Shareholder Value Bites the Hand That Feeds it

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Shareholder primacy has many victims, including employees, the environment and the communities where corporations operate. Surprisingly, it harms its intended beneficiaries, shareholders, as well, according to a number of studies.

By contrast, studies show that sustainable management -- which explicitly takes environment, social and governance (ESG) factors into account -- benefits shareholders, as well as other stakeholders, by improving companies' profitability and stock market price.

In other words, doing the right thing is not only good for the world but also good for the wallets of corporate owners and investors.

This message seems to be getting through to the public, as ESG investments now account for one-quarter of all assets under management in the USA.[1] In addition, high profile groups such as the Business Roundtable have recently proclaimed their allegiance to stakeholder value over shareholder value.[2]

But skepticism abounds over corporate titans' level of commitment to goals other than maximizing financial return. [3] Only when the facts are fully understood and accepted by all in the business community can we finally lay the ghost of shareholder value maximization.

It's not surprising that shareholder value doesn't deliver the goods, as the theory is based on ideology and unsupported assumptions, not empirical evidence. Even the two publications regarded as the theory's intellectual foundation both lack roots in the real world.

The first came from Milton Friedman, a Nobel Prize economics winner and top-selling author, who introduced the notion of shareholder primacy to popular culture in an article in The New York Times Magazine in 1970. At the time, Friedman was a leader of the libertarian "Chicago School" of economists who rebelled against the Keynesian orthodoxy of the era, with its expansionist government activity and "pump-priming" spending.

Friedman stood for unfettered markets, minimal government intervention and maximal protection of property rights. The title of his article says it all: "The Social Responsibility of Business is to Increase its Profits." [4]

The core of Friedman's argument is that corporate executives are agents for owners and investors, whose sole responsibility is to deliver financial returns to their clients. If the shareholders want to spend their money on social responsibility, they can do so, but it is not the CEO's duty to do it on their behalf using corporate assets. Even when stockholders instruct management to support social causes, they are

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in effect imposing taxes on their customers -- because this activity must be paid for in higher prices -- and thereby usurping the proper function of government.

Friedman stretched this argument as far as possible, by linking corporate social responsibility to … socialism. He wrote, "The doctrine of 'social responsibility' … does not differ in philosophy from the most explicitly collectivist doctrine… I have called it a 'fundamentally subversive doctrine' in a free society."

Friedman's article quickly became the go-to reference in CEO suites and boardrooms, as it portrayed naked self-interest as not only economically rational but also, during the height of the Cold War, a noble defense of freedom.

Friedman's seminal article was propaganda, not science. But later in the decade, two business school professors gave Friedman's agency theory rigorous mathematical treatment and academic respectability.

This second cornerstone of shareholder value -- "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," published in 1976 by Michael Jensen and William Meckling [5] – is still regarded by many as a landmark piece of theorizing.

In essence, the paper defines the company as a "legal fiction which serves as a nexus for contracting relationships " -- a kind of mini-market in which owners, lenders and managers frenetically negotiate with each other with the sole objective of extracting the highest financial return for themselves.

For all its mathematical rigor, the paper contains little real-world data and is based on assumptions that beg the question, such as, "No outside owner gains utility from ownership in a firm in any way other than through its effect on his wealth or cash flows." In the Jensen-Meckling world, a shareholder is a single-minded profit taker, with zero concern about the effect of the corporation on its workers, its customers, its community or the environment. In such a world, it is not surprising that the paper "proves" that profit is the sole purpose of the firm.

Despite its lack of validation in actual company performance data, shareholder value maximization became the dominant principle of corporate governance during the 1970s and 1980s, as liberalism gave way to Reaganomics and the "Me Decade."

But now enough time has passed for studies to measure the impact of shareholder value on company operations, allowing us to ask the question: How did it go?

Very well for CEOs, whose compensation during 1978 – 2013 increased by 937% -- more than twice the increase in either the S&P 500 or the Dow Jones stock indexes. [6]

But shareholders, whose interests CEO were being paid to serve, have been short-changed.

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During the 50-year heyday of shareholder value, from 1965 to 2015, the aggregate return on assets of US firms across the economy fell from 4.7% to 1.3% in 2015, a cut in profitability rates of more than two-thirds. [7]

The top performers in the economy -- firms in the highest quartile -- delivered slightly lower returns to shareholders while the lowest quartile firms destroyed shareholder value at a greater rate. [8]

Predictably, however, the greatest losers in the shareholder value game were workers, as labor productivity grew 90% during 1978-2013 [9] while typical worker compensation only inched upwards by 10%. [10]

When workers are treated as cogs in a machine and not stakeholders in their own right, cutting compensation to increase shareholder value is considered a virtue. Consequently, it is not surprising that only 13% of employees showed high levels of "worker passion" in 2016. [11] Workers with low motivation are unlikely to generate above-market performance.

But to be fair, how do we know that firm profitability would not have fallen in any case? Perhaps there were factors outside the control of shareholders and managers driving down returns? Maybe managing for shareholder value even mitigated the worst of the damage?

In order to test this view, an ingenious 2007 study by Berkeley professors Neil Fligstein and Taekjin Shin[12] looked at profit levels across 62 industries from 1984 to 2000 that used shareholder value techniques to build their profitability.

Their paper found that industries with lower net income adopted classic shareholder value tactics on a large scale:

- They had higher levels of mergers and acquisitions.
- They laid off more employees as firms consolidated operations.
- They pushed out labor unions to a greater degree.
- They invested more heavily in technology.

All of these measures should have driven improvement in the bottom line, if the theory of shareholder value worked. But in reality, the profits at these industries mainly continued a downward trend.

By 2009, even Jack Welch, whom many consider the godfather of the shareholder value movement for his aggressive deal-making as chairman and CEO of General Electric from 1981 to 2001, had thrown in the towel.

"On the face of it, shareholder value is the dumbest idea in the world," he said. "Shareholder value is a result, not a strategy . . . Your main constituencies are your employees, your customers and your products." [13]

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But shareholder value adherents have a second line of defense, claiming that a corporation's board of directors is legally bound to maximize returns to owners. The only problem is that the legal case for shareholder value, like the business case, also falls flat.

It is a long-established principle of law that corporate directors are charged with looking after the overall interests of the corporation – not just shareholders. In addition, most US state legislatures have passed laws that make this explicit. For example, Vermont law authorizes directors to consider, among others, "the interests of the corporation's employees, suppliers, creditors and customers; the economy of the state, region and nation; [and] community and societal considerations." [14]

The Chicago Cubs hit a home run for this principle in 1968, in a famous case still cited as precedent. Directors of the corporation that owned the baseball team refused to hold night games out of concern for the quality of life of nearby residents. Minority investors sued, claiming that night games would increase the Cubs' profits. But the Illinois state appellate court firmly upheld the directors, finding that board decisions should not be overturned in the absence of fraud, illegality or conflict of interest.[15]

In general, under a principle known as the "business judgment rule," "unless the directors have a conflict of interest, nearly all board business decisions are beyond judicial review," according to noted law professors Antony Page and Robert Katz. [16] There is one exception, however: if a public corporation decides to go private, directors must turn into auctioneers and negotiate the best price for shareholders.[17]

This means that so long as directors of a publicly listed company keep it public, and avoid self-dealing, "they can give [corporate earnings and assets] to charity; spend them on raises and health care for employees; refuse to pay dividends so as to build up a cash cushion that benefits creditors; and pursue low profit-projects that benefit the community, society, or the environment," in the words of former Cornell Law professor Lynn Stout, who wrote a well-received book on the subject. [18]

Furthermore, "They can do all these things even if the result is to decrease – not increase – shareholder value." [19]

Private equity funds – which now control more companies in the USA than are publicly listed [20]— illustrate well the damage that flows from exclusive pursuit of financial returns. PE funds are perhaps the most doctrinaire practitioners of shareholder value, as typically they are evaluated on one metric only: returns to investors. Moreover, the industry practice of "carried interest" allows them to keep large chunks of the cash they can extract from their portfolio companies above a stated baseline. Given this, examples abound of asset-stripping and other abusive self-enrichment by PE funds on behalf of their investors.

A few anecdotes will suffice:

- Sun Capital Partners bought a Midwest grocery store chain, Marsh Supermarkets in 2006, recouped its investment by selling store real estate, then bankrupted the company in 2017,

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leaving $80 million in unpaid debt for workers' severance and pensions. But while 4,000 workers lost their company pensions, the company's CEO got a $7 million retirement package.

This was not an exceptional deal for Sun – over a 10-year period, it took five of its portfolio companies into bankruptcy, leaving behind employee pension debt of about $280 million. [21] On its website, Sun describes itself, without apparent irony, as "a global private equity firm focused on identifying companies' untapped potential and leveraging its deep operational and financial resources to transform results." [22]

- A fund managed by Carlyle Group – one of the country's largest and most respected private equity firms -- bought the country's second-largest nursing home chain, HCR ManorCare, in 2007. Over the next decade, the new owners loaded $5 billion of long-term financial obligations onto the company – increasing its leverage sixfold – while paying themselves handsomely in fees and dividends. Staggering under its debt load, the nursing home chain went bankrupt in March 2018.

  During this run, patients suffered. As staffing levels fell to free up cash to service the company's debt, health code violations rose by 26% between 2013 and 2017, three times faster than the industry as a whole. The stories of neglected patients, their families and overworked staff are heartrending. But the CEO's sorrow was eased by walking away with $117 million for his services to shareholders. [23]

- Cerberus Capital Management had become the largest owner of single-family houses in Memphis, TN, actively buying up foreclosed properties, as of December 2018. As a rental property manager, this private equity fund was unusually aggressive, filing for eviction at twice the rate of its peers, despite the low-income status of many of its tenants. Meanwhile, it racked up property code violations at a far higher rate than similar housing – including a burned-out house that sat nearly a year without attention until the city stepped in.

  "They don't care," said the city official in charge of code enforcement. "They are just here to lease their properties without consequence." [24]

Fortunately, there is a better way. And it comports not just with common sense and a moral view of the universe – it actually works in practice.

The flip side of shareholder value is "sustainability" – the notion that companies serve a social function, and are not just black boxes generating cash for owners. Sustainability calls for the company to take all its "stakeholders" – employees, customers, suppliers, host communities, the environment, as well as owners and managers – into account.

While terminology and definitions of sustainable investing strategies vary, the broadest measure is usually termed "ESG" : managing for positive environmental, social and governance outcomes as well as financial ones.

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Since the early 2000s, when the term ESG first came into common use, [25] researchers have investigated the effects of stakeholder-oriented management on company performance. There are hundreds of good quality studies, but perhaps the most useful is a meta-study of more than 200 different research papers, all dealing with the effects of ESG on company profitability and share price.

The papers surveyed in the report analyze companies' performance along each of the three axes, typically including factors such as:

Environmental:

- Minimizing carbon emissions
- Reducing raw material use
- Recycling more waste
- Enhancing biodiversity

Social:

- Making the workplace safer and healthier
- Maintaining a more diverse workforce
- Supporting the welfare of host communities
- Marketing products responsibly

Governance:

- Reducing board size so that directors take personal responsibility
- Linking executives' pay to a combination of social and financial metrics
- Avoiding conflicts of interest, ethics violations and corruption
- Governing transparently

The meta-study, *From Stockholder to Stakeholder*, [26] a joint venture between Oxford University and fund manager Arabesque Partners, concluded that there is "a remarkable correlation between diligent sustainability practices and economic performance."

Specifically, 88% of the papers the authors reviewed found "better operational performance, which ultimately translates into cashflows" in companies with strong ESG policies.

In addition, 80% of reviewed studies showed better stock price performance in companies that have a sharper focus on ESG.

In sum, the report said, "Responsibility and profitability are not incompatible, but in fact wholly complementary." [27]

At one level, it stands to reason that a company whose only goal is delivering profit to shareholders will foul its surroundings, squeeze its employees, short-change its customers and govern itself with blinders

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on. Over time, the damage it inflicts on itself and all around it will actually reduce the wealth it delivers, compared to a company with a more balanced and broad vision.

But it's a different matter when common sense is bolstered by rigorous studies that draw conclusions based on real-world data.

Since this ground-breaking report in 2015, several other large meta-studies and extensive research projects have replicated the core results. [28]

ESG, admittedly, is not as easy to define and measure as net income. One criticism is that ESG only looks at company performance within an industry, not at the social merit of the industry itself. That is why Coca-Cola, Exxon Mobil and Philip Morris, for example, all have solidly average ESG scores, [29] although many socially-minded investors would feel uncomfortable with these stocks in their portfolio.

For this reason, "negative screening" is often used to exclude questionable business sectors. An investing style with screening – negative or positive – is often called "socially responsible investment (SRI)," although, confusingly, this term is sometimes used interchangeably with ESG. There is some concern that less diversification may harm the returns of screened index funds returns relative to non-screened ones.[30]

In total, as of the start of 2018, a full quarter of the $46.6 trillion invested in US publicly listed companies -- almost $12 trillion -- was invested following ESG/SRI strategies. [31] As the industry has grown, a number of research companies have begun providing investors with ESG ratings for individual companies and funds, including such well-known names as Bloomberg, Dow Jones and Thomson Reuters. [32] Their criteria are different, but all provide independent evaluations that investors can use to compare sustainability with market performance.

Investors may also come cross the term "impact investing." Typically, this investment style, unlike ESG and SRI, accepts below-market returns in exchange for high social value. In principle, "impact" companies don't merely manage ESG issues well, they change the world for the better, albeit at the risk of lower profits. As a niche strategy, impact investing accounts for only 2% of total sustainable assets under management in the USA. [33]

Economic historians sometimes forget that the current shareholder-stakeholder debate is not new. Almost 40 years before Milton Friedman proclaimed that the only social responsibility of business is to increase profits, a critical argument about the purpose of the corporation was unfolding in the depths of the Great Depression. [34]

The stakes were high, as the nation was reeling from corporate bankruptcies and growing poverty, and faith in capitalism itself was eroding.

Perhaps reflecting on the misery of mass unemployment, Harvard Law School professor Merrick Dodd asserted in 1932 that, "The business corporation is an economic institution which has a social service as well as a profit-making function."

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The same year, Columbia University professor Adolph Berle, author of the influential study *The Modern Corporation and Private Property,* sharply disagreed, writing, "all powers granted to a corporation or to the management of the corporation … [are] at all times exercisable only for the ratable benefit of the shareholders."

World War II later provided evidence in Dodd's favor as private industry recovered to arm the Allies, and then expanded rapidly in the post-war economic boom to provide employment and benefits for millions of returning servicemen and others.

Conceding the point in 1954, Berle wrote: "Twenty years ago the writer had a controversy with the late Professor Merrick E. Dodd of Harvard Law School, the writer holding that corporate powers were powers held in trust for shareholders, while Professor Dodd argued that these powers were held in trust for the entire community. *The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention* (emphasis added)."

Once again we find ourselves at a moment of crisis of faith in our fundamental economic principles. Again there are two views of the corporation competing for public favor – one inclusive and embracing social responsibility, the other narrow and disdaining the common good. Hopefully there will be many with the good sense and courage to stand up squarely, like Merle, and affirm that corporate power is held in trust not exclusively for owners but for the entire community.

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