Revalue shareholders

Finance Putting investors first is not always good for companies, writes **Justin Fox.**

One could attach many adjectives to the giant banks that tumbled during the financial crisis of 2007 and 2008: reckless, greedy, hubristic, stupid. Here's one that may come less readily to mind: shareholder-friendly. But that's what they were. Several studies have found that the more shareholder-oriented a bank's corporate governance and executive-pay arrangements were heading into the crisis, the more trouble the bank got into. A misplaced focus on pleasing shareholders, it seems, must be added to the roster of causes of the crash.

It makes sense. Shareholders supply only a small fraction of a bank's funding (most comes from depositors and bondholders), yet they get all the upside if the bank books big profits. And as we learned in 2008, the government sometimes steps in to keep giant financial institutions from failing. So from the perspective of a shareholder, a bank CEO who takes bold, financial system-endangering risks is just doing his job.

This mismatch between bank shareholders' interests and those of society is now widely understood in academic circles. Yet last year, when Jamie Dimon, the CEO of JPMorgan Chase, was under pressure for losses incurred by London-based traders, he hastened to reassure markets that he was out to "maximize economic value for shareholders". Bank executives regularly point to return on equity (return to shareholders, basically) as the metric that matters most.

Let's get this straight. Big banks that emphasize return to shareholders above all else have been shown to be menaces to society. Yet one of the main responses to the problems banks got into has been to reaffirm the primacy of shareholders.

Such is the power of the ideology known as shareholder value. This notion that shareholder interests should reign supreme did not always so deeply infuse American business. It became widely accepted only in the 1990s, and since 2000 it has come under increasing fire from business and legal scholars, and from a few others who ought to know (former General Electric CEO Jack Welch declared in 2009, "shareholder value is the dumbest idea in the world"). But in practice—in the rhetoric of most executives, in how they are paid and evaluated, in the governance reforms that get proposed and occasionally enacted, and in almost every media depiction of corporate conflict—we seem utterly stuck on the idea that serving shareholders better will make companies work better. It's so simple and intuitive. Simple, intuitive, and most probably wrong—not just for banks but for all corporations.

As Cornell University Law School's Lynn Stout explains in her 2012 book *The Shareholder Value Myth*, maximizing returns to shareholders is not something US corporations are legally required to do. Yes, Congress and regulators have begun pushing the rules in that direction, and a few court rulings have favoured shareholder primacy. But on the whole, Stout writes, the law spells out that boards of directors are beholden not to shareholders but to the corporation, meaning that they're allowed to balance the interests of shareholders against those of stakeholders such as employees, customers,

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suppliers, debt holders, and society at large.

Proponents of shareholder value argue that, whatever the law says, corporations would be more successful—and do more good—if executives and boards spent less time balancing their various obligations and focused instead on making money for shareholders. This idea began percolating at the University of Chicago and on a few other campuses in the 1960s and '70s and it made some sense at that historical moment.

Former General Electric CEO Jack Welch once declared shareholder value 'the dumbest idea in the world'. PHOTO: BLOOMBERG

American corporations were struggling in the face of global competition and technological change, yet most were complacent. If only executives were forced to pay more attention to their companies' plummeting stock prices—by the threat of a hostile takeover, perhaps, or by a strong link between their pay and those prices—they might take the risks and make the changes that the times demanded. Or so the thinking went.

These arguments began to reshape corporate practice in the 1980s. By the mid-'90s, they had congealed into the simple doctrine that the job of a chief executive is to keep shareholders happy. Executive-pay packages were stuffed with stock options and a newly restive breed of professional investor began goading boards into pushing out managers whenever a company's stock price languished. Underlying both practices was the belief that stock prices were the best measure of corporate performance—which made it pretty easy to judge whether a CEO was doing a good job or not. For a few wonderful years, all of this seemed to work.

This heyday ended with the stock-market collapse that began in 2000. The popping of the tech-stock bubble demolished the notion that stock prices are reliable gauges of corporate value. And as the economy languished, the shareholder-driven US corporate model ceased to look so obviously superior to its Asian and continental-European rivals.

The intellectual assault on shareholder value began, and has been gaining strength ever since.

Yes, the case against putting shareholders first is not quite the slam dunk for all corporations that it is for highly indebted, too-big-to-fail financial institutions. Outside of banking, the empirical evidence against the doctrine is more suggestive than dispositive. Supporters of shareholder rights can point to studies showing that certain shareholder-friendly changes, such as removing defences against hostile takeovers, tend to bring higher share prices. Sceptics argue that this says little about long-term impact, and point instead to a more expansive, but impressionistic, set of indicators. The performance of US stock markets since shareholder value became doctrine in the 1990s has been disappointing, and the number of publicly-traded companies has declined sharply. The nation in which shareholders have the most power, the United Kingdom, has an anaemic corporate sector; on Fortune magazine's list of the world's 100 largest companies, it claims only three, compared with nine from France and 11 from Germany, where shareholders hold less sway. Multiple studies of corporations that stay successful over time—most famously the meticulously researched books of the Stanford-professor-turned-freelance-business-guru Jim Collins, such as *Good to Great*— have found that they tend to be driven by goals and principles other than shareholder returns.

Collins's books embody the most common criticism of shareholder value: that while delivering big returns to shareholders over time is great, focusing on shareholder value won't get you there. That's what Jack Welch was getting at, too. In a complex world, you can't know which actions will maximize returns to shareholders 15 or 20 years hence. What's more, most shareholders don't hold on to any stock for long, so focusing on their concerns fosters a counterproductive preoccupation with short-term stock-price swings. And it can be awfully hard to motivate employees or entice customers with the motto We maximize shareholder value.

An older complaint that has gained ground since the financial crisis is that making the most money for shareholders, even over the long run, might not always be best for society. This criticism has long been applied to companies that use lots of natural resources or pollute heavily. It's now clearly an issue for big banks. And scholars have been looking into how corporations out to maximize shareholder returns are able to shape the rules of the game (tax laws, accounting standards) in ways that increase profits but harm the economy.

None of these critics have put forth a theory of corporate governance that's as simple as shareholder value. But in a smart new book, *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It*, the British economist Colin Mayer offers a view of the corporation that at least approaches shareholder value in explanatory power.

In Mayer's telling, corporations succeed by entering into commitments with employees, customers, suppliers, and shareholders. Many of these commitments go well beyond contractual requirements, and ultimately, they are what make long-term investment and business success possible. Putting all authority in the hands of shareholders who can sell at a moment's notice makes it hard for a corporation to credibly commit to anything. Over time, Mayer argues, this narrows business possibilities by leaching away the goodwill of other stakeholders.

He offers some proposals for strengthening commitment. One is the creation of trust firms, whose boards would be charged with ensuring that corporations hew to goals and principles beyond profit. Another is the sale of shares that offer greater voting power in return for a commitment to hold on to them for a number of years. But his overall message is that there is no one right way to run a corporation.

Mayer, a former dean of the University of Oxford's Said Business School, has been studying corporate governance since the 1980s. He has seen fashions come and go. His experience has taught him that nobody has the perfect answer – and the most dangerous people in corporate governance are those who think they do.

He is therefore mostly a fan of the US system, which allows for significant variety in how corporations are run, because each state sets its own rules. But Mayer worries about current attempts by federal lawmakers and regulators to give shareholders more say. "The direction of travel in US policy is very much toward intensifying shareholder pressure," Mayer says. That may be exactly the wrong direction.

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Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It, Colin Mayer, Oxford University Press. Justin Fox is the editorial director of the Harvard Business Review.