The Rising Correlation between Investment Returns and Universal Qualitative Norms – or Normative Ethics

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The Rising Correlation between Investment Returns and Universal Qualitative Norms – or Normative Ethics

Summary

In the search of the source of superior long-term returns in the coming decade, the author identifies an unexpected link between profits and the adherence to normative values — whether they go under the name of ethics, corporate responsibility, accountability or sustainability principles. The author argues that the evolution of our economies towards more intellectual capital-driven industries illustrates one of the links between the pursuit of normative human values and investment returns. Creativity and innovation create new frontiers of value-creation. Yet, as these are by-products of intellectual human capital, we must seek intrinsic motivation. We find people motivated by intrinsic factors more than ever. There are certain normative values to which we must adhere. In our increasingly global industries these values must transcend cultures and nations and can form the foundation of qualitative principles which in business to secure superior returns. The dynamic is apparent in sectors where intellectual capital generates a large part of the value - such as the media and information industries. The author contends that similar dynamics may be at work with consumers and investors throughout different sectors and at different points along the value-chain of industry. The fields of corporate responsibility and sustainability therefore appear to be where a number of frameworks are evolving that can be used as tools to enunciate and evaluate businesses and investments to capture superior returns.

Keywords: Corporate Social Responsibility, Sustainability, Industrial Evolution, Economic Growth, Intellectual Capital Media, Technology, Innovation, Creativity, Intrinsic Motivation, Applied Psychology, Non-zero-sum, Game Theory, Normative Values, Business Ethics, Investment, Economic Returns, Socially Responsible Investing

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THE RISING CORRELATION BETWEEN

INVESTMENT RETURNS

AND

***NORMATIVE ETHICS*:**

Illustrated at the information sector frontier

In the search of the source of superior long-term returns in the coming decade, the author identifies an unexpected link between profits and the adherence to normative values — whether they go under the name of corporate responsibility, accountability or sustainability principles. The author argues that the evolution of our economies towards more intellectual capital-driven industries illustrates one of the links between the pursuit of normative human values and investment returns. Creativity and innovation create new frontiers of value-creation. Yet, as these are by-products of intellectual human capital, we must seek intrinsic motivation. We find people motivated by intrinsic factors more than ever. There are certain normative values to which we must adhere. In our increasingly global industries these values must transcend cultures and nations and can form the foundation of qualitative principles which in business to secure superior returns*. *The dynamic is apparent in sectors where intellectual capital generates a large part of the value - such as the media and information industries. The author contends that similar dynamics may be at work with consumers and investors throughout different sectors and at different points along the value-chain of industry. The fields of corporate responsibility and sustainability therefore appear to be where a number of frameworks are evolving that can be used as tools to enunciate and evaluate businesses and investments to capture superior returns.

Introduction

In the coming decades, a key source of superior value-creation and investment returns increasingly stems from a source often omitted by investment analysts. Most investment analysts avoid qualitative assessments in their evaluations. In the meantime, the fields of corporate responsibility, accountability and sustainability have shown significantly rising prevalence. These fields often exhibit confusion as to the real context of the issue and they also mostly originate from a desire to address social concerns. However, their rising prevalence can be ascribed to changes taking place within the structure of society and industry – which are relevant in the search for superior value-creation over the long-term. This paper identifies an unexpected and mind-shifting correlation between normative human values – perhaps "normative ethics" – as well as the need to evaluate a greater number of stakeholder relationships and investor returns; one which will only strengthen with time. By working from first principles and using principles from the fields of evolutionary theory, game theory and applied psychology this paper posits that we can better understand the economic impact of 'normative values' in business and the consequent necessity to evaluate a greater number of relationships or stakeholders.

This paper traces the following lines. Over the very long-term, history has shown a consistent improvement in our economies' ability to process and transport energy, information and matter. Our economies continue to become more driven by intellectual capital as it generates greater value than ever before; and will, most likely, continue to do so. Evolution also continues to lead people and organizations towards ever-greater interdependence. As interdependence increases, so does the potential for gains through non-zero-sum cooperation. The industries at the frontiers of our industrial evolution exhibit the most potential for abnormal returns – since, in economists' terms, they are typically not perfectly competitive. As a result, the creativity and innovation of human intellectual capital can generate returns superior to those generated by mature businesses that create value from more tangible assets. Reflecting this, the differential between a business' worth and its book value is rising.

Because of this continuous rise, human intellectual capital is therefore an increasingly key asset in value-creation. In order to engender the optimal performance of that intellectual capital, we need to optimize its alignment with corporate goals. Latest research confirms that across broader numbers of people, organizations need to go beyond meeting basic needs to capturing the intrinsic motivation of people. We need to provide a purpose that is fundamentally aligned with people's own sense of what is merit-worthy.

There are several ways in which we can infer a valid purpose in business. Modern psychology confirms that worker satisfaction is driven more by the means than by the end: by how we achieve, rather than by what we achieve. As interdependence grows, and the need for cooperation among people deepens, we need to harness the motivating force of human values which cut across various groups of people. For example, recent works, outside of management theory, have sought to identify the values that run through different cultures and people. These provide one starting point for a set of standards against which we may evaluate corporate values. In doing so, we can harness the motivations of all of those with whom we ally ourselves to create value, and therefore generate better returns for investors.

At an even deeper level, the means affect the end: the way that an organization pursues its objectives will determine what it ultimately achieves. As the rate of change in industry continues to rise, change will come upon us sooner than we are accustomed. In an environment where disruptive innovation to business models takes place within shorter and shorter time periods, the challenge for investors is to find a sustainable element in business models which are increasingly driven by the creative innovation of human capital. By adhering to normative principles of human conduct – we could optimize alignment between the values of our productive workers and their organization's mission. But, values that guide how we work determine the objectives that we achieve, and the importance of intrinsic motivation to human capital will continue to rise. By complying with normative values, we will best guide our business missions and investments down a path that maximizes value-creation and returns over the longest term. Evaluating business purposes and values against normative principles will help identify and sustain superior returns.

The media and information sectors currently face extraordinary transition. As businesses and investors in the sector scramble to find solutions and strategies to cope with the impending changes, we suggest that an answer to capturing superior value lies in some of these concepts. We will use the sector to illustrate the practical effects of these dynamics at work in the field.

While our argument will focus on human capital as a workforce and an input into production or service, analogous arguments can be made about people as consumers, investors and suppliers, or any contributors in the value-chain of industry.

It is also through recent research and writing from spheres as disparate as game theory and gene research that our ability to make the arguments here is stronger than ever. Additionally, to elucidate the economic argument, we need to be open to the language and thinking of different fields.

Finally, while this paper falls short of an empirical analysis and evidentiary confirmation of a thesis, it posits a particular hypothesis of the line of causation between values and returns. While the hypothesis requires further empirical analysis, I consider it prudent to firstly seek publication of the hypothesis herein in order to first, hopefully, attract debate and critique from those interested in the subject at hand; which should therefore determine if and how this thesis should be progressed.

I. THE CONSENSUS

Some corporate social responsibility advocates, socially responsible investors and sustainability contenders argue that there is proof that responsible companies perform better financially[1]. On the other hand, other writers, such as David Vogel in his book *The Market for Virtue* contend that there are significant limits on the impact of these principles to business success. One writer contends that the empirical evidence is "fairly clear [that] ethical investments yield returns similar to those of other investments of the same risk level. In a way, this is good news for the proponents of ethical investing: ethics doesn't "cost" anything, so even those with fiduciary responsibilities (such as endowment funds) can invest with their values" [2]. This was in the context of evaluating non-activist, mutual fund investing and regardless of the value-set abided by the fund – the sample involved any fund claiming investment analysis with any normative values.

In a treatise on persuading companies to address social challenges, Simon Zadek[3] quotes evidence that companies that excel at managing their stakeholder relationships produce above-average financial returns and stock price performance when compared to companies of a similar size in similar industries, or with broad market indicators such as the S&P500. He quotes two significant studies proving a correlation with investor returns.

[1] Such as in Marjorie Kelly, "Holy Grail Found", *Business Ethics: The Magazine of Corporate Responsibility Online,* Vol. 18 #4 Winter 2004 referring to two studies of studies where a balance of studies indicate that "a statistically significant association between corporate social performance and financial performance exists, which varies 'from highly positive to modestly positive'.

[2] Richard Hudson, "Ethical investing: Ethical Investors & Managers", *Business Ethics Quarterly,* Vol. 15, No. 4, Oct 2005

[3] Simon Zadek & John Weiser, *Conversations with Disbelievers: Persuading Companies to Address Social Challenges,* Nov 2000, page 40.

He then states that while "these studies are very compelling, it is still worth noting that it is quite difficult to distinguish causality." Do these companies perform better financially because they engage in these principles? Or is this because they have excellent management, and one of the things that excellent managers do is to manage all stakeholders better?

The World Economic Forum's report, "Mainstreaming Responsible Investment," published in January 2005 states that the deliberate incorporation of material social considerations in investment decision-making has yet to be embraced by the investment community.[4] The question that remains is why investors would have to heed such concerns when they don't know how it influences the outcome of their mandate to maximize returns.

The weaknesses of the material in these fields is two-fold: firstly, there remains the challenge of defining the criteria that create the positive impact; and secondly, most available studies have not developed hypotheses about precisely *how* increasing corporate engagement with these issues is supposed to improve financial performance.[5]

In this paper, I hope to shed some light on answers to these questions and point to places where we can continue to find more, by working from first principles.

II. EVOLUTIONARY THEORY AND ECONOMIC GROWTH

At the outset, if we are to evaluate changes to our assumptions in business, it would be most prudent to evaluate trends from first principles over the very long term, which could then imply trends for the shorter term.

Rising complexity, interdependence and plurality

Consequently, the first premise of our thesis is necessarily a very macro one: that history and the evolution of society have moved in a particular direction. Large parts of society's evolution have an underlying direction that is less than random – and importantly, they will continue to do so. I defer to the extensive argument of other writers, most recently and foremost Robert Wright's *NonZero: History, Evolution & Human Cooperation*.[6] Francis Fukuyama advocated a similar view in this respect. Sociologists and historians have largely denied this premise over the last several decades - largely due to the use of the argument to defend the principle of racial supremacy. In explaining the differences in development among peoples, there are now more well-informed and rationally argued treatises such as Jared Diamond's *Guns, Germs and Steel,* which cites geography, demography and other attributes of nature and nurture.[7]

One undeniable historical trend that Wright compellingly argues has been rising complexity. Another is a consistent rise in interdependence in society and therefore industry. The rise in the complexity of interrelationships and interdependence amongst participants in industry has led to specialisation, which has, in turn, only led to further interdependence.

Another trend has been a consistent improvement in humanity's ability to transport and process matter, energy and information over the millennia.[8] I will call this a rise in our "means." We are, at our core, an information-processing, energy- and matter-processing race. Our biological evolution reflects that – our minds have evolved as information processing organs; and, most likely, will continue to do so.

Let's take one of the frontiers of our evolutionary development – that of our improving ability to transport and process *information*. Drawing on Wright's arguments again, while there have been shorter-term aberrations throughout history, over the long-term, there has been a consistent decline in the costs of communicating and a consistent rise in the power to communicate. Coins were a primitive form of information communication that represented units or conveyed other information. At a later date, scribes and transport communicated information; then came printing presses, the telegraph, telephone, fax, email and internet. The cost involved at each stage has consistently declined.

There is also sufficient evidence to say that, failing a catastrophic disaster or short-term regression, we will most likely continue to progress along these lines over the long-term. I don't purport to seek to supplement the arguments of Robert Wright and Fukuyama in this regard, and refer

[4] See World Economic Forum, *Mainstreaming Responsible Investment*, January 2005, page 7.
[5] Zadek & Weiser, page 44.

[6] Robert Wright, NonZero: History, Evolution and Human Cooperation
[7] See Jared Diamond, *Guns, Germs and Steel.* See also Ridley, *Nature and Nurture.*
[8] Please refer to Robert Wright's NonZero.

readers to their work.

This continued decline in the costs of communication has led to the simultaneous fragmentation of the number of people or organizations that innovate. This, also, has been a consistent trend over the very long term. It is the destiny of all forms of communication to become more and more niche.[9] In a particular way, this allows more people to communicate, and causes the proliferation of sources of creativity and innovation.

While the advent of printing presses facilitated a cheaper form of content production, more people have access to desktop publishing and even more can create a web page with global reach than through a printing press or a monastery full of scribes. More people have access to telephonic communication than before. The number of Internet users worldwide has risen from a negligible number in 1992 to more than 850 million people today.[10]

In this sense, over the very long term, as things become more ubiquitously accessible by ever-larger segments, there has been a consistent increase in the level of, "plurality": our improved means leads to a broadening of the bases of power. The more accessible means of communication and the more information there is to process, the more people have their voices heard more easily and at lower cost. Otherwise disparate groups of people can cooperate over wider geographies. French speakers in Quebec can share content and information with their fellow Francophones across the Atlantic through French language television channels and other audiovisual products.[11] Global trade can be facilitated through email and fax communication more than when messages had to arrive by ship. Individuals are more at liberty to work more independently from the proximate resources of large organizations.

Lower communications costs are just one of the dynamics that facilitate cooperation across ever larger distances and networks. They both increase interdependence and result from greater interdependence. As communications costs fall, the ease of communication rises, as do the connections among larger sets of people. Rising interdependence is a prominent feature of the evolution of our social organization. As the number of interdependencies between players in industry rises, so does the amount of cooperation required for success. The power base of society has broadened and arguably will continue to broaden.

Wright notes late in NonZero that the "process of expanding, non-zero-sumness has brought not only more respect for more people, but more liberty for more people. … [This growth], driven by technological change, but rooted more fundamentally in human nature itself, has in this one basic and profound way improved the conduct of humans." To this we will return later.

Various writers have argued that cooperation is a fundamental feature of human social organization[12]; amongst other, Matt Ridley in *The Origins of Virtue*, and Robert Wright in *The Moral Animal*. Francis Fukuyama in *Trust: The Social Virtues and the Creation of Prosperity* argues that the most pervasive cultural characteristic influencing a nation's prosperity and ability to compete is the level of trust or cooperative behaviour that prevails based upon shared norms. Alex Michalos, the ethicist, has also specifically pointed out the importance of trust in business.[13] To these issues, we shall also return. It is sufficient to say, for now, that cooperation is a rising necessity in an increasingly interdependent world.

Cooperation, specialization and economic growth

If we extrapolate this tendency forward, it does not mean that every person or organization needs to cooperate with all others to prosper. A growing web of interdependencies between people and things - and therefore an *ability* to cooperate amongst a broader network of individuals - does not mean that we all should engage in limitless cooperation. Humans are inherently competitive – stemming from our biological construction and the means by which we have competed for finite resources to scale the inter-generational competition to survive and thrive.

We compete with our neighbors, unless there is good reason for us to cooperate. In other words, or in game-theory terms, zero-sumness leads us into a search for *either* zero-sum gain through competition *or* non-zero-sum gain through cooperation. To simplify, in terms of the classic

[9] Robert Wright, NonZero
[10] *Wall Street Journal article – insert reference.*
[11] Robert Wright, NonZero reference.

[12] For example, two of our key protagonists: Robert Wright in *The Moral Animal;* Matthew Ridley in *The Origins of Virtue*; and Francis Fukuyama in*Trust: The Social Virtues and the Creation of Prosperity.*
[13] Alex Michalos, "The Impact of Trust on Business", *Journal of Business Ethics,* 1990, 9(8), pp. 619-638.

negotiation strategy example, if you want the last-remaining orange and I want that same orange, we can either fight over it if we think it a zero-sum game; or we can realize that I want the juice and you want the rest for your cake – and thereby each derive non-zero sum gain.

It is this ability of humans to cooperate or derive non-zero-sum gain that lies at the source of value-creation at the fringes of evolution. Consistent with the premise of Adam Smith's *Wealth of Nations*, if we each specialize, we can all produce more than the sum of the parts. As evolution progresses, so does our specialization, and our ability to create and capture more value. Our specialization also arises from the very necessity to do so. It is both driven by, and leads to, the rise in complexity.

Non-zero-sum gain also lies at the very source of economies' and industry's search for continued economic growth. Business strategy literature such as Chan Kim's latest work – *Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant*[14] strikes at the heart of this. It contends that a more prosperous source of growth for enterprises lies not in competing in existing markets, but in redefining the market and creating a whole new value proposition. Finding co-operative ways to create value is non-zero sum value creation at the frontiers of industrial evolution.

This is where human evolution converges with economic growth. We have evolved as biological and social beings through cooperative relationships. This is evident, firstly, not only in our own biological evolution - an evolution of cooperation among the interdependent parts of our own biological composition - but, also, in the evolution of our society as one characterized by cooperation in a web of increasingly interdependent and cooperative *human* relationships. Advances in technology reflect an increase in cooperative relationships among producers or service providers in an ecosystem.

At the macro level, our ability to engender sustained economic growth derives from this improvement in our ability to derive non-zero sum gain through rising networks of cooperative relationships. Some argue that the world's greatest political and industrial leaders have been those who have been able to induce cooperative relationships amongst broader sets of previously less interrelated groups.[15],[16] It could be argued, for example, that Alexander the Great engendered human progress, despite his ruthless warring, through the channels of distribution, sharing of knowledge and trade that he formed across the disparate communities of Asia Minor.[17],[18],[19].

With a fixed level of the world's resources, is it reasonable to argue that equilibrium lies in continued economic growth? Well, yes. It stems from improvements in our ability to seek cooperative relationships to create value, or to derive greater non-zero-sum gains amongst otherwise disparate numbers of people and things.

As interdependence rises, so does the need to evaluate the interests of a greater number of stakeholders. As global communication costs decline dramatically - as all means rise and plurality rises - interdependence among parties in industry and society rises. This is where corporate social responsibility comes in. With rising interdependence among the actors in our society – whether business, community, government, consumers or investors, a growing commercial rationale for CSR lies in the impetus it provides to evaluate a broader set of stakeholders for potential non-zero-sum alliances.

[See Box 1 at end for further illustration in the context of private equity funds]

III. ABNORMAL RETURNS AT THE FRINGES OF EVOLUTION

Imperfect competition at the margin

[14]Chan Kim & Renee Mauborgne, *Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant.*

[15] Cynthia Crossen, *The Rich and How They Got That Way: How the Wealthiest People of All Time – From Genghis Khan to Bill Gates – And How They Got That Way.*

[16] Another, more contemporary example is that Microsoft's operating platforms enabled the ability to capture more value to its internal units of innovation by providing a consistent platform on top of which innovation could be built. A coherent platform for growth, innovation, cooperation and sharing of knowledge within Microsoft and its surrounding eco-system. Consistent railway gauges across Europe could enable the more easy transport of goods by train.

[17] Again, we steer clear of any value judgments about the way in which this may have been achieved. See Manfred Kets de Vries, *Alexander the Great: Are Leaders Born or Are They Made?: The Case of Alexander the Great*.

[18] Add more weight/evidence to this argument?

[19] Thankfully, we are more civilised now. Indeed this becomes a very point at the heart of Wright's work, to which we will come back to: that despite the proclamations of many, and numerous short-term regressions or what Wright quotes from other authors as 'cultural lag' in necessary societal adjustments, the world has significantly improved in some definable way – whether it be called more civilised or better in some way. We no longer, for example, beat our competitors over the head with clubs in the contemporary western business.

It is an accepted principle of economic theory that abnormal returns tend to prevail in imperfectly competitive markets. Monopolies and oligopolies attract superior returns on investment due to their pricing power. But, as abnormal returns attract other competitors to an industry, perfect competition deteriorates abnormal returns to normal.

At a macro level, abnormal returns prevail most at the evolving fringe of our industrial evolution. As we master each new industry, existing business models mature. To generalize, the more mature the industry, the greater the returns commoditise.[20] Abnormal value-creation declines or returns to "normal" as business models, products or services mature. It is through innovation that we generate new value-creating frontiers. The creativity and innovations of human capital are what produce each consecutive step-change towards a new business model of potentially higher non-zero-sum value creation.

The rise of innovation & intellectual capital

At each earlier stage of history, the depth and breadth of innovation in industry has been less. This is due in part to the very effect of rising fragmentation, complexity and interdependence, and, in part to the improvements in our means, such as our better ability to communicate. Innovation originates from human effort. It is this innovation that can generate greater levels of value than more "tangible" forms of capital.[21] In 1998, an average of all U.S. companies, regardless of sector, required 20 percent less in the way of tangible assets to produce a dollar's worth of sales than they did a generation ago.[22] The effect is more concentrated in segments driven by intellectual-capital. In 1995, Microsoft's market capitalization was over seven times its book value.[23]

Business organizations facilitate cooperation of and capture the value created by intellectual capital. IBM, Intel, Microsoft each created and captured the value of creating and providing hardware, processing power and software for processing information. They harnessed the value-creation stemming from our ability to innovate - and sought continued sources of non-zero-sum value gain. They harnessed the complementary skills of individuals, which, combined, produced more value than those individuals could do alone. However, that value was predominantly generated by human intellectual capital. Stock options were a way of sharing the rewards of value-creation with one of the increasingly key resources in the value creation process. Yet, again, the value-generation they created has matured and become competitive as the knowledge they generated has spread.

At the same time, value-*destruction* also proliferates at the margin. While evolution generates new forms of communication, it destroys the utility of older forms. Voice-over-IP (VoIP) has the potential to replace mainstream technologies of voice communication, as it takes advantage of tremendously lower cost economics. Value is destroyed when incumbent telecom operators fail to change their strategy in the face of the latest disruptive technology.

The dynamic of declining costs of communicating leads to the shift in value-creation towards more innovative "intellectual" capital. As costs of communicating fall, a shift takes place towards greater returns at other points along the value chain. All other things being equal, economic value shifts to more "creative" or "innovation-driven" activities, ever-propagating the rising importance of human capital.

The more our industries evolve, the more value that human innovation can generate than more tangible asset-heavy businesses. In fact, again, this has always been the case. However, it is also increasingly the case. Microsoft has more workers innovating than Ford. That's not to say that assembly line workers at Ford did not innovate; but the proliferation of Ford's innovation was less.

These dynamics are all part of the evolution towards more "knowledge-driven economies" or "information-economies". The objects of our contemporary information-economy and the terminology we use in relation to it are new. The magnitude of the transformation to information-weighted economies is new. But, this tendency is not new. As Wright states, there has been a constant rise in the "value-to-mass" ratio throughout recorded history.[24] 'Weightless' information has ever-rising value.

As parts of industry mature and access to capital increases, one strategy to seek higher returns is to outsource the capital-intensive and commoditized parts of a business and to leverage return on

[20] Add reference and example?
[21] Thomas A. Stewart, *Intellectual Capital.* Thomas A. Stewart, *The Wealth of Knowledge.*
[22] McKinsey consultant Lowell Bryan has estimated, in Stewart (1998), p.
[23] See Sveiby (1997) Chapter 1. Other examples follow therein.
[24] Robert Wright, NonZero

invested capital on more intellectual capital-driven functions. This could be in automobile manufacturing, PC manufacturing or in beverages. The better performing players in these industries seek to offload capital-intensive parts of their business and derive their returns from design, sales, marketing and distribution. Coca-Cola retained these functions in-house and removed the capital-intensive bottling function off its balance sheet to maximize returns on equity. Whether in sales or marketing, innovation or design, human capital activity has the potential to generate superior returns on a given amount of capital.

At the same time, the units of innovation and creativity in industry continue to fragment and proliferate. The creators of content or the innovators of functionality can create abnormal value as they tap human innovation and creativity to fill, and add features to, the pipes of communication, and the information processing power of PCs and software. While three or four commercial television networks one or two decades ago allowed a given quantity of audiovisual product; 450 satellite- or cable-television channels engendered more. Satellite and cable television represented a newer form of communication that could deliver more content and information through a more efficient infrastructure.[25] It resulted in proliferation of units of content creation, with each channel having increasingly more niche appeal.

There are now vastly more units of content creation and innovation than in the world of three or four commercial television networks. Now, yet again we see another significant step change in the quantity of content that can be disseminated. Internet protocol, digitzation, software and their eco-systems reduces the costs of communicating even further, allowing ever greater quantities of content, and the need for ever-greater niches of content. For some segments, the costs of communication are approaching zero. Skype's mission statement promises that it will *never* charge for phone calls within its voice-over-IP network…. ever. Rather, it hopes to charge for value-added services and functionality added to the communication.

As our communications networks evolve, the need for content and functionality will be propelled; the forms that that content and functionality take will continue to evolve. In fact, consistent with our previous premises, we can also say that they always have. Information, content or media have always been evolving, as have our "means" of communication. The meaning of the word has adapted. Media today includes digital content. Previously, media meant the paper upon which scribes wrote to convey a message that was transported by horseback.

Human capital and its innovation becomes the prime asset that generates value at the margin, and potentially more value than that created by "older, more tangible" assets. Yet, if we seek excellence in the performance of that asset, and the consequent superior returns, how do we sustain and feed that productive resource so that it can deliver higher returns?[26]

IV. OIL IN THE COGS OF HUMAN CAPITAL

Oil in the cogs of human capital- "flow"

It takes more than food to feed our creative and innovative workers.

There is ample research on the demands and interests of our ever-more demanding working population. As our basic needs are met, we seek more, and can afford to demand more than a basic wage to support our families. This dynamic also stems from the improvements in our means that we mentioned earlier. Mihalyi Cziksentmihalyi has found that we all want to do something that we, as unique individuals, believe both fits our unique strengths and provides us with sufficient challenge and growth. These are the key requirements for a person to enter into a state of - what he first coined as - "flow."[27]

In order to sustain and optimize the performance of our working population we should ensure that we, as workers, are each most closely matched to our unique skills and desired type of challenges - so much so that we would be happy doing it in our spare time. Having said that, nowhere is intrinsic motivation more prevalent than in creative or innovation-driven industries.[28] There inventors and artisans perform often best even if they weren't remunerated for their passions. But if intrinsic motivation is a recipe for harmonious participants in business, and is conducive to the "well-oiled" assets of human capital generating superior returns, then why is there unrest amongst

[25] Although some investors lost significantly through their investments in cable networks, this is a separate matter.

[26] Does the above section need more supporting evidence or more clarity in its argument?

[27].Mihalyi Cziksentmihalyi, *Finding Flow*

[28] Richard Florida, *The Rise of the Creative Class*; Teresa Amabile, *Creativity in Context.*

investors in these segments? Let us turn to some sources of these.

Investing in creativity and innovation

Investors rightly have many concerns with creative and innovative segments. Firstly, there is no unwavering asset to leverage. The asset being managed is people. Herein lies one of the first key differentiators of the emerging segments of media as an industry; and its prospects for investors. While investment may be managed by those with knowledge and expertise in managing financial assets, the prime assets in any creative industry are human, not financial. Managing human 'assets' is a skill inherently different to that of managing financial or 'tangible' assets. As tangible-asset-heavy distribution businesses continue to commoditise and value-creation shifts towards more intellectual property rights created by human capital and creative innovation in the media sector, the qualifications of those in the investment selection process must also shift to include qualitative factors such as evaluating the organisational design of a business or the means by which it sustains innovation.

A second problem with the sector for investors is that, at the more creative end, earnings' forecasts and business plans are inherently less meaningful and therefore difficult to value. A business that commercializes innovation and creativity presents challenges in its valuation due to the sporadic nature of innovation. However, this problem can extend to, and be resolved in the context of, companies that such generate innovation in a range of industries – take the recently highly successful IPO on London Stock Exchange of the government's former technology and defence innovation business, Qinetiq.[29]

A third concern is that money is not the highest motivation for the creative classes.[30] They do not respond to the rational beacon of returns. However, this ties in with a fundamental component of Warren Buffett's investment strategy. The seasoned investor seeks out managers and CEOs who have intrinsic motivation in the desire to manage their companies - the companies that Buffett's Berkshire Hathaway acquires as subsidiaries.[31] This insight evolved as Buffett made the transition from investor to manager after the dissolution of the Buffett Partnership and his acquisition of the textile mill that was then called Berkshire Hathaway. He avoids any employment contracts and refrains from interfering in the management of his subsidiaries.

Then, how is it that Buffett seeks intrinsic motivation in his managers for simple bricks-and-mortar businesses, but investors show concern about its presence in creative segments? And what can we learn from this distinction?

In his Letters to Shareholders, Buffett often refers to the book value of the company as the bottom line measurement of value. He separately calculates, but does not disclose his measurement of, intrinsic value. The gap between book value and intrinsic value is ever-rising in our economies.[32] The creative and innovative segments generate returns from a resource with little or no book value – intellectual capital.

At the same time, while discussing intellectual capital in "creative and innovative segments", we must recall that all industrial sectors demand more innovation and creativity – more intellectual capital. Richard Florida argues in *The Rise of the Creative Classes* that the level of innovation and creativity required across many, if not all, *industries* and *functions* has risen, and consistent with Wright's postulation, most likely will continue to rise.[33]

As industries migrate into more intellectual capital-weighted businesses, in seeking out superior returns in the next decade, we must return to the requirements of human capital. Over and above what we've discussed, investors at the margins must ask a soft question: what do people want out of work?

The role of corporate purpose

Mihalyi Cziksentmihalyi and others have advanced thinking since his work on "flow". While applying our unique strengths and seeking challenge are key to contentment and success in our work life, something more is required to motivate our intrinsically-driven workforces: we must believe that what we do is for a purpose – and a good purpose, as we each define it for ourselves. [34] As C. William Pollard stated, "when there is alignment

[29] articles on Qinetiq in FT.
[30] See for example, the quote of Quadrangle Group LLC Managing Partner, in The Economist, Feb 2005, XXX.
[31] James O'Loughlin, *The Real Warren Buffett: Managing Capital, Leading People*
[32] See Sveiby
[33] Florida, *The Rise of the Creative Class.*
[34] Mihalyi Cziksentmihalyi, *Good Business: Leadership, Flow and the Making of Meaning,* Howard Gardner, William Damon, Mihaly Csikszentmihalyi, *Good Work: When Excellence and Ethics Meet*

between the cause of the firm and the cause of its people…, there will be extraordinary performance."[35]

Many would argue that this is a statement of the obvious. Others contend that this is an idealist's view. Intuitively, we may find it to be correct as we scale the pyramid of needs. Regardless, more now than before, studies and research support it.[36] If we in the developed world can readily obtain food and shelter, why else would we want to spend the rest of our lives performing meaningless work? The cause that we have been called to could be the one that we have chosen, or what many of us do simply to pay the bills. Inherent in the definition of a "good" purpose is a definition that we must each reach. Each of us must believe that what we do is for a purpose that our belief system holds to be good. Furthermore, not just are we increasingly driven by purpose in our work, but also in our consumption habits and the causes we support[37] [38] - a point to which we will return.

Of course, people's beliefs are diverse and varied. In defining the purpose for which business should endeavour, each organization could adopt goals that are consistent with their participants' subjective preferences. There will always be differences regardless of commonalities.

However, if industry evolves along a trajectory of increasing interdependence thanks to a more interrelated global economy, there must also be a number of objects that are acceptable to a broader set of people whose interests coincide. Is there a purpose that is compatible across diverse work environments? Are there interests that are compelling for "non-zero sum relationships" that cut across cultures and belief systems? There must be. If value-creation is engendered through increasing levels of non-zero-sum gain among previously more disparate people, then, given the ever-increasing levels of globalization, how can we determine a purpose that is compatible across multinational work environments, cultures, and belief systems?

A harmonious vision of purpose across an increasingly diverse set of stakeholders would only be possible if there are unifying ideals. Of course, we can take Samuel Huntington's view in *Clash of Civilizations* and emphasize difference between peoples or Fukuyama's *End of History* view of the convergence of ideas and systems. Left with the lack of any explanatory resolution of two seemingly antithetical trends at the end of Samuel Barber's *Jihad vs McWorld*, I now contend we must agree with both. There will always be zero-sum lines of competition even within otherwise non-zero-sum groupings. The web of interdependence necessitating cooperation will not encompass every living thing. Your allies on some matters could be your opponents on others. However, webs of rising interdependence lead to more interconnections within and outside of any non-zero-sum grouping. Ever greater cooperation is required. So, we must ask ourselves again; are there any aspirations or *purposes* which cut across the diverse people of our interconnected world?

Purpose through method: Means determine the end

First, let's point out that in seeking a worthy "purpose" for a business organization, with which we can align the objectives of each person's work, we are led to an interesting question. Czikzsentmihalyi's research on the conditions of flow and work satisfaction have led to the conclusion that the theoretical optimum state for any individual is when we become "autotelic" – that is, when we are engaged in an activity for its own sake, because experiencing it is the main goal. Czikzsentmihalyi, Seligman and others argue that to obtain this optimal state of satisfaction, "what" we do and "how" we do it are what matter, not the end result – that is, the means matter, not the end.

At the same time, there is an increasing focus on purpose in business organizations.[39] If the focus is on purpose, a business adapts beyond one business model – which may be outdated - to the purpose at hand. Purpose binds the otherwise disparate motivations of people towards a single goal. The sum-total of our purposes determine whether, how and the extent to which we progress, or regress. Differently, the *way* we do things impacts what we achieve and what we strive towards. They are, in fact, quite circular. The way we tread determines the direction we travel.

In this way, values thereby take on a new importance. What we do and how we do them determines the purposes or goals of an organization; our end-goal is driven by how we

[35] Cited from Cziksentmihalyi, *Good Business.*
[36] Cziksentmihalyi, Gardner, Peterson, *Good Work, Good Business,* Seligman etc.
[37] Interview with Emmanuelle Bassmann, Freelance contract trendspotter, 7 August 2004, London.
[38] See the UK Ethical Consumption Report, in *The Independent,* 12 December 2005 "Shoppers with a conscience take over the high street", page 6.
[39] Thomas Stewart, *The Wealth of Knowledge.*

pursue it. Values provide boundaries of behavioural principles with which a business shall pursue its ends. Whether a business will pursue continued learning, for example, will determine the end results it can achieve. [40]

If research shows that we are most satisfied when we are doing what we do for its own sake, then we would be most content when our purpose is to do things in a manner that is consistent with principles that reflect our values about *how* to do things.[41] Therefore, if we could find universally revered principles about *how* to do things, then we could motivate a larger subset of our increasingly diverse working population.

In seeking the optimal purpose which will captivate the energies of the largest subset of people involved in our global working organizations, we should be interested in whether there are any universally revered "ways" of going about our work. Are there universally revered principles or values that cut across people from all backgrounds and beliefs? There are a number of ways that we can answer this question, but in short, latest research and writings confirm that the answer is yes.

Universal human values and principles

One way to find increasingly universal normative principles of conduct is to survey the values that have been revered by people throughout history and across different cultures and religions.

An evaluation of the most significant scripts and texts throughout documented history reveals universally regarded "virtues".[42] Work along these lines has been led by Martin Seligman, resulting in the publication in 2004 of a handbook and classification of human strengths and virtues. It undertakes a systematic classification and measurement of universal strengths and virtues from all virtue catalogs of written history, including religions and philosophies from Confucianism to Catholicism.[43] It seeks the common denominators of definitions of virtue across human history. These virtues, by definition, describe conduct to which humans have always aspired. They include at the most generic level: knowledge; courage; humanity; justice; temperance; transcendence; and are further subdivided and described. They could form the foundation of a more empirically-based universal code of ethics which traverses East and West, North and South. These "universal virtues" represent the way we should "go about" pursuing our purpose. While not for business application, they would logically form a sound foundation for the normative principles we seek.

Other authors have also contended, with fresh evidence, that, just as certain biological laws have consistently prevailed, there are also human interpersonal characteristics or traits that have historically prevailed; take for example, the compendiums of Matt Ridley in *The Origins of Virtue* and more recently in *Nature via Nurture* (which reviews extensive and recent findings of genetic and scientific research) and Robert Wright in *The Moral Animal.* There are inherently winning laws of behaviour and therefore of humanity which stem from our biological makeup and the functioning of our society. Some principles have triumphed over others: these are innate winning human characteristics that are common in all cultures. So by inductive reasoning, we could extrapolate from biology normative principles across human society.

At the same time, society is not static, so we may need to look to emerging trends in values. Demographer writer Richard Florida defines the "creative classes" as those involved in the media, design, arts and entertainment. They "rely on individual creativity and imagination allied with skill and talent, and produce value through the generation and exploitation of new intellectual property and content." He argues that creativity is also required of "creative professionals" who work in high-tech, financial services, the legal and health care professions, and business management. These people engage in creative problem solving, drawing on complex bodies of knowledge to solve specific problems. Doing so, typically requires many years of formal education and thus a high level of human capital. After showing that the extent of creativity in professions is rising, his research asserts that these "creative classes" are highly driven by qualitative factors such as the acceptance of diversity and meritocracy.[44] As industrial evolution necessitates increasing levels of "creative" functions in industry,

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[40] Better example of a value that determines outcome?
[41] While sounding quite esoteric, this is a fundamentally key point. But reads terrible. Need to clean up how it is expressed.
[42] Dr Martin Seligman, *Authentic Happiness*; Christopher Peterson and Martin Seligman, *Character Strengths & Virtues,* 2004.
[43] The handbook is *Character Strength and Virtues*, noted above, by a group of psychologist researchers in the Values in Action Classification Project.
[44] Richard Florida, *The Rise of the Creative Classes*; Teresa Amabile, *Creativity in Context*; Jans Johansson, *The Medici Effect: Breakthrough Insights at the Intersection of Ideas, Concepts and Cultures.*

the values of the creative classes may well point to values of emerging importance.

Reconciling the values of Seligman's study of universally revered virtues, with Ridley's biologically embedded innate human characteristics and Florida's values of the creative classes, are beyond the scope of this paper, but they do point to the fact that norms can be reconciled, and potentially lead to definitions of qualitative principles upon which successful businesses will "increasingly" need to be based.

These could provide a baseline norm of values that will capture the motivations of a broader set of individuals in the value-creation process. By doing this, we would be broadening the spheres of co-operation (through alignment with common virtues and goals) to engender even more non-zero-sum gain. "Ethics" may be a term that we use to connote values that embody these universal principles.

At the suggestion of common human virtues, our contemporary instincts may be to reject any normative principles. We typically consider words such as "good" or "virtue" to be subjective, judgmental or self-righteous. However, let's redefine them for the purpose of this argument. Let's say that "good" is an action that is consistent with a direction of the normative principles of human interpersonal relations. "Progress" is when we move further down that non-random trajectory of industrial evolution towards rising complexity, interdependence, means and plurality, and all the other "benefits" that come with that. It must be the path that enables continued improvements in humanity's means which can lead to economic growth and consequent long-term rises in human prosperity. One way we could define "ethics" may be the codes of conduct that most propel us along that path – but to this we shall return in more detail.

Take integrity; a virtue found to be universal.[45] Integrity, then, is a value which, when pursued by an organization will harness the motivations of people towards shared goals. By aligning corporate goals with "integrity" we are likely to motivate the people that contribute to the value-creation of an organization.[46] The pursuit of integrity will inspire our human capital as a workforce (and as we shall suggest later, people as consumers, suppliers or investors). Interestingly, when it came to investing, George Soros argued that no one has a monopoly on the truth.[47] Similarly, one of Buffett's principles is his unwavering commitment to integrity with his shareholders and managers.[48]

Qualitative Norms in Business & Profits

Should these qualitative norms – or 'virtues' - be adhered to in the absolute in business? Are they in conflict with the principles of profitable and diligent business performance? Absolute integrity to our principles may be life-threatening or loss-making at times.[49] Our argument, as far as we have reasoned, only shows that consistent with the evolution of our industry and society, integrity is a goal that we should pursue more aggressively now than ever before. It is a value that organizations should strive towards in the interest of their long-term prosperity; long-term because the importance of human capital and its motivations will only rise.

We have not enunciated any form of measurement and, therefore, valuation, yet. The fact that integrity is a virtue that is consistent with human values points us in a worthwhile direction if we seek sustainability. All indications are that, over the long-term, integrity will generate superior returns through the congruence of principles with the baseline common denominator values of human intellectual capital. The changing dynamics of our society indicate that returns are likely to be a reward for integrity more today than they were in the past. The rise in our means and the consequent rise in interdependence and cooperation mean that we must all adhere to common norms or values ever more.

However, businesses which did not follow these principles in the past – and there are, of course, many - should not be relegated to the status of an aberration or exception to our argument. We are saying that businesses need to comply with these normative principles to a greater extent now than ever.

The increasingly emerging fields of corporate

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[45] See *Seligman, Character Strengths & Virtues.*

[46] If we also accept the principle that people seek 'growth' from a situation where they are engaged in working with a cooperative group of individuals in an organization, then perhaps that growth extends beyond growth simply in business skills and acumen but to strengths in a broader sense, by prodding us more towards becoming people who abide by the universally-admired principles.

[47] George Soros, *The Alchemy of Finance*.

[48] James O'Loughlin, *The Real Warren Buffett: Managing Capital, Leading People*; Other Buffett sources.

[49] Even in Mahatma Ghandi's strict veganism, he did give way to the consumption of goat's milk to save him from dysentery, which he continued over a life time. See The Life of Mahatma Ghandi, author.

social responsibility, ethics and sustainability point us to a number of potential principles, frameworks and tools that are emerging to evaluate and classify qualitative principles of conduct in positive or negative ways. Having said that, I still agree with Milton Friedman in his historic 1970 article that the only "social responsibility of business is to increase profits", in that a social responsibility to all of any given society is typically placed in the hands of institutions who are typically responsible for the good of the whole. Business is, by necessity, partisan within our conventional definition of a single society – that is, one based on geographic lines. Therefore, to say that business has a social responsibility, may be misleading but, in our line of reasoning, the path to superior value-creation lies along one which considers frameworks and principles that most likely are incubating within this realm.

Virtues capture the motivations of your allies

We have said that economic progress is engendered through the pursuit of non-zero-sum gain. But that non-zero-sum gain must be fostered through the pursuit of "values-based" or virtuous conduct of business. And we contend, at this stage, that the dynamic is most prevalent at the fringes of evolution in industrial activity. As our economies become knowledge-weighted, so does our reliance on productive human capital. But human capital, and especially that possessed by people who are engaged in innovative or creative industrial activity, is driven by the fundamental purpose and values of their productive activity. Therefore, to have congruence of purpose and values between people and businesses, we need to appeal to universal human principles that will determine how we pursue our business objectives and therefore our ultimate purpose.

By doing so, we ensure that our corporate objectives will be consistent with a path of long-term sustainability for superior value-creation. In identifying values which are likely to harness the motivations of a wider set of interdependent people, we need to act in accordance with a specific set of norms. At one level, this is a human resource argument. However, the importance of these norms is ever-greater thanks to a conflation of cause and effect: between our method of doing things and our purpose for doing them – which arguably is a deeper element of how we can drive corporate evolution down the path of superior value-generation. How does this help investors maximize returns?

V. INVESTING THROUGH VALUES, CSR, SRI AND OTHER ACRONYMS

Investing consistent with our long-term trajectory

As we stated earlier, the goal of an organization defines its mission. Goals will determine the direction of any business: what it produces, what purposes it serves. Goals will, in aggregate, determine the direction of our industrial evolution. We also concluded earlier that opportunities for abnormal value-creation are most significant at the fringes of non-zero-sum gain – and it is those non-zero-sum gain developments that will determine the trends of our industrial development.

At the beginning of this paper we asserted that history has a particular direction – one characterized, amongst others, by a consistent rise in complexity, interdependence, plurality, means, lower cost of access to means and a broadening of the bases of power; and it is *most probable* that these trends will continue. If we project all those trends forward, we could hypothetically, and (very) abstractly focus on a potential ultimate destination of our history. Of course, there is not any single point of future destination.

There are many variations within these consistent themes. The QWERTY keyboard evolved as the most common English-language typing keyboard despite its invention to slow the typist's hand and minimize the jamming of levers on the old mechanical typewriters. This, like many things, is not optimal. Nevertheless, there are certain attributes in which we follow a continuum; and, as far as those are concerned, there must be – in theory – a range, but a limited one, of potential evolutionary possibilities. We are unlikely to revert to scribes and horseback to convey our messages. So there is a line along or between which we will progress.

If we could, again in theory, move forward as directly as possible along those lines, we would avoid any distractions from our path of greatest value-creation on the trajectory of industrial evolution. We would minimize any "sub-optimal" paths of value-creation. By ensuring that the frontier of our industrial energy points most directly towards the next stage in our industrial evolution, we would maximize the potential for value-creation.

If progress goes hand in hand with economic growth, then we could invest in propositions that we know will generate superior returns. If we knew where that path will lead, we could short-sell those investments in the capital markets that diverge from our long-term trend direction of maximum value-creation, and invest in those that do follow that path.[50]

But, this is a terribly abstract and theoretical path; we don't know where it will lead next year, in the next decade or by the end of the next century. So then, what can we do to maximize the value-creation that eventuates through progress instead? How can we pursue this hypothetical “fastest” or “most efficient” path?

Let’s recap to answer.

Abnormal, and therefore potentially superior, value-creation is most evident on the frontiers of industrial evolution. We are increasingly reliant on the innovation and creativity of human capital. To stimulate greater intrinsic motivation, we must align our corporate goals with individual goals; by doing so we engender the best performance of our human capital and potentially best investor returns, *today.*

However, the importance of human intellectual capital is most likely on a path of continuous rise – due to the increase of means, plurality, interdependence, and the ‘weight-to-mass’ ratio. Therefore, the need to heed normative principles of human conduct will do nothing but increase. Then, if these principles do nothing but rise in importance, then the path of the future is one guided and bounded by adherence to these principles.

There will always be competing threads of values within any group of society – zero-sum groupings, within any non-zero-sum group. We could invest according to partisan values determined by values-based paradigms such as religion. We could almost hedge values. [51]

At the same time, concepts about “how” best to do things must be increasingly congruent with the values of a wider spectrum of people as industry globalizes, because these will lead us to the goals that will capture the spirit of our workers (and indeed, all of our coalition partners, whether employees, consumers, shareholders or suppliers). The goal of an organization defines its mission. Those that advance progress will, in theory, succeed for a longer period than those that don’t. A values-based investment fund based upon long-term successful principles across a broader spectrum of people should, in theory, maximize returns over the long-term.

Since industry has rapidly become ever-more-global, by pursuing our industrial activities in accordance with the norms that cut across many beliefs we would ensure that industry travels the most efficient path along the trajectory of industrial evolution. By ensuring that the way we do things complies with “universal virtues” about “how” to do things, we would be ensuring that our path of industrial development hews close as possible to the purposes and objects that are on a path of our optimal long-term trajectory and therefore maximize value-creation. We could call this ”ethical” business or investing; but this could confuse our argument. Using these terms could imply that there is something novel about this concept. Our thesis, however, only shows that there has been a consistent rise in the level of ”ethics” over every preceding stage of our industrial history. We could call it “socially responsible” investing, but this could imply that we defer returns to the pursuit of social causes; when that is a mission we have vested in our governments. At the same time, our use of these words could point to the fact that we recognize the significant rise in the importance of these principles that will ensue.

As citizens, we should ensure that regulatory regimes should capture the effects and side-effects of as much of the economic activity of industry as possible; in industry, we should recognise that excellence and maximizing investor returns will require an evaluation of ever-broader alliances and stakeholders; and that by necessity, normative values should be heeded more than ever. We should forever refine accounting methods to improve that measure. As our societies have moved beyond the realm of barter exchange

[50] We could invest in the equity of businesses that we found to comply with these guiding principles. If we believed that, ultimately, the dietary preferences of people in the UK would improve, we would invest in retailers who focus on these segments and short-sell those wholesalers who have embedded their business models in less-healthy foods. See *Financial Times*, 6 Jan 2006, “Jamie Oliver’s Campaign sends Canterbury Foods bankrupt.”

[51] See FT 28 December 2005. There is a small but rapidly growing band of faith-based mutual funds. Their returns vary, and indeed a “vice” fund which invests in alcohol, tobacco, and gambling returned less than the S&P’s 5 percent in 2005. For the year 2005, the main US Muslim fund has beaten funds run according to the principles of the Catholics, the Mennonites, the Presbyterians, and the evangelical Christians, posting a 22 percent return for the year, according to data provided by the investment fund valuation service, Lipper. Of course, such a statistic is hardly meaningful over a year, but you get the point. *[Find more data]*

to currencies representative of value, pursuing bottom line gain is the best measure our societies have constructed to measure value created. At the same time, we need qualitative frameworks to help us evaluate the various limbs of our businesses and the extent to which they will respect the normative values in building our alliances.

However, let me reiterate our core thesis.

By abiding by universally respected values we are more likely to realize superior returns on our investment, not merely by capturing the spirit of workers, but by ensuring that our objects and purposes are consistent with that goal. The importance of that goal will only rise in the future, thanks to the consistent trend of our economies towards more intellectual-capital value-creation and continually rising levels of interdependence, means and other attributes of industrial progress. The universal laws that have always won out in our intergenerational race for genetic longevity will enable us to continue down a path that maximizes continued value-creation.

Failing to comply with these laws is less likely to lead us to sustained success in the highly interdependent world in which we live. Failing to respect integrity in one's relationships will probably create more problems now than it did in the past. Game theory tells us that in a one-shot game or relationship, short-termism can pay off. But in a multi-round game, cooperation is most likely to pay. One's duplicity towards a neighbor will probably catch up with one sooner now, because interdependencies are rising. There are fewer degrees of separation between you and a future business ally now than there were 50 years ago.

Given this rising interdependence and the changing sources of value in our continuously restructuring economies, the pursuit of this form of normative "good" will become ever more important to guide business and investment decision-making.

Let's return to our pragmatic illustration of this abstract, confounding conclusion.

The media, information, communications & technology frontier

The media and information industries face a pressing challenge. With the significant rapid decline in the costs of communication over the last ten years, returns on distribution and communications assets, as opposed to content, in the media sector continue to commoditize: they either face increasingly normal returns or the risk of being cannibalized. This presents the media industry and its investors with a dilemma.

One business magazine recently encapsulated the situation, after describing the excellent returns of a media-focused private equity fund which has predominantly invested in distribution assets in media. "Now, newspaper readers are defecting to the Internet. Music lovers download tunes from the Web, TV networks sell *CSI* to fans with cell phones and portable video players for $1.99 per show. That's rocking assumptions about profit and revenue, making a winning investment tougher to spot. 'Private equity firms have to be selective and opportunistic,' says one analyst. In the next five years, growth in traditional media will be spotty; if there's any at all. One investment partner says, "It's hard to point to a traditional media business that doesn't have profound threats."[52]

The dilemma is, in the face of commoditized returns on distribution assets, and the sporadic nature of returns on content assets, where are above-normal returns to be found? From where can we secure superior investment returns in an environment where the costs of distribution increasingly approach zero? With the distribution costs of media content descending, the answer, consistent with our earlier answer, is innovation and creativity. However, this stems from human capital. It is content that will still yield value to the ultimate consumer, but as the necessity of distribution assets to communicate that content to the ultimate users declining, there are declining barriers for content creators to access their audiences. In this way, ever-greater value does not stem from a fixed asset that has a particular lifetime and will generate a particular number of units of manufacture per annum. How do we sustain this and secure its long-term maximum returns?

There are resources of a wider organization that are beneficial to all those who are intrinsically motivated. Remember: specialization helps generate greater value-creation. The band Arctic Monkeys sky-rocketed to fame by posting their songs on the website myspace.com. They have become the fastest selling debut album ever in UK. They are unlikely to be financial or legal wizards. But, they less needed to navigate the legal minefield of negotiating with record producers to have their music heard. We need a way to bind an organization of people's industrial

[52] Monee Fields-White, "Quadrangle's New Media Gamble", Bloomberg Markets, April 2006.

endeavour into a cohesive, sustainable fabric. That fabric needs to be focused and driven towards its goals. More than ever, we need values to harness the energies and motivations of our innovative and creative human capital. In making decisions in business and investment, we need to heed to these principles much more than we have had to. Universal normative values will enable innovating organizations and investors to perform better.

Of course, it is inherent in our definition that this requires more than public relations exercises in these values: organizations must walk the talk.

Now, before we dismiss the argument as an abstraction – irrelevant for many decades - let's turn to a number of simultaneous dynamics that make this principle more impending than we may otherwise think.

VI. MAXIMIZING VALUE IN A MORE RAPIDLY EVOLVING WORLD

Rising innovation & longevity of business models

When we invest in a business, the longer the term of stable returns, the more value we can ascribe to it. When we consider the multiples of the earnings of any investment proposition, what we are doing is assessing the durability of the returns on that investment. We assess the risk of those returns, and the length and sustainability of the corporation's business model. This leads us to a forecast of the value that the investment is likely to contribute to us over that period.

In this context, let's consider this: our industries are evolving faster than ever. If there is a rise in complexity, then it must be accompanied by a rise in the *number* of interactions among components of industry. As the number of interactions multiplies, so does our ability to connect pieces of information. Connecting divergent information is the nexus of innovation.[53] With our improving ability to convey and process information, there is a simultaneous rise in the *rate* of communications among otherwise independent people or things.

If one thinks of a join-the-dots type square, and how the number of relationships between dots rises with the addition of each new dot, a mathematical relationship ensues.[54] In a similar way, our brains have evolved. Like microprocessors; Moore's Law[55], the prediction by Intel's founder Gordon Moore that microprocessing power of integrated circuits and their complexity will double every 18 months, refers to a non-linear correlation between the rise in micro-processing power and time. Bill Gates has also talked about a digital nervous system.[56] With a rise in complexity, change must be accelerating.

The extent of change we can ascertain in a decade two thousand years ago is very different to the amount of change within the last decade. One consequence of this is that our rate of innovation must be accelerating. It is also more than likely to continue to rise. As the rate of innovation rises, so does the extent to which our cycles of innovation of disruptive technologies create and destroy value in a business model or technology. [57] As voice-over-Internet Protocol technology challenges the business models of telecom incumbents, not more than a decade or two since we last saw a wave of investment into those players, long-term investors have to ask themselves what they are really investing in.

If the valuation of a company is determined by the quantum, risk and longevity of its returns, and if technological transformation is likely to destroy value in shorter and shorter time frames at the frontiers of industrial evolution, how then can we assess the entities in which we should invest beyond taking a fixed multiple of their current-year profits?

Norms as a long-term driver of value

We are investing less and less in a business model, tangible asset or piece of technology, and ever more in systems for organization of human innovation.

The systems surrounding human innovation could well include deeper systems of incentivization. Microsoft's stock options played a key role in its remuneration packages. The company early on recognized that its most important asset was people.[58] Private equity is driving deeper forms of incentivization to senior management and allocators of capital, while Google searches for a

[53] See Johanssen, *The Medici Effect: Breakthrough Insights at the Intersection of Ideas, Fields and Cultures.*
[54] The number of relationships that ensues between n independent parties where they all perfectly interrelate with each other is n(n-1)/2.
[55] The prediction by the founder of Intel that microchip processing power will double every 24 months. [elaborate]
[56] Bill Gates, Business at the Speed of Thought: Using a Digital Nervous System
[57] HBSP, Destructive innovation article.
[58] HBS Case: Microsoft.

model of incentivization that is as flat in structure as possible.

We could also argue that the structure of organizations needs to evolve to allow more flexible structures for innovation and creativity.[59] "Traditional" media companies are not optimally structured to innovate at the level of fragmentation that is increasingly required. It is even argued that Google has a better system of innovation than Microsoft for emerging models of software.[60] Older media companies acquire internet "assets", but run the risk of buying static value unless they have a system of maintaining innovation. The larger portion of sustainable value lies within a business model's ability to continue to innovate. Organizational forms need to adapt; and they have dramatically over the last few centuries – craftsmen's[61] guilds to corporations.[62] But that's not all.

When investing in businesses at these frontiers for more than the very short-term, to protect the security and growth of our capital, we need to invest in an organization with sustainable value. Consistent with our thesis, our direction will be on the most efficient path towards value-creation if it is guided by normative values. The best way is to ensure that is by making the "way" it pursues its purpose consistent with normative principles.

The long-term is increasingly short-term

A rising rate of innovation also implies that investment timelines are growing shorter. "Long-term" investing is no longer long-term. Faster industrial evolution means shorter life-cycles of investment and a greater need to focus on the long-term. Herein lies the importance of "sustainability" analysis in investment. As the majority of a business's valuation often lies in the "longer-term," issues of sustainability grow.

In our rapidly evolving industries a sustainable organization generates returns beyond any single business model. It needs to continuously innovate. But, to best harness our aspirations as innovating workers, we need to believe in the cause of what we are doing. We must ensure that we are bound by a common set of values – and, again, what better place to start than a time-hallowed set of values? As the long-term becomes increasingly short-term, the *rate* of innovation rises and the value of an organization becomes embedded into its ability to sustain itself; the importance of these principles rises *at an increasing rate*.

[See Box 2 at end for further illustration in the context of private equity funds]

VII. HUMAN CAPITAL IN THE VALUE CHAIN AND OTHER FRONTIERS

While we have looked at the information frontier, these dynamics will exist in other sectors. The dynamics of the rising importance of normative values – through their relevance to human capital as inputs in the value chain - are most apparent in segments where a large portion of the value is created by human intellectual capital. The media, information and communication segments illustrate how increasing levels of interrelationships will require ever higher levels of values to perpetuate growth at the information frontier. These effects will be apparent at other frontiers of our progress along the lines of industrial evolution. Biotechnology may exhibit similar principles. The impact of industry on our natural environment will also drive environmental innovation in the longer-term. At the same time, when we extend our analysis of the effects of interdependence beyond human capital as workers, the impact widens.

Until now, we have focused on individuals as workers – or human capital as a contribution to the value-creation process, and traced the connections to investor returns through the value chain. While I have not traced an analogous path for people as consumers, investors, or any other contributor in the value-chain, I believe similar consequences would be observed.

As consumers, the dynamics of rising interdependence will affect us all. We will be concerned about the source of our Nike products, and the likely working conditions of Nike workers, as those regions of the world will be a cheaper flight away and falling communications costs only exacerbate the "CNN effect" of images from formerly more remote parts of the world. What this means is that consumers will demand the values of the organizations whose products and services they buy to be congruent with theirs; and we then revert to seeking a common denominator of normative values again.

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[59] Note the current debate over forms of organization for software production at Microsoft in the face of challenges from Google's organizational structure. Google has offered an even deeper model of incentivisation, proposing Google Stock Units to individual innovations of tremendous value generation. References?

[60] See "Code Red: Battling Google, Microsoft Changes How It Builds Software", Wall Street Journal Online, 23 Sept 2005.

[61] Intentionally politically incorrect use of craftsmen, as it was the case.

[62] See Chapter x in Richard Florida, *The Rise of the Creative Class.*

As investors, the interrelationship between us and the invested companies approaches an interesting convergence. Most of the world's capital is managed by institutional money-managers, who are investing it for the world's working population through pension fund arrangements. Workers are already beginning to demand the transfer of their pension funds to organizations that share their values. Will they insist that their money be placed in the hands of money managers who share their values?

It may depend on what, if anything, it costs them. If investing in ABC Petroleum costs the taxpayer twice the proportion of taxes needed to repair the damage to the common property of society that XYZ Petroleum costs, they will take notice. Taxpayers will soon be able to make that calculation through metrics such as carbon emissions trading. If the benefit to ABC Petroleum's share price (and therefore to my pension fund return) from its cheaper and less effective, emissions filtering systems, doesn't outweigh the taxpayer cost of clean-up, I might insist that my pension fund steer clear of ABC Petroleum. This also exemplifies our rising ability to capture effects and side-effects within the definitions of our economic system.

At the same time, there is a rising number of people in the investment decision-making chain who are influencing such outcomes. Take the high-school principal in Texas pressing his fellow trustees of his profession's retirement fund to prohibit investments in what he considers socially unacceptable companies – such as those that produce porn, whether in public equities or private investments.[63]

Furthermore, as what companies manage becomes more complex, the need for specialized knowledge increases. Investment analysts who have spent their careers in finance may not readily comprehend all of a pharmaceutical or biotechnology company's activities. As our pension fund moneys flow into these companies, the feasibility of employing enough experts within an investment fund who comprehend the workings of portfolio companies becomes economically impractical. While actively managed portfolio companies – without the information disadvantages of the public markets – may assist overcome the information disadvantages of the minority investor in public securities, as may a greater alignment of incentives – such as sharing capital gains with the investment managers – analysts will still need to rely on a certain base level of compliance with normative principles where laws and regulations no longer reach.

Similarly, as complexity rises, so might the ability to circumvent but not breach accounting rules and regulations to maximize earnings. Investors need to have faith that portfolio companies will not engage in overly-creative accounting to maximize their earnings. Buffett in this regard is exemplary, as his stated principles promise shareholders, "Over time, the large majority of our businesses have exceeded our expectations. But sometimes we have disappointments, and we will try to be as candid in informing you about those as we are in describing the happier experiences."[64]

These precepts will extend to all participants in the value chain. Rising interdependencies are transforming all these relationships to the point where normative values in harmony with inherent human characteristics will be key to obtaining buy-in from a broader set of stakeholders.

VIII. COMPETITIVE INSTINCTS AND CLARIFICATIONS

At this point, let me make some much-needed clarifications.

First, as touched on earlier, while the relationships among more disparate groups of people are increasingly interdependent, this does not mean that corporations should diffuse their resources by trying to help everyone. We should pursue our competitive vested interests for gain; otherwise, we could be rendered powerless against our competitors. Ultimately, all organizations and people have limited resources. Progress, value-creation, returns on capital and achievement of any end rely on the allocation of scarce resources. As interdependence continues to rise, firms have a growing base of stakeholders. But it is an irrevocable tenet of human nature and society to compete and generate sustained value-creation through both zero-sum and non-zero-sum scenarios. In the zero-sum scenarios, firms should not let down their guard in the pursuit of mutual gain with competitors where there is none. Firms that seek goodwill with parties whom they consider allies should not seek "goodwill" returns where there are none.[65]

[63] Institutional Investor, *Porn Perils of a Socially Responsible Texas Pension Fund Trustee,* 10 February 2006

[64] In Principle 6 in Berkshire Hathaway's *Owners' Manual*, issued in June 1996 to its Class A and Class B shareholders.

[65] This is consistent with the contended principle of Simon

One of the lessons to be drawn from this article is that any firm's core business involves a greater number of stakeholders. Modern firms must pay attention to those relationships, but not relinquish efforts to preserve zero-sum competitive advantages. The argument of this paper is that more returns are likely to ensue from relationships that were previously zero-sum (that is, of no commercial benefit) due to rising interdependencies. Corporations and investors are all groupings of non-zero-sum allied parties against other zero-sum correlated parties. Therefore, it should be considered their mission to seek and derive gain while mindful of the rising set of interdependencies. An obvious motto could still be something like "reward your allies, challenge your competitors." The challenge is to redefine the extent to which those allies – through multiple interdependencies - interrelate.

Wider social benefits are still the core mission of a non-zero-sum grouping that we call government – an alliance among citizens, taxpayers and authorities, which has a wider or different ambit of alliances and seeks longer-term returns than does business. There will be an increasing importance of public-private partnerships as stakeholders interrelate more as a result of industrial progress.

This paper argues that returns to investors can *increasingly* be maximized through the incorporation of universal values into the methods and purpose of business, since there are more, growing alliances to heed.

Second, while the pursuit of short-term profit can, of course, lead to gain, what we are advocating is that the pursuit of values will enable long-term sustainable returns. Long-term relationships represent a multi-round, repetitive game. With increasing interdependence and interrelationships that arise from improvements in technology, value principles are more important in our global village. The rising rate of innovation will engender a rise in the importance of values much sooner than they have risen in the past. While we may steal from a store in a foreign city, and hope that our anonymity will protect us, the CCTV camera pictures may well be used to track our identity wherever we go. *[change example.]*

Third, we are not saying that any of the "universal" values need to be adhered to in the absolute. What we are saying, is that historical trends such as rising interdependence, the declining cost of means which leads to rising access to, rising complexity and access point to an ever-increasing level of importance for these values. Pursuit of these values and adherence to them will engender greater business success tomorrow than it did yesterday.

Fourth, we do not contend that we know exactly what these values constitute, but what is of importance is the intention to pursue these rules of conduct. There will always be shades of meaning within our definition of these values. It is the mission of this paper only to stress their rising importance.

Fifth, let's not forget "tit-for-tat." This is still the most successful strategy in game theory. Trust at first, and cooperate until the competition doesn't. Then challenge them, until they do. Our contention in this paper does not in any way detract from this principle. We should not let down our defences indiscriminately in the pursuit of greater alliances for superior value-generation.

Sixth, our ability to regulate (as we know it) may not be infinite. Just as organizational structures may be not be able to manage all parts of an organization, regulatory authorities may not be able to provide the web of regulation needed to control an increasingly interdependent world. Using information as an example, as the world's content proliferates and penetrates the walls of nation-states through its digitized content forms, is it realistic that governments will be able to regulate or even create and monitor the necessary quantity of laws to regulate the activities of the players entirely themselves?

At some point in the distant future, organizations with an instilled set of self-regulatory inherent universal values may be preferred as service providers. Perhaps authorities, investors, consumers and suppliers alike will all subtly come to prefer the players that are self-regulating or regulated by their own set of value principles in harmony with the world's different legal ecologies. I point here to recent examples of Chinese authorities preferring interactive games suppliers instilling "values" into software for children's games.[66]

Seventh, I have advocated nothing about value-capture or strategy. In seeking to create value, we should also capture that value within our organization. We should commercialize our

Zadek in *Conversations with Disbelievers: Persuading Companies to Address Social Challenges,* November 2000

[66] Reference.

innovations where appropriate. I have not advocated relinquishing any other strategic methods.

Finally, we face a challenge of proof. The thesis of this paper is not, and arguably cannot ever be, definitively proven. What we are arguing is that values are likely to be more important tomorrow than they are today. We can look to the past to find trends that surface in the events that have evolved until today - something that we and the authors of works cited in this paper have commenced to do, but that only proves the past. Our contention is about the future state of affairs being "more likely than not" in a particular way. In doing so, we have a moving target of evidence - the future.

IX. VALUE-CREATION IN THE 21ST CENTURY

At the risk of choosing a fashionable closing example, in his book *The Search,* John Batelle explains that the founders of Google, Sergey Brin and Larry Page wanted to create a search engine that delivered the purest and most accurate results; results with the greatest integrity, if you will.[67]

At an early point in the company's history, members of the company met to address what would become a fundamental challenge to the young company's future: how to manage growth and how the company should ensure that its original DNA – the founders' vision, values, and principles – remained intact?

The founders brought together a group of employees to address the mission of elucidating Google's core principles as a business and a place to work. In Batelle's words "This particular brand of soul-searching is typical for just about any young company experiencing hyper-growth" and was nothing new. "What was new, however, was what came out of that meeting." One of those involved recounts "Some of us were very anti-corporate, and we didn't like the idea of … specific rules." He continues, "engineers in general like efficiency – there had to be a way to say all these things in one statement, as opposed to being so specific."

That's "when someone in the group blurted out what would become the most important three words in Google's corporate history. 'All of these things can be covered by just saying, *Don't Be Evil*.' The phrase has become a "cultural rallying call at Google, initially for how Googlers should treat each other, but quickly for how Google should behave in the world as well. The message spread, and it was embraced, especially by Page and Brin. "The phrase captured what we all inherently felt was already true about the company," another Google employee recalled. Larry Page explained "When you are making decisions, it causes you to think."

Google has certainly faced its share of challenges in the aspiration to live up to its motto. I am not advocating that Google or any other company fulfils this aspiration in the absolute. That would mistake the nature of my argument, which is that these things need to be considered more today than they ever have been before – given digitization, the Internet and a raft of emerging co-dependencies. Nor am I advocating any particular valuation of a company. I do, however, assert that the aspiration to comply with a particular set of values is a key link in a corporate methodology that seeks a higher level of congruence between normative principles and that will become a key competitive advantage in value-creation.

As consumers, think about this. Every email we send and every query we enter into a search engine is recorded in the servers of our corporate Internet service and search engine providers. In the aftermath of September 11, 2001, the Bush administration swiftly introduced legislation that expanded the federal government's power to conduct domestic surveillance. Under the USA Patriot Act, the U.S. government can demand information on your emails, your searches and your clickstream – the pathways of your viewings on the Internet. It can issue a warrant, not on you, but on the company that you use as your connection to the world's information – whether Google, Microsoft, or your local provider. The standards for whom the government can tap in this way and whether it informs them at all have loosened tremendously. In fact, your entire digital track is recorded into digital history and the U.S. government may trace its track without your ever knowing.[68]

John Batelle, again, reflects on the consequences of this. "As we move our data to the servers at Amazon.com, Hotmail.com, Yahoo.com, and Gmail.com, we are making an implicit bargain, one that the public at large is either entirely content with, or, more likely, one that most have not taken much to heart. … That bargain is this: we trust you to not do evil things with our information. We trust

[67] Taken from Batelle,*The Search.*

[68] See John Batelle's analysis of the implications of the USA Patriot Act at *The Search,* p. 197ff.

that you will keep it secure, free from unlawful government or private search and seizure, and under our control at all times. We understand that you might use our data in aggregate to provide us better and more useful services, but we trust that you will not identify individuals personally through our data, nor use our data in a manner that would violate our own sense of privacy and freedom."[69] These are all contractual conditions to which we agree as users of any search engine, email or Internet service provider. However, if these conditions were breached in your instance, at law, what amount of pecuniary damages would be sufficient?

Batelle continues "…That's a pretty large helping of trust we're asking companies to ladle onto their corporate plate. And I'm not sure either we or they are entirely sure what to do with the implications of such a transfer. Just thinking about these implications makes a reasonable person's head hurt." We can ease the pain by continuing this discussion.

Organizations and investors across all sectors must recognize that in our increasingly interdependent and ever-faster-evolving world, normative human values or virtues will be key to securing superior value-creation and investment returns.

Spyro Korsanos

[69] John Batelle, *The Search,* p.15

Box 1: Hyper-helpers or rising plurality, fragmentation and access to capital?

The translation of these insights into financial and corporate application can be compelling. In his 2006 Letter to Shareholders, Warren Buffett condemned the proliferation of intermediaries between investors and their ultimate investment. He stated that ''hyper-helpers", such as private equity funds and hedge funds, consume capital through layers of fees including management fees and performance fees for minimum value-add.

If we apply the long-term evolutionary trends to investment markets, at a very macro level, the rise in plurality and importance of human capital is consistent with the long-term growth of these investment funds as a business organization. One of the core elements of these funds is the structure of incentives, whereby the investment managers are entitled to, typically, 20% of the gains generated for the investors.

As the units of industry innovation fragment, pooling capital and investment managers across a greater number of business models enables a more efficient allocation over these resources. Plurality, or the broadening of the bases of power – whereby more individuals are more empowered to facilitate business models through lower barriers of access to "means" - requires a shift in the allocation of rewards between capital providers and those using their intellectual capital to manage the capital and the business models into which it is invested.

(At the same time, this does not lessen problems with the alignment of incentives in private equity funds for downside risk, which Buffet argues. That is, while investors may lose their shirts, investment managers don't, yet are entitled to 20% of the upside return. Investment managers need to face analogous risks to the investors in the circumstances of the downside risk (or losses) for their incentives to be better aligned.)

As talented managers obtain greater access to the capital of private equity investors and take a greater share of the rewards, this phenomenon can be viewed as a consequence of the rising accessibility of capital to those of merit-worthy management abilities.[70] It is an accepted form of business organization to structure joint ventures where different parties make different 'contributions' to the joint relationship. One party may contribute more capital than another; depending of the in-kind contributions of the parties. Along analogous lines, these forms of investment funds heighten the alignment of incentives between capital providers and capital managers, such that the capital managers share in the proportion of returns differently to salaried returns which may be more discretionarily set.

Conclusion: the rise of private equity and hedge funds structures is not a passing fad, but one reflected by the long-term evolution of industry and managers' relationship to capital markets.

Box 2 - Hyper-Helpers and Innovation

Consistent with this perspective, we can humbly beg to differ with Warren Buffett's contentions about hyper-helpers again[71]. As innovation rises, change comes upon us faster than ever before. Technology developments bring with them fundamental changes in business models across all sectors. Business models have shorter lifecyles.

The type of management required for a business with a stable business model is very different from that required for a business geared for transformation. Private equity-style investment funds enable capital allocators to transform businesses more effectively when significant transformation could be less well achieved by a steady state business management team. As the rate of change in industry rises, private equity discipline engenders greater concentration of the capital allocators to the transformation process required. Furthermore, by avoiding the public market's needs for consistent quarterly returns, these funds enable businesses under transformation to go undergo change more effectively than would the public markets.

Equally, where the extent of innovation or creativity is highly fragmented, private equity funds managed by money managers who lack skill in managing people will be at a disadvantage, since the core asset in the value-creation process is human intellectual capital. Specialized knowledge and operational knowledge are increasingly key in investment allocation.

Conclusion: private equity & unregulated

[70] There are, of course, numerous other reasons for the rise in the private equity and hedge fund business model – including the rising level of wealth amongst a greater number of individuals (a very consequence of plurality itself) – and another which we shall return to shortly (the rising rate of innovation).

[71] From his 2006 Letter to Shareholders.

investment fund structures can be more appropriate investment organizations in a context where the transformational changes facing any business model or industry are increasingly faster.

