The Cost of Stakeholder Capitalism

Executive summary

- Since 1986, the U.S. S&P 500[1] has outperformed the Stoxx Europe 600[2] by 3.25% annualized due to American capitalism's commitment to maximizing shareholder value.
- That outperformance is now under threat by a European-based ideology called stakeholder capitalism, which holds that corporations should prioritize not just shareholders, but anyone affected by their actions.
- American CEOs and asset managers are signaling their commitment to stakeholder capitalism and have allowed it to influence their business decisions under the guise of considering environmental, social, and governance (ESG) risk factors, especially by discouraging fossil fuel use and investment.
- After 2020, the American oil and gas major companies that stayed focused on shareholders' interests amid stakeholder pressure outperformed their European competitors, but that U.S. energy outperformance is now endangered by the same ESG constraints that dragged down Europe.
- Our thesis is that when a company deviates from its core mission to pursue social goals, its shareholders pay the price.

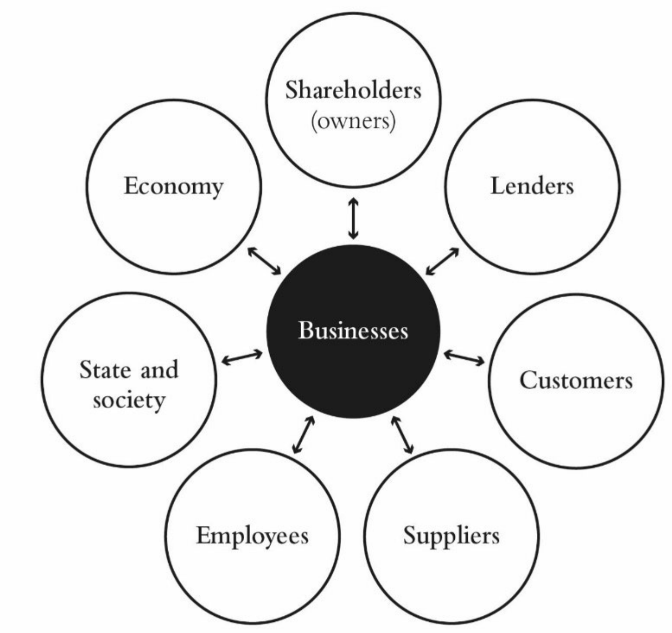
[1] The Standard and Poor's 500, an index tracking the performance of 500 of the largest companies listed on stock exchanges in the United States. The referenced index performance is shown for general market illustrations and is not reflective of any investment nor is it meant to represent Fund performance. Investors cannot directly invest in an index; unmanaged index returns do not reflect any fees, expenses, or sales charges. Past performance is no guarantee of future results.

[2] The Stoxx Europe 600, an index operated by Stoxx Ltd. tracking 600 large, small, and mid-cap European public companies. Indices cannot be directly invested in.

Introduction

American capitalism's stellar performance is under threat from an outside ideology that refuses to put profit first. That ideology is called stakeholder capitalism. It holds that instead of maximizing shareholder profit, a corporation should advance the interests of anyone affected by its actions. That means being accountable not just to shareholders, but to local and national communities, suppliers, and the environment.

Leading proponent Klaus Schwab illustrated stakeholder capitalism in 1971:



Source: https://www.weforum.org/agenda/2021/01/klaus-schwab-on-what-is-stakeholder-capitalism-history-relevance/

Since 2015, BlackRock, State Street, and Vanguard (the "Big Three" asset managers) have asserted their responsibility to promote society-wide sustainability by focusing on environmental, social, and governance (ESG) factors, especially by achieving the net-zero emissions targets of the Paris Climate Accords. That commitment to stakeholders extends far beyond their dedicated ESG funds. In 2021, for instance, the Big Three used the weight of all the shares in their non-ESG funds to join climate activist fund Engine No. 1 and override Exxon's management to install three directors on its board to focus the company on carbon emission reduction.[3]

Asset managers who implement stakeholder capitalism through ESG investing claim that doing so is consistent with their fiduciary duty to maximize returns. At Strive Asset Management, we are committed to shareholder primacy, the belief that corporations should maximize the long-term profits of their owners. We believe that when a company deviates from its core mission and pursues anything other than shareholder value, its shareholders pay the price. In this article, we quantify the costs stakeholder capitalism imposes on investors and show how it has infiltrated their portfolios.

Shareholder primacy outperforms

We don't have to speculate. Putting shareholders first has been tried by America, and it has performed very well, while putting stakeholders first has been tried for decades by Europe, and it has performed poorly.

Shareholder primacy is the foundation of modern American capitalism. In 1919, the famous case *Dodge v. Ford Motor Co.* held that corporations have a legal obligation to act in the best interests of their investors.[4] With shareholder primacy's rewards for innovation, the U.S. economy produced the modern world's greatest inventions, including assembly lines, airplanes, air conditioning, computers, supermarkets, cell phones, and the internet. Shareholder capitalism built the companies that built America.

The data reflects this point. A study in the *Journal of Finance* found that the U.S. market provided no special benefit versus other developed markets in the fifty years before *Dodge v. Ford*; it had only a 5.43% annualized total return.[5] Through the rest of the century, that rose to 8.22%. American capitalism found a sweet spot of profitability.

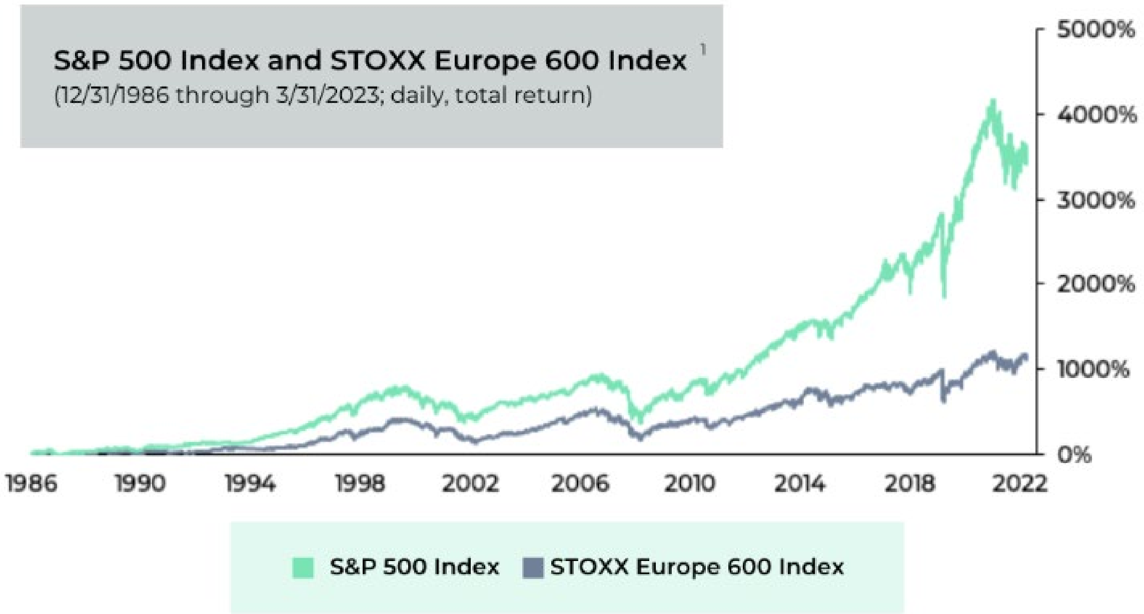
Fifty years ago, some executives and academics questioned that sweet spot and the diametrically opposed principles of shareholder and stakeholder primacy emerged from the debate.

[3] Jennifer Hiller, "Exxon loses board seats to activist hedge fund in landmark climate vote," *Reuters*, May 26, 2021.
[4] *Dodge v. Ford Motor Co.*, 170 N.W. 668 at 684 (Mich. 1919).
[5] Philippe Jorion, William N. Goetzmann, "Global Stock Markets in the Twentieth Century," *Journal of Finance,* (1999), p. 39.

University of Chicago economist Milton Friedman convinced America to rededicate itself to shareholder capitalism. His 1970 article "The Social Responsibility of Business Is to Increase Its Profits" argued that a company's responsibility is to maximize its owners' profits within the bounds of law.[6] Shareholders could then use those profits to advance their social and political preferences as they saw fit.

European countries diverged and implemented stakeholder capitalism, following the lead of University of Geneva professor Klaus Schwab. In 1973, hundreds of business leaders at the European Management Forum (now the World Economic Forum) released the Davos Manifesto, which began: "The purpose of professional management is to serve clients, shareholders, workers and employees, as well as societies, and to harmonize the different interests of the stakeholders."[7] The conclusion acknowledged the implication for shareholders: earning them profit was a mere means to the end of serving society.[8]

The results of Europe's experiment in deprioritizing shareholder profit are clear:



The above chart indicates that over the past 35+ years, American shareholder capitalism has outperformed European stakeholder capitalism by 3.25% annualized (measured by the

[6] Milton Friedman, "A Friedman doctrine - The Social Responsibility of Business Is to Increase Its Profits," *The New York Times,* Sep. 13, 1970.
[7] "Davos Manifesto 1973: A Code of Ethics for Business Leaders" (1973).
[8] Id.

S&P 500 and the STOXX Europe 600). U.S. stocks outperformed Europe by a smaller margin before stakeholder capitalism took hold there: when financial historians measured all the way back to 1900, they found that the U.S. market outperformed Europe by only 2.4% annualized despite two world wars.[9]

It's not rocket science: this is the difference between a market that tries to maximize shareholder profit and one that views it as a means to the end of serving other stakeholders. Swiss bank Maerki Baumann explains the difference in performance with operating margin: "The profitability of the companies in the S&P 500 is 30% better relative to the firms in the European Stoxx 600."[10] The data indicates that historically, companies that put profit first make more of it, and that translates into more valuable shares.

Stakeholder capitalism enters Americans' portfolios through ESG

Despite the data, many corporations and asset managers have recently attempted to redefine the purpose of American corporations by endorsing a shift toward the European philosophy of answering to all stakeholders.

In 2019, the Business Roundtable released a new "Statement on the Purpose of a Corporation" signed by the CEOs of nearly 200 major U.S. companies. The subtitle summed it up: "*Updated Statement Moves Away from Shareholder Primacy, Includes Commitment to All Stakeholders*."[11] It was the American version of Europe's Davos Manifesto.

Stakeholder capitalism quickly found its way into U.S. investors' portfolios under the guise of considering environmental, social, and governance factors. ESG investing often involves discouraging the use and production of fossil fuels. In 2020, hundreds of firms signed on to the Net Zero Asset Managers initiative, committing to "accelerate the transition towards global net zero emissions and for asset managers to play our part to help deliver the goals of the Paris Agreement and ensure a just transition."[12]

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[9] "Historical Returns of Global Stocks," *Mindfully Investing*, January 26, 2022.
[10] Gérard Piasko, "US and Europe – significant differences persist," Market Comment, *Maerki Baumann & Co. AG.*, Nov. 2019
[11] "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans," *Business Roundtable*, Aug. 19, 2019.
[12] "The Net Zero Asset Managers Commitment," *Net Zero Asset Management Initiative*, last accessed Aug. 29, 2023.

Today, the Net Zero Asset Managers initiative has 315 signatories representing $60 trillion in assets, which they use to pressure portfolio companies to reach net zero emissions targets. Crucially, these asset managers don't simply use the limited shares in their dedicated ESG funds to push net zero policies—as the Big Three did with Exxon, they use the vast holdings in their non-ESG funds to advance ESG goals.

ESG underperforms

We believe forcing ESG onto clients violates fiduciary duty. By definition, imposing any non-financial constraint like "ensuring a just transition" on investment decisions must hurt financial performance. As Lori Heinel, Global Chief Investment Officer at State Street Global Advisors, conceded, "I've been steadfast in saying, imposing a constraint on a portfolio, if you just do basic investment principles that's a constraint. And so, I have been steadfastly encouraging our teams to not think of ESG as a performance enhancement, for example."[13]

The standard move is for supporters of stakeholder capitalism to argue that ESG is all about considering financial risk factors, like disfavoring fossil fuel investment to avoid future regulations or stranded assets. But many financial institutions that publicly endorse ESG must not believe their own arguments, because they privately act as if ESG will lose money.

The SEC[14] and EU regulators[15] are both cracking down on greenwashing, the common practice of offering an ESG-labeled fund without any focus on ESG holdings. The obvious question is, if all those asset managers think ESG improves financial performance, why don't they practice it?

New evidence keeps emerging that many firms who offer ESG funds don't believe it makes money. The latest is a study finding that most ESG-labeled mutual funds load up on ESG stocks right before quarterly disclosures and sell them right afterward.[16] This standard practice of green window-dressing, say the authors, allows funds to keep their high Morningstar ESG rating but avoid ESG strategies' expected underperformance.

[13] Will Hild, *X*, Dec. 15, 2022, https://twitter.com/WillHild/status/1603492415410692111.
[14] Patrick Temple-West and Madison Darbyshire, "SEC lawyers subpoena fund managers over ESG disclosures," Financial Times, Aug. 15, 2023
[15] Caitlin McErlane and Kimberley Everitt, "European Union: ESMA ramps up ESG compliance and greenwashing scrutiny on asset managers," *Baker McKenzie*, July 12, 2023
[16] Gianpaolo Parise and Mirco Rubin, "Green Window Dressing," Feb. 28, 2023. Available at SSRN: https://ssrn.com/abstract=4459352 or http://dx.doi.org/10.2139/ssrn.4459352.

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Studies about ESG's actual performance are beset by cherry-picked timeframes and shifting definitions. For direct causal evidence, we can look to the relative performance of European and American fossil fuel producers because the energy sector is the one most directly affected by ESG investing, which implements stakeholder capitalism. The two continents' fossil fuel producers performed similarly for most of the last decade. Then European majors adopted ESG policies the American ones did not, and subsequently performed significantly worse due to those policies.

Stakeholder capitalism's effect on oil and gas company performance

Source: Bloomberg Finance

Shell and BP's shares performed similarly to their American sisters Exxon and Chevron for most of the last decade, but the record suggests that an anchor was strapped onto the European-based producers around 2020. That anchor is ESG, which constrained BP and Shell's decision-making more than their American competitors.

Shell[17] and BP set aggressive net-zero emission targets and accelerated the timelines of their energy transitions plans, pivoting away from their traditional business.

- In 2020, BP issued an overly ambitious plan to reach net-zero by 2050 or sooner and to reduce gas production by 40% by 2030.[18]
- In 2022, BP said it would raise its 2030 emission reduction target from 30-35% to 50%.[19]
- Shell agreed to a 50% reduction of absolute emissions by 2030 from 2016, to cut oil and gas production by 40% by 2030, and reduce carbon intensity by 9-12% by 2024, 20% by 2030.[20]
- Their targets require higher investment in new low-carbon businesses and products aimed at compensating them for future demand-led reductions in oil and gas revenues.

In contrast, when presenting Exxon's superior 2022 annual results, Chairman and CEO Darren Woods pointed to the company's focus on hydrocarbon production and investments, saying "We leaned in when others leaned out."[21]

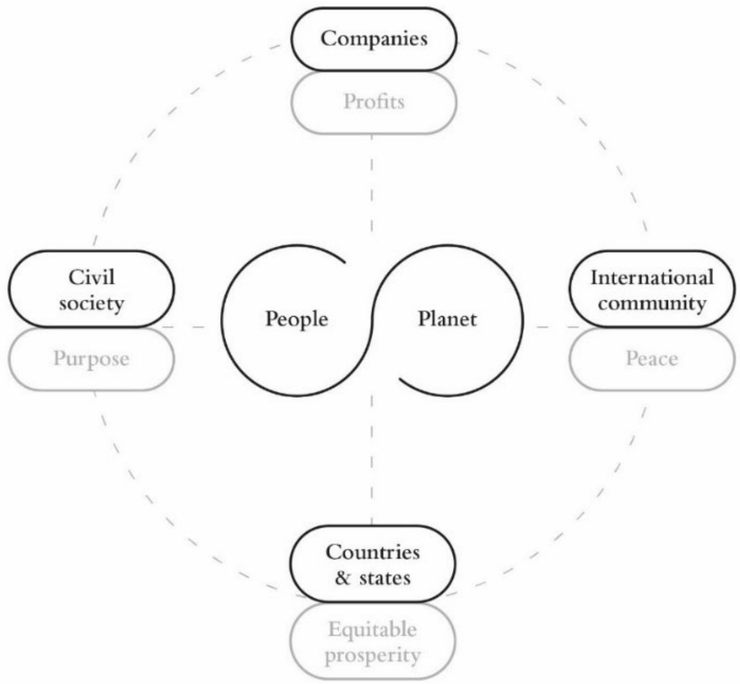
The shares of American companies who stayed focused on their mission of hydrocarbon production and investment outperformed the European ones.[22] This was driven by high oil and gas prices after the Russian invasion of Ukraine in 2022 and BP and Shell's underwhelming returns on renewable energy investments. BP estimated that renewable energy produced a return on investment of 6-8%, compared to 15-20% expected return on hydrocarbon investments.[23]

The European majors viewed the events around the pandemic as an opportunity to focus on ESG issues and accelerate their emission reduction targets. They have belatedly recognized the problem: BP scaled back its plans to reduce oil and gas production by 2030 from 40% to 25%.[24] Shell indicated it would dilute or delay some of its transition targets, maintaining

[17] "Shell accelerates drive for net-zero emissions with customer-first strategy," *Shell Global*, Feb. 11, 2021.
[18] "BP sets ambition for net zero by 2050, fundamentally changing organisation to deliver", *BP*, Feb. 12, 2020.
[19] "BP Sustainability Report 2022," *BP*, 2022, at p. 18.
[20] "Achieving net-zero emissions," *Shell Global*, last accessed Aug. 29, 2023.
[21] Darren Woods, "ExxonMobil announces full-year 2022 results," *Exxon*, Jan. 31, 2023.
[22] Jermey Beaman, "Energy giants are choosing the oil patch over green ventures," *Washington Examiner*, Feb. 12, 2023.
[23] "BP Net-Zero Ambition Progress Update," *BP*, Mar. 2023, p. 32.
[24] Ron Bousso, Simon Jessop and Shadia Nasralla, "Climate-focused investors irked by BP's pivot back to oil," *Reuters*, Feb. 10, 2023.

its current oil production until 2030.[25] “Ultimately, I am in service of shareholder value,”[26] CEO Wael Shawan said, even contemplating relisting in the U.S.’s pro-shareholder market to achieve it.

But Europe’s underperformance could be coming to America. American oil and gas companies have faced numerous stakeholder pressures to adjust their business strategies to advance political and social issues. Meanwhile, the leading proponents of stakeholder capitalism have updated their picture of how it works and made shareholder profit even less important:



Source: https://www.weforum.org/agenda/2021/01/klaus-schwab-on-what-is-stakeholder-capitalism-history-relevance/

Notice something interesting: in Klaus Schwab’s original diagram of stakeholder capitalism, shareholders were presented as one group businesses served, along with six other equally important stakeholders. In the new version, the idea that companies answer to their owners has literally dropped out of the picture; now they make profit only to serve people and the planet.

[25] Zoë Yujnovich, “Investor Presentation at Capital Markets Day,” *Shell Global*, June 14, 2023 p.23-29.
[26] “Shell CEO calls it ‘irresponsible’ to cut oil production now,” *AP*, July 6, 2023.

That is what Strive resists. A core differentiator of Strive is our approach to proxy voting and corporate governance; we engage with portfolio companies to ensure that they focus on their missions and maximize shareholder value.[27] Strive has holdings in Exxon and Chevron through DRLL,[28] a passively managed ETF with broad market exposure to the U.S. energy sector. We saw that Exxon and Chevron were being pressured on matters that harmed their long-term financial value and we encouraged them to refocus on their core missions. Following our recommendation, Exxon added two profit-focused members to its board of directors; we continue to engage with Chevron.

Conclusion

To the average American, prosperity means the freedom to earn, save, and spend money. Stakeholder capitalism threatens all three.

The *Wall Street Journal* recently reported that the average EU country is "poorer per head than every U.S. state except Idaho and Mississippi"—much poorer.[29] In 2022, the EU's GDP per capita was only $37,000, while the U.S.'s was $76,000.[30] According to International Monetary Fund, "The eurozone economy grew about 6% over the past 15 years, measured in dollars, compared with 82% for the U.S." The *Wall Street Journal* article repeatedly stressed that between high inflation and rising energy costs, European workers had trouble providing for their families.

That cannot be our future. But on our current track, it could be. A report from the European Centre for International Political Economy illustrates and explains Europe's underperformance: "The EU economy experienced lower economic dynamism, R&D spending, and higher energy costs than the US."[31]

[27] Proxy Voting 101 – White Paper, *Strive Asset Management*
[28] Data as of 08/31/2023. Holdings are subject to change. For a complete list of fund holdings please visit https://www.strivefunds.com/drll.
[29] Tom Fairless, "Europeans Are Becoming Poorer. 'Yes, We're All Worse Off.'," *The Wall Street Journal*, July 17, 2023.
[30] "World Bank GDP Per capita European Union & United States," *The World Bank Data*, accessed Aug. 29, 2023.
[31] Fredrik Erixon, Oscar Guinea, and Oscar du Roy, "If the EU was a State in the United States: Comparing Economic Growth between EU and US States," *European Centre for International Political Economy*, July 2023.

That could all change if European stakeholder capitalism continues to take root here. In 2021, the amount U.S. consumers spent on energy grew to over $1.3 trillion, a 25% increase from 2020.[32]

The rising cost of living compounds America's savings and retirement crisis. The average American has around $141,542 in their retirement accounts. Those 65 or older have about $280,000, less than half what they need to retire comfortably.[33]

Retirees may be the biggest victims of stakeholder capitalism's fiction that ESG investing is about returns. Its thesis rests on an unfalsifiable claim that disfavoring fossil fuel investment may increase returns in the distant future. But older investors preparing for retirement or currently in it cannot wait decades for those promised rewards. The fact that the ESG movement never acknowledges that some investors have shorter timeframes than others is strong evidence that its goal is not truly to benefit shareholders.

Shareholder primacy is not just about greed, or even ownership; for many investors, it is a matter of survival. During this time of profound economic, geopolitical, and technological change, we should export American capitalism, not import stakeholder capitalism.

[32], "Inflation-adjusted U.S. energy spending increased by 25% in 2021," *United States Energy Information Administration*, Aug. 3. 2023.
[33] "Retirement 2023: Here's How Much the Average American Has in Their 401(k)," *GoBanking Rates*, July 3, 2023.

IMPORTANT INFORMATION:
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Specific risks for DRLL can be found here.

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