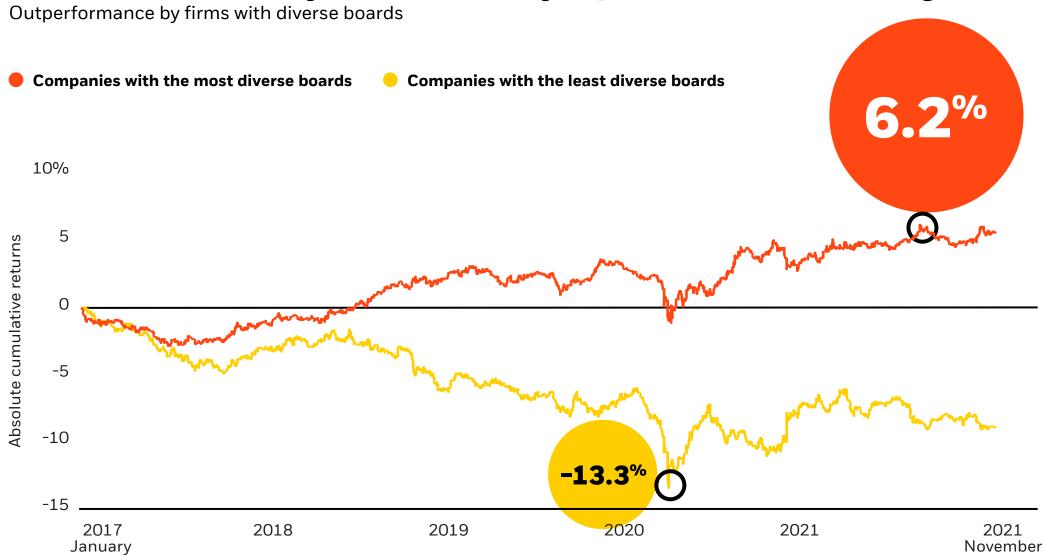
Looking at a different element of workforce composition, we find that hiring veterans can contribute positively to company performance, as well as to better employment and health outcomes in local communities. This is a 'double bottom line' result, with improved social and financial outcomes. Specifically, we <u>find</u> that private-sector government contractors that hire more veterans tend to be awarded more government contracts, resulting in potential new sources of revenue. At the same time, states where veteran hiring rates are higher may have improved health outcomes for veterans, as shown by lower numbers of veterans in need of health-care services.

In recent years companies have made a stronger push to integrate more diverse perspectives at the board level, not just within the workforce. Our preliminary research shows that firms whose boards have a strong representation of racially and ethnically diverse directors – who do not already hold multiple directorships – tend to perform better. We also find that our measure of racial and ethnic board diversity quality correlates with several additional positive outcomes for shareholders and stakeholders, including increased innovation, better financial management and higher levels of employee engagement and community involvement. To evaluate this aspect of board quality, we divided companies in the S&P 500 into quintiles, from lowest to highest board diversity score. We find that companies with the highest diversity score outperformed between 2017-2021.



Source (chart right): VETS-4212 Reports, USASpending.gov, BlackRock Systematic Research on firms across all GICS sectors, December 2020.

Returns from diversity are enhanced by expansive board recruiting



Source: BlackRock Investment Stewardship, ISS, as of December 2021. BlackRock analysis of the impact of board diversity on firm performance as of December 2021. The chart shows cumulative absolute returns (stock price) for companies with the least diverse boards and the most diverse boards within the S&P 500 Universe (2017-2021).



### Who is a shareholder?



In the context of longterm capitalism, it can be tempting to view 'shareholders' as a monolith – and a faceless one at that. **But shareholders differ** in their interests and time horizons.

Investors can be individual or institutional; hedge funds; pension funds, endowments and sovereign wealth funds; strategic partners or family owners. Some seek capital appreciation and/or dividend income. Some shareholders own shares specifically to push for change in strategic direction or management.

Given their differing investment objectives and horizons, shareholders' interests may not align and may even directly conflict, for example in the case of activists seeking near-term change that long-term investors do not see as likely to create value over time.

Whether the shareholder is a family saving for a home or education; a state pension fund managing the retirement funds of its public-sector workers; a sovereign wealth fund investing for the benefit of future citizens; or an endowment supporting the investments in education and infrastructure that underlie future economic growth, the benefits ultimately flow to individuals. It's important to recognize, as we said earlier, that asset managers are not asset owners. Asset managers like BlackRock are instead fiduciaries acting on behalf of asset owners – the shareholders.

It's also important to recognize that the lines between shareholders and stakeholders, and across different types of stakeholders, can be blurry. The same people often have multiple perspectives on a single issue. Employees of a company may also be its clients or customers. Employees typically live in communities where that company operates, and as taxpayers and voters, they may have a further set of interests around the broader community. They may also be shareholders, particularly if their compensation or retirement savings include equity in the company.

### **Clients**

Companies committed to building mutually beneficial customer relationships may stand to benefit from better business results.

Our <u>research</u> on consumer financial protection has shown a connection between real-time consumer feedback and the strength of financial companies. We collect alternative data showing geographically tagged consumer complaints on financial products through online public-facing data portals from the US Government. Our research has shown higher levels of complaints are tied to worse debt-to-income levels across counties and higher non-performing loans for financial institutions controlling for total deposits. Banks that receive more complaints and negative feedback may not be fostering consumer well-being (the stakeholder outcome) and are more likely to experience negative financial results (the shareholder outcome).



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# Why shareholders are different from stakeholders

Some commentators describe shareholders as only one on a list of important constituents, not fundamentally different from any other group of stakeholders. In our view, however, they are not the same.

Legally, in much of the world, shareholders are owners with rights to residual cashflows and with control rights, including the appointment of directors to oversee managers. Legally, in much of the world, other constituents do not have these rights.

Ownership matters because companies seeking to balance competing claims need a 'north star' for decision-making. This is true regardless of where the conflicts arise: whether between stakeholders and shareholders or among different categories of stakeholders. The ultimate primacy of shareholder interests can provide an anchor for decision-making – while not undercutting the view that relationships between the two groups can be mutually beneficial and can help to create value for shareholders. Saying that shareholders' interests must ultimately carry the day is not to say that stakeholders don't matter.





# How engagement with stakeholders can generate value for shareholders and stakeholders alike

Our research initiative will focus on datadriven research to investigate and understand the ways in which long-term capitalism creates and maintains value for shareholders.

To illustrate the type of research we will do, we offer a handful of examples of analysis that has already been done at BlackRock, (including BlackRock Systematic and BlackRock Sustainable Investing)<sup>1</sup>. These examples are placed throughout the report.

These teams analyze non-financial data, such as gauges of employee sentiment and diversity data, to capture financial outcomes, such as profitability, efficiency and productivity. These non-financial data can help us to assess future earnings and returns as well as to evaluate the financial and societal outcomes they can create. While this analysis draws on traditional company fundamentals and standard environmental, social and governance (ESG) measures, we also find utility in leveraging alternative data sources and the vast quantities of unstructured data that are now available.

### Community

Environmental issues typically fall under the umbrella of stakeholder concerns, since a company's environmental footprint also affects its communities, employees and clients. We <u>find</u> that improved environmental performance – reducing emissions, water use and pollution – drives stronger financial performance. For example, companies with lower carbon emission intensities tend to have higher excess returns, which is consistent with these companies being more efficient in their production overall. This is true regardless of the state of government penalties and rewards, and it applies for all firms, not just for resource and commodity firms.

These relationships may be concurrent rather than causal: companies that are more efficient in carbon utilization do tend to have more efficient operations overall. Carbon efficiency tends to be a marker of behaviours that are broadly indicative of efficient operations across the business.

We have also <u>looked</u> at firms that commit to meeting external standards, such as LEED certification for new buildings and the Science-Based Targets Initiative around emissions reductions. We find that nearterm and specific commitments tied to these external standards are linked to lower emissions in the future. Companies with more LEED certified buildings tend to outperform companies with fewer.

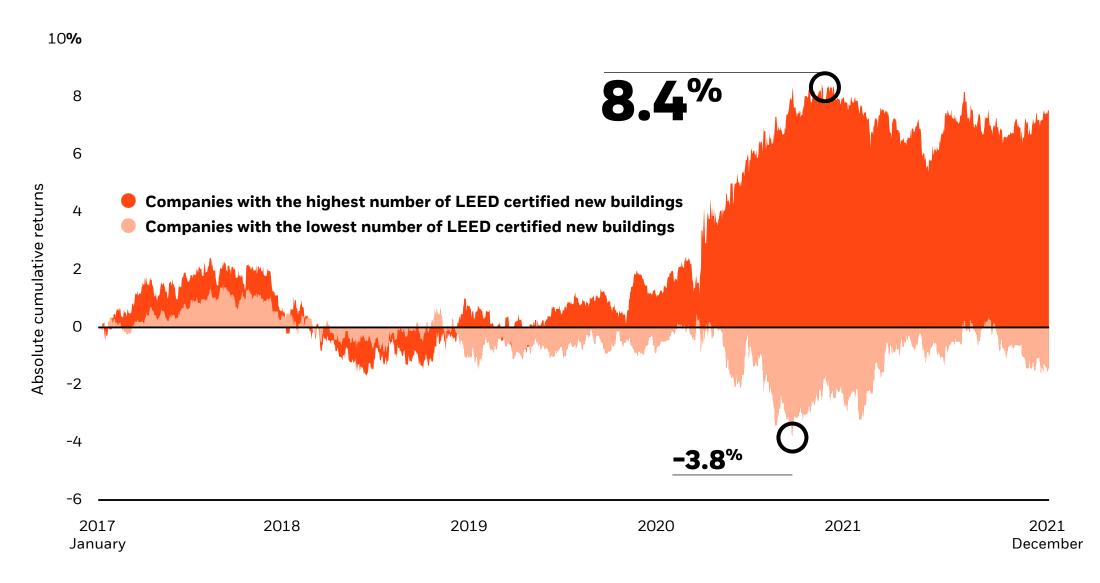


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### The impact of LEED certifications for new buildings on firm performance

Outperformance by firms with a higher number of LEED certified new buildings



Source: BlackRock Systematic Research, US Green Building Council, as of December 2021.

BlackRock analysis of the impact of LEED certifications for new buildings on firm performance as of December 2021. The chart shows cumulative absolute returns (stock price) for companies with the highest and lowest number of LEED certified new buildings.

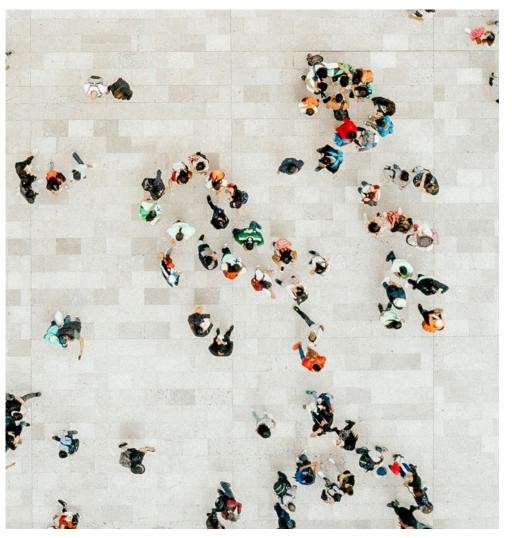
### Community

Taking a broad view of what constitutes a community – in this case, a broad swathe of society rather than a specific geographic location – also allows us to evaluate research and innovation through a stakeholder lens. We find that research and innovation in the social dimension are linked with long-term outperformance.

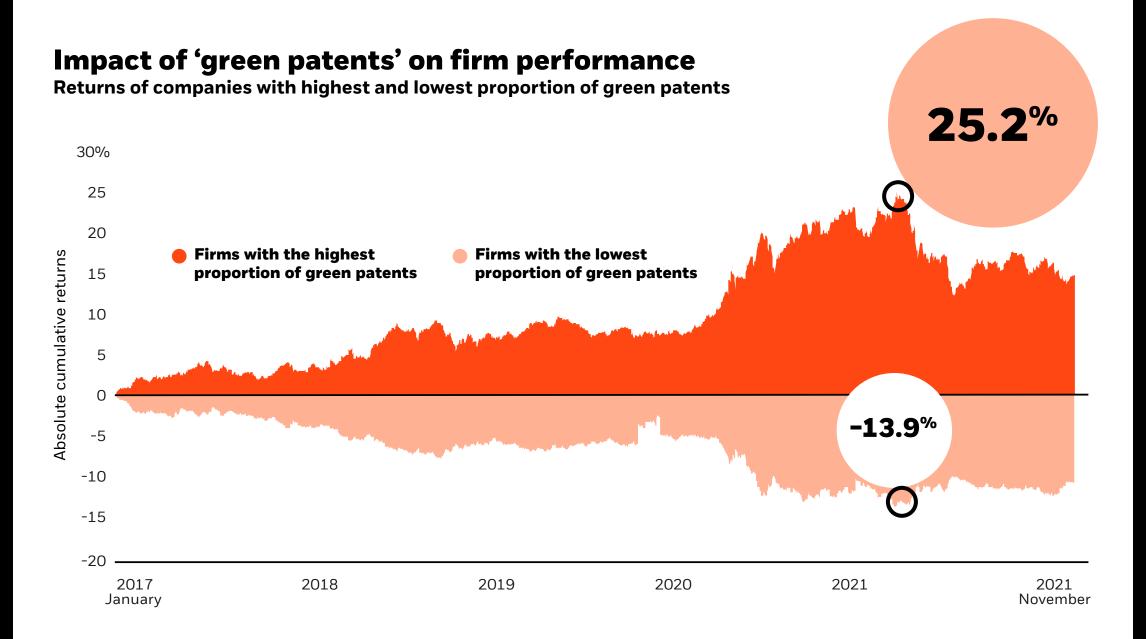
'Green patent' filings, relating to green technologies, are highly correlated with R&D spending, suggesting that companies that file a greater number of green patents compared to peers may be making larger investments in innovation.

<u>Companies</u> with the highest proportion of green patents tend, on average, to have higher earnings and ultimately higher returns than their peers. Using machine-learning techniques to analyse employee reviews and corporate call transcripts, we find that companies with more mention of words tied to 'innovation' may benefit from improved productivity and higher profitability than their peers.

At a company-specific level, we can also see investments in community stakeholders as a potential source of future growth. For instance, consider a financial firm developing pilot programs to integrate small and medium enterprises into the formal payments system or to expand their access to credit. These programs could improve community outcomes while creating a new pool of clients and strengthening the firm's brand and reputation.



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Source: BlackRock Systematic Research, IFI Claims Patents, as of December 2021. BlackRock analysis of impact of Green patents on firm performance as of December 2021. The chart shows cumulative absolute returns (stock price) for companies with the highest and lowest proportion of green patents within the MSCI World Universe.

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