

The Value of Relational Equity

BY JOSEPH BRAGDON

In this article, Jay Bragdon, author of *Profit for Life* (SoL 2006), explains why companies that mimic living systems consistently outperform those that exist as mechanical entities. The term he uses to describe this emerging living systems model is relational equity. Over the past ten calendar years he tracked equity returns on the sixty companies in his learning lab against widely used benchmark indices – ones that broadly represent traditional bottom-line-first management methods. His data revealed that companies driven by a traditional bottom-line approach, on average, either lost value or barely broke even. However, those that followed a relational equity model were able to catalyze a powerful reinforcing cycle of profit. In reading this article, we learn that a business managed as if it were a living organism creates a radically different and more beneficial set of relationships than one managed as a static entity. Firms that operate as living systems inherently place a significantly higher value on people and Nature (living assets) than they do on non-living capital assets. They understand, as we as practitioners need to understand that, at a fundamental level, living assets are a prolific source of capital assets.



Joseph Bragdon

Relational equity is the foundation of financial equity. How companies relate to employees, customers, suppliers and other stakeholders matters more than most people think. Corporate leaders who understand this build cultures that inspire systems thinking and organizational learning. Those who do it well catalyze a powerful reinforcing cycle of profit, which turns their firms into innovation hothouses.

By contrast, the more traditional, bottom line-driven management too often sacrifices relational equity in single-minded pursuit of profit. Hampered by tunnel vision, they become accident-prone and profits suffer. The shocking rise of bankruptcies, forced takeovers and credit downgrades of once-great companies – among them, General Motors, Merrill Lynch, Citigroup, Kodak and American Airlines – is largely a result of putting profit ahead of relationships.

For several decades companies that excel at developing relational equity have generated superior investment returns – regularly outperforming industry peers in both rising and falling markets. Over the past ten years, a learning lab of such companies, called the Global LAMP Index®, has more than doubled in value while the S&P 500 and leading global indices have lost value. As the operating methods of these leadership firms become better understood, they are redefining capitalism.

The new market leaders model their organizations and management practices on living systems rather than mechanical ones. This still evolving approach represents a tectonic shift in business thinking towards the new sciences of quantum theory, ecology and systems dynamics – which inform us that relationships matter – and away from the deterministic laws of the older physical sciences that revere mechanical efficiency. In a larger sense, it represents a reawakening that life is central to everything we value.

Managing a company as if it were a profit-making machine imposes a linear thinking mentality that blinds it to important relationships. Nowhere is this more apparent than in generally accepted accounting principles (GAAP), which measure only costs that directly contribute to a transaction. Social and environmental costs that fall outside this linear path – such as plant closings, frequent layoffs, toxic waste accumulations and carbon emissions – are considered external and are largely disregarded absent government regulation. This undermines stakeholder relationships in virtually every realm. Further, when managers become slavish to a linearly defined bottom line, they are apt to cut costs that result in product failures and shoddy service, which ultimately turns off employees and customers.

Managing a company as if it were a living organism – which it is – creates a radically different, and more beneficial, set of relationships. Firms that operate this way place a higher value on people and Nature (living assets) than they do on non-living capital assets. They understand at a fundamental level that living assets are the source of capital assets, and that capital assets can't function without direction from people or inputs from Nature.

Living Asset Stewardship

Companies that model themselves on living systems typically practice what I call living asset

stewardship (LAS). To them, profit is not so much a goal in itself as the means to a higher end of service. When such ends are condensed into a compelling vision – one that calls forth the life affirming instincts and future hopes of employees – the firm becomes a profoundly inspirational workplace. The operating leverage in this is easy to understand. Employees who work with their hearts as well as their minds are more productive than those who simply “do a job.”

Companies that best exemplify these five attributes have come to the practice of LAS mainly by trial and error, catalyzed by the ethical impulses of inspirational leaders. A rare few old timers – such as Hewlett Packard, HSBC, Johnson & Johnson, Novo Nordisk, Panasonic and Toyota – inherited a leaning towards these attributes from their founders.

Although much has been written about these five attributes in isolation, they are not widely seen as part of an integrated whole, much less a unified theory of management that transcends the older industrial model of capitalism. Only recently have new companies, like Google, embedded these attributes into their strategic thinking and management practices. Yet even in such instances, what we call living asset stewardship is presented as adaptations of an older system rather than a totally new way of defining capitalism.

TABLE 1 **Living Asset Stewardship Attributes**

Companies that practice LAS share five attributes common to all life. Although varying in style, these are expressed as:	
Attribute	Life Purpose
Highly decentralized/networked organizations	To serve as a feedback (nerve) system
Open, sharing, self-organizing cultures	To speed adaptive learning
Nurturing relationships with stakeholders	To build network (physical) strength
Frugal instincts re energy and resource use	To ensure staying power, survival
Symbiotic nature, futuristic vision	To provide for future generations



This lack of a universally recognized name does not detract from the relevance or effectiveness of LAS. Like democracy, it has millions of authors: people probing for better solutions, experimenting and learning from practical experience. Over time their observations have coalesced into a unified whole – a distillation of essential concepts that connect the health of the firm to those of the living systems in which it operates.

Managing by Means

Living asset stewardship puts a laser focus on relationships as a means of achieving corporate goals. Companies can *own* inert non-living capital assets and bend them to their purposes. But they must *steward* living assets, which have a capacity to push back unless treated with respect. When companies treat people like property, they get resistance, not cooperation. And when they approach Nature as they would a machine, with the intent of controlling it, depleting it and disposing it when used up, they get pushback in the form of uninhabitable toxic waste sites, exhausted soil, run down aquifers, polluted air and waterways, global climate change and public condemnation.

“There is an inherently minimum set of essential concepts and current information, cognizance of which could lead to operating our planet Earth to the lasting satisfaction and health of all humanity.”

R. Buckminster Fuller, *Synergetics*¹

Managing by means (MBM) is all about relationship building. Unlike the traditional business practice of linearly managing by objectives (MBO), it anticipates feedback effects. Mentoring employees and building team competence, for example, yield better results than ordering them to achieve abstract objectives, such as numerical sales or profit targets. Listening to employees, engaging them in “group visioning,” and welcoming a diversity of viewpoints as Nokia does, buys more commitment and loyalty than catching them making mistakes and criticizing them.

Known as “servant leadership,” this style of management holds that the further someone is from the value creating process – such as the corporate executive team – the less that individual can directly add value. Consequently, the role of leaders should be to serve the personal and professional growth of those nearest the action.

“[It] is important to build community-friendly plants that exist in harmony with their surrounding environments – plants that employees can be proud of and the people in the local community can trust.”

Toyota President Katsuaki Watanabe²

The Toyota Way is an apt example of servant leadership. It describes the ideal leader as “thoughtful” – someone who has “the ability to energize and invigorate others, willingly giving realistic challenges and development opportunities, and fostering a sense of accomplishment” in team members. Toyota employees grow via “360 degree feedback assessment,” where they get multiple points of view on their performance – from superiors, peers, customers, vendors or anyone else who interacts with them. This balanced approach of mentoring and feedback helps individuals grow towards their fullest capacities and strengthens

organizational learning and has made Toyota the world’s premiere manufacturing firm.

Toyota further strengthens employee productivity and stakeholder relationships – the means by which it generates value – by continually evolving a shared and inspirational vision of the future. Its corporate *Vision 2020* looks “toward finding a harmonious balance between the cycles of nature and the cycles of industry” in a way that “opens the frontiers of tomorrow.” It is a direct appeal to employees to “create a new path to a new world and to work steadily towards the realization of society’s dreams.”³ This vision is the latest iteration of an evolving set of guiding principles that look to “the harmonious and sustainable development of society and the earth.”⁴

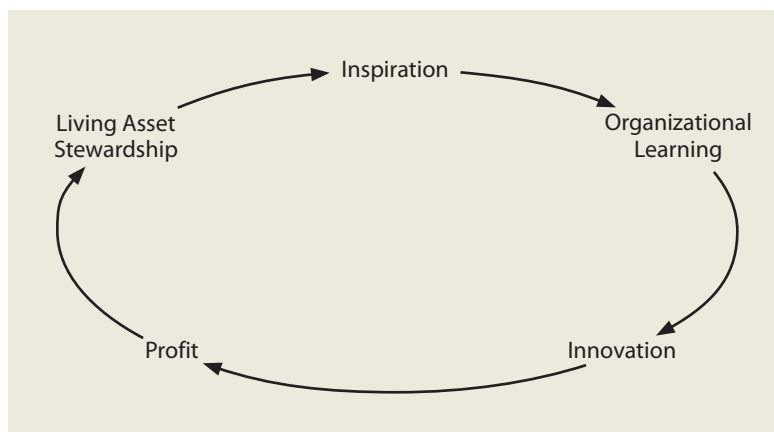
In sum, Toyota’s management style is more holistic and interactive than linear in approach – more relational than ordered, more focused on process than outcome. Happy, empowered employees and inspired teams generate more value more easily than bossed employees and harried teams working to produce MBO-directed numbers. Such is the power of systems thinking, where means become consistent and congruent with ends. It is no wonder that Toyota has the only AA/AAA credit rating in the auto industry and has gained market share against all of its major competitors for over three decades.

The Reinforcing Cycle of LAS

The power of LAS is best described as a reinforcing cycle. Its creative energy comes from inspiring people to serve a goal higher than profit – a vision or mission towards which they willingly invest their intellectual energy. In the following diagram we see how that inspiration connects to organizational learning (OL), which in turn generates innovation and profit. The reinvestment of that profit naturally keeps the cycle running.

In this cycle LAS is both cause and effect. As a cause, it inspires creative thinking, a desire to learn and contribute, and a drive to innovate. As an effect, it is fed by the profit it generates. In this

FIGURE 1 **A Reinforcing Cycle of Inspiration and Profit**



sense, like all life, it contains the possibilities of continual regeneration.

The cycle both feeds and is fed by relational equity expressed via stakeholder trust and loyalty. This translates to repeat customers, willing investors, eager suppliers, welcoming host communities and keen thinking partners within universities, consultancies and NGOs.

In keeping with the universal principle of interdependence in all living systems, the cycle also implicitly recognizes that profit can only arise from life in which case profit must serve life.

The internal workings of the cycle are entirely natural. They leverage intelligence, an unlimited human resource, and conserve those that are scarcest and most vulnerable: Earth's physical resources.

Toyota's approach to OL looks to employees' innate life-affirming (biophilic) instincts, their diverse perspectives on the way it relates to Nature and society, and their desires to serve goals higher than profit. It is based on *Nemawashi*: an open "process of discussing problems and potential solutions with all of those affected, to collect their ideas and get agreement on a path forward."

Global LAMP Index®

To test the effectiveness of companies that mimic life, and the practice of living asset stewardship, we created over a seven-year period (1996–2002) a learning lab of sixty companies. Called the Living Asset Management Performance (LAMP) Index®, it includes the most dedicated LAS pioneers in every major global industry/sector. The selection process evolved iteratively as our definition of best LAS practices evolved.

To be included, firms were scored on the earlier discussed five attributes and the length of time these had been evolving. Companies founded after 1980 were not included in the Index because they had not been in existence long enough to affirm the durability of their LAS practices. Our

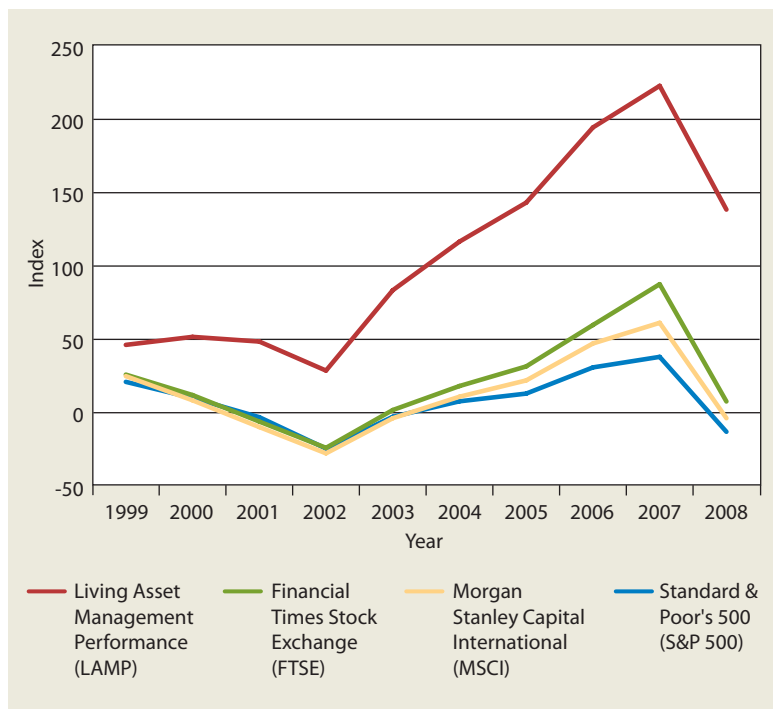


goal was to test each LAMP company's LAS practices through a number of economic cycles, where their stewardship commitments would be challenged.⁵ While this test policy introduced some survivorship bias into the lab, it also excluded strong LAS performers founded after 1980, such as Costco and Google.

It is worth noting that there have been only three changes in the LAMP 60 since 2002: two due to acquisitions and one to an error in our selection process. In this respect, LAMP differs from peer indices, whose constituent companies rotate regularly. Such consistency adds to the significance of performance evaluations both within key industries (e.g. Toyota vs. other automakers) as well as broader index comparisons, which can be seen in figure 2 (page 6).

Over the ten year period shown here the equal-weighted Global LAMP Index® more than doubled in value. By contrast, its nearest comparators – the Morgan Stanley Capital International (MSCI) World

FIGURE 2 Investment Returns for the Global LAMP Index Relative to Leading Global Benchmarks



Index, the Financial Times' FTSE World Index and the S&P 500 – either lost money or barely held their heads above water. Independently verified results for prior ten-year periods show similar patterns of excess LAMP performance.⁶ By gaining more in up-market years and losing less in down years, LAMP results have compounded at a vastly superior rate.

The ability of LAMP companies to outperform in down markets owes much to their futuristic vision, frugality, learning capacity and adaptability. By maintaining these virtues from cycle to cycle, they continually strengthen their relational equity and typically gain market share on weaker competitors. This, in turn, contributes to their durability. Incredibly, the average and median ages of the sixty LAMP companies well exceed a century – more than double the life expectancy of the average corporation.

In a 2009 survey of the world's 50 "most innovative" companies, conducted by the Boston Consulting Group, over a third were LAMP companies. Excluding from BCG's list the nine companies

founded after 1980 – the cutoff date for LAMP index eligibility – over 40 percent of those remaining were from the LAMP60.⁷ This is an affirmation of the creative energy released by the reinforcing cycle of LAS and organizational learning, which catalyzes innovation and earnings growth and maintains the vitality of companies more than a century old.

Northfield Information Services, which independently verified Global LAMP Index® results through 2007, affirms that both the equal-weighted version of the Index (shown above) and a version based on market capitalization weights, had risk-adjusted returns that were far above peer indices in terms of alpha.⁸ It also affirmed that the Index was reasonably comparable to its benchmarks in terms of tracking error (TE) and R-squared.⁹ These findings contributed to their conclusion that the LAMP 60's excess returns were "economically and statistically meaningful."

Beyond Business: Why LAS is Important

The economic and business models that emerged from the 19th century industrial revolution treated life as an object – something to be manipulated, controlled or dominated in pursuit of profit – rather than the central subject of our existence and the source of all value. Living asset stewardship reverses this order of priorities. In this sense it is a paradigm shift of huge significance.

The importance of this shift cannot be overstated. The deleterious effects of business as usual on the biosphere and the growing gap between the world's rich and poor have bred ecological collapse, disease, resentment, social backlash and more recently economic chaos. These call into play our survival instincts. Humanity cannot tolerate such failure. In this sense the counter-revolution of LAS, and the urgency of adaptive learning that operates within LAMP companies, is understandable.

Thinking contextually, it is easy to see how the industrial model of capitalism evolved in spite of its obvious flaws. To economists of the early 19th

century, Nature seemed vast and inexhaustible. Most people were manual laborers. This led to a common perception that land and labor were easily replaceable or substitutable “factors of production.” By comparison capital (plant and equipment), was relatively underdeveloped and scarce. Classical economic theory, embodied in Say’s Law, added to the mystique of capital by extolling its efficiency. It held that supply created its own demand and that workers would buy each other’s produce. If workers’ output was accelerated by the use of capital, many believed that industry could become a perpetual growth machine that would ultimately benefit everyone.

We now know the fallacy of that theory, which seemed so plausible a century ago. Simply put, earth cannot sustain the perpetual growth of physical throughput. The combined effects of humanity’s resource demands and waste disposals have driven important ecosystems into collapse: fisheries, arable land and forest systems that support the biospheric web of life and, by extension, us. According to the Global Footprint Network, it now takes the “biocapacity” of one and a third planet earths to sustain human consumption, and the gap is rapidly growing.

Biocapacity is here defined as the capacity of eco-systems to produce useful biological materials for human use and to absorb waste materials created by humanity employing current management schemes and extraction technologies. This is measured in terms of global hectares area (gha). In 2005, for example, the average biologically productive area per person worldwide was 2.06 gha against which humanity consumed 2.69 gha per capita, indicating an excess of 30.58 percent. The US ecological footprint in that year was 9.42 gha per capita versus a domestic biocapacity of 5.02 gha, indicating an excess of 87.65 percent.¹⁰

It is no coincidence that the collapse of global capital markets has come at a time when important ecosystems are also in collapse. The two are joined at the hip. The economy is a subsystem of the biosphere and utterly dependent on it. This is an unalterable systemic fact.

Companies that practice LAS basically understand this systemic order. Although far from perfect and still learning how to live in closer harmony with Nature and society, they are on the right path. Global capital markets – which embody the collective wisdom of billions of savers, investors, buyers and sellers – clearly agree. While they may not yet understand how the new order works, they certainly prefer its results.

The word “harmony” takes us back to relationship. The success of LAMP companies resides precisely in the quality of their relationships with employees, customers, strategic partners, investors and host communities. There is no better lead indicator of financial equity than relational equity. This is not to say LAMP companies are immune to the forces of disintegration now swirling through global markets. But if we had to pick survivors of today’s economic chaos it would be from among these new paradigm leaders.



ENDNOTES

- 1 Buckminster Fuller. *Synergetics: Explorations in the Geometry of Thinking*. "Introduction: The Wellspring of Reality." (MacMillan Publishing. 1975).
- 2 Toyota Sustainability Report 2008, page 7.
- 3 Ibid, page 11.
- 4 Ibid, page 10.
- 5 When the Global LAMP Index® was finalized in 2002, its constituent companies had been through four recessions (1980, 1982, 1991, 2001). This gave us an opportunity to test their commitments to living asset stewardship through difficult times as well as more expansive ones.
- 6 Results for the Global LAMP Index® for the years 1996 – 2007 were independently verified by Northfield Information Services. These included tests for survivorship bias that resulted from back testing as well as detailed risk-reward analyses.
- 7 *BusinessWeek's* 2009 list of the "World's Most Innovative Companies" was published on April 9, 2009. The list is compiled from an annual survey of top executives by the Boston Consulting Group. For details, see: http://www.businessweek.com/magazine/content/09_16/b4127046252968.htm.
- 8 Alpha is a measure of risk-adjusted return relative to a benchmark index. Both the equal and cap-weighted Global LAMP Index® produced consistently positive alphas in relation to universally used benchmark indices, such as the FTSE World and the S&P 500 indices.
- 9 Tracking error (TE) and R-squared are used to determine how well a portfolio performs relative to a benchmark index. TE measures for the variation in rates of return (risk) relative to a benchmark, and R-squared measures for correlation. The Global LAMP Index® had predicted TEs in the range of 5% to 6%, which means its returns should be within 5% to 6% of benchmark returns roughly two-thirds of the time. The R-squared on the Global LAMP Index® relative to its primary global comparators was in the range of .84 to .92 for ten-year periods ending in 2006 and 2007. Since a 1.0 indicates perfect correlation, these are good scores.
- 10 Global Footprint Network, *National Footprint Accounts*, 2008 Edition. Because it takes time to collect and assimilate ecological footprint (EF) data, there is normally a 3-year time lag in published information. As a result, data published in the 2008 Edition is for calendar year 2005. To refresh EF data, see: www.footprintnetwork.org.

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