4711 - Session II Jeff Gordon

[Start of recorded material at 00:00:00]

Merritt: All right. I'm Merritt Fox, and it's my pleasure to introduce Jeff Gordon, who everybody already knows; a sparkplug behind organizing this conference. I'm supposed to moderate this session. Normally one person doesn't need moderation, but perhaps Jeff does.

Jeff: Okay. Thank you. The talk that I want to give, to some extent, is responsive to Colin's talk; but it comes at things from an angle that's a little different. Is this working? Hello. So the question is whether the corp governance that we've been discussing today plays an important role or not. To some extent it's a different approach than Colin's, I think; because it asks whether the questions we face really are addressable at the level of the firm; which is, I think, the basic claim that we heard this morning.

The alternative perspective that, in a general manner, I'm going to be setting forth, is that the issues really are of the dynamism of social change, economic change, the change in the markets in which these firms perform, they operate. So rather than focus on the firm as the molecule of greatest concern, I think the real issue is one of, essentially, social insurance; having the right form of government match to the preservation, the maintenance, the re-upping of human potential over the lifetime of employees in an economy that is a dynamic one and in which no single firm is able to offer thick enough insurance; thick enough income maintenance insurance, any other form of insurance.

Therefore the question really is: What is the right form of government match to the economy we have? That is the general theme. So I developed some of this in an article in the British Academy journal that Colin put together. So I think the current malaise is really consisting of three elements: inequality, economic insecurity, and slow economic growth. By governance idea, it's the way power is exercised within the firm; but one point is to realize that, although the legal framework of governance has remained stable over a very long period of time, the implications – the cash value of it within the firm – has varied radically over the period that I've been in this business.

That's because ownership has changed in a radical way. So it's the interaction between, in fact, the legal framework and ownership which creates the governance environment. Governance is very much in the news. Senator Warren has been referred to before, her proposal for codetermination. Colin's book, which focuses on the purpose of the firm, is I think the central idea, which he's explained; indeed, suggesting in light of that, those outside the shareholder body might actually exert a governance role.

So I just want to – the focus of the talk I have in the short time is really going to be on economic insecurity, which I think is of first order importance. Presumably there is a strong governance feature to it. So inequality: very serious, but I do think that corp governance plays a secondary role in its creation and persistence. The Piketty stuff initially focused on executive comp as a major source of inequality. I think there is a governance role there. It addresses mostly the top one percent; the [PE] channel, for which there is some governance element, the top 0.01 percent; but I think the real sources of inequality are really different.

They relate to the structural changes in the nature of work and the different ways that some firms succeed, and some firms are not succeeding. That's work done in various [economists]. I offer [cites] here. Part of what I hope is that the legal academics who think about these questions will pay attention to what these economists are saying about the sources of inequality and will not overstate the governance role that is an element of them.

David Autor's work, for example, relating the superstar firm, points out that there's huge inequality across firms; much more severe than the inequality within firms. The secretaries at Google are extremely well paid, but their wages are not the same as the secretaries of similar staff across the Bay Area. Indeed I think the real way to address inequality doesn't have anything to do with the corp governance tools, but there was the Dutch historian at Davos – that famous YouTube video – who basically said, the way to address these issues is taxes is taxes, taxes; and from my perspective, estate taxes and all the rest is BS.

So that's the way to address inequality, not worry about how firms are managing it. Similarly I don't think that the governance stuff, the corp governance stuff, has much to say about slow economic growth; even though it's been blamed for it. The claims about the role of stock buybacks and cutbacks in R&D is undercutting significant investments that would promote an economic boom. Jesse Fried, who's here, and coauthor, has done, I think, really very good work showing the frailty of that position.

Indeed there's a recent piece by Steil and Della Rocca on the buybacks, which show that the buybacks are occurring predominantly in those part of the economy where essentially the ROI is very weak; places where, in effect, management should be returning money to the shareholders, because they don't have really good investments to make on their own.

Then there are alternative hypotheses as to why we see this slow growth. There is the Robert Gordon idea that, basically, the big inventions – that was a different era. We aren't going to have electricity. We aren't going to have automobiles. The internet just doesn't really cut it. A hypothesis that I find appealing is the failures of government. So how can firms plan to make significant investments over the long term when we've seen the policy erraticism and failures of government, in which we aren't sure what the EU what the EU is going to look like in a month? We weren't sure three or four years ago if the euro was going to survive, and the U.S. turn in a nationalist direction also makes it hard for firms to plan and make investments over the long term.

Then the whole idea of the government playing austerity – a policy mistake. It seems to me that a lot of politicians who point to the buybacks really are looking for the firms to play Keynes, a Keynesian way to promote the economy by spending the shareholder money to promote a boom.

So I think economic insecurity is really where the deep issues lie; because when you lose your job, you're cut off from the social network. You lose not just the income stream. You are cut off from, in the United States, the system of social welfare and insurance which is run through the workplace. That's a real loss. So if there's a big idea here, it's that the present environment has produced what I call the great risk shift. There's been a risk shift away from the shareholders, who now can diversify all firm specific, all idiosyncratic risk.

The result of that dynamic and the governance energy that flows from that is to shift risk onto the employees who are far less able to bear that risk and to ensure against it. So governance I see as, in a sense, a way that the changes in the world – the way firms are funded, the markets in which they compete – a way in which those pressures are mapped onto the firm specific level, and that the economic insecurity point – not so much a governance issue, but it's an insurance issue; which no single firm is able to address.

So the policy prescription, if there is one, is that there needs to be a new match between government and enterprise, which will recognize that the need to renew human potential is a lifetime concern. Government now is structured to finance education, K through eight, once upon a time. In U.S. the high school movement of a century ago moved it to K through 12, K through 16. Firms could, presumably, provide that training; but they don't, because it's inefficient, because we expect government to play that role.

Well, similarly in the dynamic economy that we have in which firms are not able to provide the kind of insurance that they once were, then it seems to me the right move is to think about robust ways in which governments can change the match that they provide to enterprise over the need to revive these human potentials over a lifetime. This is not redistribution. I want to be clear about that. There's obviously an element of that, to take some of the gains and make sure that everybody gets a fair share; but it's not just that.

The whole rationale for "layoffs" is, in effect, that we don't want firms wasting the valuable input that might be put to higher value use. So firms should conserve on the resources that they use; but realistically layoffs in the modern economy mean the wipeout of firm specific investments in a way that inures to the damage of the employee.

So this match that I'm calling for, this reinvestment in employees, is in a sense to rebuild the resource that has been lost. It's to make society as a whole more productive; dealing with, among other things, some of the demographic issues that the U.S. and other places are going to face.

The final, quick point of the summary – I'm going to try to limit myself here – is the interesting position of the Black Rocks of the world, the asset managers of the world; because the product they offer, as we pointed out, is not any firm specific investment. It's a low cost diversified portfolio of all firms in the economy. So if that's your product, the only way that you can improve the outcomes for your investors is by increasing expected returns and lowering systematic risk across the portfolio as a whole; that is, the whole economy.

So in a sense their concern, if you think hard about this, is, how do they mitigate systematic risk. That's the way that they create value. If you think that some of the disruption we see at the individual firm level creates political risks to stability – and we've seen those express themselves in the political realm – then stability seeking becomes one way that a diversified investor can reduce the level of systematic risk. So if you think that some system of broader social insurance, particularly this revival of human potential over a lifetime, is part of not only increasing expected returns across the portfolio or across the economy, but also at mitigating a certain sort of political risk; then the question is, what position should the asset managers play in moving towards this consensus.

They hold the shares. They have the vision to perceive this. The question is, how involved are they going to end up in politics, and what does that do to their business model.

So I just want to spend a minute on this diversification point, because I think that's sort of key to understanding the world in which we live. It was a Nobel Prize winning idea that investors should want to pursue the maximization of utility, which is to say the highest expected risk adjusted returns. The way to achieve that is diversification of a portfolio, which minimizes firm specific idiosyncratic risk. Therefore what does this mean? It means that investors want firms to be aggressive, to take business risks; accepting that this will increase the rate at which firms fail.

So who are the other parties to the firm? Well, the creditors of the firm can adjust to that over time. The managers of the firm can adjust to that, because we pay them in stock based pay that incents them to take these risks. It's, in effect, the employees who, I think, as an empirical matter, are not adjusting to the extra risk that the changed incentives of diversification give to shareholders to encourage risk taking. The organization of firms changes. In [M&A] last week I talk about the conglomerate firms of the '50s and '60s and how they were failures of business ideas, in part because why? Investors who wanted diversification could get it at the portfolio level. They don't need diversification at the firm level; and indeed diversification at the firm level adds expense, because it requires managers to have skill across a broad range of things. It's managerialist.

But when you think harder about that, who is protected through the diversification of a conglomerate firm? It's really the employees, because the diversification of the cashflows, realistically, means firms will be less likely to lay off employees of a unit that's in trouble in a diversified firm than in a single-business focused firm. This risk shift from the shareholders to the employees falls out both in the theory, the theoretical way we understand how parties do and should invest. It falls out as well from the mechanisms that we have created to permit lowest cost diversification.

Okay, so I'm going to leave time for discussion here. The governance claim that I want to address, point to: The two channels of the high-power government system we've got are first the takeovers; the hostile bids of the '80s, and the hostile activists, of now. They're really on the same spectrum, the point of which is to eliminate slack as seen from a shareholder point of view. The difference is that the amount of slack, given the dispersion of share ownership of the '60s and '70s, that could trigger the bid was just much greater than the slack that is now permissible today in effect with re-concentration of ownership that makes the proxy battle so much more effective today than it ever was in the prior generation.

So we have a system that is extremely efficient in the utilization of resources; but the result is, as I say, risk shifting from the shareholders to the employees. This leads me to think that, in effect, firms can't insurance against this sort of risk. There's no way for the firm to provide a relationship that would make the employees whole against the risk that they're exposed to. This is the case for what I'm calling the need for the government match; the claim basically being that, if we're going to have the governance system we have; if we're going to be in a world in which the dynamism of the economy pushes the governance system we have, not only in the global dimension but in the domestic dimension; the Walmarts, the Amazons, the Netflixes, who completely disrupt the way business is done; these are exogenous features that don't depend upon the governance model we have.

But the result is that a disproportionate share of the risk of change is being borne by employees and not buy the shareholders. To conclude, it seems to me that's the call for a rethinking of social insurance, the lifetime human potential endowment insurance, that ought to be the next way that policy turns. So it's not a codetermination strategy. That doesn't solve it. That doesn't get us anywhere. It's to realize that the issue is an economic concern. It's the way the world has turned, and it requires a different sort of match between government and enterprise.

Merritt: Well, thank you very much, Jeff. We have about 15 minutes for Q&A. Let me take the privilege of the chair to give you the first question; which is, I think you very neatly, among many other things, mapped out the current situation in terms of the power of Black Rock and the other large index funds in their potential to influence corporate governance; but at the same time you're arguing corporate governance isn't the solution to our problems.

Can I invite you to speculate a little bit more about whether you think these large asset holders should be playing some kind of political role?

Jeff: There are two different ways to play a political role. One is a direct role in buttonholing folks. The other is stating what they believe to be the case. So when Larry Fink says the issue is firms who will invest for the long term, and that's the problem, I think the diagnosis he offers is not helpful one; and it pushes us away from policy that would be constructive on dimensions that I've described, because it suggests that, on a firm specific basis, if firms only behave better if managers only behave better, if we only got rid of the activists, maybe if we moved to Colin's system we could change things.

If you take the view that I pushed out, which is that there – global change, literally, in the environment in which these firms do their business, identifying what the global changes are and the way that in fact it's very difficult to resolve these tensions at the global level; his diagnosis, while not politically – a different way to diagnose what the concern is would, I think, advance the ability of the political branches to respond in a better way.

Merritt: Okay. Let me take questions. Alan.

Alan: Jeff, I had a couple of questions. I think you're right that employees bear more risk than they used to. In the safety literature we know that are risk adjusted wages; so I wondered if you thought there are, or might be, risk adjusted wages reflecting the new shift in risk bearing. My other question with respect to acquiring human capital is – I understand, but very weakly; because I'm not an expert in this. Adult retraining programs tend to have low returns. I wondered if you had thought about those programs in light of what you've said.

Jeff: Right. I guess I haven't seen the evidence that employee wages, in a general way, are risk adjusted; in part because the risk is hard to measure until it materializes itself. The market for that isn't very good. The second one was about retraining, about the success of those. That's – I gave a version of this in class. Some of the very good students said, you're assuming a lot about the plasticity of human beings and about the way of refocusing careers at different stages; how is that going to work.

The evidence on retraining pilots is not so great, but it's also the case that the U.S. spends the least amount on retraining in the entire OECD. It makes me think we have yet to think very hard about how we might make portals in and out of different careers readily available, more readily available than we do now. John [Macy], when he and I were discussing this, says that the U.S. system is incredibly biased in terms of incentives for physical investment relative to human endowment investment.

You get to – if you install a robot, under the new tax code you get to expense it in the year in which you make that investment; but we haven't thought in a coherent way about how to encourage folks to invest in themselves over the long period of their careers.

Male Voice: In a sense what you're saying is, look; we used to ask corporations to balance all sorts of missions, some of which were private and generated large returns, and others which were social – redistribute income within the firm; do good things for the society. You're saying in a vibrant, competitive global marketplace, we can't ask individual firms to do that; and if we value these things like economic security or equality, we should let the public sector do that and let companies do what they do best, which is be rapacious profit maximizers.

That's a nice theory. The problem is that, in a political economy sense, you've forgotten one thing, at least in the United States; which is, the very forces that want to push ruthless profit maximizing also have their hands on the testicles of the political system; and they prevent developing the kind of regulation and social safety net that you want the public to offer. By the way, there is an analogy here in terms of environmental. You say, don't ask the companies to behave well environmentally; come up with rules that force them to; similarly other things.

They won't do worker safety, but we can have rules about worker safety. So you're basically wanting us to adopt a sort of Northern European model, which they did in Denmark; which is, okay, we won't ask the firms to provide this; we'll let the economy provide it. In this country, anyway – I can't speak to England, but in this country – everything's been going the other way. It's been going the other way because the very forces that support the thing are undermining government at every turn.

So I don't know how you get us out of that conundrum. In some ways you have a system that works very well in theory, but not very well in practice. You just did one comment, which was that the reason companies offer stock buybacks is because they've done a very rational calculation, and they decided that the return – they can't get a better return from investing internally; so they'll do it the other way. I think that is so out of touch with the way things work in the corporate boardroom. The reason they do stock buybacks is because everyone else is doing it, period.

They have not made a rational calculation about the relative rate of return of a stock buyback versus the other. That's just not why they're all doing it. If they were all doing it, it couldn't possibly be that they've all made that rational calculation. Apple computer, the biggest buyback of all, has very returns, actually. The fact that Apple did it probably cause all sorts of other people to do it. There's a lot of fashion involved in corporate decision making.

To go back to the main point, it's a great theoretical model; but I don't see it happening in the United States.

Jeff: Okay. So – a lot there. There is evidence that, in general, firms in sectors where in fact the ROI is low are returning at a much greater rate, are performing the buybacks at a much greater rate than firms in the sectors where they ROI is higher. I could show you the graph on that, but let me just focus on the main point, which I think is a really serious issue.

That is, if you think – let me back up. So I guess the claim I would make is that firms in a rational way, self-interested way, would in fact favor greater government investment along the lines that I'm suggesting; precisely because the political frictions associated with the present system are becoming very intense.

Male Voice: But there's no evidence that they behave that way rationally in the political market. They, in fact, behave just the opposite way. They oppose every regulation. They oppose every tax redistribution. They oppose ever increase in spending on education. That's the way the business community behaves in the real world.

Jeff: Well –

Male Voice: I'm from Washington. I can tell you that's true.

Jeff: Right. I don't want to claim more than I can claim, which is a possibility theorem as to how the world might well get better, rather than a predictive path as to how it will get better; but if the alternative is some other proposal, which seems even less appealing to them, then – it's the Overton window point. You open a space of the Green New Deal, and then this proposal – which calls for investment in human development of the lifetime all of a sudden seems like the moderate alternative.

I wouldn't presume to suggest a political feasible path, but it's just as – given the world in which we're in, the point I'm making is, this is the way; this is a case for doing it this way; as opposed to depending upon the kindness of firms, the kindness of managers; which seems to be an alternative on offer.

Male Voice: I don't think you have to appeal to the kindness of firms. If firms want to attract good, young, talented employees; if they want to attract consumers; if they want to attract a certain kind of investor; they would have to behave in a certain way. The question is whether our legal system allows firms to behave in that way, or whether certain constituencies are favored under the law so that they can't behave that way.

Merritt: Okay. We can have last quick question.

Male Voice: Okay, quick observation and a quick question: The first, observation, is, I don't think there's any disagreement between you and I about the fact that one needs government to support activities that companies cannot legitimately internalize; but I do think that you're understating the extent of the problems with trying to do that. You haven't talked at all about the moral hazard elements associated with running a public insurance scheme and the incentives that gives to companies; for example to lay off people, to lay off the least able in terms of retraining.

I'd also like to get your views on – you seem to say that universal owners were affected predominantly by systemic risks, which I believe to be the case.

Jeff: Right.

Male Voice: So is there not an incentive on universal owners, then, to internalize precisely the externalities that you are concerned about in terms of the environmental risks, et cetera?

Jeff: The incentives to internalize or externalize?

Male Voice: To internalize those, because those are what affect the performance of, for example, index funds.

Jeff: Well, right; but I guess some of these risks create systemic risks. In other words, if firms don't attend to sustainability or the climate change matters, for example, that's a systemic risk. It affects the value of every firm in the portfolio. So they –

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