MAXIMIZING SHAREHOLDER VALUE 1970-???: THE MORALLY BANKRUPT, INCOMPARABLY DESTRUCTIVE (NOT LEGALLY REQUIRED) ECONOMIC IDEA THAT DECAPITATED MODERN BUSINESS AND IS SPURRING SOCIAL INSTABILITY

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A short collection of thoughts about the 50-year history of the disastrous worship of "Maximizing Shareholder Value"*

I. THE BACKSTORY

HARVARD BUSINESS SCHOOL AND THE PROPAGATION OF IMMORAL PROFIT STRATEGIES

(from Duff McDonald, *The Golden Passport: Harvard Business School, the Limits of Capitalism, and the Moral Failure of the MBA Elite*)

"In the aftermath of the 2008 financial crisis, much of the country was enraged because not a single Wall Street hotshot—the guys who got us into the mess—was prosecuted. While there are many financiers who could have been made to take the perp walk, there's also a case to be made that the fault lies with those who laid the intellectual foundation upon which a market-driven financial crisis could happen in the first place. . . .

"In 1970, Nobel Prize–winning economist Milton Friedman published an essay in *The New York Times Magazine* titled 'The Social Responsibility of Business Is to Increase Its Profits.' *Flouting the midcentury view (and that of the most influential faculty at the Harvard Business School) that the best type of CEO was one with an enlightened social conscience, Friedman claimed that such executives were 'highly subversive to the capitalist system.' His tone was snide. '[Businessmen] believe that they are defending free enterprise when they declaim that business is not concerned "merely" with profit but also with promoting desirable "social" ends, that business has a "social conscience" and takes*

***Inspired by the "Share the Prosperity" initiative of The Drucker Institute and The Aspen Institute**

seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers. In fact they are—or would be if they or anyone else took them seriously—preaching pure and unadulterated socialism.' **. . .**

"Friedman was suggesting the release of those people from their obligations—contractual or otherwise—to anyone but the shareholder. They'd let their good nature get in the way of getting the job done, he was arguing, and it was time to throw off such naïve notions for the good of the country—nay, for capitalism itself. It was a remarkable intellectual sleight of hand. Executives who act in ways most of us would consider moral—with an eye to the environment or some other social goal—are, Friedman said, acting immorally. . . .

"Twenty-two percent of the 150 largest public companies in the United States as of 1980 had merged or been acquired by 1988, with another 5 percent taken private. The highly public spectacle of the takeover of RJR Nabisco was an object lesson for all CEOs who weren't used to looking over their shoulders. Downsizing became the hymn song of the managerial church. Thanks in large part to President Ronald Reagan's tax cuts and deficit spending, the U.S. economy found its footing again after 1982. However, as Walter Kiechel pointed out in a 2012 article in *Harvard Business Review*, unlike in the 1950s, '[the] rising tide didn't lift all boats. In the name of beating foreign competition, completing (or avoiding) takeovers, and serving the interests of shareholders, it became acceptable to sell off businesses that didn't fit the new corporate strategy and to lay off battalions of workers.' . . .

"In 2003, the school added a Leadership and Corporate Accountability course that sounds like a direct repudiation of [Professor Michael] Jensen*: 'decisions that involve responsibilities to each of a company's

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***Professor Jensen was the chief acolyte of Milton Friedman. He de facto led the "maximize shareholder value" movement at the Harvard Business School.**

core constituencies—investors, customers, employees, suppliers, and the public,' with discussions on insider trading rules, the fall of Enron, human character, employee responsibilities, labor laws, corporate citizenship, socially responsible investing and serving the public interest. But in this, its influence is akin to pushing on a string. Because Michael Jensen helped create a Frankenstein monster no one knows how to kill.

"(Reporter's note: When I began researching The Golden Passport, from which this excerpt derives, I asked Harvard Business School if it would be interested in making administrators and faculty available for interviews or providing access to the school's extensive historical collection. To my surprise, HBS told me that it had zero interest in engaging with me, and would not make a single person at the school available for an interview, from the dean on down. HBS did offer to make historical material available to me on an ad hoc basis, except for any material from the past 50 years—something that I could get myself, thanks to the internet. I asked on a handful of occasions over the next three-plus years if they'd changed their mind, and when I went back to them one final time, they declined again.)" (emphasis added)

II. "PROFITS WITHOUT PROSPERITY"

(William Lazonick/HBR0914)

449 S&P 500 companies publicly listed in 2003-2012:

54% of $2.4 trillion to earnings/stock buybacks

37% dividends

9% remains for "productive capabilities or higher incomes for employees"

500 top-paid execs: 83% of average $30.3M income from stock awards and stock options

Laurence Fink, Chairman/CEO of BlackRock: "It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. … Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks."

William Lazonick: ***"The very people we rely on to make investments in the productive capabilities that will increase our shared prosperity are instead devoting most of their companies' profit to uses that will increase their own prosperity."***

WWII to late 70s: ***"retain and reinvest"***

Late 70s to today: ***"downsize and distribute"***

“MANAGING FOR THE LONG TERM”

(Special section/HBR5-6.2017)

III. “The Data: Where Long-Termism Pays Off”

(Dominic Barton/former Managing Director/McKinsey, James Manvika, Sarah Keohane Williamson/HBR0517)

615 non-financial companies/2001-2014/65% of total U.S. market cap

“Seeking to quantify the effects of short-termism at the company level and to assess its cumulative impact on the nation’s economy, we tracked data on 615 nonfinancial U.S. companies from 2001 to 2014 (representing 60% to 65% of total U.S. market cap). We used several standard metrics as proxies for long-term behavior, including the ratio of capital expenditures to depreciation (a measure of investment), accruals as a share of revenue (an indicator of earnings quality), and margin growth. To ensure valid results and avoid bias in our sample, we compared companies only to industry peers with similar opportunity sets and market conditions. Adjusting for company size and industry, we identified 167 companies (about 27% of the total set) that had a long-term orientation.” (emphasis added)

2001-2014: Long Term Investors vs. All Others

Average Company Revenue: +47%

Average Company Earnings: +36%

Average Company Economic Profit: +81%

Average Market Capitalization: +58%

Average Job Creation: +132%

“MANAGING FOR THE LONG TERM”
(Special section/HBR5-6.2017)

IV. “The Error at the Heart of Corporate Leadership”
(Joseph Bower and Lynn Paine)

“The question of whether shareholders benefit from [hedge-fund] activism beyond an initial bump in stock price is likely to remain unresolved. . . . No doubt in some cases activists have played a useful role in waking up a sleepy board or driving a long-overdue change in strategy or management. However, it is important to note that much of what activists call ‘value creation’ is more accurately described as value transfer. When cash is paid out to shareholders rather than used to fund research, launch new ventures, or grow existing businesses, value has not been created. Nothing has been created. Rather, cash that would have been used to generate future returns is simply being paid out to current shareholders. The lag time between when such decisions are taken and when their effect on earnings is evident exceeds the timeframes of standard models, so the potential for damage to the company and future shareholders, not to mention society more broadly, can easily go unnoticed.”

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Average Holding Period for Public Company Shares

USA/1976: 5.1 years
World: 3.9 years

USA/2015: 7.4 months
World: 7.3 months

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“The idea that corporate managers should make maximizing shareholder value their goal—and that boards should ensure that they do—is relatively recent. It’s rooted in what’s known as ‘agency theory,’ which was put forth by academic economists in the 1970s. At the theory’s core is the assertion that shareholders own the corporation [TP: FALSE—SEE BELOW] and, by virtue of their status as owners, have ultimate authority over its business and may legitimately demand that its activities be conducted in accordance with their wishes.”

“A better model, we submit, would have at its core the health of the enterprise rather than near-term returns to shareholders. Such a model would start by recognizing that corporations are independent entities endowed by law with the potential for indefinite life. With the right leadership they can be managed to serve markets and society over long periods of time. Agency theory largely ignores these distinctive and socially valuable features of the corporation.”

CONCLUSION: ***“The time has come to challenge the agency-based model of corporate governance. Its mantra of maximizing shareholder value is distracting companies and their leaders from the innovation, strategic renewal, and investment in the future that require their attention. History has shown that with enlightened management and sensible regulation, companies can play a useful role in helping society adapt to constant change. But that can only happen if directors and managers have sufficient discretion to take a longer, broader view of the company and its business. As long as they face the prospect of a surprise attack by unaccountable ‘owners,’ today’s business leaders have little choice but to focus on the here and now.”***

V. THE SHAREHOLDER VALUE MYTH

Lynn Stout is a professor of corporate and business law at the Cornell Law School. She cuts to the chase in her short-but-very-sweet book, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*:

"The notion that corporate law requires directors, executives, and employees to maximize shareholder wealth simply isn't true. There is no solid legal support for the claim that directors and executives in U.S. public corporations have an enforceable legal duty to maximize shareholder wealth. THE IDEA IS FABLE." (emphasis added)

"Courts uniformly refuse to actually impose sanctions on directors or executives for failing to pursue one purpose over another. In particular, courts refuse to hold directors of public corporations legally accountable for failing to maximize shareholder wealth." (emphasis added)

"What about shareholders' rights to sue corporate officers and directors for breach of fiduciary duty if they fail to maximize shareholder wealth? Such a right turns out to be illusory. Executives and directors' duty of loyalty to the corporation bars them from using their corporate positions to enrich themselves at the firm's expense, but unconflicted directors remain legally free to pursue almost any other goal."

VI. "FIND SOMEONE ELSE"

Oddly, soon after reading Professor Stout's book, I gave a presentation to the leadership team of a major ($10B+), publicly traded electronic components company. With the book very much at top of mind, I ended up in conversation with the CEO, and mentioned Professor Stout's assertion. His response was this,

"I told my board that if they want to get the share price up 50 percent in the next 12-18 months, I could do it without raising a sweat. <u>But it would destroy the long-term prospects of the company</u>. I made it clear I wouldn't tread that path, and they'd need to find someone else to do the job."

VII. “PERNICIOUS NONSENSE”

From “The ‘Pernicious Nonsense’ of Maximizing Shareholder Value,” by Steve Denning: ***“I agree with*** **[professor and former Medtronic CEO]** ***Bill George when he says that unconstrained capitalism focusing on short-term gains can cause great harm to employees, communities, and the greater needs of society. . . .***

“And it is precisely because of this that we have the rise of populism around the world. . . .

“Our titans of industry are shooting themselves in the foot by not comprehending the existential threat populism holds for their businesses.” (emphasis added)

VIII. ENOUGH.

The spirit of "more than shareholder value" is captured by the late Vanguard Funds founder Jack Bogle in the introduction to his extraordinary book, *Enough:*

"At a party given by a billionaire on Shelter Island, Kurt Vonnegut informs his pal, Joseph Heller, that their host, a hedge fund manager, had made more money in a single day than Heller had earned from his wildly popular novel *Catch-22* over its whole history. Heller responds … 'Yes, but I have something he will never have … ENOUGH.'" (emphasis added)

To get the flavor of Bogle's book, consider the chapter titles:

"Too Much Cost, Not Enough Value"
"Too Much Speculation, Not Enough Investment"
"Too Much Complexity, Not Enough Simplicity"
"Too Much Counting, Not Enough Trust"
"Too Much Business Conduct, Not Enough Professional Conduct"
"Too Much Salesmanship, Not Enough Stewardship"
"Too Much Focus on Things, Not Enough Focus on Commitment"
"Too Many Twenty-first Century Values, Not Enough Eighteenth-Century Values"
"Too Much 'Success,' Not Enough Character"