



Building Companies That Leave the World a Better Place

Published : February 28, 2007 in [Knowledge@Wharton](#)

In Firms of Endearment: How World-Class Companies Profit from Passion and Purpose (Wharton School Publishing), authors Raj Sisodia, Jag Sheth and David Wolfe suggest that the best firms in today's marketplace are those that deliver emotional, experiential and social value to all their stakeholders, from customers and partners to investors and society. By emphasizing such principles as authenticity and empathy, the authors contend, companies gain "share of heart," not just share of wallet, and, in the long run, are able to gain competitive advantage over firms that are focused only on profits. Below, Knowledge@Wharton offers an excerpt from Chapter Six, "Investors -- Reaping What FoEs Sow."

Chris is an accomplished investment manager for one of the largest financial institutions in the United States. At a meeting convened in the fall of 2005 to discuss the establishment of an FoE investment fund, Chris said he had been following FoE Whole Foods for sometime. "When each quarter's reports come in, I say to myself, 'The PE (stock price to earnings per share) ratio can't go any higher.' But it always does." At the time of the investment fund meeting, Whole Foods Market's stock had gained 70 percent for the year.

Who would have believed that a grocery company in perhaps the narrowest margin business of all could turn in such a performance? Chris confessed to being bewildered by this phenomenon. However, when he was introduced to the FoE business model, the picture of Whole Foods Market's remarkable financial performance became clearer. Only time will tell how long Whole Foods will continue to outperform, but it is truly astonishing that as we write this, a grocery chain is commanding share prices as though we were still in the era of "irrational exuberance," to bring back to mind Alan Greenspan's famous appraisal of investment mania in the dotcom era of the late 1990s.

Recall from an earlier discussion that the firms of endearment we have cited collectively performed exceptionally well for investors over 10-, 5-, and 3-year time horizons. And remember, we selected FoEs for discussion in this book based on their dedication to the interests of all stakeholders. Only then did we analyze them for their financial performance. As we said earlier, we intuitively expected good performance, but nothing like what we discovered to be the case.

In Chapter 1, "It's Not Share of Wallet Anymore; It's Share of Heart," we provided a brief summary of the impressive financial results generated by these companies. We contrasted them with the overall stock market, represented by the S&P 500. We also compared FoE performance with that of companies identified by Jim Collins as having made the transition from Good to Great.

In this chapter, we present further details on the financial performance of FoEs. Before getting into the numbers, however, we want to discuss several issues related to investors as stakeholders.

The Declining Life Expectancy of Companies

Interestingly, as the life expectancy of people rises, that of companies is dropping. Most of us tend to view institutions as (at least potentially) virtually immortal, whereas humans are mortal. The best-known work in examining corporate longevity is probably by Arie de Geus. He found that one third of the companies listed in the 1970 Fortune 500 had vanished by 1983. They had been "acquired, merged, or broken to pieces." He quoted a Dutch survey showing the average corporate life expectancy in Japan and Europe was 12.5 years. Another study found declining corporate life expectancy across the major



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European economies (for example, from 45 to 18 years in Germany, from 13 to 9 years in France, and from 10 to 4 years in Great Britain).

Many companies that enjoy impressive success during their early years eventually get caught up in a cycle of feast or famine that ultimately enervates the company and sends it into a period of steady decline. Some such companies simply fail without going through a prolonged path of morbidity. Here today and poof! -- gone tomorrow. Recently, we have seen an epidemic of big-company mortalities; of the 15 largest bankruptcies in history, 10 have occurred since 2001.

Given the turbulence of the times, it is more important than ever to uncover the factors that lead to long-term corporate health. As we said in Chapter 1, endearing companies (those that secure the emotional loyalty of all their stakeholders) tend to be enduring companies. Let's examine the track record of one such company.

The Whole Foods Way to Shareholder Wealth

FoE Whole Foods stands as an extraordinarily vivid exemplar for the stakeholder relationship management (SRM) business model. The company's business philosophy is embodied in its Declaration of Interdependence, which is posted in every store and reflects the essential interdependencies between stakeholder groups. It states in part:

Whole Foods Market is a dynamic leader in the quality food business. We are a mission-driven company that aims to set the standards of excellence for food retailers. We are building a business in which high standards permeate all aspects of our company. Quality is a state of mind at Whole Foods Market.

Our motto -- Whole Foods, Whole People, Whole Planet -- emphasizes that our vision reaches far beyond just being a food retailer. Our success in fulfilling our vision is measured by customer satisfaction, Team Member excellence and happiness, return on capital investment, improvement in the state of the environment, and local and larger community support.

Our ability to instill a clear sense of interdependence among our various stakeholders (the people who are interested and benefit from the success of our company) is contingent upon our efforts to communicate more often, more openly, and more compassionately. Better communication equals better understanding and more trust.

Later on in the Declaration of Interdependence:

Satisfying all of our stakeholders and achieving our standards is our goal. One of the most important responsibilities of Whole Foods Market's leadership is to make sure the interests, desires and needs of our various stakeholders are kept in balance. We recognize that this is a dynamic process. It requires participation and communication by all of our stakeholders. It requires listening compassionately, thinking carefully and acting with integrity. Any conflicts must be mediated and win-win solutions found. Creating and nurturing this community of stakeholders is critical to the long-term success of our company.

Two pivotal questions: "Has Whole Foods made money for its shareholders?" and "How well does Whole Foods do in comparison with its competitors?" Over the past 10 years, Whole Foods has proven to be a better bet for investors than any of the five biggest grocers: Wal-Mart, Kroger, Albertsons, Safeway, and Costco. In second place for shareholder enrichment by percentage gain is Costco, another FoE. As of this writing, Wal-Mart has not added a nickel's worth of value to shareholders' wealth in six years. In fact, it has lost value since 2000.

Whole Foods stands out even among the stellar performers that make up the FoE universe. It has returned 185 percent over the past three years, 400 percent over the past five years (when the S&P 500 rose by only 13 percent), and 921 percent over the past 10 years! In fact, between December 31, 1995 and June 30, 2006, Whole Foods has returned over 1800 percent.

The performance of Whole Foods and other FoE companies over the past decade suggests a need to revise the criteria for designating a company as a "great company." Look at Kroger's 10-year stock performance. It was one of Jim Collins' picks as a "good" company that became "great." Compare Whole Foods

Market's financial performance with that of the Kroger grocery chain. Kroger made the Good to Great cut in 2000 from an original roster of 1,435 companies. Its stock had reached its then most recent 10-year high in early 1999. By the end of the next year, Kroger's stock had lost more than half of its value. Six years after being named a great company, in mid-2005, Kroger stock languished around 45 percent of its 1999 price.

What went wrong at Kroger is open to debate, but we suspect that in large part it is because Kroger lacks the kind of corporate culture and core values that serve a company best in times of volatile change.

Who Are Today's Investors?

Owning stocks and bonds used to be the near-exclusive preserve of the wealthy and the privileged. This is no longer the case. The Federal Reserve's Survey of Consumer Finances found that the percentage of American households owning stocks rose from 19 percent in 1983 to 32 percent in 1989, 41 percent in 1995, and 51.9 percent in 2001. Even more significantly, investors have become a major political force. In the 2004 election, exit surveys found that 70 percent of voters owned stock.

Because the investor class has now converged, in essence, with the mainstream of society, protecting investor interests has moved to the forefront of the public policy agenda. Spearheaded by New York Attorney General Eliot Spitzer, governments and regulatory agencies have moved aggressively in recent years to bring much-needed reforms to the financial sector. Primary among these have been the removal of conflicts of interest between the advisory role of investment firms and their roles as underwriters of the very stocks they were advising investors to buy. Despite the reforms, most investors remain understandably suspicious of the information and advice they receive from stockbrokers or analysts, and even from companies. Firms of endearment, on the other hand, continue to enjoy a high degree of trust with their investors.

The mainstreaming of stock ownership has helped drive the move toward greater corporate transparency. However, it is having another effect, too. Many individual investors are bringing their personally held moral values into their investment decisions. They subscribe to the idea of socially responsible investing. Steven J. Schueth, president, First Affirmative Financial Network, LLC, writes on his company's website:

The motivations of investors who are attracted to socially responsible investing tend to fall into two, often complementary, categories. Some wish to put their money to work in a manner that is more closely aligned with and reflective of their personal values and social priorities. Others are interested in putting investment capital to work in ways that support and encourage improvements in quality of life in society at large. This group is more focused on what their money can do to catalyze movement toward a more economically just and environmentally sustainable world that works for all inhabitants. They tend to be more interested in the social change strategies that are an integral part of socially responsible investing in the U.S.

A dozen years ago, America's premier management guru, the late Peter Drucker, wrote, "The rise of pension funds as dominant owners and lenders represents one of the most startling shifts in economic history." Continuing, he said:

All told, institutional investors, including pension funds, controlled close to 40 percent of the common stock of the country's large (and many midsize) businesses. The largest and fastest-growing funds, those of public employees, are no longer content to be passive investors.

When reflecting on Drucker's insights and the fact that more than half of U.S households own stock, Frederick Reichheld's revealing insights about how investors can both add to and subtract from stock value come to mind. He faulted day traders and other short-term investors for being destroyers of value by exerting pressure on executives to take shortsighted decisions at long-term cost. Reichheld advises companies to develop strategies that court the interests of such long-term investors as pension funds and mainstream American households. He shows with indisputable metrics how long-term investors add value to a company. This is a key feature of all stakeholders in the FoE business model. From customers to communities, FoE management sees value creation as Reichheld does. All stakeholders add value and each benefits from gains in company value. A company can create value on its own to some extent, but by involving all stakeholders, it taps into a broader and deeper set of resources to create even greater value.

FoEs are Warren Buffet's kind of investment. When asked how long he prefers to retain an investment, he often says, "Forever." Commenting on his view of churn in Berkshire Hathaway's 1992 annual report:

... we believe that our shares turn over far less actively than do the shares of any other widely-held company ... The frictional costs of trading -- which act as a major "tax" on the owners of many companies -- are virtually nonexistent at Berkshire Hathaway.

We put a lot of stock in Reichheld's and Buffet's views. The first has diligently studied the relationship between stock churn and erosion of shareholder value; the second became the world's second-richest man in part by understanding that relationship and investing accordingly. So why is it that more companies do not have similar views? Could it be that boards of directors encourage top executives to take short-term, value-destroying decisions by rewarding them primarily for short-term gains? You, the reader, be the judge. As you fulfill that role, however, keep in mind that top executives in FoEs characteristically are not rewarded in this way.

Because of growing activism among investors, we suspect that the era of outsized executive compensation is coming to an end. It is inconsistent with the ascendant values in the Age of Transcendence. Besides, mega-compensation works against shareholders' interests.

The Zen Way of Viewing the Pursuit of Profit

The view we have promoted throughout this book -- one that growing numbers are buying into in this new era -- is that achieving business success is less a matter of obsessing over the financials than about focusing on how a business adds value to society by contributing to solving its problems and enabling its members to better achieve their potential and otherwise improve their quality of life. In support of this indirect approach to pursuing profits, noted British economist John Kay reminds us that objectives are generally best pursued indirectly or tangentially.

For example, if you try to learn how to juggle, you will be told, "Focus on the throw, don't worry about the catch." The trick is that if you get the throw right, the catching takes care of itself, and in fact becomes quite trivial. The principle of indirectly pursuing an objective is reflected in the following Zen-like paradox: Trying harder to make money leads to making less money. To put it another way, the most profit-oriented companies are usually not the most profitable, whereas most companies that are highly profitable are not primarily focused on profit making. As Peter Drucker explained, "Profit is not the explanation, cause or rationale of business behavior and business decisions, but rather the test of their validity." Recall from the preceding chapter, LL Bean CFO Lee Surace saying, "For me, this business is not all about money. You have a sense that you are really improving people's life" Those are words you never expect from a CFO -- except from the CFO at a firm of endearment.

Research by McKinsey, the world's leading consulting firm, clearly demonstrates the efficacy of taking a long view and letting profits take care of themselves, so to speak, like a juggled ball finding its way almost mysteriously into the juggler's hands. In a 2005 special edition of *The McKinsey Quarterly*, Richard Dobbs wrote, "The companies that created the most shareholder value over the past 15 years also created the most employment and invested the most in R&D."

McKinsey's research also examined the relationship between a company's short-term performance and its long-term health. Healthy companies are those that sustain superior performance over time. They are characterized by "a robust strategy; well-maintained assets; innovative products and services; a good reputation with customers, regulators, governments, and other stakeholders; and the ability to attract, retain, and develop high-performing employees."

Unfortunately, especially for investors, too many companies fail to realize that focusing on achieving exceptional short-term results can be highly damaging to their long-term health. This brings to mind those elite athletes who take steroids and other performance-enhancing drugs, with devastating long-term consequences. Companies can readily boost short-term performance by reducing staff, cutting back on service levels, eliminating employee "perks," and other such initiatives. However, such actions significantly increase the odds for poor performance in the future. Yet, how often do we see a company's stock rise when a large-scale round of layoffs is announced? That may heat up trading and work for day traders, but long-term investors should read it as a warning about the future health of the company.

Listen to McKinsey's take on the question of "What is the business of business?"

Paradoxically ... the language of shareholder value ... hinder(s) companies from maximizing their shareholder value. Practiced as an unthinking mantra, "the business of business is business" can lead managers to focus excessively on improving the short-term performance of their businesses, thus neglecting important longer-term opportunities and issues, including societal pressures, the trust of customers, and investments in innovation and other growth prospects.

In terms of the interests of all stakeholders -- not just shareholders -- too many managers remain all too susceptible to short-term pressures. A study by the National Bureau of Economic Research found that most managers would not make an investment that offered an attractive return if it meant that they would miss their quarterly earnings target. Shockingly perhaps, more than 80 percent of executives would cut marketing and R&D expenditures for the same reason, even if they truly believed that doing so would hurt the company in the long run.¹⁶ And, boards award them cash bonuses and stock options for thinking this way.

The quarter-to-quarter pressures put on companies by influential stock analysts is a well-known phenomenon. McKinsey's research finds that although many analysts do indeed exert pressure on management to deliver short-term results, the stock market as a whole rewards long-term performance:

... expectations of future performance are the main driver of shareholder returns: In almost all industries and almost all stock exchanges, cash flow expectations beyond the next three years account for 70 to 90 percent of a share's market value.

McKinsey recommends that company management spend much more time with analysts to discuss industry trends and explain their long-term vision and strategy. Some companies do just that and also separate the discussion of long-term strategic issues from discussions of quarterly results. Companies must also decouple managerial compensation from short-term results and link it much more closely with indicators of long-term corporate health.

Bonding Investors, Employees, and Customers

The investors, employees, and customers of a company can be bound together in a way that results in greater stability for the company and greater harmonization of interests across all stakeholder groups. For instance, at most well-run companies, and certainly at FoEs, employees are encouraged to become customers of the company through discounts on the company's products and services. In many cases (especially with lifestyle products), companies find that their best hires come from within the ranks of their most loyal and demanding customers. Most such companies also have various kinds of ESOPs (employee stock ownership programs). Instead of focusing just on awarding stock options (which tend to be short-term in nature) to employees, companies should give more attention to rewarding and providing incentives to employees to purchase and hold the company's stock for the long run.

The possible linkages between customers and investors are more unusual and in some ways more interesting. Companies should encourage hybrid relationships; they should try to get their investors to become customers and vice versa. They should consider giving long-term investors the same discounts that employees get. On the flip side, some companies have started experimenting with new types of loyalty programs for their best customers. Instead of rewarding them with free products and services, as is the norm, some companies reward their best customers with stock. For example, Jameson Inns rewards customers who stay three or more nights a year in its hotels with company shares worth 10 percent of their nightly room rate. The company has also launched a plan to sell stock (without any commissions) to customers.

The advantages of bonding stakeholders together in this manner are obvious. Stakeholders with multiple relationships with the company are more likely to be valuable to the company, and they are also more likely to stay with the company when it goes through turbulent times. Stakeholders should be bonded not just with each other but also directly with the company. Companies should not hesitate to bring representatives of all stakeholders (not just the three mentioned here) directly into their long-term strategic planning process.

Shareholder Returns -- FoE Composite Excels

What makes FoE firms different in the eyes of investors? What makes their stock prices outperform the 11 famous Good to Great companies? We have found that FoE firms are valued differently than other firms in several ways. FoE firms generally earn higher shareholder returns, typically have premium price-to-earning (P/E) ratios, and earn a premium return on equity (ROE), while incurring no more risk than the overall stock market (reflected in the S&P 500).

To compare shareholder returns, we examined the historical price activity for the 17 public FoE firms, the 11 Good to Great (GtG) firms, and the S&P 500 over the past 3-, 5-, and 10-year periods, ending June 30, 2006. This time frame represents a volatile time in the market that included the early years of the Internet boom, the bursting of the tech bubble, and a transitioning period out of a recession. It covers a long enough period to report conclusive information from our findings. [Our research shows that] the stock price performance of FoE firms has dwarfed that of the S&P 500 for all three time periods.

Note that as soon as a company was publicly traded for a full month, it was used in the analysis of composite returns of the FOE portfolio. Thus, Google, Jet Blue, UPS, eBay, Amazon, and CarMax all factor into the 10-year analysis the first month their individual data became available. That is different than excluding the company if it is not available at the start of a period. While neither methodology (exclude it if it is not there at the start of the period, or bring it in as soon as it becomes available) is "correct" in a strict sense, it is standard practice to use a company as soon as it is available; otherwise, we would be discarding valid data.

Some highlights:

- Using our longest time horizon (10 years), FoE firms produced an outstanding aggregate return of 1,026 percent.
- The GtG composite could manage only 32 percent of that, earning a 331 percent return, whereas the S&P 500 returned just 122 percent. The FoE portfolio thus outperformed the broad market by a more than 8-to-1 ratio!

ROE and P/E Ratios -- Is There an FoE Premium?

Return on equity is a profitability measurement that reflects the success of a firm in turning shareholder investments into a profit. Figure 6-4 shows that FoE firms deliver more profit per shareholder dollar invested: 22.4 percent versus 20.9 for the S&P 500. Profitability is a major concern to companies, and the higher profitability experienced by FoE firms (as reflected in the ROE measure) suggests that FoE are more profitable despite spending more on employees and other stakeholders than most companies.

P/E ratios reflect the market's future growth expectations of a stock. A P/E ratio that is higher than the norm reflects the market's belief that the company will grow faster and enjoy superior returns than its peers. In our view, a premium P/E ratio is an indicator that a firm has balanced its major stakeholders effectively. We expect these companies to continue to carry higher P/E ratios than the general market (reflected in the S&P 500).

Other Evidence Supporting Superior FoE Performance

The financial results achieved by firms of endearment are very impressive and quite heartening to those of us who believe in the power of business to do more than turn a profit for investors. Some may find these results hard to believe, and may be tempted to ascribe them simply to a statistical aberration. However, a great deal of academic literature supports our basic premise and provides further concrete evidence of the soundness of an FoE managerial mindset.

Perhaps the most impressive of these studies is also the oldest. In 1992, Harvard Business School professors John Kotter and James Heskett published their landmark book *Corporate Culture and Performance*. In this study, Kotter and Heskett studied the performance of 207 large U.S. companies in 22 different industries over a period of 11 years. They found that companies with strong business cultures that addressed all stakeholders and empowered managers at all levels dramatically outperformed other companies by wide margins on three key indicators: revenue growth (682 percent versus 166 percent),

stock-price increase (901 percent versus 74 percent), and net income increase (756 percent versus 1 percent). To quote the authors, "All their managers care strongly about people who have a stake in the business (customers, employees, stockholders, suppliers)."

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