You Can See Where This is Going

Where progress comes from, and how the next generation will invest their money.

By Morgan Housel and the Collaborative Fund team

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More than $30 trillion will be passed from baby boomers to their children over the next 30 years. This does more than generate a new set of bank account numbers. Like every generation before it, millennials view the world differently than their parents. They have different values and expectations. They have different priorities.

This report views the coming decades of business and investing through the lens of a new generation.

The most fascinating part of history is trying to understand how people who are exactly like us could behave in ways we cannot fathom.

Take an example from Harvard psychologist Steven Pinker's book *The Better Angels of our Nature*.

A treatise on how people become less violent over time, the book explains barbarous practices that used to be normal. One was animal torture—a fixture of public entertainment for most of history until the 19th century. The details of what took place don't matter. What matters is that the majority of society used to find animal torture perfectly acceptable.

"Spectators enjoyed cruelty, even when it served no purpose," Pinker writes. "Torturing animals was good clean fun." Crowds—which included the noblest of kings, queens, and priests—"shrieked with laughter as the animals" were killed.

The common reaction is to consider these people monsters. But they weren't. Biologically, they were no different from you or me. And the crowds who enjoyed these events were so large and diverse—so representative of the entire town—that we can't chalk this up to a few sadists. Violence and torture 300 years ago were as socially accepted as, say, contact sports are today.

How can this be?

It’s a complicated topic, but here’s a simple idea that helps explain how cultures settle on norms.

Life was abjectly miserable for almost everyone 300 years ago. And misery in your own life limits how much mental bandwidth you have for sympathy toward others. Animal welfare barely registered as relevant when the health of your own children was so tenuous, and famine and plague lurked around every corner. Life was a daily battle to protect yourself.

As generations rolled on and life improved for nearly everyone, norms changed.

Better health, more comfortable living conditions, and more prosperous jobs meant less time worrying about your immediate surroundings, which opened the doors up to empathizing with how others were doing. Life has improved so much over the last 300 years that we now have enough bandwidth to consider the wellbeing of not only other people, but animals.

This is how all progress is made.

“Secure your own mask before assisting others,” the instructions say. My point is that the long arc of history shows more people securing their own mask and moving toward assisting others. Sometimes it’s slow, and sometimes masks fall off. But the overall trend has been intact for hundreds of years. Most generations enjoy higher living standards than their parents, which makes their lives a little easier, which opens the door a little wider to empathy and understanding. Which means every new generation has a little less tolerance for violence, mischief, dishonesty, and oppression.

This is obvious when comparing the last 300 years. It’s less obvious in shorter periods, like thinking about how millennials view the world differently than their parents.

But today’s younger generation does view the world through a different lens than their parents.

Information barriers that slowed their parents down are gone.

Data that used to be buried is now open.

Social connections that used to be out of reach are now instantaneous.

You may not think millennials’ lives are easier. But the information age has opened their eyes, at warp speed, to how other people live. Just like dozens of generations before them, this pushes their view of the world a little closer toward empathy and understanding other people’s situation.

And their view is increasingly important. Millennials are in the process of two big trends:

- They are moving into top management and political positions.

- They will inherit $30 trillion from their baby boomer parents over the next 30 years.

This report views business and investing in the coming decades through the lens of a generation that has a little less tolerance for deception, dishonestly, exploitation, opaqueness than any that came before it.

It promotes one idea: The generational transfer of wealth and power to millennials shifts the center of gravity toward a world where two things—**transparency, and companies taking care of all stakeholders**—become an important part of most investment decisions.

To understand where we're going, we have to remember how we got here. So let's go back 114 years, to a time when those who controlled wealth had a very different view of the world.

Part 1: Transparency

U.S. Steel did something in 1903 that no other company had before. It published an annual report with audited financials.

There were no rules requiring companies to do this. Many companies didn't release any information to their shareholders, especially small shareholders. John D. Rockefeller once told a court that the only thing valuable to shareholders in an annual report was the level of revenues. Everything else, he said, was a trade secret that could benefit his competition.

But U.S. Steel went big. It published 40 pages of information about its business, including details on headcount, margins, factory output, and executive compensation. No one had done this before, which took people off guard. George O. May, a senior partner at Waterhouse & Co., who audited the numbers, wrote:

> *All authorities will probably agree that the first full report of the United States Steel Corporation, which was for the year ending December 31, 1902, was a landmark in the history of [disclosure].*

Scientific American called the report "the most complete and circumstantial report ever issued by any great American corporation."

It took decades for this practice to catch on. Audited annual reports weren't the norm until Depression-era regulations forced stronger disclosure. For the century of stock-market history that came before that, outside shareholders knew practically nothing about the companies they invested in, except perhaps sales, profits, and dividends—the first two of which are as easy to manipulate as Silly Putty.

Information has been scarce for most of history. Even really important information. Food companies weren't required to be "honestly labeled" until the Supreme Court forced them to in 1965. The Federal Reserve didn't tell the public what it was doing with interest rates until 1994—before then, investors and economists had to reverse engineer its moves.

This is changing, fast. And it's one of the most significant changes of the last 50 years.

A big difference between today's young generation compared to those before them is the expectation that all pertinent information is not only disclosed, but easily accessible. They have this expectation because the biggest progress the economy has made in the last 30 years is exposing information that used to be buried, either because it was too hard to make public, or served someone's interest to keep it out of sight. **We've gone from an age where investors didn't know how much profit a company earned to being able to look up a company's employees on LinkedIn to see where they went to college. This is not a small shift.**

To understand how much impact the new age of disclosure and transparency has, consider the rise of Vanguard.

John Bogle started Vanguard in 1974. His idea was not theoretical. It was basic arithmetic: The net return stock investors pocket is the whatever the market generates minus all costs. So, on average, investors with the lowest costs will pocket higher returns.

It was so easy, so *inarguable,* you'd think it would catch on quickly.

But it didn't.

Vanguard effectively went nowhere for 15 years after launching, despite offering the lowest-cost option that consistently outperformed its high-cost rivals.

As early as 1991, *Fortune* magazine recognized that Vanguard investors "start each year more than a full percentage point ahead of the competition" thanks to its low-cost structure. Yet it managed just over $3 billion at the time —a tiny sliver of the fund market, even back then.

Why did Vanguard have trouble getting people's attention?

My dad purchased his first mutual fund in 1991, so let's consider his experience.

He needed information to make his decision on what funds to buy. Yet:

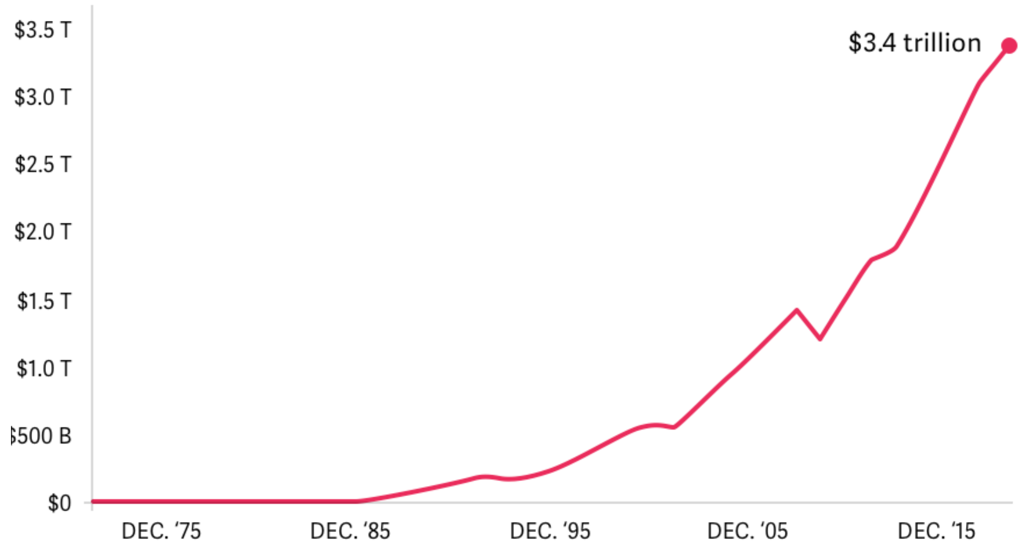
- There was no Morningstar.com
- There was no Yahoo Finance
- There was no Google Finance
- There were no financial advisor blogs
- There was no Twitter

So he did what everyone did in 1991. He went to his local stockbroker, who recommended a list of mutual funds—none of which were Vanguard funds, since Vanguard didn't charge high enough fees to pay the broker a commission. That was its whole advantage in the first place. But since information was expensive back then—its price tag was the broker's salary and bonus—Vanguard didn't go far.

That changed in the mid and late 1990s.

Vanguard's assets jumped from $3 billion in 1991, to $500 billion by 1999, to more than $3 trillion today.

Vanguard assets under management
1975–2015



What changed over the last 20 years wasn't Bogle's arithmetic. It was access to information.

People like my dad, who before the mid-1990s relied on salesmen for information, could suddenly look it up themselves. They could easily compare products with information that was accessible and nearly free. When they could, Bogle's arithmetic sold itself. As Jason Zweig of the *Wall Street Journal* put it: "As Hemingway wrote, bankruptcy happens 'gradually and then suddenly.' The popularity of indexing occurred the same way." On the other end, high-cost managers have experienced more than half a trillion of redemptions in the last decade.

Vanguard is an example of something important: When information is expensive, as it was in my parents' generation, you could get away with keeping the truth away from your customers. You could hide behind information barriers. That's no longer the case. Whether it's Morningstar, or Yelp, or Glassdoor, or Amazon reviews, customers' ability to compare your product to the competition is now nearly perfect. **And it means businesses that hope to succeed over the coming decades will only do so by adding honest, transparent, and comparatively superior value.**

It's happening all over the place.

Financial advisors are switching from commissions to flat fees, which put customers' interests first.

Consumer companies are highlighting where, how, and by whom their products are manufactured.

Everlane, a clothing company, breaks down how it settled on the retail price of its clothes, showing how much of your purchase price goes towards supply, labor, shipping, and profit.

For most of history, customers' impression of a company was shaped entirely by what the company wanted people to see, which it controlled with marketing. Now customers can see what the company might prefer stay hidden. This age of transparency—which the young generation demands—forces viable companies toward a direction of honesty and integrity.

This is not to say that bad behavior doesn't exist. It always will. But there are fewer places to hide for companies that don't add legitimate value for their customers.

Jeff Bezos once said:

> *The balance of power is shifting toward consumers and away from companies. The right way to respond to this if you are a company is to put the vast majority of your energy, attention and dollars into building a great product or service and put a smaller amount into shouting about it, marketing it.*

Michael Dell said something similar:

> *You can't trick the consumer anymore. The businesses that had an advantage because they sold things in a geographic area where people had limited information, and they couldn't travel to go buy something else. Those folks are in real trouble. The Net kind of destroys that business model.*

There have always been three (legal) ways to run a business:

• Solve someone's problem.
• Scratch someone's itch.
• Exploit someone's weakness or misunderstanding.

The new age of transparency means the latter two are becoming more difficult, and the last one is becoming nearly impossible in some industries.

Part 2: Taking care of all stakeholders

Lehman Brothers' stock peaked in 2007. It was bankrupt 10 months later.

It's shocking how close these two events occurred. But when you piece together what happen, it starts to make sense.

Lehman Brothers was formed in 1850. It nearly failed after the Civil War, but merged with a cotton merchant and financed the South's reconstruction to come out stronger than before.

It thrived for the next 140 years, surviving multiple depressions, at least five financial panics, two world wars, and more than a dozen recessions. But 2008 was too much to handle.

The death of one of the oldest and largest banks in the country isn't caused by one things, and can't be explained in simple points. But a big factor was its gradual shift from a focus on clients to a focus on profits.

Months before it went under, Lehman CEO Dick Fuld told shareholders on a conference call that "our goal is simple; that's to create value for our shareholders."

This was a common message.

Lehman's 2006 annual report explained that the company had one overarching goal: "maximizing shareholder value."

As the banking industry began to break in 2008, Fuld put a peculiar amount of focus on the company's short-term stock price. "I will hurt the shorts, and that is my goal," he said in April 2008.

These comments might seem benign. But they're not.

All business decisions sit on a spectrum, with customers on one end and shareholders on the other. In between sits employees, suppliers, the community, regulators, and other stakeholders.

Managers have to choose how much effort they put into looking after the wellbeing of each one of those stakeholders. Lehman put almost all its effort into one stakeholder—shareholders—with a goal of profits be damned at the expense of clients, financial markets, or the broader economy.

A company that doesn't balance the needs of all stakeholders will eventually need to correct its imbalance, since no stakeholder can be abused forever. And correcting those imbalances, as Lehman found, is often too much for a company to handle.

Striking a balance is tough. The pendulum of power between stakeholders has swung from one extreme to the next over the last century.

In the 1920s, big shareholder returns came at the expense of poverty wages for millions of workers.

In the three decades after World War II, big wage gains and a thriving middle class gave unions so much power that corporate profits were smothered to the breaking point, which came in the early 1980s.

Over the last 30 years, we've swung back to a system where, on average, the sole mission of many businesses is profit maximization, even if it comes at the expense of other stakeholders. That's pushed income inequality back to heights not seen since the 1920s.

As the world opens up and everyone becomes more aware of how everyone else is doing, there is a newfound push toward businesses that actively take care of every stakeholder in their organization.

Employees need to be taken care of.

Suppliers need to be taken care of.

Customers.

Communities.

The environment.

And, yes, shareholders too.

This isn't just about businesses having empathy toward others—although that social mission is worthy enough. It is one of the clearest ways to reward shareholders in the long run.

Investors should only get excited about the prospect of something that not only works, but works in harmony for everyone who is involved with it. That's the only way to be reasonably sure that something is sustainable indefinitely. And indefinite sustainability is where the largest compounding gains come from.

My favorite example of this comes from a former tire wholesaler doing business with his local Costco warehouse in the 1990s.

Costco and this tire supplier—let's call him Bob, although he wishes to stay anonymous—worked for weeks hammering out a deal. The negotiations were fierce. They left Bob with little profit margin. But doing business with a company like Costco felt worth it.

One week after the deal was struck, Costco called Bob. They wanted to renegotiate the deal's terms. They wanted to offer a new price.

Bob was furious.

"I can't go any lower on price," he told Costco. "A penny lower and I'll be losing money on this deal."

That was why they were calling, Costco told him.

After digging through the numbers more, Costco realized how stretched Bob was on the deal. It bothered them. So it offered to pay him more for the tires.

Costco's reasoning, Bob said, was that having a partner squeezed so close to the razor's edge of losing money was bad for Costco. Pushing Bob out of business would hurt Costco, since it would mean having to find a new supplier, which is costly. It would rather do business on terms that formed a long-term relationship where everyone remained happy, rather than feeling exploited. That ultimately meant making sure Bob earned enough profit.

That might still sound crazy. Bob agreed to the initial terms, after all.

But Costco is a good example of realizing that exploiting someone's weakness is not a good business model, even if you can get away with it for a while. Which is a point more companies, investors, and consumers are realizing as the world becomes more connected and transparent.

Costco practices a similar ethos with its employees.

It pays wages substantially above its closest competitor, Sam's Club. As of 2013 (the most recent I could find data on) Costco paid an average of $20.89 per hour, vs. $12.67 an hour at Sam's Club.

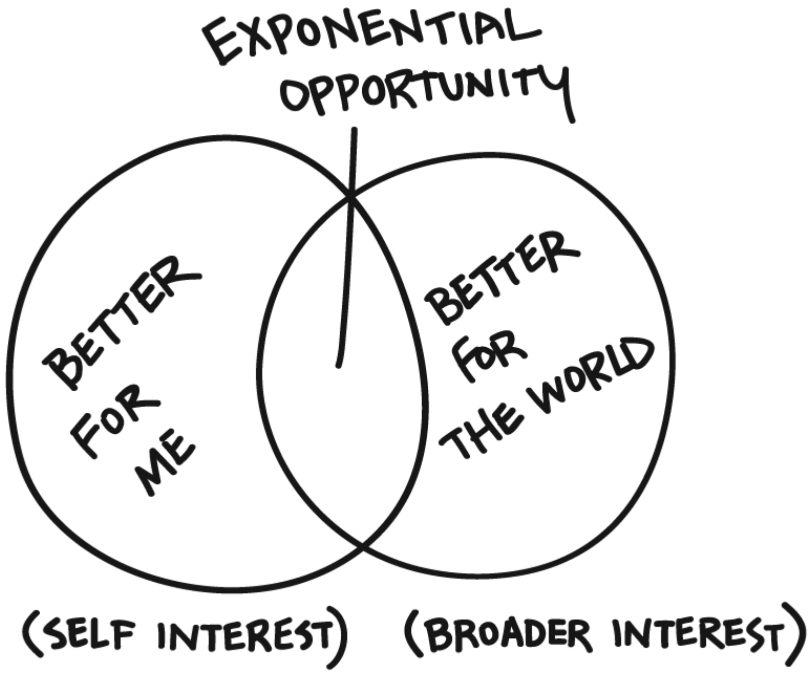
This might sound irresponsible to shareholders. But it's the opposite.

Costco employees are some of the most loyal and productive in the business, which is what you'd expect at an employer who takes exceptional care of its workers. And loyal employees who stick around and don't need to constantly be replaced are exceptionally good for business, and good for shareholders. Harvard Business Review explained:

> *In return for its generous wages and benefits, Costco gets one of the most loyal and productive workforces in all of retailing, and, probably not coincidentally, the lowest shrinkage (employee theft) figures in the industry. Costco generated $21,805 in U.S. operating profit per hourly employee, compared with $11,615 at Sam's Club. Costco's stable, productive workforce more than offsets its higher costs.*

When your view of the world is restricted to the narrow lens of what you see around you, it's easy to view business as a competition where the winner is whoever can drive others furthest into the ground. But when you zoom out and see how important cooperation of all parties is to making a business work in the long run, you realize how smart it is to lift others off the ground in an attempt to keep them happy and motivated. **As business becomes more open and connected, more people's view of the world does indeed zoom out. Which is why businesses that go out of their way to take care of all stakeholders is an increasingly important philosophy. It assists everyone, including shareholders.**

Craig Shapiro of the Collaborative Fund drew a simple sketch that captures this idea:



Astro Teller, a former Google employee, put it another way: “Purpose is the point. Profit is the result. It’s the natural order of things.”

Part 3: Where the world is going

None of these ideas matter without evidence that the incoming generation of investors takes them seriously and will put their money behind them.

Thankfully, there’s plenty.

For most of history, allocating capital was viewed as binary. You had philanthropy on one side, and the pursuit of profit on the other.

One of the biggest trends over the last decade is the acknowledgment that there is something in between.

More investors are going out of their way to invest in for-profit companies that put thought into their social mission. These are not charities. But they also don’t see profit as the singular win-at-all-costs goal. If the Gates Foundation is at one end, and Philip Morris at the other, then Costco is in between. And more investors are opting for the Costco-type investments than Philip Morris-type investments.

This is not a small trend. Assets managed with an ESG factor—stocks ranked by their engagement in environmental, social, and corporate governance issues—is rising not by billions, but trillions of dollars. *The New York Times* explains:

> *The amount of assets managed using E.S.G. factors has more than tripled to $8.1 trillion since 2010, according to a report issued in November by the US SIF Foundation, which tracks sustainable investing. The TIAA-CREF Social Choice Equity Fund has doubled in size to a current $2.3 billion in the last five years. Exchange-traded funds linked to MSCI E.S.G. indexes have tripled to $3 billion in the last three years.*

Most of these funds don't exclude any specific industry. Instead, they rank companies against their peers based on how well they've performed on certain characteristics of taking care of all stakeholders. Rather than ranking stocks based on market cap, profits, or revenue growth alone, factors like environmental impact are mixed in. *The Times* gives a good example:

> *In oil and gas, the Norwegian giant Statoil ranks near the top based partly on its record of spills and low emissions, while the American company Chevron ranks near the bottom with higher-risk operations, including forced shutdowns this year of a new $54 billion liquefied natural gas plant in Australia.*

This is an important point. Extreme shifts away from norms can be socially exciting, but realistically less feasible. They shake up the existing order too much to be adopted in a big way. What's promising about the shift toward ESG investing is that interest in it is huge, but the mechanics of the movement itself are not so dramatic that things like portfolio diversification are being upended. There is a push toward preferring investments in companies that care for all stakeholders. But it is not a black-and-white, pitchforks-and-torches surge. This calm, collected shift toward more thoughtful companies is precisely why the movement is so promising.

Some of the biggest investment shops are putting resources behind this trend. *The Economist* explains:

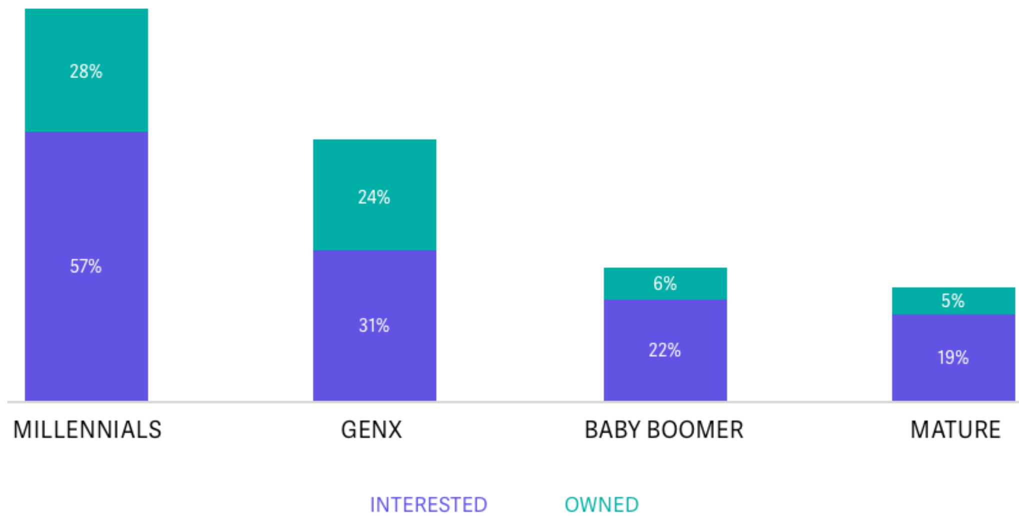
> *In the past two years BlackRock, the world's biggest asset manager, launched a new division called "Impact"; Goldman Sachs, an investment bank, acquired an impact-investment firm, Imprint Capital; and two American private-equity firms, Bain Capital and TPG, launched impact funds. The main driver of all this activity is investor demand.*

Interestingly, that demand is overwhelmingly from young investors.

U.S. Trust surveyed 700 clients last year, gauging their interest in social impact investments—a loose term for for-profit companies with a social mission.

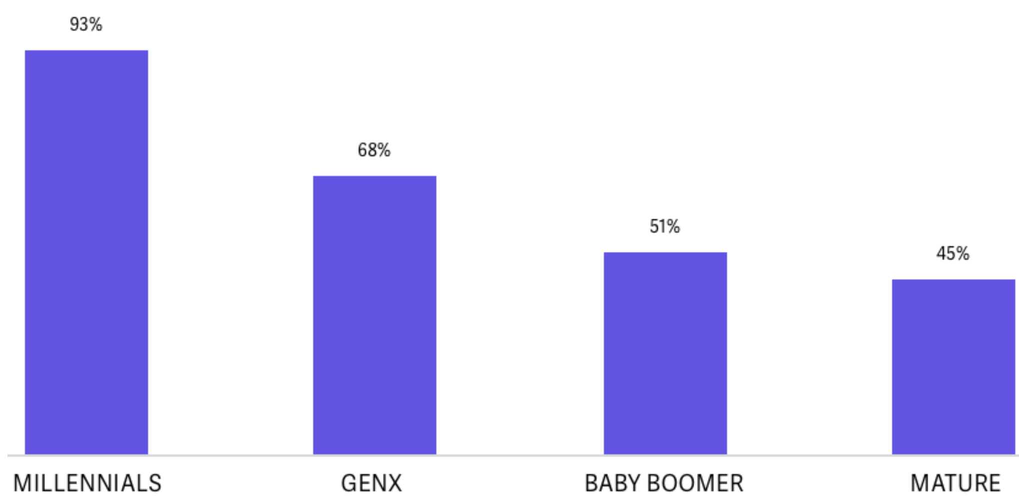
The results were clear. Older generations, who currently control the most wealth, were indifferent. Younger generations, who will control tomorrow's wealth, were gungho.

Own or interested in social impact investments



Same thing when asked about the importance of social factors when making investment decisions:

Social is an **important factor when making investment decisions**



To wrap your head around how these changes play out, it helps to remember how previous young generations' views shaped the world they inherited.

The Greatest Generation -- those born in the 1910s and 1920s -- saw a world that didn't need to adhere to the strict social and gender standards of their ancestors. They moved from a world in the early 1900s where, as historian Frederick Lewis Allen wrote, "At any season a woman was swathed in layer upon layer of underpinnings—chemise, drawers, corset, corset cover, and one or more petticoats," to one where Rosie the Riveter helped win World War II in jean coveralls.

Baby Boomers saw the racial segregation that their parents found normal to be abhorrent. They pushed for equal rights, making tremendous progress over the last 40 years. They also increasingly removed gender as a barrier to any profession.

These views seemed far fetched at the beginning of each new generation. But they became reality because each generation eventually took control of capital, business, and politics, transforming a fringe view into an accepted truth.

When you claim the younger generation has marginally higher expectations of transparency, inclusion, and empathy, you're not claiming they're morally superior. You're just pointing out the normal progress of what happens when a generation grows up with wider access to information, slightly better living standards, and a little more bandwidth to think about how other people go about their day.

Max Planck, the physicist, once explained why science is slow to change. New concepts, he said, aren't accepted by changing people's minds. Instead, science accepts a new truth "when its opponents eventually die, and a new generation grows up that is familiar with it."

It's the same with culture and social norms.

A lot of these ideas—the Internet promoting product transparency, for example—are available and obvious to today's older generation. They've learned to use them, and see the benefits. But for the younger generation, who has never known anything different, these aren't new tools; they're just a reality of how the world works and business gets done. Social progress can be hard to understand if you didn't grow up with the specific things that change. But for those who have never known anything different, it's inconceivable to consider anything else.

Baby Boomers ushered in similar improvement in their day.

As did the Greatest Generation.

And now millennials—on the cusp of assuming social, economic, and political power—are in the early stages of nudging the economy, ever so slightly, in a new direction.