The Friedman Doctrine vs Larry Fink & Additionality (again)

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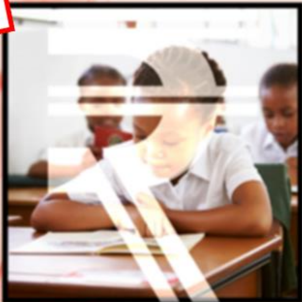

PRICING IMPACT

Extending impact investing to price externalities and lower the cost of capital to impactful investments

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Recently, an interesting response to the notes I have been writing raised two points of disagreement.

The first point revolves around the purpose of corporations. It is the apparent conflict between, on the one hand, Milton Freidman's argument that the responsibility of a company is to its shareholders (expressed by maximizing shareholder value) and, on the other hand, the belief expressed by Larry Fink in his 2019 letter[1] to CEOs that a company's purpose is important to creating sustainable long term growth and profitability, purpose being a broader concept taking into account a wider group of stakeholders than Friedman's narrower view focusing on the maximization of shareholder value.

The punchline was that investors want maximization of shareholder value, not the consideration of other stakeholders needs and, until this changes, the broader approach espoused by Mr Fink will be a bust as companies practicing a broader approach will be outcompeted by those practicing the Friedman Doctrine and get absorbed by rivals or targeted by LBO groups.

The second point revolves around the role of additionality in creating impact. The critique was that full-market-return impact investing adds no additional social impact. Rather, the type of investing undertaken by DFIs such as IFC is potentially the most impactful by paving the way for private capital.

Let us begin with the Friedman Doctrine versus a broader view of who is a corporate stakeholder.

My view is that it is entirely possible to retain the Friedman Doctrine as the operational paradigm and still reach the conclusion that corporations need to take impact into account in order to maximize shareholder value.

In his 1970 New York Times[2] piece Friedman focuses on a principle-agent problem and what exercises him is corporate executives who spend corporate funds on things which they value but which lack a clear alignment with maximizing shareholder value:

"Of course, the corporate executive is also a person in his own right. As a person, he may have many other responsibilities that he recognizes or assumes voluntarily–to his family, his conscience, his feelings of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job, for example, to join his country's armed forces. If we wish, we may refer to some of these responsibilities as "social responsibilities." But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are "social responsibilities," they are the social responsibilities of individuals, not of business."

Friedman is clear that what matters, what should drive the actions of corporate executives, is the desires of the principals, the shareholders. However, he recognizes that it is possible that the desires of the shareholders may extend beyond purely profit motives (emphasis added):

"In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. *Of course, in some cases his employers*

[1] https://www.blackrock.com/hk/en/insights/larry-fink-ceo-letter

[2] "The Social Responsibility of Business is to Increase its Profits". Milton Friedman, New York Times Magazine September 13 1970

may have a different objective. A group of persons might establish a corporation for an eleemosynary purpose for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.*"*

It is all down to what the shareholders want.

So what do shareholders want?

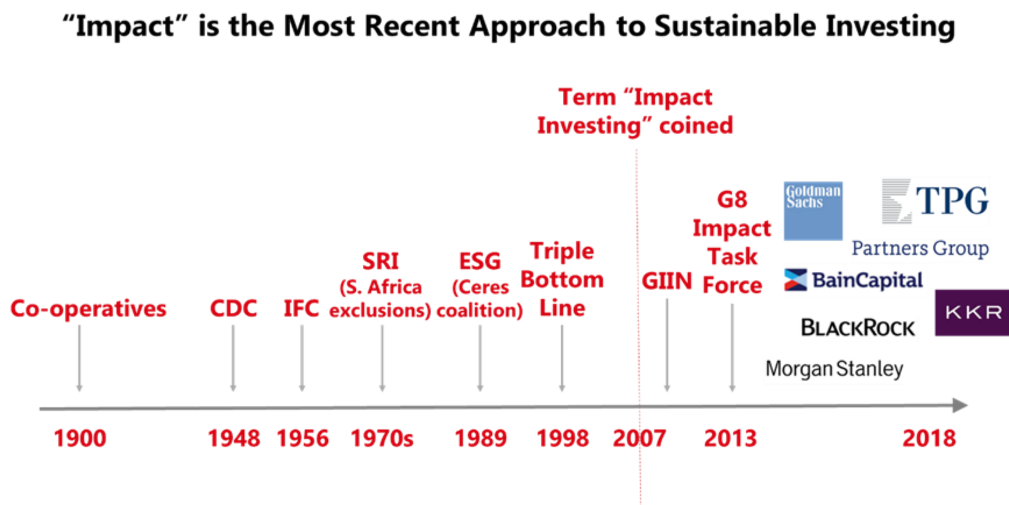
In my experience travelling globally to meet with large institutional investors, family offices and wealth advisors, these financial intermediaries increasingly are finding that their clients, who are the ultimate owners of capital, want impact incorporated into the management of their portfolios. The demand for the inclusion of impact in a new risk-return-impact approach to portfolio management is coming bottom-up from the ultimate owners of capital – individual savers, members of pension funds, family members – and is geographically very widely spread.

So widely spread that I think the relevant question is not if, but when, will the inclusion of impact into investor mandates alongside risk and return begin to send pricing signals that investors who lack an interest in impact cannot afford to ignore? Not if, but when will around a third of invested capital be considering impact alongside risk and return, reaching the tipping point at which it becomes necessary for all investors to consider impact as a relevant variable in capital allocation decisions?

Impact is still a young investment discipline and, in my view, it suffers from design issues which hinder its broader adoption into portfolio management. It is in response to these design issues that I wrote 'Pricing Impact'[3] and the other notes which enlarge upon it. There is enough investor interest in impact globally that, one way or another, the design issues will be solved and impact will be included as a decision variable across enough investor mandates to reach the tipping point within, I believe, five to ten years.

Investor interest in impact will be identified first by the financial intermediaries whose clients are the ultimate owners of capital. There is no doubt that these intermediaries have recognized the rising client demand for impact, as illustrated in Chart 1 by the recent rash of activity in the impact space by large financial intermediaries.

Chart 1   Timeline of the Evolution of Impact Investing



[3] "Pricing Impact. Extending impact investing to price externalities and lower the cost of capital to impactful investments" David Wilton, September 2019 available at https://zhengpartners.co

It is not a large step from recognizing the shift in client demand to anticipating the potential consequences of this shift in demand for the pricing of capital.

Incorporating impact as a third variable alongside risk and return in portfolio asset allocation decisions will, inevitably, alter the way in which capital is allocated in a manner which favors more impactful assets over less impactful assets. The cost of capital to more impactful assets will decline.

Larry Fink is anticipating this change in the pricing of capital when he writes in his letter to CEOs:

"As wealth shifts and investing preferences change, environmental, social, and governance issues will be increasingly material to corporate valuations."

Sam Zell is mistaken to characterize this as "I didn't know Larry Fink had been made God"[4]. Mr Fink is simply signaling market information for which he is well placed to be an early recipient.

Returning to the apparent conflict between the Friedman Doctrine and a broader view of who are stakeholders: in terms of reaching a decision on whether or not to incorporate impact considerations into corporate decision making, I do not see any conflict between the two viewpoints.

Once the point is reached at which a sufficient number of investor mandates require the consideration of impact, the maximization of shareholder value will require companies to include the impact consequences of their activities and decisions into their strategic thinking alongside risk and return.

The relevant question here is not which view point is correct. The question is "What is the probability that sufficient investor mandates come to incorporate impact that both viewpoints converge on the same answer: Corporate management needs to incorporate impact into its strategic thinking in order to maximize shareholder value?"

Impact investing is still new and developing. Reasonable minds can disagree on this probability.

However, occupants of the C-Suite who rigidly cling to a narrow and static interpretation of the Friedman Doctrine position themselves to fall into the trap sketched by Keynes[5]:

"Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist".

I hardly believe Milton Friedman to be defunct. His own writing quoted above suggests the Friedman Doctrine is more adaptable than a narrow reading would suggest.

However, wrapping oneself in a narrow and rigid interpretation of Friedman is likely to prove unhelpful in successfully recognizing and adapting to the evolving requirements of the ultimate owners of capital. Brandishing a rigid interpretation of Friedman as a talisman to keep back the tide of impact is likely to be as effective as King Canute's much earlier attempt to hold back the tide. By disregarding the evolving wishes of shareholders, corporate executives place themselves in the same position as the earlier generation of executives criticized by Friedman. Disregarding the evolving requirements of the ultimate owners of capital is likely to lead to diminished shareholder value.

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[4] Interview on Squawk Box

[5] The General Theory of Employment, Interest and Money, ch. 24, p. 383 (1935)

The economic precept which may be defunct is Marx's belief that capitalism contains within itself the seeds of its own destruction. Rather, capitalism appears to contain within itself the seeds of its own transformation. A market-based economy, receptive to signals, proves to be quite adaptable.

Now let us turn to the second point, the relationship between additionality and impact and the idea that full-market-return impact investing creates no additional social impact.

If we focus on the additional quantity of impactful outputs which an asset is likely to produce (such as jobs, access to education, carbon offset, etc), which is the relevant focus if we are to achieve the UN SDGs, then the question is: "What type of assets are likely to create the greatest increase in impactful outputs?"

Referring to the general theory developed in "Pricing Impact", the assets mostly likely to contribute the largest quantity of additional impactful outputs are those with the most attractive combination of:

- Contribution of organic growth to returns
- Scale, over which the organic growth is operating
- Exposure to a disadvantaged population as employees and/or consumers
- Exposure to high impact themes such as the environment, health, education etc

Additionality has no effect on any one of these four variables which, in combination, provide a good indicator of the potential quantity of impactful outputs an asset is likely to create.

So why is additionality seen by many as being central to the definition of impact?

Additionality occurs when you contribute to something which, in some way, would not happen without your participation. Without your participation it either would not happen at all, or it would happen at a smaller scale or at lower quality.

Conversely, if your involvement is not additional, then the thing would happen anyway. It would happen and it would happen at the same scale and at the same quality. You are interchangeable with any number of other people who would willingly get involved.

At its core, additionality is about attribution. Are the outcomes clearly and definitively attributable to my involvement or am I merely one of many willing and interchangeable actors so that the link between my involvement and the outcomes is, in a sense, diluted. I acted and things happened, but if I had not acted someone else would have and the same things would have happened.

But why does attribution matter, particularly in the context of achieving outcomes such as the SDGs in the framework of a market economy?

In the context of the actions of an individual investor with a mandate which requires additionality, attribution matters. For example, the shareholders of a DFI such as IFC require additionality as a means to ensure that the capital they have contributed to IFC is directed to activities that commercial investors are unwilling or less willing to undertake. The purpose of a DFI is not to replicate the actions of a commercial entity.

Additionality has meaning within the micro context of an individual investor with a specific type of mandate. It is a constraint to ensure compliance with the mandate. Attribution is the yardstick by which mandate compliance is measured.

In the macro context of a market economy, attribution of outputs to individual actors is irrelevant. Whatever the policy objective may be – reduce inflation, stimulate growth, achieve the SDGs – it is achieved by creating the right incentives for economic actors to behave in a manner which makes achieving the objective likely.

In a market-based economy economic goals are achieved by calibrating and re-calibrating the parameters within which market participants act to drive a large enough mass of capital in the right direction to achieve the desired goal: towards saving and investment to reduce inflation, toward consumption to stimulate growth, toward more impactful assets rather than less impactful assets to achieve the SDGs.

In this macroeconomic market context, attribution of outcomes to individual actors is without meaning. Attribution is irrelevant to achieving the desired outcome.

Were we discussing a centralized command economy, things would be different. In a centralized command economy each economic actor is given a target to meet which the central planner calculates will, when aggregated, achieve the objective. In this case attribution is important. The planner has estimated the required contribution from each economic actor and each actor has to demonstrate that it has contributed the prescribed amount. Or face the consequences of non-compliance.

Fortunately we are dealing with a market economy in which such fanatical accounting for attribution is irrelevant.

Chart 2 illustrates a potential chain of events which leads to the creation of increasing quantities of impactful outputs.

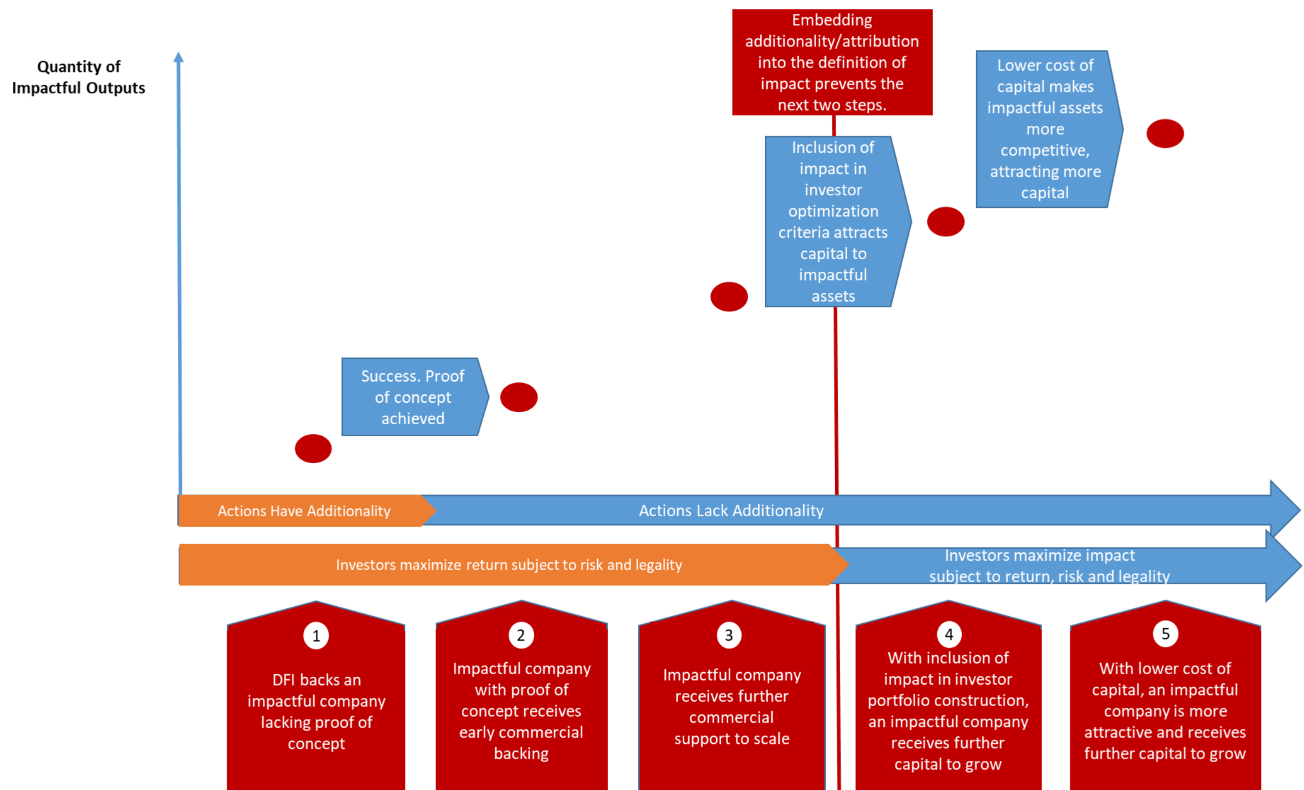
The initial 'spark' with which the chain of events begins is the action of a DFI with an additionality mandate. The initial action possesses additionality. All actions beyond this initial spark occur because economic actors are responding to their own mandates and incentives without any reference to additionality.

The first three steps in the chain take place in an economy in which investors are interested solely in maximizing returns within constraints of risk and legality.

After the third step in the chain, a change in investor objectives is introduced. Shareholders now include impact among the variables in which they are interested and the objective becomes to maximize impact within the constraints of return, risk and legality.

Including impact among the decision making variables directs capital toward impactful assets, lowering the cost of capital for these assets. The lower cost of capital makes impactful activities more commercially viable, which in turn attracts further capital.

Chart 2   Chain of Events Leading to Greater Quantities of Impactful Outputs



The quantity of impactful outputs increases steadily as we progress further and further along the chain of events, quickly dwarfing the initial impactful output of the initial action-with-additionality.

The initial action, which possesses additionality, cannot on its own create a large enough quantity of impactful outputs to achieve the SDGs.

The entire chain of events of additional actions and non-additional actions, brings us much closer to achieving the scale required to meet the SDGs.

What happens to this chain of events if we impose a strict additionality requirement?

In the market economy context we impose an additionality requirement through a definitional requirement that, without additionality, there can be no claim of impact. To claim impact, attribution is required.

With this definition in place, in a market economy in which the goal of shareholders is to maximize returns subject to constraints of risk and legality, the chain of events probably continues as far as the third step, at which point risk and return are in equilibrium relative to other assets and there is no incentive to invest further capital.

If shareholder preferences now change and impact is included in investor objectives, but the definition of impact is limited to "impact-with-additionality", the introduction of impact into investors' portfolio optimization will not initiate steps 4 and 5 in the chain of events. The additional quantity of impactful

outputs created by steps 4 and 5 when investors sought impact without the constraint of additionality is lost.

The constraint of additionality greatly reduces our chances of creating the quantity of additional impactful outputs required to achieve the SDGs.

The riposte to this might be "But investors who value impact-with-attribution will allocate their capital to the type of assets possessing additionality which ignited the chain of events".

The hope that additionality will crowd money into the types of investment that initiated the chain of events in Chart 2 is sometimes expressed by those working in philanthropy, NGOs and DFIs. Expectations that an additionality requirement will lead to a blow-out in funding for the types of investment undertaken by these groups are likely to be disappointed.

Chart 3 represents the impact opportunity space and is developed in the note "Extension of Section 6"[6].

The y-axis of Chart 3 is a rating from a general-theory-based scoring methodology indicating the additional quantity of *impactful* primary outputs an asset is likely to produce.

The x-axis is ordered low-to-high by the annual revenue generated by an asset. The percentages above each revenue bracket represent the potential simple quantity of primary outputs an asset is likely to produce, without any reference to whether or not the outputs are in fact impactful, as a percentage of the maximum score. The simple quantity of primary outputs is determined by the combination of (i) organic growth present at the particular level of revenue and (ii) scale, indicated by revenue.

The shape of the curve is driven by the relationship between (i) the presence of organic growth and (ii) scale, while the position of an asset within any revenue bracket is determined by the exposure of the asset to disadvantaged populations and high impact themes.

The low points of Chart 3 are at each extreme. At the left, high organic growth is off-set by very small scale, while at the right large scale is off-set by very low organic growth.

The colored bands crossing the chart indicate the degree to which an asset is exposed to high impact themes and disadvantaged populations.

As we move from left-to-right across Chart 3, five transitions take place.

(i) Scale increases.

(ii) The contribution of organic growth declines.

(iii) Exposure to High Impact Themes and Disadvantaged Populations declines.

(iv) Financial risk declines over the initial few columns of the impact opportunity space before normalizing over the remainder of the space.

(v) Financial return increases over the initial few columns of the impact opportunity space before normalizing over the remainder of the space.

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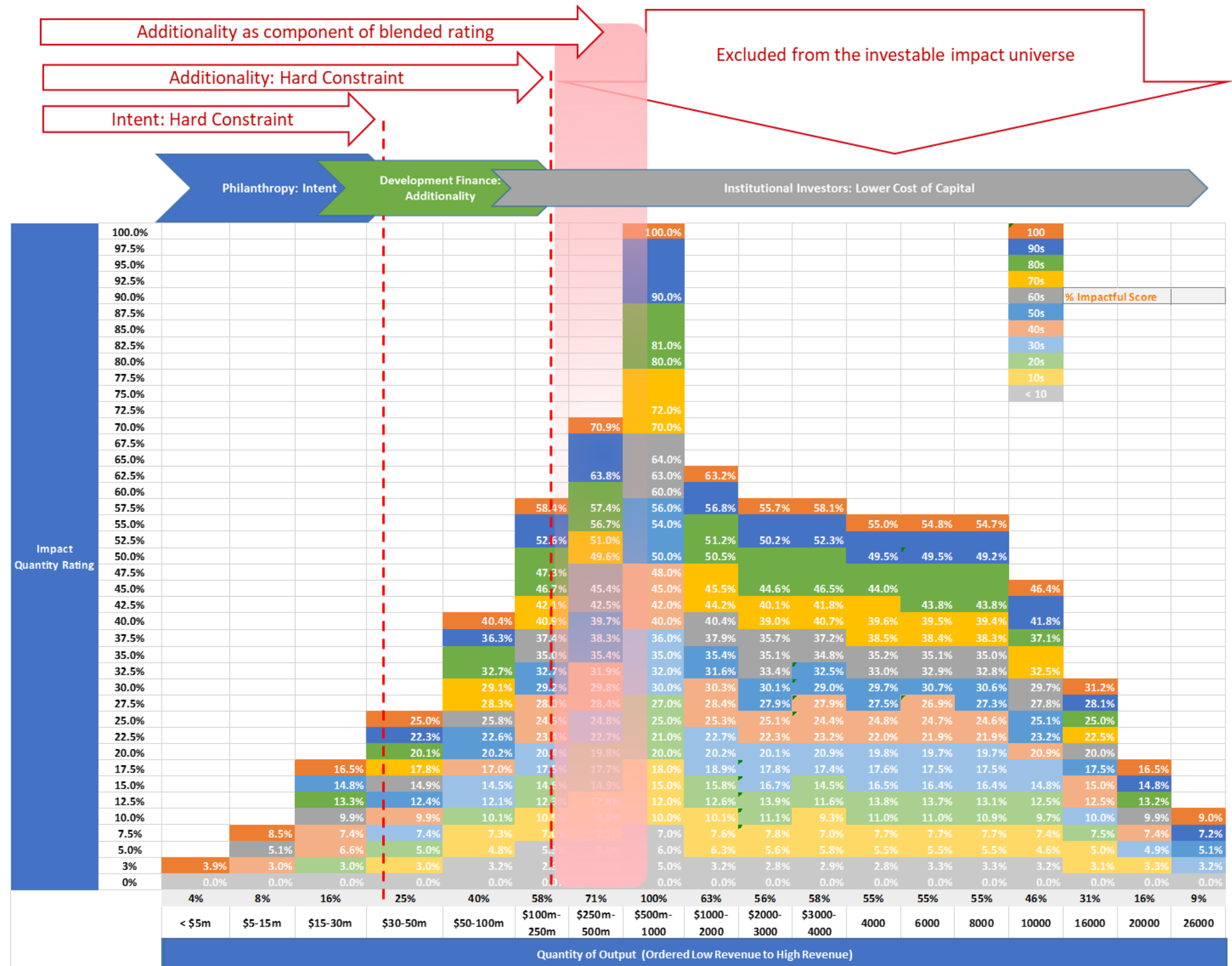
[6] "Worked Example of Mapping the Impact Opportunity Space Extension of Section 6", David Wilton December 2019 available at https://zhengpartners.co

Chart 3 The Effect of Hardwiring Intent and Additionality into the Definition of Impact is to Shrink the Investable Part of the Impact Opportunity Space



The result of these five transitions is that assets which are likely to be associated with additionality are clustered in the part of the impact opportunity space to the left of the two dashed lines. This is because assets in this area have smaller scale, which is frequently associated with lower return and higher risk.

Generally, it is easier to concentrate exposure to a single factor in a smaller asset than it is in a larger asset. Achieving larger and larger scale eventually necessitates diffusion of focus, especially in terms of exposure to Disadvantaged Populations.

Generally, smaller assets are the location of first time funds, start-up businesses, new ideas and innovative business models. As assets gain in size, they are generally moving from concepts to working models; from working models to proof of concept; from proof of concept to scalability; and from scalability to established corporatized businesses with both scale and full C-Suite functionality. As an asset moves through this progression, risk declines.

Generally, quite small activities with limited scalability have sub-commercial returns. Potential return increases with scalability. Smaller activities with the potential to scale but lacking proof of concept have the potential to generate commercial returns, but also carry higher risk, so risk-adjusted the expected

return may not be commercially attractive. Once activities have grown to the stage where there is proof of concept, returns begin to normalize around commercial levels.

Because assets which are located in the part of the impact opportunity space in which additionality is likely to be present are likely to be smaller, higher risk and lower return, they are unlikely to benefit significantly from an additionality-driven crowding-in effect. These assets are difficult for institutional investors to include in their portfolios in any meaningful volume for one or more of the following reasons:

- They are likely to be too small to meet minimum investment size criteria.
- They are likely to be too risky to contribute much to portfolio diversification.
- The return is likely to be below commercial expectations.

If we seek to achieve the SDGs by harnessing investor interest in impact through integrating impact into existing portfolio management processes, we are likely to achieve the increase in impactful outputs represented by steps 4 and 5 in Chart 2. This is likely to contribute much more to the large increase in impactful outputs required to meet the SDGs than an approach to achieving the SDGs that relies upon crowding-in.

Another group which occasionally expresses a belief that additionality is central to impact are occupants of the C-Suite who hold a limited interpretation of the Friedman Doctrine and would prefer it if the need to consider impact remained with the philanthropies and DFIs. Unlike those who see additionality as a potential constraint with which to crowd-in capital to their part of the spectrum, these corporate executives see additionality as a potential prophylactic to protect them from infection.

If the up-take of impact by the ultimate owners of capital develops into only a niche activity, these corporate executives will not need protection. They will be able to continue to maximize shareholder value while ignoring impact.

However, if shareholders' desire to incorporate impact into portfolio construction grows far beyond niche status, which I believe it will, the prophylactic powers of additionality will not provide protection from the diminishing shareholder value brought about by failing to take into account the evolving requirements of shareholders.

To achieve the SDGs I believe we need to create an investment ecosystem in which more capital is directed towards all impactful assets, both with and without additionality. The creation of impact will be maximized by taking advantage of all opportunities present in the impact opportunity space, not just this or that subset of opportunities.

Further, if we want to achieve the SDGs I believe we are better to frame the creation of impact in the same way as we frame achieving other macroeconomic goals. That is, to focus on incentives and the mass movement of capital, without concern for attribution.

Outside of a command economy, focusing at the micro level and requiring attribution[7] for each claim of impact by all individual actors is an over-constrained dead-end, as are command economies.

[7] Attribution goes beyond measurement to claim causality. The measurement of impactful outputs is very important for both credibility and to improve our knowledge of how impactful outputs are created.