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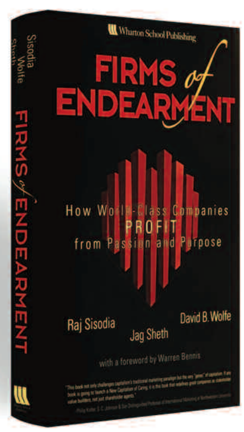

By Rajendra S. Sisodia, David B. Wolfe and Jagdish N. Sheth

How World-Class Companies Profit From Passion and Purpose

FIRMS OF ENDEARMENT

THE SUMMARY IN BRIEF

American business has entered the Age of Transcendence, with an increasingly older population searching for the higher meaning in their lives, not just more possessions. According to the authors, a *historic social transformation of capitalism is under way*. In this book they provide a measure of the scale of change by profiling companies that have broadened their purpose beyond the creation of shareholder wealth to act as agents for the larger good.

They call these companies firms of endearment (FoEs) because they strive through their words and deeds to endear themselves to all their primary stakeholder groups — customers, employees, partners, communities and shareholders — by aligning the interests of all in such a way that no single stakeholder group gains at the expense of other groups. They're driven as much by what they feel is right (subjectively grounded morality) as by what others might more objectively claim to be right.

FoEs are run by executives who reflect in their managerial philosophies the changes in culture they are talking about and who are champions of a new, humanistic vision of capitalism's role in society. Firms of endearment are companies people love doing business with, love partnering with, love working for, love investing in.

This summary reveals how FoEs are blowing away the S&P 500 averages and increasing "share of heart" by delivering the emotional, experiential and social value stakeholders are demanding.

IN THIS SUMMARY, YOU WILL LEARN:

- The distinctive set of core values, policies and attributes of FoEs.
- How FoEs outperform *Good to Great* companies.
- Why the best way to serve shareholders in the long term is to embrace a Stakeholder Relationship Model (SRM), as Costco does.
- How companies such as Patagonia, Whole Foods and Google attract and retain employees who see their jobs as a calling.
- The unspoken contract that FoEs honor.

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by Rajendra S. Sisodia, David B. Wolfe and Jagdish N. Sheth

It's Not Share of Wallet Anymore; It's Share of Heart

The meaning of life — and of one's own life in particular — is a perennial issue in midlife and beyond, but the search for meaning has a major influence on the ethos of society and this plays a big role in reshaping corporate culture. The search for meaning is changing expectations in the marketplace and in the workplace, and therefore is *changing the very soul of capitalism*.

Humanistic companies or firms of endearment (FoEs) seek to maximize their value to society as a whole, not just their shareholders. They create emotional, experiential, social and financial value. Some call the emotive dimension the "soul of a company." Companies without a soul face a doubtful future.

What Is a Firm of Endearment?

Consider the words love, joy, authenticity, empathy, soulfulness and other terms of endearment. Until recently, such words had no place in business. Today, a growing number of FoEs embrace such terms. They endear themselves to stakeholders by bringing the interests of all stakeholder groups into strategic alignment. These companies meet the tangible and intangible needs of their stakeholders in ways that engender affection and loyalty to the company.

Firms of Endearment That Made the Final Cut

Most studies of corporate exceptionalism or "greatness," to use Jim Collins' term, start with financial performance and work backward. In *Firms of Endearment*, we instead used humanistic performance — meeting the needs of stakeholders rather than shareholders — and worked forward. In the book is an *illustrative* list of FoEs. None of these firms is perfect; each has areas in which it is relatively weak or somewhat vulnerable. It is important to note we do not claim that a company will forevermore be a great investment once it adopts the Stakeholder Relationship Model (SRM) that characterizes FoEs.

The 30 companies we believe best exemplify a high standard of humanistic performance are Amazon, BMW, CarMax, Caterpillar, Commerce Bank, The Container Store, Costco, eBay, Google, Harley-Davidson, Honda, IDEO, IKEA, JetBlue, Johnson & Johnson, Jordan's Furniture, L.L.Bean, New Balance, Patagonia, REI, Southwest, Starbucks, Timberland, Toyota, Trader Joe's, UPS, Wegmans and Whole Foods.

In terms of how these companies perform, the publicly held FoEs returned 1,026 percent for investors over the 10 years ending June 30, 2006, compared with 122 percent for the S&P 500; that's more than an 8-1 ratio. Over five years, the ratio is even higher, because the FoEs returned 128 percent while the S&P 500 only gained 13 percent. Over three years, FoEs returned 73 percent versus 38 percent for the S&P 500. ■

New Age, New Rules, New Capitalism

For a century, the consumer economy has been grounded in a materialistic *having* focus. That focus is now being diffused by rising desires for a sense of meaning that cannot be drawn from material things. Consumers may still want a given product, but along with that product, many want a high-road experience

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New Age, New Rules, New Capitalism

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that connects with their more mature *being* focus. For example, shoppers at pricey FoE Whole Foods pay substantially more than they would pay for eggs at Kroger just for the good feeling that they are doing right by purchasing eggs from free-range hens. As more consumers make purchases based on self-actualization — the need to make the most of their abilities and strive to be the best they can — the way business is done is being reshaped gradually.

Shareholders Versus Stakeholders

The best way to serve shareholders in the long term is to embrace a Stakeholder Relationship Model, as Costco does. On average, Costco pays its employees 65 percent more than Wal-Mart and 40 percent more than Sam's Club. Its benefits are also more generous. *Yet, Costco generates significantly more profit per employee than Sam's Club does*. It achieves this seeming alchemy by being far more efficient (spending only 9.8 percent of earnings on SG&A — sales, general and administrative expenses) and having a very low employee turnover (only 6 percent in the first year, compared with 21 percent at Sam's Club and 50 percent at Wal-Mart).

Finding the Will to Change

No doubt some will argue that the idea of capitalism undergoing a social transformation is nonsense. Nevertheless, the remaking of capitalism into an instrument of broader purpose appears unstoppable. Stakeholders are demanding more socially aware management from companies and consumers will push for this by closing their wallets to companies that don't comply.

In May 2005, *Fast Company* published an article by Alan Deutschman about the myths that motivate a change in behavior. The following list takes a look at four of the myths:

1. Fear is a powerful impetus for change. More often, it is a powerful impetus for denial. According to a famous survey by Royal Dutch Shell, most companies do not reach the 40th anniversary.

2. Giving people objectively provable facts is an effective technique for stimulating change in behavior. If this were true, 65 percent of Americans would not be overweight.

3. Slow change is more effective than sudden change. Incrementalism works no better in companies than it does with the people who run them.

4. Past a certain age, people can't change. The issue is not whether people (and companies) can change after decades of following the same patterns, but whether they can muster the will to change.

Change can be massively challenging for companies that have been around long enough to form entrenched bureaucracies; however, if a company does not make an attempt to change, it will become a company that fails to reach its 40th anniversary.

Changing to Become an FoE

Einstein famously said, "A problem cannot be solved by the same consciousness in which it arose." The consciousness that has ruled business enterprise over the past two centuries is rooted in classical notions that reason is superior to emotions in the affairs of people. This has reduced stakeholders (including shareholders) to largely bloodless statistical entities.

Reflecting on Einstein's dictum, the new consciousness that will lift a company successfully into the loftier realms of new capitalism recognizes that all reality is personal and infused with affect. Objectivity has proven to be an overreaching effect of science, and subjectivity currently rules in terms of garnering stakeholder loyalty and affection. ■

Firms of Endearment Versus Good to Great Companies

Jim Collins' best-selling book *Good to Great* identified 11 companies as going from "good" to "great" by delivering superior returns to investors over an extended period of time. (The companies had each delivered cumulative returns at least three times greater than the market over a 15-year period.) We compared our set of publicly traded FoEs with these 11 companies and discovered:

- Over a 10-year horizon, FoEs outperformed the *Good to Great* companies by 1,026 percent to 331 percent (a 3.1-1 ratio).
- Over five years, FoEs outperformed the *Good to Great* companies by 128 percent to 77 percent (a 1.7-1 ratio).
- Over three years, FoEs performed on par with the *Good to Great* companies: 73 percent to 75 percent.

Note that none of the *Good to Great* companies made our cut, though one (Gillette) did come close.

The Chaotic Interregnum

The globally iconic Coca-Cola brand is wallowing in disorder. Its maker is trying to regain its footing under CEO Neville Isdell, who replaced Doug Daft in May

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The Chaotic Interregnum

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2004, who replaced Doug Ivestor in 2000, who followed the legendary Roberto Goizuetta, whose death in 1997 ended an era of plenty for the world's most recognizable brand.

Shortly after taking the position, Isdell vowed to double the value of the company's trademark within a decade by focusing on advertising with a youthful point of view. However, he seemed unaware that the population growth among the young has slowed to a crawl in the United States. This and the fact that soft drink consumption generally falls off around the mid-30s means demographics are working against Coke's growth prospects. Companies like Coca-Cola are riding through the greatest storm of change and disorder since the beginning of the Industrial Revolution.

A Solution to Disorder: Natural Capitalism

FoEs reject the hierarchical control-minded templates inspired by Newtonian science long central to organizational theory. FoEs transcend that tradition by tapping natural laws governing *complex adaptive systems* — self-organizing networks of entities that continuously form and reform in response to evolving needs and environmental changes.

Leadership at the top is more catalytic and inspirational than directive. The General Electric jet engine factory in Durham, N.C., is such a place. It has no factory leader. Rank-and-file workers manage everything from process improvement and work schedules to the overtime budget. Managers who have never held an engine-making tool in their hands no longer shape the happenings on the factory floor.

The Communications Challenge in the "Era of Disorder"

The balance of information power is now in the hands of the masses. This has changed the rules of communication between companies and their stakeholders, especially customers. What the Internet has done is make conversations (a.k.a dialogues) less optional and more of an essential part of everyone's day. Here are the four crucial principles of effective dialogue:

1. Establish a positive relationship (or reinforce an existing one) before getting down to business.

2. Show willingness to be vulnerable. Honda ritualizes managerial vulnerability through the practice of *waigaya*, a protocol whereby rank is put aside to facilitate problem solving.

3. Foster reciprocal empathy, whereby stakeholders reciprocate the company's empathy. Every customer wants to be understood. The same goes for every employee, supplier and business partner. After the first Gulf War, the insurance giant USAA, which serves military personnel and their families, sent refunds to policyholders who had gone to the Gulf, covering the period they were not driving at home. Some 2,500 policyholders mailed the refunds back with a note of appreciation saying they wanted to keep USAA financially sound.

4. Conduct conversations with genuine reciprocity. This makes for good and lasting relationships. The Body Shop's Anita Roddick gathered ideas from customers in suggestion boxes, and the staff wrote a personal reply to the author of every message. ■

Employees — The Decline and Fall of Human Resources

In the Age of Transcendence, people are looking for more than a paycheck from their work; they want "psychic income" as well as monetary income. People want work that engages the whole person, work that fulfills social needs, work that is meaningful — psychologically rewarding. People want to view their work as a calling.

FoEs can afford to be highly selective in employee recruitment because they are attractive places to work and generally rank well above average in their categories for wages and benefits. Progressive Insurance goes far beyond the norm in benefits, extending medical benefits to employees' grandchildren, parents and kids over 23.

Executive leadership in FoEs generally comes up through the ranks. This turns into a big motivator for new employees. At CarMax, employees choose one of four career tracks: Sales, Purchasing, Operations or Business Office.

FoE Leaders Understand the Fine Art of Building Trust

A distinguishing mark of FoEs is the high degree of trust that pervades them. They draw on four key elements to build trust with employees:

1. Respect for individuals: FoEs view each individual employee as a "whole person" rather than an impersonal factor of production. Management encourages employees to participate in company decision making, regardless of their rank.

2. Transparency: FoEs are free of the paranoia many companies have about sharing information with all employees as well as other stakeholders. New Balance

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Employees — The Decline and Fall of Human Resources

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opens up its books, building trust *and* helping employees understand what it costs the company to produce shoes in the United States versus in China. Management considers this an important factor in improving efficiency and remaining competitive.

3. Team building: FoEs cultivate an uncommonly strong sense of team participation. At JetBlue, new employees spend an hour each with the president and the CEO, as well as the vice president of people (a warmer, more humanistic term than *human resources*).

4. Empowerment: FoE employees generally have the authority (and obligation) to spend company resources necessary to make a customer happy or fix a production problem. In its early years, Southwest was forced to sell one of its four planes. Rather than operate on a reduced schedule (which would require fewer people), employees devised a plan to maintain the existing four-plane schedule. They reduced turnaround time at the gate by having everyone pitch in: pilots and management helped with baggage handling, flight attendants streamlined cabin cleanup and ground crews revamped the beverage stocking process.

FoEs Put Fun Into the Work Environment

FoEs stress a fun, collegial, productive and meaningful work environment, which is a key factor in attracting, motivating and retaining employees. These companies create an atmosphere that drives people to give their best without feeling pressured. FoE work environments are distinguished by three characteristics:

1. Fun. Jordan's Furniture once surprised everyone by closing down its stores and chartering four jumbo jets to fly all 1,200 employees to Bermuda for the day, treating them to a 90-degree day of beach, BBQ, music, water games and dancing.

2. Balance and flexibility. FoEs are disposed toward accommodating their employees' unique scheduling needs. Google grants each employee the right to spend 20 percent of his or her time at work on independent projects, several of which have developed into important new offerings for the company, including AdSense for Content, Google News and Orkut (for social networking).

3. Creative quality-of-life benefits. Google provides employees with an on-site physician, free massages, a game room, showers, subsidized child care, free gourmet lunch five days a week, dry cleaning, counseling on IRS matters, personal and family services and business legal services.

Training and Development Are High Priorities

FoEs are exemplary in their focus on helping employees maximize their potential through training, development and mentoring. They constantly celebrate their employee's achievements and successes, large and small. The Container Store has a long-standing reputation as one of the best employers in the country. A major reason for its success is its extraordinary commitment to training — 235 hours per year for new employees, compared with seven at the average company in the U.S. retailing sector.

Many FoEs have their own corporate "universities" to train employees, including Southwest, Commerce Bank, Toyota and UPS. In its initial two years, the UPS "Earn and Learn" program helped more than 20,000 part-time employees attend college.

The HR Department of the Future

The innovative and humanistic practices that FoEs follow in dealing with employees reflect a deep understanding of what people are looking for in their work lives today. In the past the HR function was something of a corporate backwater, a primarily administrative function dealing with payroll and staffing. This is fast changing as companies outsource the basic functions of administering benefits plans and payrolls. This frees HR to focus on more strategic issues such as employee performance and retention, which can directly affect the bottom line.

Essentially, it comes down to treating employees as customers. The ultimate goal of Jordan's Furniture's management team is to create "raving fans" out of its employees by providing internal growth opportunities, offering extensive benefits and considering them as another form of Jordan's customers.

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How FoEs View Part-Time Employees

Relatively few companies offer meaningful benefits to part-time workers. FoEs are distinct exceptions to this norm. Nearly all offer generous benefits, in some cases to those working as few as 15 hours a week.

Wegmans' employees become eligible for free health coverage and profit-sharing retirement plan contributions if they work 17.5 hours per week. The company tries to hire single moms as part-time workers. It views their employment as a win-win: The company gets staffing during difficult hours, and single moms get what they most need: health coverage. Unionized part-time employees at UPS get free health insurance and college tuition assistance.

Employees — The Decline and Fall of Human Resources

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Benefits That Flow to Shareholders From Doing It Right

The two main indicators of strong employee equity are low turnover and high productivity. Without exception, every FoE has an employee turnover rate much lower than its industry norm. FoE employees are also highly productive. Costco employees earn more than twice as much as Wal-Mart employees but generate three times the revenue.

Low turnover and high productivity are related to one another, because low turnover leads to more experienced employees, which translates to higher productivity. As a result, companies can have relatively low overall costs and be competitive while paying good wages and generous benefits.

FoEs have proven that the mother lode of wealth creation runs not through the executive corridors but through the vocational landscape of frontline employees. ■

Endearment as a Business Model

Heart is not a word often heard in B-school. But heart — a symbol of empathy, nurturing, caring, giving — has recently made a quantum leap and landed in the middle of mainstream business consciousness.

The problem is that many Wall Street analysts have not caught on to the idea that there is much profit to be gained by bringing love into business operations. Most business leaders think in terms of *numbers* and *profit*. *Love* and *profit* is an alien conjunction of words that is quantitatively murky. It is attention to the immeasurable qualitative dimensions of life that gives FoE companies their crucial competitive differences from their competitors.

The New Marketing Paradigm

The main trait of the 20th-century marketing paradigm was hucksterism — aggressive promotion and selling that put sellers' objectives ahead of the *real* needs of consumers. Consumers became prey. Marketers and salespeople became predators. Love is the antidote for this dehumanization. The former head of Meredith Publishing Magazine Group, the former chief solutions officer of Yahoo! and the CEO of one of the world's largest advertising agencies talk about love in the marketplace without being concerned about raising eyebrows.

New Balance is a FoE with a holistic-based market strategy, founded on the principles of healing that Jim Davis and his wife and business partner, Anne, continue to uphold a century after the company's founding.

The Unspoken Contract That FoEs Honor

From customers and employees to suppliers, partners, shareholders and the community, the full spectrum of a company's stakeholders is bound up with a company via these two contracts:

• A legal contract (mostly explicit) based on quantitative performance criteria established by jurisprudence as well as representations by a company and its agents in writing, oral communications and actions.

• An emotional contract (mostly implicit or unspoken) based on qualitative performance criteria established by stakeholders in the form of expectations that reflect their moral and ethical values and their experiential desires — what they want to experience and what they want to avoid experiencing.

FoEs understand that their business operations are shaped by both spoken and unspoken contacts. Like partners in a successful marriage, they know that failure to honor the emotional contract with a customer means the end of customer loyalty.

FoEs Are Soulful

People do not go to Wal-Mart for soulful experiences. However, they do go to Whole Foods with that in mind. They also go in mobs to the service-rich, family-owned Wegmans Food Markets for a soulful experience. They shop at Jordan's Furniture with its shoppertainment bonanza for a fun-filled, soulful experience.

Soulfulness is a hallmark of FoE companies. It is a distinctive component of culture in the Age of Transcendence that is reflected by an upsurge of interest in spirituality — in turn, a reflection of the aging of society. ■

Investors — Reaping What FoEs Sow

FoE Whole Foods is an extraordinarily vivid exemplar for the SRM business model. Over the past 10 years, Whole Foods has proven a better bet for investors than

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Investors — Reaping What FoEs Sow

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any of the five biggest grocers: Wal-Mart, Kroger, Albertsons, Safeway and Costco. In second place for shareholder enrichment by percentage gain is Costco, another FoE.

Whole Foods stands out even among the stellar performers that make up the FoE universe. It has returned 185 percent over the past three years, 400 percent over the past five years (when the S&P 500 rose by only 13 percent) and 921 percent over the past 10 years! In fact, between December 31, 1995, and June 30, 2006, Whole Foods returned more than 1,800 percent. ■

Partners — Elegant Harmonies

Concinnity is an ancient English noun, little used today. It means "a skillful blending of the parts achieving an elegant harmony." It is found in poetic descriptions of finely crafted artifacts. It is also used to describe elegantly constructed thoughts. However, organizations can achieve this state of concinnity as well.

A good example of concinnity among competitors is IKEA, Costco and Jordan's Furniture. When IKEA opened its first Boston store, its next-door neighbors Costco and Jordan's Furniture agreed to let IKEA use their adjacent parking lots for the grand opening. Jordan's even lined the street with signs saying "Jordan's Welcomes IKEA." FoEs expend goodwill to everybody, even their competitors.

Making the World Better Can Make Shareholders Richer

FoEs frequently take actions that produce results quite different from what conventional management logic would indicate. For example:

• FoEs decentralize decision making, but do so in ways that increase rather than decrease top executive influence at all levels of a company.

• FoEs typically pay frontline staff above norms in their categories. Rather than increasing cost of sales, this often reduces the percentage of a revenue dollar that goes to wages.

• FoEs typically depend little or not at all on conventional marketing practices, yet often experience explosive growth due to the affectionate regard that stakeholders have for them and the word-of-mouth promotion that results.

• Publicly traded FoEs tend to be less influenced by expectations of Wall Street analysts but typically achieve higher price/earnings ratios.

• FoEs operate with greater transparency than most companies but are involved in less litigation. ■

Society — The Ultimate Stakeholder

It is a given that no company likes to pay taxes. However, FoEs are generally sticklers for following not just the letter, but also the spirit of the law, and the area of taxation is no exception. None of the 17 public FoE firms we identified exempted themselves from paying taxes. As surprising as it seems, FoEs commonly view tax levies as fair pay obligations.

FoEs and Society

FoEs view the well-being of each stakeholder as an end in itself rather than merely a way to maximize shareholder wealth. These are some of the ways in which FoEs fulfill their keenly felt societal obligations:

• **Encouraging employee involvement.** FoEs encourage and reward employees for volunteering time and talents to support initiatives that benefit the local community. Patagonia has an environmental internship program that gives employees up to two months a year of paid leave to volunteer with an environmental organization of their choice.

• **Nurturing local communities.** FoEs strive to make themselves welcome in local communities and endear themselves by responding quickly to local exigencies. Progressive made job offers to 300 Zurich Personal Insurance employees who lost their jobs when the company moved its operations from Colorado Springs to Baltimore.

• **Cultivating global community.** FoEs strive to be exemplary global citizens, going well beyond local requirements. IKEA uses uniformly high environmental and safety standards worldwide, even when local regulations are less demanding.

• **Improving competitive context.** FoEs are adept at aligning social and economic goals. IDEO has a history of incorporating ecological and societal concerns into its product design.

• **Focusing on sustainability.** FoEs strive to operate in environmentally friendly ways. BMW turned a German law requiring firms to be responsible for their products over their lifetime into a profit opportunity. It has learned how to disassemble cars in an economical and environmentally sound way that gives it a sizable advantage over other automakers subject to the same law.

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Society — the Ultimate Stakeholder

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• **Cooperating with governments.** FoEs view governments as important partners in facilitating their ability to achieve their broad purposes and creating a better world for everyone. ■

Culture — The Secret Ingredient

FoE's strongest competitive difference is their corporate cultures. The passion, dedication, generous spirit and expansive creativity found in every FoE are products of their culture. It exerts a transformational influence on those who experience it, especially employees. Employees pumped up about their companies infect customers with their enthusiasm. Customers reciprocate with their own enthusiasm to round out a symbiotic relationship whose significance is lost on those who gauge companies strictly by the numbers. The three primary elements to organizational culture are:

1. Organizational vision. This is about creating and implementing a winning game plan. A common element found in every FoE is dedication to maximizing the creation of value for all stakeholders.

2. Organizational values. This is the aligning force that keeps an organization centered and balanced.

3. Organizational energy. This is the force that propels the organization forward at a steady speed. All FoEs are high-energy organizations.

Setting Organizational Vision

Firms of endearment share five primary elements in their corporate visions for seeing the bigger picture:

• A broader purpose than wealth generation

• Dedication to servant leadership

• Emotionally intelligent leadership

• Commitment to exemplary citizenship

• Recognition that they are part of an economic ecosystem with many interdependent participants. ■

Lessons Learned

Seven traits distinguish FoEs. Many companies can lay claim to some of the same traits. However, it is how the FoEs express these traits and weave them through their culture and operations that give them unique standing.

1. FoEs freely challenge industry dogma. This willingness means that they do not fit into the norms that Wall Street is comfortable with and leads analysts to criticize FoEs that pay wages and benefits above industry standards.

2. FoEs create value by aligning stakeholder interests. FoEs regard all their stakeholders as assets. FoEs have an uncanny ability to transmute stakeholder groups from separate, sometimes competing groups into a cohesive system in which the value of the whole is greater than the sum of the parts.

3. FoEs are willing to break traditional tradeoffs. Instead of "if/then" or "either/or," the alternative style of thinking — "both/and" — opens the mind to accommodate seemingly contradictory conditions.

4. FoEs operate with a long-term perspective. Although a number of FoEs presented here are privately owned and thus shielded from Wall Street pressure, publicly traded FoEs tend to be relatively impervious to such short-term pressures. In their IPO filing for the SEC, Google's founders warned potential investors they would not make operational decisions based on projected or actual quarterly earnings.

5. FoEs favor organic growth to growing by mergers and acquisitions. Most FoEs could probably grow at a faster rate than they have chosen. JetBlue's growth mode focuses primarily on continuing increases in flight frequency on existing routes as opposed to taking the costlier route of cultivating target market segments in numerous new locations.

6. FoEs blend work and play. Rule breaking regularly occurs in FoEs, with management's enthusiastic encouragement. It's all part of having fun.

7. FoEs reject traditional marketing models. One of the more important bonuses of being an FoE is lower marketing costs. FoEs are sustained by direct experience and great word of mouth. They do not rely on frequent sales and other dramatic promotions. This is a huge cost saver.

FoEs offer a cornucopia of valuable lessons for the rest of the business world and represent the architectural template for a new genre of business models that most midsized and larger companies will need to adopt to survive in the long run. Leading companies of the future will almost always be those that have crossed over to the other side of complexity to transform their organizations into firms of endearment. ■