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# Journal of APPLIED CORPORATE FINANCE

## *Corporate Purpose—and EVA Once More?*

Columbia Law School Symposium on

### Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)



Columbia Business School

VOLUME 31
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# *Journal of* APPLIED CORPORATE FINANCE

**IN THIS ISSUE:** *Corporate Purpose—and EVA Once More?*

During my nearly 40 years as editor, this journal has been devoted to exploring the idea that public companies should be run to maximize their own long-run value. However much you may have been persuaded by the Business Roundtable's recent statement that the idea has outlived its usefulness, it received a pretty remarkable show of support in an event that took place at Columbia Law School early this year—and that provides the main focus of this issue.

by Don Chew

The event, which was nicely designed and orchestrated by Jeff Gordon and Kristin Bresnahan at the law school's Millstein Center—and included an opening statement by Ira Millstein himself—was billed as a symposium on "Corporate Governance Counter-Narratives: On Corporate Purpose and Shareholder Value(s)." The occasion and organizing focus were provided by publication of Colin Mayer's book, *Prosperity—Better Business Makes the Greater Good*.

Mayer himself, well-known corporate finance and governance academic, and inaugural dean of Oxford's Said School of Business, launched the first of the five sessions with a 30-minute address that, without notes, slides, or AV equipment of any kind, issued a flawlessly articulate and stirring call for a "radical reinterpretation" of what corporations are supposed to do. The corporation, as Mayer starts by pointing out, from its beginnings 2,000 years ago in the Roman Empire until the rise of serious shareholder activism in the early 1980s, has combined commercial activities with a public purpose. But since Milton Friedman's famous pronouncement in 1970 that the social goal of the corporation is to maximize its own profits, the gap between the social and private interests served by corporations appears to have grown ever wider, helping fuel the global outbreaks of populist protest and indictments of capitalism that fill today's media.

In Mayer's vision, the boards of all companies will either take it upon themselves—or be required by law—to publish statements of corporate purpose that envision some greater social good than maximizing shareholder value. And to carry out that purpose, he urges companies to make continuous investments of their financial and other resources in developing their human, social, and natural capital—and also to account, quite literally, for such investments in much the same way they now keep track of their investments in physical capital. Although the author appears to prefer that such change be enacted through new legislation and enforced by regulators and the courts, his main energies are directed at enlisting the support of today's largest owners of corporations, many of which—particularly wealthy founding families, institutional shareholders, and sovereign wealth funds—are already favorably predisposed to ESG initiatives.

In their responses to Mayer, both the world's most famous corporate lawyer, Marty Lipton, and distinguished Columbia and Stanford law professor, Ron Gilson, begin by suggesting that mandating such changes is neither desirable nor feasible. Lipton, after praising Mayer's proposals and noting much common ground with his own New Paradigm, also views the support of large shareholders as critical, and efforts to secure it as the most promising strategy. Gilson, on the other hand, sees a number of major challenges to this approach. Apart from the courts' inability or unwillingness to enforce such statements of purpose, he expresses concern about the political risks associated with ever-more concentrated ownership of public companies in a world where populist distrust of all concentrations of wealth and power is clearly on the rise.

But even more troubling for the companies themselves is the confusion such proposals are likely to create in corporate boardrooms. As Gilson points out, corporate managements face not one, but *two* hugely costly ways of putting their own interests ahead of their shareholders.' One is the much cited problem of *myopia* or *short-termism*, whose most common form is underinvesting in the corporate future to boost near-term earnings. (But if short-termism gets a lot of attention during the conference, Harvard Law's Mark Roe provides little if any support for its existence or consequences in reviewing the studies.) The other big problem, seldom discussed these days, is what Gilson calls *hyperopia*, or overinvestment designed to preserve (low-return) growth and the status quo. (And in the article that immediately follows the five Columbia sessions, University of Pittsburgh's Dave Denis provides a nicely compact review of three decades of research suggesting that overinvestment is by far the more widespread of the two problems.)

And as Gilson goes on to argue, perhaps the most challenging, and important, responsibility of boards is achieving the right balance in guarding against these two value-destroying tendencies—failure to invest in the future, and failure to return capital to investors that will be wasted on unproductive investment. Gilson's answer to the problem is simple: "better management," as exemplified by, say, Costco's ability to operate profitably while—and perhaps because—paying above-market wages. More generally, the answer is devoting another dollar of resources to all important stakeholders, as long as the present value of the expected payoff—over any time horizon management is comfortable explaining to its investors—is at least a dollar.

A more direct and impassioned warning about the consequences of confusion about the corporate mission was provided by SEC Commissioner Robert Jackson, when commenting in the third session on stakeholder theory and the role of corporate boards:

*Asking boards of directors to make major strategic business decisions while putting all these different stakeholder interests on a par with shareholders' imposes a decision-making burden on the institution that we cannot and should not expect boards to carry. Look, I've been in those boardrooms. They're filled with good people who are trying to do the right thing. But the fact is that corporate boards do not hold the keys to our environmental future, or to ending inequality. They don't have the authority or knowledge or resources to solve those problems. And expecting them to do that is a prescription for profound unhappiness for millions of families who rightly feel let down by modern corporations.*

*Moreover, taking away companies' clear, single-minded objective function of increasing long-run shareholder value raises real accountability problems. Without such an objective, what will guide boards when making the difficult tradeoffs among stakeholders that effective oversight and management require?*

But in some ways an even more remarkable statement of the so-called shareholder primacy doctrine comes from Delaware Supreme Court Chief Justice Leo Strine. After invoking the New Deal, and expressing admiration for the way its ideals and its social programs—especially protections for workers and the unemployed—have been put into practice by Northern European social democracies, the Judge responds to the more extreme demands of today's ESG movement by falling back on the prescription of Columbia Law's most famous professor, Adolph Berle. Even while serving as one of Roosevelt's "Brain Trusters" and framers of the New Deal, Berle also insisted that companies "stick to their knitting by putting shareholders first" as the only way of ensuring the accountability of corporate managements and boards to the public. And in a provocative closing statement, the Judge warns that when thinking about ESG,

*[W]e ought to be very careful not to forget, or to confuse, what the Securities Acts were about. It's important that everyone understand what corporations do—both what they are supposed to do for society, and what they are not supposed to do. That's something everyone should know, whether they own publicly listed securities or not.*

Jill Fisch, co-director of the University of Pennsylvania Law School's Institute for Law and Economics, responds to the Delaware Chief Justice by questioning whether corporate America in fact has a major governance problem. As Fisch points out, U.S. companies have been taking voluntary measures—in some cases even flouting the *de*regulatory initiatives of the federal government—to address environmental problems; and like Costco, many have raised their workers' wages well above market rates, while urging Congress to increase legal minimums. And perhaps most important, all this has taken place not only without any legal challenges from the companies' largest shareholders, but generally with their encouragement and applause—and higher stock prices. What's more, echoing Judge Strine's concerns, Fisch closes by expressing skepticism about the very idea that companies *are able to* come up with a single social purpose—other than maximizing their own long-run efficiency and value—that would be appropriate for, and end up satisfying, all their different stakeholders. "Who," she asks, "would make the tradeoffs among competing priorities when the social purpose comes into conflict with economic value?"

Columbia Business School's Bruce Kogut closes the session with the suggestion that our greatest problems today may be coming not from the shortsightedness and other failings of corporations, but from "deep, deep distrust of the competence of the state." Kogut's main prescription is that, to take advantage of the enormous potential gains from effective arm's-length collaboration between business and the public sector, governments at all levels should find ways to strike "Coasian bargains" with the private sector—think what might have been between New York City and Amazon—that make the best possible use of the core competencies and resources of each.

After a pair of articles by the University of Pittsburgh's Dave and Diane Denis—Dave's, already cited, on corporate overinvestment and underinvestment, and Diane's, a clear and compelling restatement of "the case for long-run value maximization"—the issue concludes with reported sightings of a comeback by a measure of corporate performance called EVA, or Economic Value Added, once a regular subject in these pages. When I was talking to Colin after the conference about the accounting challenge of capturing the value of "non-financial" investments, Bruce Kogut jumped in with, "I thought EVA solved that problem years ago." And in the last six articles in this issue, starting with the tribute by Bennett Stewart, the co-founder of EVA (and Stern Stewart & Co.), to his co-founder Joel Stern, who died in May, we present a brief history of the rise, fall, and apparent resurgence of EVA. As the last three articles show, that comeback has been accompanied by a sea change into forms rich and strange.

Shareholder value is dead, long live shareholder value! EVA is dead, long live EVA! —DHC

*Columbia Law School Symposium on*
## Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)

### Session I: Corporate Purpose
*Colin Mayer, Ronald Gilson, and Martin Lipton*

In this first of five sessions of a recent Columbia Law School symposium devoted to discussion of his new book, *Prosperity—and The Purpose of the Corporation*, Oxford University's Colin Mayer begins by calling for a "radical reinterpretation" of the corporate mission. For all but the last 50 or so of its 2,000-year history, the corporation has combined commercial activities with a public purpose. But since Milton Friedman's famous pronouncement in 1970 that the social goal of the corporation is to maximize its own profits, the gap between the social and private interests served by corporations appears to have grown ever wider, helping fuel the global outbreaks of populist protest and indictments of capitalism that fill today's media.

In Mayer's reinterpretation, the boards of all companies will produce and publish statements of corporate purpose that envision some greater social good than maximizing shareholder value. To that end, he urges companies to make continuous investments of their financial capital and other resources in developing other forms of corporate capital—human, social, and natural—and to account for such investments in the same way they now account for their investments in physical capital. Although the author appears to prefer that such changes be mandatory, enacted through new legislation and enforced by regulators and the courts, his main efforts are directed at persuading the largest institutional owners of corporations—many of whom are already favorably predisposed to ESG—to support these corporate initiatives.

Marty Lipton, after expressing enthusiasm about Mayer's proposals, suggests that mandating such changes is likely neither feasible nor desirable, but that attempts—like his own New Paradigm—to gain the acceptance and support of large shareholders is the most promising strategy. Ron Gilson, on the other hand, after voicing Lipton's skepticism about the enforceability of such statements of purpose, issues a number of warnings. One is about the political risks associated with ever more concentrated ownership of public companies in a world where populist distrust of all concentrations of wealth and power is clearly on the rise. But most troubling for the company themselves is the confusion such proposals could create for corporate boards whose responsibility is to limit *two* temptations facing corporate managements: *short-termism*, or underinvestment in the corporate future to boost near-term earnings (and presumably stock prices); and what Gilson calls *hyperopia*, or overinvestment designed to preserve growth (and management's jobs) at all costs.

### Session II: Capitalism and Social Insurance
*Jeffrey Gordon. Moderated by Merritt Fox*

In what Jeff Gordon describes as "the great risk shift," large U.S. companies have responded during the last 50 years to the forces of globalization and increased pressure from investors by transferring the risks associated with product and worker obsolescence from their shareholders to their employees. Layoffs have generally meant very large, if not complete, losses of "firm-specific investments" by displaced employees. And the problem is especially troubling in the U.S., where the employees of large companies lose not only their jobs and income streams, but also often their connection to their social network, to the entire system of social welfare and insurance that tends to be provided by large companies and the workplace.

While applauding corporate retraining programs, Gordon suggests that individual company efforts are likely to be overwhelmed by the demand for such services. The solution accordingly lies in the form of government-provided social insurance—in programs that, whether orchestrated and funded at the state or federal level, provide the most cost-effective government "match" designed to ensure the preservation of human potential and lifetime earnings power of employees.

### Session III: Securities Law in Twenty-First Century America: A Conversation with SEC Commissioner Robert Jackson
*Robert Jackson. Moderated by John Coffee*

SEC Commissioner Robert Jackson comments on three major issues the Commission has been investigating: (1) the concentration of ownership among American stock exchanges; (2) the extent of common ownership of, and potential for undue influence over, U.S. corporations by large institutional shareholders; and (3) the role of corporate boards in promoting and protecting stakeholder interests as well as shareholder interests.

In the first of the three areas, Jackson argues that the ownership of 12 of the 13 U.S. stock exchanges by just three financial conglomerates suggests a competitiveness problem—one that, despite the significant reductions in trading costs during the last 15 years, should receive further investigation. To the concerns raised by the common and increasingly concentrated ownership of U.S. public companies by institutional shareholders, the Commissioner's main response is to note that whatever culpability corporate America is forced to assume for our large and growing environmental and social problems must be shared with the largest U.S. institutional shareholders, whose collective resources and influence confer a responsibility to help guide companies when responding to such problems. Finally, on the issue of stakeholder theory and ESG, Jackson insists that asking corporate boards to put the interests of all stakeholders on a par with their shareholders' when making strategic business decisions would be a mistake. Besides creating a major accountability problem, the adoption of stakeholder theory in place of "the clear, single-minded objective function of increasing long-run shareholder value" would deprive boards of their principal guide "when making the difficult tradeoffs among stakeholders that effective oversight and management of public companies require."

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### Session IV: The Law, Corporate Governance, and Economic Justice

*Leo Strine, Mark Roe, Jill Fisch, and Bruce Kogut. Moderated by Eric Talley.*

The Chief Justice of the Delaware Supreme Court begins by invoking the New Deal, and expressing admiration for the way its goals and some of its social programs have been put into practice by Northern European social democracies. Most important are their protections for workers and the unemployed—protections the Judge finds deplorably absent in U.S. law and corporate labor practices. Nevertheless, when contemplating how corporate boards in the U.S. might respond to the growing demand for U.S. public companies to address social problems like the environment and economic inequality, the Delaware judge falls back on the prescription of Adolph Berle, who, though one of the framers of the New Deal, insisted that companies "stick to their knitting" by putting shareholders first as the only way of ensuring the accountability of corporate managements and boards.

Harvard Law's Mark Roe responds with a defense of corporate America against the charge of corporate short-termism by noting that, although U.S. capital expenditures have declined in the past 15-20 years, corporate investment in R&D and other intangible assets have both grown sharply. Corporate distributions in the form of dividends and stock buybacks are rising, but so have the net borrowings of the companies making the distributions, leaving the cash balances of U.S. companies also near record levels. And the remarkably high valuations of successful high tech companies are themselves forceful rebuttals of the idea that pressure from the stock market for current earnings is a serious deterrent to investment and innovation.

The University of Pennsylvania's Jill Fisch follows Roe's dismissal of the short-termism argument with even more forceful questioning of whether corporate America in fact has a major governance problem. U.S. companies have been taking *voluntary* measures to address environmental problems—in some cases even in the face of federal deregulatory initiatives—and many have raised their workers' wages, without any challenges (and often with encouragement) from their shareholders. And echoing Justice Strine's concerns, Fisch also ends up questioning the premise that companies can be asked to define a single social purpose (other than maximizing shareholder value) that would be appropriate for, and end up satisfying, all their different stakeholders.

Columbia Business School's Bruce Kogut closes with the suggestion that our greatest problems today may be coming not from the shortsightedness and other failings of corporations and corporate law, but from "deep distrust of the competence of the state." Kogut's main prescription is that to take advantage of the enormous potential gains from effective arm's-length collaboration between business and the public sector, governments at all levels should find ways to strike "Coasian bargains" with the private sector that makes the best possible uses of the core competencies and resources of each.

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### Session V: Macro Perspectives: Bigger Problems than Corporate Governance

*Bruce Greenwald and Edmund Phelps. Moderated by Joshua Mitts*

Columbia Business School's well-known authority on value-based investing begins by attributing today's economic problems to a "global economic dislocation," one that is rooted in the ongoing—and in Greenwald's view, inevitable—decline of manufacturing and displacement by services. Like the other example of dislocation in modern times, the Great Depression of the 1930s, the 2008 global financial crisis and protracted recession—still very much with us—are viewed as originating in the sharp decline of a major "sector" of the global economy. In the Depression of the '30s it was agriculture; in the recent financial crisis it was manufacturing. In both cases, technological advances and economy-wide productivity increases led to huge increases in stock and financial asset prices—but also to sharp drops in the prices of farm and manufactured goods, and massive overcapacity and ruinous competition in both sectors.

According to the author, the working off of overcapacity in the agricultural sector was accomplished largely by the effect of World War II in moving huge numbers off the farm and into the mainly urban industrial sector *at government expense*. This labor force relocation, which occurred in all developed economies, was essential to a global economic transformation that for the next 50 years provided high productivity growth and greater equality of income and wealth.

More recently, however, the global economy has been confronted with the challenge of accomplishing a transition from manufacturing to services that will feature lower productivity growth and more inequality. Foreseeing a long, difficult process, Greenwald's biggest concern is that government intervention will distract businesses from making this transition effectively—which means continuing to operate as efficiently as possible, downsizing when necessary—and so make the problems worse. And while business focuses on preserving its own efficiency and value, Greenwald urges governments to look for more cost-effective ways—for example, expanded use in the U.S. of the Earned Income Tax Credit—to cushion workers from the consequences. Nobel laureate Edmund Phelps, while agreeing with much of Greenwald's analysis, has a different explanation of the U.S. productivity dilemma. Innovation is viewed as the primary driver of the prosperity of the advanced economies. Higher income and wealth matter less than job satisfaction, participation, and an array of non-material "modern values" that have somehow been lost and that, for Phelps, are the key to restoring economic growth and "mass flourishing."

## Is Managerial Myopia a Persistent Governance Problem?

*David J. Denis*

Critics of U.S. corporations have long argued that companies are overly focused on short-term results and, as a consequence, sacrifice their own long-run value and competitiveness. These criticisms have expanded in recent years to include those from prominent politicians, investors, consultants, and academics. If such criticisms have merit, they would imply a massive governance failure in which there has been decades of underinvestment with little adjustment on the part of managers, boards, or the market for corporate control.

This article evaluates the economic underpinnings of these criticisms and analyzes their implications in the context of empirical evidence produced by several decades of research on corporate investment policies, the outcomes of corporate control events, investor horizons, and the market pricing of companies with little if any earnings. In reviewing the findings of these studies, the author finds little evidence to support the view that U.S. companies sacrifice long-run value and competitiveness by systematically underinvesting.

First, although U.S. companies have indeed cut back on tangible investments such as property, plant, and equipment, these cutbacks have been more than offset by the dramatic growth in investment in intangibles, such as spending on developing knowledge capital, brand-building, and IT infrastructure. Second, when subjected to events that have the effect of reducing managerial control over investment policies and transferring control to outside investors—such as leveraged buyouts and recapitalizations, forced CEO dismissals, and shareholder activist campaigns—companies tend to reduce, not increase, investment spending. In fact, it is difficult to find any corporate control threats that have had the goal or effect of *increasing* investment. Third, and at the same time, the rising concentration of large institutional investors, including indexers such as BlackRock and Vanguard, suggests that investors have become, if anything, more long-term oriented over time. Fourth, there is no evidence that the market shuns companies that have yet to report large (or indeed any) earnings. These findings suggest that curbing *over*investment, and not discouraging myopia and underinvestment, may well still be the larger corporate governance challenge facing investors when monitoring and attempting to influence the performance of U.S. companies.

## The Case for Maximizing Long-Run Shareholder Value

*Diane Denis*

Criticism of the shareholder model of corporate governance stems in part from misunderstanding about what shareholder wealth maximization means for the other stakeholders of public companies. The corporate goal of shareholder wealth maximization does not imply that such stakeholders "do not matter." Managers maximize shareholder value by maximizing the expected cash flows that are at least potentially distributable to all of their stakeholders (after all have been given their contractual due). To maximize such cash flows, managers must provide their customers with desirable goods and services at attractive prices—which in turn requires that managers attract the employees, suppliers, and financial capital needed to conduct their businesses by providing each of these groups with market-determined returns on their contributions to firm value. In this way, successful corporations benefit all of their stakeholders, and what is good for the corporation is generally good for society.

External forces such as the media and government exert considerable influence on corporate actions and, in so doing, they play a role in helping to limit negative corporate "externalities" such as pollution and climate change. But direct regulation of productive activities should be used sparingly, and subjected to ongoing cost-benefit analysis. Government regulation replaces the collective decisions of a broad marketplace of stakeholders using their own resources to act in their own interests with decisions made by government officials with complicated incentives and using resources generated by others. More generally, government should seek to regulate corporate actions only in the limited situations in which there are no market solutions for reducing the effects of externalities. For example, government plays a critically important role in identifying and deterring corporate fraud, and in ensuring competition and a level playing field for companies and all their stakeholders.

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### A Tribute to Joel Stern

*Bennett Stewart*

The co-founder of corporate finance consulting firm Stern Stewart and Co. pays tribute to Joel Stern, the well-known popularizer of "modern corporate finance" and consultant to hundreds of companies worldwide who died on May 21, 2019. During a 45-year career that spanned his graduation from the University of Chicago's School of Business in 1964, a 14-year stint at the Chase Manhattan Bank, and the formation of Stern Stewart (and its successor, Stern Value Management), Stern traveled the world over, always eager to address and make converts among legions of corporate executives, board members, and MBA students. One key to his success was a passionate reverence for the academic scholars who developed modern finance. Joel's translation of the Miller-Modigliani valuation model into a practical framework for evaluating corporate performance gained a following among a generation or two of corporate leaders, leading ultimately to the development of EVA, or Economic Value Added, a practical framework for value-based financial management.

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### A Look Back at the Beginnings of EVA and Value-Based Management: An Interview with Joel M. Stern

*Interviewed by Joseph T. Willett*

In this interview conducted five years ago, one of the pioneers of value-based management discusses his life's work in converting principles of modern finance theory into performance evaluation and incentive compensation plans that have been adopted by many of the world's largest and most successful companies, including Coca-Cola, SABMiller in London, Siemens in Germany, and the Godrej Group in India. The issues covered include the significance of dividend payouts (are dividends really necessary to support a company's stock price and, if so, why?) as well as the question of optimal capital structure (whether and why debt might be cheaper than equity).

But the most important focus of the interview is corporate performance measurement and the use of executive pay to strengthen management incentives to increase efficiency and value.

As Stern never tired of arguing, the widespread tendency of public companies to manage "for earnings"—or in accordance with what he refers to as "the accounting model of the firm"—often leads to value-destroying decisions. As one example, the GAAP accounting principle that requires intangible investments like R&D and training to be written off in the year the money is spent is likely to cause significant underinvestment in such intangibles. At the same time, the failure of conventional income statements to reflect the cost of equity almost certainly encourages corporate overinvestment.

Stern's solution to this problem was an executive incentive compensation plan whose rewards were tied to increases in a measure of economic profit called economic value added, or EVA, which research has shown to have a significance relation to changes both in share value and the premium of market value over book value. Moreover, by combining such a plan with a "bonus bank" that pays out annual awards over a multiyear period, boards could ensure that management will be rewarded not for good luck but for sustainable improvements in performance.

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### EVA, Not EBITDA: A New Financial Paradigm for Private Equity Firms

*Bennett Stewart*

Private equity firms have boomed on the back of EBITDA. Most PE firms use it as their primary measure of value, and ask the managers of their portfolio companies to increase it. Many public companies have decided to emulate the PE firms by using EBITDA to review performance with investors, and even as a basis for determining incentive pay. But is the emphasis on EBITDA warranted?

In this article, the co-founder of Stern Stewart & Co. argues that EVA offers a better way. He discusses blind spots and distortions that make EBITDA highly unreliable and misleading as a measure of normalized, ongoing profitability. By comparing EBITDA with EVA, or Economic Value Added, a measure of economic profit net of a full cost-of-capital charge, Stewart demonstrates EVA's ability to provide managers and investors with much more clarity into the levers that are driving corporate performance and determining intrinsic market value. And in support of his demonstration, Stewart reports the finding of his analysis of Russell 3000 public companies that EVA explains almost 20% more than EBITDA of their changes in value, while at the same time providing far more insight into how to improve those values.

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### Beyond EVA
*Gregory V. Milano*

A former partner of Stern Stewart begins by noting that the recent acquisition of EVA Dimensions by the well-known proxy advisory firm Institutional Shareholder Services (ISS) may be signaling a resurgence of EVA as a widely followed corporate performance measure. In announcing the acquisition, ISS said that it's considering incorporating the measure into its recommendations and pay-for-performance model.

While applauding this decision, the author also reflects on some of the shortcomings of EVA that ultimately prevented broader adoption of the measure after it was developed and popularized in the early 1990s. Chief among these obstacles to broader use is the measure's complexity, arising mainly from the array of adjustments to GAAP accounting. But even more important is EVA's potential for encouraging "short-termism"—a potential the author attributes to EVA's front-loading of the costs of owning assets, which causes EVA to be negative when assets are "new" and can discourage managers from investing in the business.

These shortcomings led the author and his colleagues to design an improved economic profit-based performance measure when founding Fortuna Advisors in 2009. The measure, which is called "residual cash earnings," or RCE, is like EVA in charging managers for the use of capital; but unlike EVA, it adds back depreciation and so the capital charge is "flat" (since now based on gross, or undepreciated, assets). And according to the author's latest research, RCE does a better job than EVA of relating to changes in TSR in *all* of the 20 (non-financial) industries studied during the period 1999 through 2018.

The article closes by providing two other testaments to RCE's potential uses: (1) a demonstration that RCE does a far better job than EVA of explaining Amazon's remarkable share price appreciation over the last ten years; and (2) a brief case study of Varian Medical Systems that illustrates the benefits of designing and implementing a customized version of RCE as the centerpiece for business management. Perhaps the most visible change at Varian, after 18 months of using a measure the company calls "VVA" (for Varian Value Added), has been a sharp increase in the company's longer-run investment (not to mention its share price) while holding management accountable for earning an adequate return on investors' capital.

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### Are Performance Shares Shareholder Friendly?
*Marc Hodak*

Performance shares, or PSUs, have become the largest element of pay for top executives in corporate America. Their spread was ignited by institutional investors looking for more "shareholder-friendly" equity awards—as opposed to restricted stock and stock options, which have been characterized as "non-performance" equity. Although that characterization has been challenged by many directors and compensation professionals, proxy advisers like Institutional Shareholder Services have continued to insist that the majority of stock be granted based on performance, compelling public companies to conform to that standard.

With over a decade of experience with PSUs, the evidence is in regarding their net effect:

• PSUs greatly complicate long-term incentives. Pay disclosures are dominated by discussion of PSUs, including metrics, goals, performance and vesting, and any differences in one grant year versus the next over three overlapping periods.

• PSUs may be contributing to the increase in pay. Companies issuing a significant portion of their long-term incentives in the form of PSUs have been granting about 35% more in value than companies granting only restricted stock and stock options.

• Shareholders don't appear to be getting anything for that added complexity and cost. S&P 500 companies using PSUs have underperformed their sector peers, and companies using solely "non-performance" equity have significantly outperformed their sector peers, and in every single year over the last decade.

Given these findings on PSUs, it is time for institutional investors and their proxy advisors to reconsider their view of these vehicles as "shareholder-friendly," and rethink their unqualified promotion of their use by the companies they invest in.

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### Why EVA Bonus Plans Failed—and How to Revive Them

*Stephen F. O'Byrne*

Most companies rely heavily on earnings to measure their financial performance, but earnings growth has at least two important weaknesses as a proxy for investor wealth. Current earnings growth may come at the expense of future earnings through, say, shortsighted cutbacks in corporate investment, including R&D or advertising. But growth in earnings per share can also be achieved by "overinvesting"—that is, committing ever more capital to projects with expected rates of return that, although well below the cost of capital, exceed the after-tax cost of debt. Stock compensation has been the conventional solution to the first problem because it's a discounted cash flow value that is assumed to discourage actions that sacrifice future earnings. Economic profit—in its most popular manifestation, EVA—has been the conventional solution to the second problem because it includes a capital charge that penalizes low-return investment.

But neither of these conventional solutions appears to work very well in practice. Stock compensation isn't tied to business unit performance, and often fails to motivate corporate managers who believe that meeting consensus earnings is more important than investing to maintain future earnings. EVA often doesn't work well because increases in current EVA often come with reduced expectations of future EVA improvement—and reductions in current EVA are often accompanied by increases in future growth values. Since EVA bonus plans reward current EVA increases without taking account of changes in expected future growth values, they have the potential to encourage margin improvement that comes at the expense of business growth and discourage positive-NPV investments that, because of longer-run payoffs, reduce current EVA.

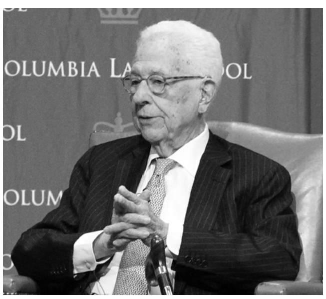
In this article, the author demonstrates the possibility of overcoming such short-termism by developing an operating model of changes in future growth value that can be used to calibrate "dynamic" EVA improvement targets that more closely align EVA bonus plan payouts with investors' excess returns. With the use of "dynamic" targets, margin improvements that come at the expense of business growth can be discouraged by raising EVA performance targets, while growth investments can be encouraged by the use of lower EVA targets.

COLUMBIA LAW SCHOOL SYMPOSIUM

# Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)

## SESSION I: CORPORATE PURPOSE AND GOVERNANCE

**Columbia Law School | New York City | March 1, 2019**



### Ira Millstein

Founding Chair,
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### Colin Mayer

Peter Moores Professor of Management Studies,
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### Kristin Bresnahan

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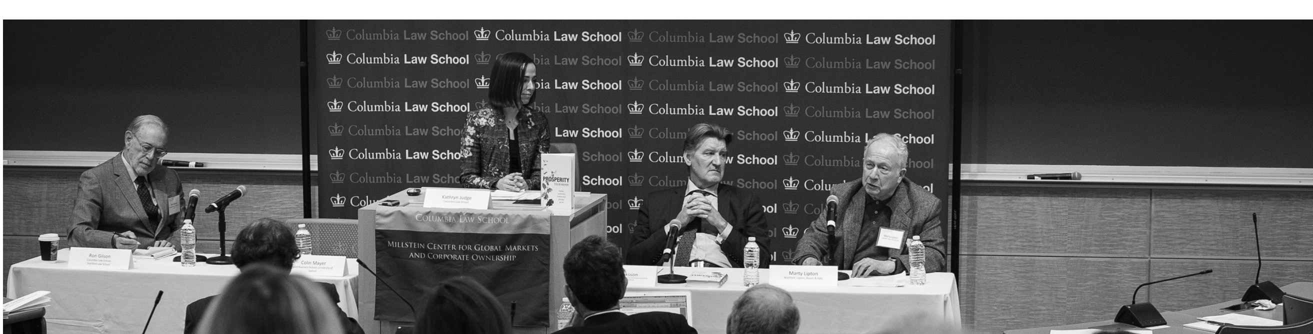
### Ron Gilson

Marc and Eva Stern Professor of Law and Business,
Columbia Law School;
Meyers Professor of Law and Business, Stanford Law School

### Marty Lipton

Founding Partner, Wachtell,
Lipton, Rosen & Katz LLP



There have been many recent and very public examples of what is widely viewed as a breach of trust between corporations and the public. For capitalism to survive and thrive going forward, we need to repair that trust. It is a multifaceted problem that will require multifaceted solutions. – Kristin Bresnahan

**Kristin Bresnahan:** Good morning, I'm Kristin Bresnahan, Executive Director of the Millstein Center for Global Markets and Corporate Ownership, and I'm especially pleased to welcome you all to Columbia Law School and to the Millstein Center's conference: Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s). Today is going to be a fascinating day of great conversations, and we're very glad you all are here to take part in them.

When I started at the Millstein Center last summer, one of the first things Ira Millstein said to me was that he wanted it to focus on issues on the corporation's role in society and on exploring plausible alternatives to shareholder primacy as the primary aim of and guide for managing corporate enterprises. We both believe that such an exploration is a critical step in righting the course of capitalism—which, while producing impressive returns for shareholders during the last several decades, has contributed to environmental problems and growing inequality.

Over the past eight months, the sense of urgency around these issues and the future of democratic capitalism has risen to the top of concerns of the collective consciousness, becoming the focus of presidential candidates, much debated proposed legislation, and countless books, articles, and op-eds, many of which have been written by people in this room. We've all seen headlines like "The Millennials and the Younger Generations Are Souring on Capitalism."

What does all this mean for the future of American business? There have been many recent and very public examples of what is widely viewed as a breach of trust between corporations and the public. For capitalism to survive and thrive going forward, we need to repair that trust. It is a multifaceted problem that will require multifaceted solutions.

Fortunately, we have gathered many great minds that have spent a lot of time thinking about these issues here today, and they're going to get us on the right track for exploring what we're going to do about it. I'm very proud of the fact that we will be hosting conversations representing a wide variety of perspectives, and I'm hoping that everyone here will be challenged to think about these issues in a different way when they leave today.

This conference is just the beginning of a larger project that we hope will frame research designed to answer questions about how best to address these issues, and in that effort we are excited to work alongside and collaborate with other organizations interested in the same goal, including the Coalition for Inclusive Capitalism and the World Economic Forum.

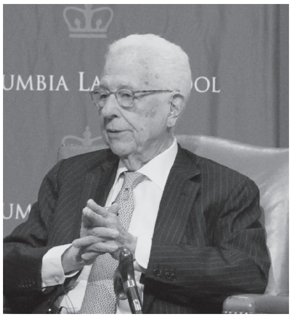
So, with that I'm going to turn the microphone over to the center's founder, Ira Millstein. Thank you.

**Ira Millstein:** Thank you, Kristin. Good morning, everyone. Thank you all for joining us and coming out for this important discussion.

Today we live and work in a very complex and constantly evolving capital market system, one that is filled with both political and economic uncertainty. This means that corporations need to be able to evolve with the changing times.

The corporation has three legs: management, the board of directors, and shareholders. Management's role has been vital from the beginning as the engine of corporate performance. For much of the 20th century, managers exercised considerable control over public companies. But once passive boards are now embracing a more active role in oversight and planning. Over the past decade, a coalescence of economic power has reinvigorated shareholders into more active involvement with the companies they invest in. Once faceless groups of shareholders of different varieties now have more significantly concentrated power, particularly the ability and inclination to wield considerable influence over the corporation through its directors.

Today's reality is that shareholders play a critical role in the success and



> Directors and corporations are not immune from the power of the capital markets, the power of shareholders to impact stock price, and the ability to raise capital, executive compensation, and a host of other sensitive points. So for me, the looming question for all of us is this: Can we find a way to help public companies achieve the necessary balance between shareholder value and stakeholder demands, which may require shareholders to forgo shorter-term profit, either temporarily or even longer-term? – Ira Millstein

longevity of a company. They provide the capital that corporations require for growth—and just to sustain their operations. So corporations cannot turn a blind eye to shareholders or their demands for faster and visible so-called "shareholder value." And shareholder value, over decades, has become the shareholder primacy standard that now prevails in corporate America. The corporation's purpose was to generate profit for shareholders.

It has increasingly been argued that this mindset has inhibited growth and innovation while boosting shareholder returns in the short term. And this mindset is now being challenged. The challenge is coming from a variety of forces and in unexpected ways from what we call corporate "stakeholders." There is currently growing momentum from a diverse group of stakeholders to think beyond quicker profits. Such stakeholders include not only the shareholders, but also employees, suppliers, customers, and the community from which the corporation draws its resources or that may otherwise be affected by its actions.

The most recent proxy season illustrates my point. Proxy demands for governance changes, including the #metoo movement, gun safety, climate and environmental change, human rights, and the opioid crisis, are on the rise. Corporations are being asked to take the lead. The calls won't go away. These shareholder demands cannot be ignored. Rather, they now must be balanced with shareholder demands for short-term profits and price swings.

So the management and oversight of a public corporation is a balancing act. And the question for all of us is: How do directors strike the right balance? Also, do the current institutional structures—including existing laws, regulations, and incentive structures—encourage this balance?

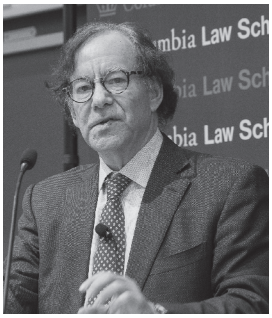
Under our existing legal framework, as long as directors satisfy their fiduciary duties, the law gives directors incredible flexibility, principally through the business judgment rule. In fact, there are very few situations where director decisions are subject to the more stringent standards of review of enhanced scrutiny or entire fairness. Directors should take solace from knowing they are legally empowered to make decisions they deem to be in the best interests of the corporation, which includes balancing stakeholder demands when appropriate. But does the current legal framework provide the freedom and protection that directors need to act?

Directors and corporations are not immune from the power of the capital markets, the power of shareholders to impact stock price, and the ability to raise capital, executive compensation, and a host of other sensitive points. So for me the looming question for all of us is this: Can we find a way to help public companies achieve the necessary balance between shareholder value and stakeholder demands, which may require shareholders to forgo shorter-term profit, either temporarily or even longer-term?

I believe these will be difficult judgment calls based, we hope, on some form of empirical studies. I have no answer yet for myself, only questions. First, the interests of management, boards, and shareholders will have to be aligned—and this will require deft handling. We can't afford internecine warfare. This implicates governance. But are we convinced that better governance will improve corporate performance? Do we need this, or is it obvious? Is it necessary?

Do we need to consider a different form of governance such as private equity? Do directors need to be more

So the way I look at the ambition of today is that we had a narrative, the Friedman approach—and really the ALI approach—in which the shareholders are first. But today we're asking: Is that a sustainable story? And if it's not, then what are the alternatives? – Jeff Gordon




and better informed on corporate operations and their extrinsic forces to make informed decisions? Do we need some legislative or regulatory changes to accompany private efforts to balance? There are many more questions, many of which will emerge from this conference. The conference, sponsored by the Millstein Center, goes to the core of the center's reason for being: gathering the best and brightest to raise even more important questions and attempt to provide the knowledge that lead to answers as neutrally as possible, without bias or ideologies.

**Bresnahan:** Thank you, Ira. Now, let me introduce Professor Jeff Gordon, who is one of the co-directors of the Millstein Center.

**Jeff Gordon:** Thank you, Kristin. I've known Ira for almost my entire career as a legal academic. Ira and Mark Roe and I have been going at these issues for a very long time. The fascinating thing is that although the questions are perennials, the answers change over time. And that's because the owners of companies change—and the markets and the world change with them.

So the way I look at the ambition of today is that we had a narrative, the Friedman approach—and really the ALI approach—in which the shareholders are first. But today we're asking: Is that a sustainable story? And if it's not, then what are the alternatives?

In thinking about today's conference, we have had the good fortune that Colin Mayer, a distinguished Oxford don, has written an exciting new book that he calls "Prosperity"—one that provides what is, in several ways, a radical take on some of these questions.

So, Colin is the anchor tenant for today's event, and we greatly appreciate his trekking across the Atlantic—and with Brexit maybe he'll even stay, but you never know.

We also thank His Honor Leo Strine for his willingness to engage in this debate today. We all know Chief Justice Strine as a judge who puts all the academics to shame, because he has a day job and manages to produce more articles in the law journals than most of the rest of us who don't have the excuse of being a judge. And Bruce Greenwald, who is a Columbia business school professor who packs in students in the courses he teaches, will also be here later in the day.

So it's going to be a day of narratives and alternatives to the narratives. And although the Millstein Center's advisory board was, I think, the instigator of this day, there are many on that board, and many associated with the center, who have different perspectives on these questions: What's the issue to be solved, and how do we solve it? I think it's the right time to be addressing these things in a fresh way.

Now let's begin our first panel with Professor Colin Mayer, who is the Peter Moores Professor of Management Studies at Oxford's Said Business School. Colin is also the academic lead for the British Academy's Future of the Corporation program, whose mission is to examine the changing relationship between business and society by looking at the interaction between statements of corporate purpose and public perceptions of business. He is also a director of the energy modeling company Aurora Energy Research Ltd., and advises companies, governments, international agencies, and regulators around the world.

Colin, the podium is all yours.

## Prosperity—and the Purpose of the Corporation

**Colin Mayer:** Thanks, Jeff, for the kind words. And thanks to you and Kristin for inviting me to participate in this wonderful conference. It's a great pleasure and privilege to be here.

I'm going to talk about one of the most important institutions in our lives. It's not the state, religion, or Columbia Law School. It's an institution that clothes, feeds, and houses us, that employs us and invests our savings, and it's the source of economic prosperity and the growth of nations around the

Companies are not just nexuses of contracts. They're also nexuses of relations of trust based on principles and values enshrined and upheld by the board of directors. Now that notion of capitalism is also a coherent, self-contained idea—one that's about solving problems by owners and boards of directors who are committed to the solution of those problems by building up relations of trust with other parties. – Colin Mayer


world. But at the same time, it's been the source of growing inequality and harm to the environment. In response to this double potential, for good and for ill, the British Academy and the National Academy of the Humanities and Social Sciences last January launched a major program of research that Jeff just mentioned called "The Future of the Corporation."

It brought together more than 30 academics from across the humanities and the social sciences around the world, including many academics in this country—including one now sitting right in front of me, Jeff Gordon!

The objective of the program is to consider how business can and should change in the coming decades to address the economic, social, and political challenges it faces, as well as the normal commercial and financial ones; and how it should best take advantage of the tremendous technological advances now in progress.

In November 2018, it published 13 papers based on that research along with a report that summarized the findings. What emerged was a remarkable degree of consensus. Despite the fact that people all worked independently and came from very different academic backgrounds, and from very different institutions and parts of the world, there was a really striking degree of consensus around three themes.

The first was the need for and urgency of change; the second was the reconceptualization of business; and third was identification of the instruments and the key policy drivers required to bring about change. And underpinning these three conclusions is one key factor: the general loss of trust in business.

Every year for the past 35 years, Ipsos MORI, the market research company, has been undertaking a survey of which professions in Britain people trust to tell the truth. At the top, alongside doctors, nurses, and teachers I'm pleased to say, come university professors. We might not have much power, pay, or prestige; but at least people trust us to do nothing, earn nothing, and take no credit for it.

Near the other end come business leaders, just above realtors, professional footballers, journalists, trade union leaders, and, at the rock bottom, politicians. And this low esteem for business leaders is not just a bankers' phenomenon; bankers are actually separately reported, and ranked above business leaders. And this is not just a post-financial crisis phenomenon; it's been true for nearly all 35 years of the survey.

Mistrust of business is profound, pervasive, and persistent. Why is that the case? I suggest the answer has a lot to do with the Friedman doctrine that there is one and only one social purpose of business: to increase profits while staying within "the rules of the game." That principle has been the basis of business practice, policy, and teaching around the world ever since. But it wasn't always so.

Indeed the corporation was established under Roman law to undertake the public functions of collecting taxes, minting coins, building infrastructure, and maintaining public buildings. For nearly all of its 2,000-year history, the corporation has combined its commercial activities with a public purpose. It's only over the last 60 years that this notion that there is only one purpose of business—to make money—has emerged. It is this that is the source of great inequality and environmental degradation—and, I would argue, of that pervasive mistrust.

And the problem is only going to get worse because, while technology offers tremendous opportunities for enhancing the well-being of society, it also poses serious risks. As technology accelerates, so too does the lag between business innovation and effective regulatory and policy responses.

But things are changing. Two months ago, Larry Fink, the CEO and President of BlackRock, wrote a letter in which he said that "every company needs a purpose—not a strap line or a marketing campaign, but a statement of its fundamental reason for being, what it does on a daily basis. Purpose is not the sole pursuit of profits, but the animating force for achieving them." And Fink is not the only leader of a multitrillion-dollar asset management firm to have said that; the leaders of Vanguard and State Street have also weighed in with much the same message.

Moreover, it's not just the leaders of investment management firms that are saying this. Britain, in some respects, led the world in setting corporate governance standards. Since the Cadbury Committee set out in 1992 what has become known as the Corporate Governance Code, those standards have provided the basis of corporate governance codes for companies around the world, including those governed by the OECD principles on corporate governance.

But last July, the Financial Reporting Council issued a new corporate governance code that declared that the objective of corporate governance is not just to address the agency problem of aligning managerial interests with those of shareholders; corporate boards are now also charged with ensuring that their companies give clear statements of and then carry out their corporate purposes. It is the role of the board of directors to ensure that companies make that commitment and have the resources to make good on it.

Two months ago, the Financial Reporting Council and the Financial Conduct Authority issued a statement about the stewardship of investment management businesses saying that such firms should have a purpose that is not simply about maximizing the returns of their beneficiaries, but also influencing the social policies of the companies in which they invest.

There's also been, as I'm sure you're aware, a significant change in political attitudes.

Elizabeth Warren has proposed her Accountable Capitalism Act, which would require corporations with revenues of at least $1 billion to have a public charter with a stated public purpose. In France, President Macron has suggested putting the notion of raison d'être at the core of the French commercial code. In Britain, the Labour Party opposition has reintroduced the idea of renationalizing the companies that Britain led the way in privatizing in the 1980s—an idea that would have been inconceivable just three years ago.

Now all of this reflects a profound change in people's attitudes towards the role of companies in society; and it illustrates the speed, breadth, and scale of the change that's in motion. But in particular, it reflects the fact that we need to reconceptualize our notion of business around why it exists, what it's there to do, and why it was created—in other words, its purpose. Then business policy and practice should follow from and reinforce that purpose.

The purpose of business is not to produce profits. The purpose of business is to produce profitable solutions to the problems of people and planet. Profits are produced as part of this process, but profits per se are not the purpose of business. Everyone who runs a successful business knows that to be the case. Successful businesses don't profit from creating problems for people and planet. Instead, they commit to pursuing the common purpose of the corporation, and they make a commitment to other parties—customers, suppliers, local communities—whose efforts in turn contribute to that common purpose.

That sense of and commitment to common purpose gives rise to reciprocal relations of trust, which provide the basis of the mutual benefits that accrue to all the parties to the firm, including the shareholders. It gives rise to more loyal customers, more engaged employees, more reliable suppliers, and to more patient and supportive shareholders and prosperous societies. And that prosperity in turn gives rise, in a virtuous cycle, to greater revenues, lower costs, and therefore more profits for businesses.

Now underpinning the operation of this cycle is the trustworthiness of companies in upholding those corporate purposes. That trustworthiness is dependent on the values of the business, their honesty and integrity, and cultures of commitment to those corporate purposes. These three notions of purpose, trustworthiness, and enabling values are what underpins the critical factors that make possible a reconceptualization of business in the 21st century.

To achieve this reconceptualization requires a fundamental rethinking of four sets of policies:

The first is in relation to law and regulation. Law, at present, we associate with shareholder rights and the fiduciary responsibilities of directors to promote the interests of shareholders. That's a mistake. The law should aim to promote corporate purpose and the fiduciary responsibilities of directors to do the same.

We view regulation in a Friedman context as setting forth and enforcing the rules of the game. But, again, that should not be the primary aim of regulation. Regulation should instead be designed to align corporate purposes with public purposes in those companies where it's appropriate to do so, in particular in the case of utilities, infrastructure companies, private/public sector providers, and banks and auditing companies. In such institutions, it's completely appropriate—and in fact critically important—to think about how one can align the private interests and purposes of companies with those of the public interest.

A second set of policies relate to ownership and governance. Ownership today continues to be associated with shareholders and, in particular, institutional shareholders. But ownership should be viewed as entailing not just the rights of shareholders but their *responsibility* and obligation to uphold corporate purposes. There are many types of owners that are best suited to performing that function in particular circumstances. Examples are families, foundations, employees, the state, as well as institutional investors.

Governance, as I just described it, has typically been associated with the agency problem of aligning managerial interests with the shareholders,' but as has been recognized in the recent corporate governance codes, the more important, or overarching, goal may instead be aligning the interests of management with corporate purposes.

The third set of policies relate to measurement and performance. At the moment, we measure the financial performance of companies by recognizing the costs of financial and material capital; but increasingly we're appreciating that what is actually more important in the 21st-century company are other forms of assets, such as human, natural, and social assets. We should be measuring and recognizing expenditures on replenishing those assets as value-adding forms of investment. And the profits of the companies should be stated not just net of the cost of physical capital, but net of the costs associated with maintaining human, social, and natural capital.

The final set of policies relate to finance and investment. In the past, we have associated finance mainly with contractual arrangements between suppliers and users of finance, partly because the tax system favors debt over equity. But even when capital comes in the form of equity, it tends to be supplied mainly by dispersed shareholders with whom it's impossible for companies to have relationships. We need to recognize that strong relationships between investors and companies are important both in the provision of debt finance, particularly in the case of banks, and for companies seeking to attract "relational" shareholders.

In so doing, we need to recognize the potential importance and value of blockholders as well as dispersed shareholders. Moreover, corporate investment depends not just on relationships with the private capital market, but also on relationships with the public sector, because there are many areas–-particularly large, long-term infrastructure investment—where private capital markets on their own are simply unable to provide the types or amounts of financing that companies need.

In such areas, it is especially important that there are strong relations of trust between government and business. It is there where the aligning of the interests of companies with the public interest is particularly important—say, by including statements of public purpose in their charters or their articles.

So, those four sets of policies around law and regulation, ownership and governance, measurement and performance, and finance and investment are the basis on which to bring about the desired change in business. None of the proposed changes is radical; in fact, many of them have already, in one form or another, been adopted. Consider, for example, the creation of the public benefit corporation, which has a stated public purpose, alongside its commercial purpose.

The incorporation of licenses within statements of public purpose is being seriously contemplated as a way of addressing the problems associated with privatization to avoid the risk, particularly in the U.K., of "renationalization." The forms of ownership that are required to produce relations between companies and investors are commonplace around the world in the form of blockholders and, in particular, family holdings. The corporate governance reforms that I've just been talking about—those requiring board consideration of social problems in corporate decision-making—have already been introduced in the U.K.

Lots of organizations have committed themselves to measuring human, social, and natural capital. There are various ways of adjusting profits in terms of, for example, impact investing that have been proposed. And the closer relationships between providers of finance and users of finance is very much a feature of the way in which some banking systems operate, including the close relationships between private capital markets and public sources of finance. This is important not just in terms of promoting the interests of society and future generations, but also in improving the performance of companies and their investments.

I want to illustrate this point by introducing an example from the most troubled industry we've had during the last few years—namely, the banking sector. But I am referring to one of the most successful banks in the world over the past 20 or so years. It earned high returns for its shareholders not only before the financial crisis, but during and after the crisis. It's one of the most highly rated banks in the world. And it has one of the best credit ratings—and one of the best liquidity and solvency ratios—of any bank in the world.

It's also a bank with a clearly defined purpose, a purpose that puts its customers first alongside the interests of its employees—while at the same time it also has an objective to be the lowest-cost provider of any of its competitors. It's succeeded in doing that for the past 44 years. And it's one of the fastest growing banks in Britain. But it's not a British bank; it's a Swedish bank—called Handelsbanken. One of the features of this bank is that it has one of the highest degrees of customer satisfaction, certainly of any bank in Britain, and in most of Europe as well.

And as one might expect, Handelsbanken has inspired much greater loyalty among its customers. That's a reflection of what I was describing just now as the reciprocal relations. Give, and you will be given. What underpins this is the governance and the values of the organization.

One major underlying principle behind the bank's success is its devolved, decentralized decision-making down to the individual branches and avoiding centralized control of the bank. Indeed the bank's mantra is; the branch is the bank.

The branch manager makes decisions about everything from the pricing of products, what products are sold, which customers they're going to serve, and how the products are marketed. What that does, of course, is to empower the branch and the branch manager to make decisions. They don't have to refer decisions up all the time in the organization. That allows those branch managers to build relations of trust with their customers, which gives rise to that observation of greater loyalty.

But what underpins the bank's success with customers is the notion of trust, of people working in the organization, that allows that devolution and decentralization of decision-making. And what underpins that trust is a very strong set of values. Those values are firmly embedded in the people who run those branches. The consequences are that because of its more loyal customers, the bank has a more stable financial source. It therefore has better financial performance and ratios than other banks.

But there's a second interesting feature associated with that element of trust in the employees. It doesn't pay its employees any bonuses.

We're told all the time that you've got to pay your employees a bonus. Handelsbanken pays no bonus until they retire at the age of 60—a truly long-term investment incentive—at which stage they get a share in the profit-sharing scheme of the bank called Oktogenen.

The third interesting feature of the bank is its ownership structure. It's listed on the Swedish stock market. It's actively traded, but it has two dominant shareholders, one of which is Oktogenen, which is the bank's own profit-sharing scheme, and the other is its Swedish industrial holding company called Industrivarden.

What this illustrates is that the bank has exactly the principles that I've just been talking about in terms of a clearly defined purpose, strong underlying values, a process of measuring performance in relation to human and social capital, and the relation of incentives to those measures of performance. It has a governance structure that is aligned with the delivery of that corporate purpose in terms of the delegation of decision-making, and it has an ownership structure in which there are identifiable "anchor" shareholders who are likely to have the strongest interest in and commitment to upholding that long-term purpose.

The significance of this arrangement is in terms of the way in which we conceptualize our notions of capitalism. This is the point on which I want to draw this to a close. At present, we regard capitalism as an economic system of the means of private ownership of the means of production and their operation for profit, and we see ownership as being a bundle of rights over the assets of the firm that confers strong forms of authority on the possessors of those ownership rights. We view companies as nexuses of contracts that are managed by boards of directors for the benefit of their owners.

That is a very coherent, internally consistent notion of capitalism; namely private ownership for profit by owners that have strong forms of authority on other parties with whom it contracts. But there's a parallel notion of what capitalism is—that is, an economic and social system whose mission is to produce profitable solutions for the problems of people and planet by private and public owners who do not profit from producing problems for people or planet. Ownership is not just a bundle of rights, but also a set of obligations and responsibilities to uphold those purposes.

Companies are not just nexuses

of contracts. They're also nexuses of relations of trust based on principles and values enshrined and upheld by the board of directors. Now that notion of capitalism is also a coherent, self-contained idea—one that's about solving problems by owners and boards of directors who are committed to the solution of those problems by building up relations of trust with other parties.

What aligns the private interest of companies with the public interest, according to the traditional model of capitalism, is a combination of competitive product markets, labor markets, and financial markets—and, in cases where markets fail, regulation. But what underpins the need for this alternative view that I'm talking about is that between market efficiency and regulatory effectiveness, there is a void; and this void is increasingly becoming a chasm as technology accelerates, and as evidence proliferates of both market failures and government failures.

In that void we rely on business to transform our private self-interest into collective, communal interest in a common purpose. To do that we depend on the trustworthiness of companies to uphold and contribute to that sense of purpose. Trust is one of the most important and largely unrecognized assets of companies, because ultimately a trustworthy corporation is a commercially successful corporation and the competitiveness of nations depends on the trustworthiness of its corporations—for the prosperity of the many, not just for the few, and for the future as well as the present. Thank you very much.

**Kathryn Judge:** Thanks, Colin. And for those of you who haven't read it, Colin's book does a remarkable job of laying out, in much greater detail than what we've just heard, a coherent vision of an alternative paradigm that is possible. And, to discuss that vision and to discuss the broader question of how we go about building a counternarrative, we have a remarkable panel to round out what has been a great start to the day.

We're going to start with Ron Gilson, who is the Marc and Eva Stern Professor of Law and Business at Columbia Law School and Meyers Professor of Law and Business emeritus at Stanford Law School. Ron is also a Senior Fellow at the Stanford Institute of Economic Policy Research, a Fellow of both the American Academy of Arts & Sciences and of the European Corporate Governance Institute, and he was one of the reporters of the American Law Institute's Corporate Governance Project. Ron's academic work focuses on the law and economics of corporate governance and acquisitions, along both comparative and domestic dimensions, and on the economic structure of transactions and complex contracting, including venture capital contracting.

## Legal and Political Challenges to Corporate Purpose

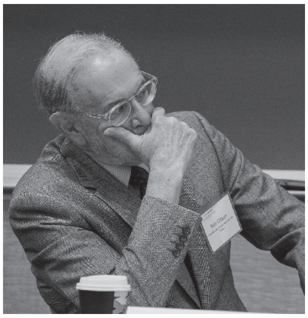
**Ron Gilson:** Thank you, Kathryn. Following Colin is always a difficult role; the combination of a spectacular presentation style and equally interesting ideas is bound to give you a sense of sweeping up after elephants. But that said, I very much appreciate the opportunity to participate in this panel. Sweeping up after elephants is an important task.

As I expect will be repeated throughout the day, this is a very unusual moment in corporate governance. Colin's presentation and, soon to come, Marty Lipton's provide perspectives on a set of issues that are as important as any I can recall in my 40-some years of studying corporate governance. Here we have two leading participants in the corporate governance debate over the years, a world-class academic and a world-class lawyer, announcing the need for a radical change in the way we do business in order to avoid a populist apocalypse. I really can't remember a similar conversation where the stakes are claimed to be so high—maybe hostile takeovers in the '80s and activist investors now, but these claims always reflected a significant amount of hype—and we're going to have the conversation with just the right people. For that reason alone, our discussion should be fascinating.

I'm going to address, in my Warhol moment, both Colin's presentation and its compatibility with the work that Marty has done in his "New Paradigm." My focus will be on three general points. The first is to ask whether in fact Colin and Marty have the issues framed right. The second is how do we get from these broad statements of principles to the claimed better place. The third is a more general and more troubling problem: does the link between managerialism and the defense of capitalism against the populist hordes confuse corporate governance and real governance?

I'll start with Colin's remarks. Colin tells us that we require a "radical reinterpretation" of the nature of the corporation. That reinterpretation involves each company's board creating a sacred text that sets out the corporation's purpose in some larger way—something between a little red book and a mission statement—whose end is to cause the company, through the exercise of crafting such a statement, to focus on the way the company's business and its interests interact with broader social policy. Under current circumstances, Colin tells us, neither the shareholders nor current corporate governance practice succeed in aligning corporate and social interests.

My simple prediction is that large institutions… will shift their indexed holdings to the most socially responsible manager… and they'll take a little bit of reduction in return because that in fact is what the managers of their beneficiaries want… [T]he result will be to shift… to a different set of activists. One set was after money—and maybe you can make a deal with those people. The other is driven by principle, which is harder to compromise. If my concern… proves right, the problem then is less socialism… but rather an activist-driven Green New Deal. – Ron Gilson



Marty, as I understand the motivation for the New Paradigm, is pretty much on the same page. Marty puts it well when he says, "Capitalism is at an inflection point." And in another nicely turned statement, he says, "The prioritization of the wealth of shareholders at the expense of every other stakeholder has given rise to a deepening inequality and populism that today threaten capitalism from both the right and the left."

The New Paradigm is Marty's response to this pincer threat to capitalism. He envisions an implicit partnership between corporate governance and stewardship. An *implicit* partnership, of course, is not a partnership at all; it's a group of people who have shared interests and voluntarily act in ways that reflect that overlap—people my age will recall Kurt Vonnegut's concept of a "karrass" in *Cat's Cradle*. That kind of partnership will allow business to address what for Marty and Colin is the real culprit—one that we all know well from the rhetoric of the last 10 years: corporate "short-termism."

Here Marty's view differs at the edges from Colin's. Marty typically has not favored imposing legal restrictions on management decision-making, even if management gets to define them. But this difference in formal implementation isn't critical, I think, because Colin's formal reinterpretation of the board's duties to require a statement of broad purpose is effectively unenforceable other than through ownership. To be sure, Colin floats the idea that a fiduciary duty can be imposed on directors to follow the corporate statement of purpose—and that, if the board does not pursue that purpose, courts will intervene to decide whether the balance among shareholders and other stakeholders was struck correctly. I expect that this proposition will strike every corporate lawyer in the room as utterly implausible—Colin's fiduciary duty is a business judgment-style standard that is highly unlikely to have any bite.

And that leads us to where Colin's talk ended—namely, to the structure of corporate ownership, and to Colin's attraction to families and other kinds of controlling blockholders. Colin notes that two management-related shareholders hold 20+% of Handelsbank's voting power with a charter limit of 10% on the votes any single shareholder can hold. Here the problem is the framing of the dilemma that has brought us here today: in a period of genuine and warranted concern about income inequality, the idea of concentrating control of major corporations in a small number of families or in management is not an issue of just *corporate* governance. It's an issue of *real* governance. In the U.S., we assign distributional decisions to those who are politically accountable for them, and allocational decisions to those who are disciplined by the market. Putting control over distributional decisions in boards of directors that, however diverse along other dimensions, are made up of older rich people who are accountable to no one hardly seems like a response that will placate the populists. At any rate, dealing with distributional issues requires thinking about how we run our democracy, not our corporate democracy, and is hardly going to be resolved by changes in corporate governance. Put bluntly, neither Colin's radical reinterpretation nor Marty's new paradigm will placate Jeremy Corbyn in the U.K. or Bernie Sanders in the U.S.

I now want to come back to Colin and Marty's framing of what seems to be the underlying problem: the curse of corporate short-termism. Each of them I think has it half right. Markets sometimes lack information that management has but cannot easily share with the market, and so can cause management to choose an investment horizon that is too short. But such market myopia is only one side of the problem. The other half is that managements can also be "hyperopic" when assessing the promise and value of their current strategy.

Governance, whether it's a radical reinterpretation or a new paradigm, confronts a single core problem. When we're operating through a board and through management, how does the board distinguish between two cases: where the market lacks management's private information, and so short-termism is likely to be the problem—and where management is holding what amounts to an out-of-the-money call option on their career and so behaves just the way that option pricing theory predicts—that is, the value of management's position is increased by extending the option's duration, making the argument that if their shareholders are patient and give them more time, the expected payoffs will materialize.

The old General Motors and GE currently provide examples of such hyperopia. A third example is closer to home for me: PG&E deferring maintenance of transmission lines and so providing Northern California both electricity and fires. So, we also have evidence of managerial skewed beliefs about the future payoffs from their current strategies.

Both myopia and hyperopia are important problems. And in some cases, identifying them isn't hard. But balancing short-term and long-term considerations when managing companies is a very difficult task, maybe the greatest challenge facing managements and boards. And for investors, distinguishing between shortsighted and well-disciplined managements—and between farsighted companies and those for whom the payoff will never materialize—is often impossible.

With that setup, what do we make of this joint Anglo-Saxon reframing of corporate governance? Albert Hirschman is the author of what is widely viewed as the most important piece of informal corporate governance scholarship. It's a book called *Exit, Voice, and Loyalty*. Near the beginning, Hirschman asks: "How do I identify when, in the face of a poorly performing organization, when we should leave, when we should yell, and when we should stay?"

Getting this question right is, as I suggested, one of the biggest challenges facing boards. And so I want to direct you to a different Hirschman book that speaks to the set of issues that Colin and Marty talk about: that business has dug itself so deep a hole that we can't climb out of it without making social interests an integral part of corporate governance. The book is called *Shifting Involvements: Private Interest and Public Involvement*. There Hirschman lays out an endogenous, long cycle in which public concern shifts back and forth between private interests and the public interest.

To illustrate the working of this cycle, I remind us of one piece of history. Long ago in a galaxy far away—Marty will remember it—people became concerned that the efforts of a Georgetown academic named Donald Schwartz to persuade Congress to federalize corporate law might actually work. The result was the American Law Institute's "Principles of Corporate Governance," which turned out to be a way to marginalize Schwartz's effort. Academics understood what was happening. If something's going on that you don't like, what's the answer? We study it. If we study it long enough, the Hirschman cycle runs—as it did in the case of federal incorporation.

So the puzzle today is this: On both sides of the Atlantic, there's been a Hirschman-like swing of the pendulum toward public interests. What's going on? Here I offer just a speculation—or more, really, a question to both Colin and Marty. On Colin's side of the Atlantic, one can't help but note the sharp difference between Colin's radical reinterpretation of corporate law and Jeremy Corbyn's and the Labour Party's approach to the same set of issues.

Labor's agenda, as I read the newspaper accounts, is renationalization, worker representation on corporate boards, limits on dividend payments, and some other pretty intrusive initiatives. Colin's proposal of requiring a corporate purpose beyond maximizing profits seems radically more favorable to management. I have no idea, though Colin may, about any correspondence between the timing of the British Academy project and Corbyn's succession to Labour Party leadership. We see the same thing on our side of the Atlantic. Senator Warren's Accountable Capitalism Act that Marty refers to essentially covers much of the same ground as, and shares many of the aspirations of, Corbyn and the Labour Party.

Let me close by talking about the feasibility of the two presentations. Focusing on feasibility is not to deny the power of the underlying theme, but rather to think about how we might get from here to there. I've mentioned my concern with Colin's framing—that the courts won't enforce it, and that the concerns of populists are not likely to be met by creating an even more unequal distribution of power within the country. Marty's solution, as one might expect from a very good lawyer, is more technical. Here I will just suggest that the real question being asked by the New Paradigm isn't a matter of corporate governance; it's really a matter of asset management.

For example, Exxon has tried to keep off the ballot an institutional investor-backed proxy proposal requiring greater disclosure of the impact of climate change on Exxon's business. The proponents included a sovereign wealth fund with $1.2 trillion under management. Although $1.2 trillion sounds like a lot, it's actually not. There's another group, Climate Action 100+, with 323 institutional investors as members that in the aggregate have assets under management of $32 trillion. That number can be significant if there is an issue that joins that group—that makes them an implicit partnership. And that does concern me.

I have six points of concern.

**Point One:** The first point starts by noting that the business of the three large index holders is pretty straightforward. Profitability depends on massive economies of scale, and hence on attracting assets.

**Point Two:** Asset flows in the index fund industry, in contrast to active management, don't depend on the managers' performance because performance by definition does not differ among competitors in terms of returns (only in terms of fees), and the price differentials are marginal.

**Point Three:** A large and growing amount of institutional assets have been voting for ESG-based proxy proposals to accommodate the perceived preferences of their own beneficiaries; the fund managers think such voting will attract asset flows, and this behavior—which is not necessarily consistent with value maximization by companies or their investors—is an example of what Jeff Gordon and I call the "agency costs of agency capitalism."

**Point Four:** The three largest index holders have different records with respect to voting on climate change. Vanguard is the least climate friendly. BlackRock's somewhere in the middle. State Street is much more friendly. And the differences are not insignificant.

**Point Five:** My simple prediction is that large institutions who are the index funds' customers will shift their indexed holdings to the most socially responsible manager—that is, the manager that votes the way the 323 institutions in the Climate 100+ want; and they'll take a little bit of reduction in return because that in fact is what the managers of their beneficiaries want.

**Point Six:** The result will be to shift the shareholder activists that Marty and Colin have been concerned about for the past ten or fifteen years to a different set of activists. One set was after money—and maybe you can make a deal with those people. The other is driven by principle, which is harder to compromise. If my concern about the way institutional investors will push money managers to vote proves right, the problem then is less socialism, whatever the term means these days, but rather an activist-driven Green New Deal. However, good shareholders are at one thing or another, and designing cost-effective responses to climate change probably isn't one of them.

That said, I'll stop. But, again, my concern with two enormously well argued positions is not about the goals they hold up—it's how do we reach them. A different, but more realistic answer is just *better* management. Take Costco, a big box store that treats its employees well but still competes extremely well against Sam's Club, which does not. There is more than one way to run a company; and if we can do a better job of persuading institutions that good managers, rather than short-sighted (or excessively optimistic) managers, are what we want, we may do better than radical reinterpretations and new paradigms.

**Judge:** That was great, Ron, thanks. Last but certainly far from least is Marty Lipton, founding partner of Wachtell, Lipton, Rosen & Katz, who advises major corporations on mergers and acquisitions and matters affecting corporate policy and strategy. Marty is the author of *The New Paradigm—A Roadmap for an Implicit Corporate Governance and Stewardship Partnership,* which argues that corporations and shareholders can forge a meaningful and successful private-sector solution to attacks by short-term financial activists.

## Some Thoughts on *The New Paradigm*

**Marty Lipton:** Thanks, Kathryn. When I listened to Ira's introduction, I said to myself, it's only people of our age—Ira's and mine—who are able to realize that this discussion has actually been going on for a very long time, and that most of the major issues are still not settled. And I'm not quite sure how we're going to settle them. Ron Gilson, as you might expect, pretty much summed up my views exactly as I would state them, so I won't repeat what he has said about them. Ron was also right in saying that my views pretty much coincide with

So what do we do about all of this? One overriding concern of mine has been regulation and legislation. It seems to me that the history of the world has shown that, as you increase the amount of legislation and regulation, and you move away from competitive market determination of these basic economic issues, you move toward and even encourage a totalitarian approach to government and its concomitant, economic failure. – Marty Lipton

Colin's, and that Colin has written a truly unique and magnificent book.

Let's start with the amazing scope of the book. Like the history of the corporation, the book really does start 2,000 years ago and work its way up to not just the current time, but even extends into the future. I think that if we're ever going to solve the problems that we've been discussing, this book is going to provide the basis, or the framework, for solving them. Now, I'm not saying that the book has provided definitive answers to our problems; but there's no question that the book—and the comments of Colin and Ron and Mats this morning—do a great job of identifying and articulating all the important issues. So, we're no longer dealing with something where we don't understand what the issues are. What we've come to recognize is that we are dealing with pretty complicated issues that are very difficult to resolve in ways that end up satisfying the majority—hopefully the vast majority—of people.

But clearly we have not reached that point of agreement or consensus—in fact, it's just the opposite. I'm not sure I can count all of the new paradigms that have been proposed in the last half dozen years to address the problem. Some of the organizations that have been established have aimed to focus capital on the long term. Consider, for example, the Coalition for Inclusive Capitalism—or some of the older organizations like the Council of Institutional Investors and ISS—and I could spend the rest of my ten minutes just listing these organizations and their goals and proposals.

And the law reviews are replete with articles calling for and offering blueprints for fundamental changes in corporate governance. In fact, I got my first major lesson in dealing with law reviews in 1979. I wrote an article that flew in the face of the Chicago school of economics, and they've been after me ever since—with my detractors urging me to recant, or at least defend, my arguments, and my admirers urging me to write more articles.

So what do we do about all of this? One overriding concern of mine has been regulation and legislation. It seems to me that the history of the world has shown that, as you increase the amount of legislation and regulation, and you move away from competitive market determination of these basic economic issues, you move toward and even encourage a totalitarian approach to government and its concomitant, economic failure. If you look at the history of socialism and communism from their beginnings to the present, you see either failure and abandonment of socialism, or the rise of totalitarian governments that become only more extreme over time. Even as in the case of China 30 years ago, when a new regime comes in aiming to create a market economy, it often doesn't take long before you end up with a totalitarian regime.

And with that sense in mind, I've always felt that it's important to try and solve the problems without government regulation. Ron aptly made reference to Ralph Nader and that point in time. The issue back then was not corporate governance. It was really about antitrust; and the debate ended up without any conclusions or resolution. But the ALI spent the next 13 years mulling things over, and accomplishing absolutely nothing. I have the two volumes on my office shelf there; and if you remove all the dust, you'd find a bright blue cover. But no one ever looks at them anymore.

Now there's a new effort underway. Ed Rock is going to try and do a restatement of corporate governance, and I'm sure it will turn out to be an excellent work. But I have my doubts that it will solve any of these problems. And I should confess that I have the same doubts about my own New Paradigm. As I mentioned, there are a lot of organizations and propositions. I wrote a proposal for the World Economic Forum a few years ago called the New Paradigm that focused on the issues of corporate governance and investor stewardship. Although it was published in September of 2016 and handed out at forum in Davos in January of 2017, it hasn't gotten much of a hearing.

Since then, a relatively new group of major investors and large corporations called the Investor Stewardship Group has encouraged me to come out with an updated version of the New Paradigm. Like the first version, the revised New Paradigm consists of principles for both corporate governance and investor stewardship, and principles meant to guide engagements of and interactions between corporate boards and investors.

All of these principles are consistent with those you heard about from Colin earlier: purpose, commitment, trustworthiness, and culture. I think we can all agree that those are the issues that we're dealing with and need to be solved. And I continue to believe that we can solve them.

For example, there is not much dispute today about what corporate boards and corporate management should do. There have been arguments about that over the past 30 years, and they've all been resolved. Almost every major corporation today pretty much follows a set of corporate governance principles that everybody else—whether they believe the principles or not—seems willing, or at least resigned, to follow. So there's not much debate going on now about board responsibilities.

But in the case of the responsibility of shareholders and investors, I'd say there are still major disagreements. To me, it seems clear that the concept of stewardship holds the key to solving the problem. Take Elizabeth Warren's stakeholder bill. Basically what it does is to impose classic stakeholder governance on corporations with a billion dollars or more in revenue each year. The problem with that solution is that, unless the shareholders—who today own approximately 80% of all large corporations—support the principles of stewardship, you're not accomplishing very much.

If BlackRock and State Street and Vanguard all come out and say, we're for purpose and culture, we agree with all of this, but then continue to vote for proposals by activist hedge funds, then we don't accomplish anything. And that's what's happened. There's nothing new in the New Paradigm, and there's really nothing new in the last 30 years. But the competitive features of the investment management business have essentially prevented a real resolution of the problem. Unless we can get the major investment institutions to buy into supporting purpose and culture, we will not solve the problem.

Kristin just held up a zero to me, which either means I'm out of time—or my whole approach to this was a zero, and I should leave knowing that I have failed. I failed once before here in Columbia. I came here in 1955 as a teaching fellow to get a JSD degree studying under Adolf Berle. I arrived with great enthusiasm—and Mr. Berle was really a terrific person. He had only one fault. He insisted that he would accept no thesis other than one that discussed the changes in corporate law that would result from the fact that shareholdings were moving from individuals into pension funds and institutions. And so my thesis should discuss the changes in corporate law that had to take place to accommodate this movement.

Well, I failed. So instead of going back to NYU to be a corporate law professor, I ended up practicing law. But every time I see Jack Coffee, I promise to send him a bundle of the articles I've written since then, and I expect him to send me my degree. I have sent him the articles, but he hasn't sent me the degree.

## Questions from the Audience:

**Judge:** As much as I would love to take moderator's privilege, I think it's important we have a little time for questions from the audience.

**Michael Graetz:** There are at least three important changes that have happened since Milton Friedman announced what you've described as his rule; and none of the speakers has emphasized any of them. I think each of them has made the problem harder and the solutions more elusive.

One is that the markets have become ever more global under circumstances where the rules remain largely national. The second is that the shareholder ownership of public companies has actually become global, and is becoming ever more global over time. The third, which I think is really most important in raising the concerns that are leading to these proposals, is that business—at least in the U.S.—has become politically dominant in a way it was not when Friedman made his rule, or when the ALI was really studying the first time.

Management has been effective in seeking benefits for its shareholders not only in the marketplace, but in the political realm. And this success has exacerbated the maldistribution of income and wealth, since the shareholders are mostly in the top part of the income distribution. This creates a particular frustration that can be expressed in only electoral, but not legislative politics; it's in the legislative arena where the businesses are dominant, not in the electoral arena. And this risk associated with electoral politics adds to all the risks that Colin and others have described.

And I'm not sure that Colin's notion of corporate purpose would really transform the role of business in the political realm. Maybe it would, depending on what the purpose was. For that reason, it seems to me that limiting business influence in the legislative arena should be somehow worked into the statement of purpose for that to happen.

**Lipton:** The problem I see with your proposal is the beginning of state corporatism. It's the problem we really want to avoid. As you get companies into government, you encourage government to get into companies. I think one of our mutual objectives is to avoid state corporatism, because it does lead ultimately to totalitarian government.

**Josephine Nelson:** Colin, you mentioned the value of closer relationships between investors and companies, providers of capital and users of capital, and how that's likely to encourage long-term investment.

For example, you hold up the relationship banking of Handelsbanken as a model. But, in the book, you also mention Bosch, one of the largest private corporations in the world, as a particular example of where a trust owns a corporation and therefore it's a private entity. In theory, private entities are supposed to be more interested in long-term profits, and so should act more ethically. But the reality is that Bosch has clearly been implicated in the Volkswagen emissions scandals, and it's now pled in the Fiat Chrysler scandals. In fact, Bosch seems to have been the entity that spread the emissions fraud all across the auto industry. And this leads me to think that even if companies are privately held and therefore more closely bound to long-term interests—at least in theory—such entities may not be particularly interested in acting ethically if it gets in the way of profit.

So this tees up this issue: How do we exert and maintain pressure for corporate purpose in the absence of shareholder primacy, or at least shareholder pressure, which we're talking about as being a source rather than potential solution to the problem? It doesn't make sense to go back to something that's totally private unless we can figure out how to maintain pressure for purpose and ethical action in that sphere.

So, Colin what would be the structural mechanisms that could bring the ideas of "companies" back into the corporation and not allow the kind of abuses that we are still seeing in private companies?

**Mayer:** Before I respond to that question, let me thank everyone here for a tremendous set of comments and observations throughout.

And to start with the panel, let me respond to Ron's really very well articulated retort to precisely what the book doesn't say. If you look at the index, it doesn't mention the word "short-termism" or "myopia" or any equivalent; and that is because the book doesn't talk about short-termism. And that's because I'm not sure I believe that short-termism is a problem; at the very least, I don't think we know how to identify and measure short-termism.

Sixty years of research on the subject has produced absolutely no conclusion on the subject. So I couldn't possibly argue that that is the central underpinning of the book. Short-termism is not what it's talking about. It's talking about contractual failure, regulatory failure, governance failure.

The book also does not say that family ownership is the solution, or even desirable. Indeed, I say that I don't expect that family ownership will be revived in Britain, which I cite as a country that has very effectively extinguished family ownership.

On the other hand, I do think the first question about the increasingly global nature of markets and shareholders becoming more global is extremely important. That development is giving rise to the phenomenon of the "universal owner"—the idea that we all collectively, by virtue of our holdings in investment firms like Vanguard and BlackRock, hold the entire global portfolio. As universal owners and global indexers, we're not influenced, or even much interested, in the performance of individual stocks. We're interested in managing the systemic risks—that is, the political risks, the environmental risks, the trade protection and regulatory risks. Those risks are the things that move the stock markets and the indices.

What that basically says is that different kinds of ownership perform different functions. The role of index funds is extremely important in allowing you and me to incur very low transaction costs when investing in equities around the world, and by so doing, allow companies to raise capital on economic terms. At the same time, the shareholder activists play a very important role in terms of providing precisely the interest in individual corporate performance that the universal owners don't.

But because that interest is short-term by its nature, it is extremely important that we have anchor blockholders that provide the third form of ownership, which has interest in individual companies that is long term in nature. That may take the form of families, but is increasingly taking other forms. Particularly promising are engaged institutional investors, such as the Canadian pension funds and some sovereign wealth funds that hold large blocks in individual companies.

The book talks about the benefits of diversity of ownership, and the need for that diversity to correspond with the purposes of companies. In the U.K., partly through misguided regulation, we've extinguished blockholders by making it basically impossible for them to continue their control of companies. The notion that my book is in any way aligned with what Jeremy Corbyn is proposing is wrong; it's exactly what Jeremy Corbyn is *not* proposing. The current Labour Party is probably the least likely political body to adopt the suggestions in this book.

I thought that Mats' comments really got to the central issues around what I would view as matters of "legitimacy"—legitimacy about what companies should be doing and what ownership should be about. Our current views on ownership are that legitimacy derives essentially from a property rights view of the firm—that owners are owners of the assets of the firm in the same way as they own any other property. And that confers those strong rights as well as serious responsibilities on owners in the way in which I describe them.

But, again, as the first questioner observed, there have been very substantial developments in three dimensions. The first is that, because companies have become much larger, and much more global, their impacts on society are not just national in nature. They too are global, not simply because they are multinationals, but because their products are now global. Think Google. Think Facebook. The implication here is that traditional government mechanisms are not well positioned to deal with the challenges to privacy and anti-competitive concerns that such companies present.

The second feature of change has been that the assets of companies have altered completely from being predominantly tangible assets to essentially intangible assets today. That means that those assets are not predominantly material. They are embodied in forms of human, social, and natural capital. The implication of this is to turn the traditional view about legitimacy on its head; that is, the legitimacy that was derived from the property rights over the assets of the firm is becoming irrelevant as companies are increasingly dependent on human, social, and natural capital; and instead corporate responsibilities to such forms of capital—not their rights—have grown.

And that brings us to the role of government in performing these public functions and, as Mats put it, promoting freedom. The trouble with the conventional view of freedom is that, while competitive markets are important, it also requires another element, which Marty very correctly referred to in terms of the capabilities of people to exercise choice effectively.

The ability to exercise choice derives from people's ability to maintain not just their purchasing power over commodities but also the relationships that are involved in terms of their delivery and people's fulfillment of what they see as their own purposes. Defined as such, the freedom that is conventionally associated with a separation of business and government, requires a close relationship between government and business in the provision of so-called "public" goods such as education and health, and large-scale, long-term infrastructure.

I'd just like to end by addressing the question that Professor Nelson raised about how one reconciles trustworthy business with corporate scandals and whether private ownership is the appropriate solution. The evidence that comes from surveys of trust in family business suggests that they are more trusted than other types of firms. In particular, employee satisfaction appears to be greater in family than other businesses. Employees feel more cared for, better treated and valued; and, as a consequence, they are more committed, devoted, and motivated—a further example of reciprocal benefits, of give and be given.

Nevertheless, there is one respect in which family firms appear to underperform and that is in regard to their wider contribution to society. They seem to view their employees and local communities as part of their wider families, but that does not extend to society and the environment more generally.

So I do not see family firms or private firms in general as a panacea, and I do not believe that we will see a return to large-scale family ownership in Britain. Instead, we should look to reform in public equity markets through more long-term, engaged institutional investors as a way of addressing their deficiencies. And there are some encouraging signs that this is beginning to happen.

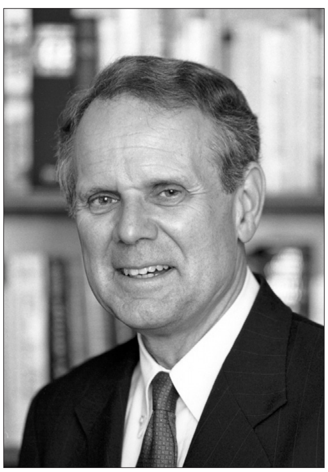
**Bresnahan:** Thank you to our panelists for their open discussion of this critical topic. We'll look forward to hearing from all of them as we continue to explore these themes at the Millstein Center.

COLUMBIA LAW SCHOOL SYMPOSIUM

# Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)

## SESSION II: CAPITALISM AND SOCIAL INSURANCE

**Columbia Law School | New York City | March 1, 2019**

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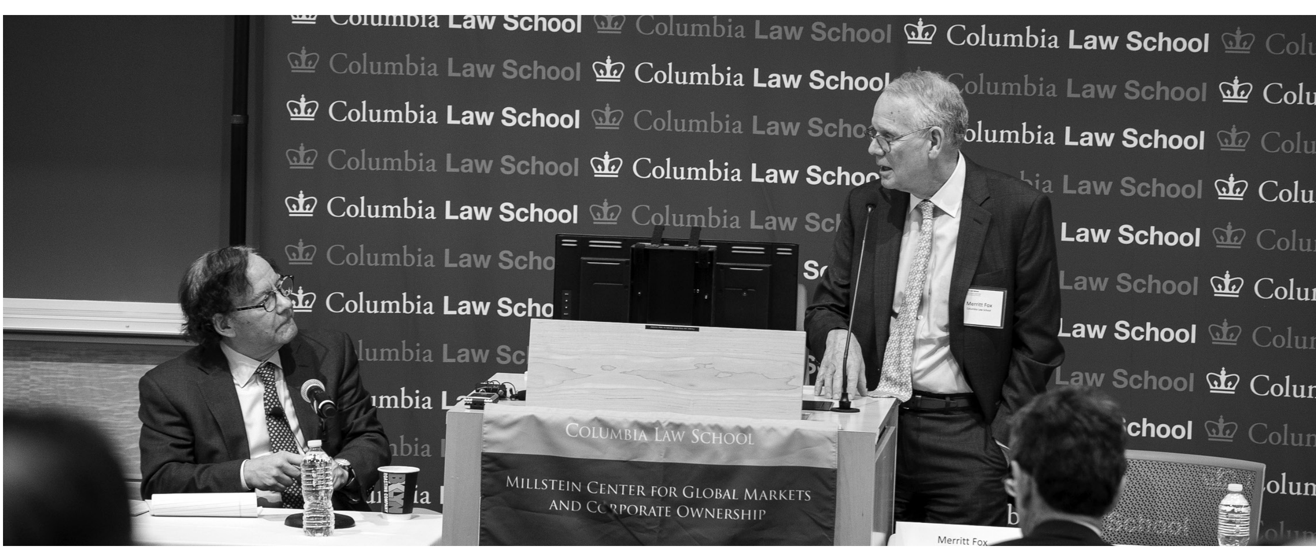
Jeff Gordon
Richard Paul Richman Professor of Law and Co-Director, Millstein Center, Columbia Law School

**Merritt Fox:** I'm Merritt Fox, Professor of Law at the Columbia Law School, and it's my pleasure to introduce Jeff Gordon, who, as Kristin told you earlier, is the Richard Paul Richman Professor of Law and Co-Director of the Millstein Center for Global Markets and Corporate Ownership at Columbia Law School. Jeff is also a Fellow of the European Corporate Governance Institute. And as you know, he and Kristin have been the sparkplugs in organizing this conference.

**Jeff Gordon:** Thanks, Merritt. This talk is, to some extent, responsive to Colin, but it will come at things from a somewhat different angle. The question I want to raise is whether "corporate governance" as we've been discussing it is capable of playing the important role in addressing social problems that we've assigned to it. And so, unlike Colin, I want to start by asking whether, or to what extent, the social challenges we face can be dealt with at the level of the firm—that is by specific corporations and their boards. This was, I think, the basic assumption of what we heard this morning.

The alternative perspective is that the fundamental issues are more clearly viewed as the economic and social effects of a dynamic and global market economy in which companies operate and are forced to compete. Rather than focusing on the firm as the unit of greatest concern, and assuming that companies themselves are responsible for, say, retraining workers whose skills have become obsolete, whose "human capital" has depreciated, I think the real issue is one of social insurance, of ensuring that we have the right form of government "match" to ensure the preservation and, where possible, the reinvigorating of human potential over the lifetime of employees. Designing and implementing this kind of insurance is critically important in a dynamic economy like ours—an economy in which no single firm is able to offer thick enough insurance, including income preservation insurance, to compensate workers, especially aging workers, for the shrinking job security associated with technological change and obsolescence.

So, to me the big question here is: What is the right form of government match for the economy we have? I developed some of my thinking on this in an article in the *British Academy Journal* issue that Colin put together, and I'll try to summarize that thinking here.

## Diagnosing the Problem

As I see it, the current malaise consists of three elements: inequality, economic insecurity, and slow economic growth. Corporate governance has to do with the way power is exercised within the firm. Although the legal framework of corporate governance has remained stable over a very long period of time, the implications—or the actual workings and effectiveness—of that framework have varied greatly during the 40 or so years I've been in this business. And what's become clear to me during this period is that these changes in governance are at bottom a function of major changes in corporate ownership. The dispersed ownership of the Berle-Means corporation of yesteryear gave managers effective control. In those days, collective action problems muted shareholder voice. Today, the re-concentration of ownership into the hands of institutional investors means that shareholder activism can effectively challenge managerial prerogative. So, it's the interaction between the legal framework and ownership that creates the corporate governance environment.

Corporate governance is very much in the news. Senator Warren's proposal for codetermination—that is, significant labor representation on boards—was mentioned earlier. Colin's book, which focuses on the purpose of the firm, suggests that forces outside the shareholder body might be given a governance role.

The focus of my talk is economic insecurity, which I think we all understand to be of great importance. Presumably there is a strong corporate governance feature to the risk of downsizing and layoffs. By contrast, although inequality is also a serious problem, I think that corporate governance plays a secondary role in its creation and persistence. Although Thomas Piketty's research identified executive compensation as a major source of inequality, I think the more fundamental sources of inequality are quite different. They relate to the structural changes in the nature of work and the different ways that some firms succeed, and some do not.

David Autor's work, for example, on the "superstar firm" shows huge inequality across companies in the pay of people with the same jobs. The secretaries at Google, for example, would be extremely well paid. Their wages would be not only much higher than those of most secretaries across the Bay Area, but also probably a good deal higher than those of the middle managers of many smaller public companies in the area. More generally, the high compensation that tech firms pay their armies of software engineers has exacerbated the sense of "inequality" throughout the Bay Area. And along with Autor, I would argue that the compensation consequences of disparate levels of economic success across firms and industries is a more profound driver of inequality than high levels of CEO compensation or rewarding corporate efforts to increase profits by controlling labor costs. And so, from this perspective, addressing inequality is not fundamentally a corporate governance issue.

In a YouTube video that went viral, Dutch historian Rutger Bregman told a Davos audience that the way to address inequality is "taxes"—particularly, *estate* taxes—and all the rest is beside the point. Estate taxes are the way to address inequality, not a focus on firm level decision-making.

Similarly, I don't think that "corporate governance" has much to say about slow economic growth, though purported corporate governance defects have been blamed. Assertions that stock buybacks produce cutbacks in R&D and prevent significant investments that would promote an economic boom are contradicted by the careful marshalling of evidence by Jesse Fried and Charles Wang in a recent issue of the *Harvard Business Review* and related work. Their research indicates that buybacks occur predominantly in those economic sectors where the ROI is low, meaning that managers (and companies) are returning money to the shareholders because they don't have good investments to make on their own.

There are of course other explanations for this slow growth. Robert Gordon, for example, argues that the really big inventions—like electricity—aren't going to happen again. And alongside something like the invention of automobiles, the Internet just doesn't really cut it. But from casual conversation, I think many business executives don't share Gordon's pessimism.

One plausible argument focuses on the negative effect on growth of erratic government policy, which can make it difficult for companies to contemplate significant investments with long-term payoffs. For example, the fiscal austerity policies that were widely followed after the outbreak of the financial crisis exacerbated and prolonged the Great Recession in the U.S. and Western Europe; during those years, companies focused on survival not expansion. Four years ago, we weren't sure if the euro was going to survive; what's the right payoff horizon facing that risk? And the abrupt U.S. turn toward economic nationalism and neo-mercantilism by the Trump administration surely disrupts long-term planning and investment.

It also seems to me that many politicians who attack buybacks are really looking for companies to provide a kind of Keynesian stimulus—that is, a way to drive the economy by spending not government funds, but more shareholder capital, to promote a boom. Whether shareholders get a competitive return on that investment is the least of politicians' concerns—though it does seem to matter to shareholders. In short, the rate of economic growth turns on factors other than firm-specific levers of corporate governance.

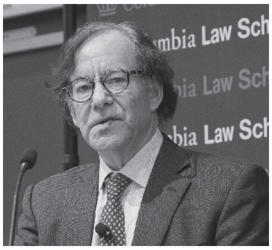
So, again, I think economic insecurity is really where the deep issues lie here in the U.S. In this country, when you lose your job, you're cut off from the social network. You lose not just the income stream, but the entire system of social welfare and insurance that is effectively supplied and funded by, and run through, the company and the workplace. And needless to say, 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 and do diversify away all firm-specific and idiosyncratic risks, and *toward* employees and all the other stakeholders who benefit from and indeed depend on the existence and stability of particular corporations. The result of this dynamic, as mediated through corporate governance, has been to shift risk from shareholders onto the employees, who are far less able to bear that risk and insure against it. Employee payoffs are firm-specific; not so for the diversified shareholder. Companies are subject to strong pressure from product and capital markets; and corporate governance, viewed as the way that companies are funded and managed, is the mechanism by which those external market pressures are transmitted to their employees. And this creates the economic insecurity that, as I'm suggesting, is not so much a governance as a social insurance issue. It's not something that companies can address acting alone.

So the resulting policy prescription focuses on the need for a new match between government and enterprise—one that recognizes the role of government, perhaps in collaboration with the private sector, in renewing human potential as a lifetime concern. Once upon a time, government financed education K through eight. In the U.S., the "high school" movement of a century ago expanded that to K through 12 and, eventually, through the state education systems and federal subsidies, to K through 16. Companies could presumably provide that initial training—but they don't, because it's inefficient and because we expect government to play that role.

Well, given that companies operating in the dynamic economy of today are not able to provide the kind of insurance they once did, it seems to me that the right move is to think about more effective ways for governments to extend the match they provide enterprise, towards maintaining lifetime human potential, in building and sustaining human capital. And I want to be clear that this is not primarily a redistribution of wealth. There's obviously some element here of using some of the gains from workplace flexibility and ensuring that people displaced by it get compensated to some extent. But much more than redistribution, it's first and foremost a more effective allocation of social resources designed to increase social wealth, the size of the overall pie that ends up getting divided by *all* corporate stakeholders. The economic rationale for "layoffs," after

The right move is to think about more effective ways for governments to extend the match they provide enterprise [with K-12 or K-16 education] towards maintaining lifetime human potential, in building and sustaining human capital. – Jeff Gordon




all, is that they preserve or increase value by preventing companies from wasting resources—potentially valuable human capital—that might be put to higher-value uses.

That at least is the theory of "constructive" layoffs, if you will. But in the modern economy with technological change and obsolescence, layoffs tend to mean a very large, if not complete, loss of "firm-specific investments" by displaced employees. The aim of this government match I'm envisioning is a social investment in our workforce, a rebuilding of the human capital that has been lost. And the ultimate purpose of this match is to make society as a whole more productive in dealing with some of the demographic issues that the U.S. and other countries are now facing.

And let me make one quick final point about the interesting position of the Vanguards and BlackRocks, the indexed asset managers, of the world. The product they offer is not a firm-specific investment, but a low-cost diversified portfolio of all companies in the economy. And 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 entire economy.

Now, how could institutional investors mitigate systematic risk? If you think that some of the disruption we see at the individual firm level creates political risks to stability—and we've seen evidence of that in the political realm—then stability-seeking becomes one way that diversified investors can act to reduce the level of systematic risk. So if you think that some system of broader social insurance, particularly this maintenance 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? These so-called "universal investors" hold the shares of all the companies. They have the vision to perceive what's going on. The question is, how involved are they going to end up in politics, and what does that do to their business model?

Let me elaborate a bit on this diversification point, because I think it's key to understanding the world in which we live, in particular the "great risk shift" that I referred to previously. It was a Nobel Prize-winning idea that investors should aim to maximize their utility by achieving the highest risk-adjusted expected returns, meaning attention to risk as well as returns. The follow-on investment strategy is portfolio diversification, which minimizes firm-specific idiosyncratic risk.

## Economic Insecurity

What are the real world implications? It means that investors want companies to be aggressive in taking business risks, while being willing to accept the greater risk that such companies will fail.

What are the consequences for other parties to the firm? Creditors of the firm can adjust to such increased risk-taking by, say, charging higher interest rates or insisting on lower leverage. The managers of the firm can also adjust; after all, we pay them in stock-based pay, which encourages them to take these risks. Increasing managers' upside will thus make them risk-neutral or even risk-seeking. But it's the employees who are unable to adjust to the extra risk arising from the changed incentives that diversification provides shareholders to encourage more corporate risk-taking.

Think about the way that the organization of companies has changed in the past 50 or 60 years. The conglomerates of the 1950s and 1960s proved to be failures, in significant part because investors who wanted diversification could get it at the portfolio level. Such investors don't need, and so won't pay up for, diversification at the firm level; and as had become clear by the end of the 1970s, firm-level diversification introduces new expenses and other inefficiencies. It requires managers to oversee a broad range of businesses, many of them with no operating synergies. And it's "managerialist" in the sense that the size and scope achieved by this kind of "empire-building," which has the effect of reducing efficiency and value, actually benefits managers because it buffers performance variation across the firm's diverse businesses.

Who else ends up being protected through the diversification of a conglomerate? Apart from management, it's really the employees, because the resulting diversification of the profits and operating cash flow means that the conglomerate will be less likely than a focused, single-business firm to lay off employees of a unit that's in trouble. Cash flows in a conglomerate can be reallocated to protect a failing unit; employees can be shifted to more profitable divisions within the firm.

But starting in the early 1980s, the decades-long process of dismantling the conglomerate structure initiated by corporate raiders and LBO firms helped bring about this major shift of risk from the shareholders to employees—a change that, as I suggested, is partly attributable to investors' growing reliance on low-cost diversification methods. With the rise of hostile takeovers in the 1980s—and running more or less continuously to today's shareholder activists—we have seen a high-powered governance system whose main goal is to eliminate corporate "slack," or inefficiency, as seen from a shareholder point of view.

The big difference between today and the 1970s and the 1980s is that the amount of slack, or value left on the table, that it would take to trigger corrective action is much less today. The dispersion of share ownership in the '70s and '80s meant that collective action problems could be overcome only through the expensive mechanism of a hostile takeover bid, in which a buyer faced all the risk of a misjudged opportunity. Today's reconcentration of ownership has invigorated the proxy battle, which can be pursued at much lower cost than a hostile bid, and in which a shareholder activist bears only the risk of its toehold stake, not 100% ownership. The consequence is that companies now have much less margin for what is perceived as strategic or operational shortfalls.

To summarize my point, investors' diversification has made profound changes in not only how parties invest, but in what shareholders want from companies, and how the companies are structured—all in pursuit of the highest risk-adjusted returns.

As a consequence, we now have a system that is extremely efficient in the utilization of resources. But one regrettable, though unavoidable, effect of such efficiency is the shifting of risk from shareholders to employees. And, again, I don't see any way for companies to insure employees against this kind of risk. There's no way for the firm to provide a relationship that would make the employees whole against the firm-specific risk that they're exposed to.

Hence my call for a government solution. If we're going to have this high-powered governance system—one that keeps our companies responsive in a dynamic global economy—then I think we also need government to play a bigger role in helping retrain employees. And this is not a problem that neo-mercantilism can solve. With companies like Walmart, Amazon, and Netflix completely disrupting the way business is done, a disproportionate share of the risk of change is being borne by employees. And unless we're willing to tax the disrupters themselves—and in so doing, discourage the process of innovation—I think we have to consider other, presumably state- or tax-funded, forms of social insurance.

At the very least, then, I'm providing a call for a rethinking of social insurance, for a kind of lifetime human potential insurance. Now, this is not a codetermination strategy. That wouldn't solve the problem; it doesn't get us anywhere. And we can view this not as an issue of fairness or redistribution or part of the safety net—although those are all legitimate framings of the problem—but rather as an economic question of the optimal kind and amount of investment in retraining workers, in reinvesting in workers whose skills have been made obsolete, whose prior human capital investment has been dissipated. It's the way the world has turned that's created the problem, and the solution requires a different sort of match between government and enterprise.

## Questions & Answers

**Fox:** Thanks 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. I think you very neatly mapped out the current situation in terms of the power of BlackRock and the other large index funds in their potential to influence corporate governance. But at the same time you're arguing that corporate governance isn't the solution to our problems. Can you speculate a little bit more about whether you think these large asset holders should be playing some kind of political role?

**Gordon:** There are two different ways to play a political role. One is a direct role in buttonholing folks, lobbying. That's politics in a direct sense and raises many concerns. The other is stating what they believe to be the case, trying to shape the debate by offering informed views.

Of course folks can disagree about what they think are the underlying problems. When Larry Fink says the goal is getting companies to invest for the long term, and that that would solve the problem, then I think the diagnosis he offers is not helpful; it pushes us away from policy that would be constructive on dimensions that I've described. By suggesting that if individual companies and their managers only behaved better, were more far-sighted—and maybe if we only got rid of the activists, or maybe if we moved to Colin's system, we could change things—we're ignoring the crux of the problem, at least as I see it. But if you accept my view that global competition and technological changes, including changes in distribution networks, are the main causes, and that it's very difficult to resolve these tensions at the level of the firm, then I think you're forced to look for a government-orchestrated and maybe government-funded solution.

**Alan Schwartz:** 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, there's some discussion of risk-adjusted wages. Could risk-adjusted wages be used to reflect and compensate workers for the shift in risk bearing? My other question has to do with acquiring human capital. My understanding is that adult retraining programs tend to have low returns. Have you given any thought to these programs as part of the solution?

**Gordon:** The evidence I've seen does not suggest that employee wages are, or have been, in a general way, risk-adjusted, and I suspect that's in part because the risk is hard to measure until it materializes. On the value of retraining programs, I think such programs are based on a pretty strong assumption about the plasticity of human beings, and the potential for refocusing careers at different stages. The evidence coming from various U.S. pilot retraining programs 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 porting in and out of different careers readily available, more readily available than we do now.

But I can think of one change worth considering. Jon Macey says that the U.S. system is incredibly biased in providing incentives for physical investment but not investment in human capital. If a company installs a robot, under the 2017 tax act the company gets to expense it in the year of the investment. But if a laid-off assembly line worker signs up for an educational program to become a pharmacy tech, he or she doesn't get a tax subsidy on tuition and living expenses incurred during the period of education. We haven't thought in a coherent way about how to encourage folks to invest in themselves over the long period of their careers.

**Steven Pearlstein:** In a sense, you're saying that 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: redistribution of income within the firm, good deeds for society. You're saying that now, 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 to be profit maximizers.

That's a nice theory. The problem is that, in a political economy sense, in the United States, the very forces that want to push 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. And much the same is going on in the environmental arena. I'm guessing you would say, don't ask the companies to behave well environmentally; come up with rules that force all companies to do the right thing. And if companies won't do worker safety, we can and should have rules about worker safety.

So, it seems to me that you're basically telling us to adopt a sort of Northern European model, something like what they did in Denmark. They don't ask companies to perform these social functions; they expect the government, the public sector, to do it. But in this country—and I can't speak to England—everything's been going the other way. The very forces that should be pushing for and supporting this expansion of a government role 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. It's a great theoretical model; but I don't see it happening in the United States.

**Gordon:** The claim I would make is that companies, acting in a rational way, self-interested way, would in fact favor greater government investment along the lines that I'm suggesting. And that's precisely because the political frictions associated with the present system are becoming very intense.

**Pearlstein:** 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, and every tax redistribution of wealth. They oppose every increase in spending on education. That's the way the business community behaves in the real world. I'm from Washington, and I can tell you that's true.

**Gordon:** I don't want to claim more than I know. All I'm offering is a way the world might well get better, not a prediction about the most likely path from here. If the alternative is some other proposal, which seems even less appealing to corporations—call it the Green New Deal—then my proposal, which calls for investment in human development over a lifetime, all of a sudden seems like the moderate alternative.

I wouldn't presume to suggest a political feasible path. My point is that, given the world in which we're in, this is a plausible way forward—as opposed to depending upon the induced kindness of companies and their managers, which seems to be the main alternative on offer.

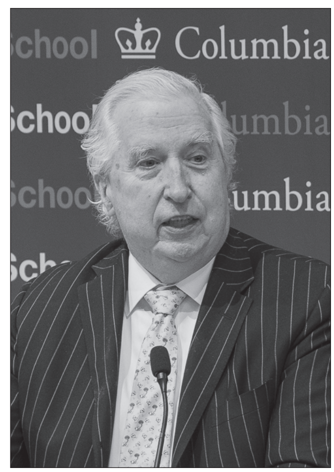
COLUMBIA LAW SCHOOL SYMPOSIUM

# Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)

## SESSION III: SECURITIES LAW IN TWENTY-FIRST CENTURY AMERICA: A CONVERSATION WITH SEC COMMISSIONER ROBERT JACKSON

**Columbia Law School | New York City | March 1, 2019**

Robert J. Jackson. Jr.
Commissioner, U.S. Securities and Exchange Commission




John C. Coffee, Jr.
Adolf A. Berle Professor of Law and Director, Center on Corporate Governance, Columbia Law School

**Jack Coffee:** Good afternoon, I'm Jack Coffee, and my job is to introduce and then lead a discussion with SEC Commissioner Robert Jackson. Rob has been an SEC commissioner for one year, one month, and 18 days. Not a particularly memorable anniversary. But in that short time, Rob's blazed quite a trail and addressed a lot of issues that he alone is focused on and that, I think, deserve exactly the attention he's giving them.

Let me start, however, with the prosaic details. Rob is a summa cum laude graduate of Wharton, and later received an MBA there in 2000. He also has a master's in public administration from the Kennedy School and a JD from Harvard Law School. Then he took a research fellowship at Harvard. What all this evidence points out is that he would do anything to avoid going to work.

But he eventually did go to work, practicing at Bear Stearns and then Wachtell, Lipton, where he specialized in executive compensation. After the 2008 financial crisis, he went to Washington to work with Ken Feinberg at the U.S. Treasury, where he helped design the rules in the Dodd-Frank provisions dealing with executive compensation. If those rules had been adopted and implemented, we'd be in a much better position; but for some reason, they didn't quite get all the way through Congress and the administration.

Then in 2010, tired of doing real work, he retired to the Columbia Law School faculty where, in 2012, he received the Willis Reese Prize for excellence in teaching, which goes to only one person per year. The students said he was the greatest thing they had seen.

But though it sounds like I'm giving a hagiography, Rob has not been completely successful at everything he's tried. I want to point to what may be his leading failure, which he can still resurrect. He wrote an article with Lucian Bebchuk arguing that the poison pill is unconstitutional—and, can you imagine, their position has yet to receive overwhelming acceptance from the courts.[1] He may be about to tell us what he's going to do with the SEC to make the poison pill disappear from the face of this earth—or he may tell us he's reconsidered his position on the pill—but I'll leave that to him.[2]

During his year, one month, and 18 days as Commissioner, he has boldly expressed skepticism about whether there is adequate competition among stock exchanges, and I think he has some good evidence on that point. Even more broadly, Rob has really been first on the Commission to see potential problems with the common ownership of public companies by a very limited number of institutional investors. And in this, he's following some work that's been done by Einer Elhauge and John Coates at Harvard, and a bunch of economists. That may be one of the issues of the future. Jeff was just suggesting the possibility of BlackRock and others lobbying Congress to fund programs to retrain laid-off workers. Well, there could be problems if such large investors already have too much power, if as few as 12 investors own a majority of or exercise voting control over our largest companies.

What lies ahead for Rob Jackson? Well, he's getting married in June. And that might slow him down, at least a little. But I'm really going to let the cat out of the bag by telling you—and Rob will deny it, but his denials won't be credible—that he is shortly heading out to Iowa, where he's meeting with community groups, local political leaders, and the citizenry—and maybe we'll see the waters tested. What you hear today might be a political campaign in just a few more weeks because, frankly, there are already 13 candidates for the democratic nomination. But do any of those 13 have his intelligence, his credentials, his ability? I find it hard to point to someone who's clearly ahead of him.

So, having dug this little hole for Rob, let's see if he can dig his way back out. Tell us what you're going to do at the Commission and elsewhere.

**Rob Jackson:** Well, thank you very much, Jack, for that very kind—and very dangerous— introduction. It's so good to be back at Columbia, and to see so many friends. I'm really very grateful to you and to the Millstein Center for the opportunity to be here today. I want to begin just by saying how much I've learned from the conversation so far, and also how glad I am to be in a room with so many important thinkers and policymakers. The people you've managed to gather here today are really at the cutting edge of the debates in corporate law.

I'm going to be brief. My plan is to speak for 10 or 15 minutes, and then I'd prefer just to take questions and have a conversation—because it felt very much to me, standing at the back of the room for the last hour, that this is an ongoing debate about some of the issues that Colin raised in his book and that really deserve our attention at the policy level.[3]

1 *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Toward a Constitutional Review of the Poison Pill*, 114 Colum. L. Rev. 1549, 1550 (2014) ("We argue that the state-law rules governing poison pills are vulnerable to challenges based on preemption by the Williams Act.").

2 *Compare id. with* Martijn Cremers, Robert J. Jackson, Jr., & John Morley, *The Value of Takeover Defenses: Evidence from Exogenous Shocks to Closed-End Mutual Funds* (working paper, January 2015) (arguing, based on event studies from a different context that "as takeover defenses became more legal, closed-end fund stock prices increased, and as takeover defenses became less legal, closed-end fund stock prices decreased. In other words, we find that in closed-end funds, shareholders *like* [] the poison pill.").

3 *See* Colin Mayer, *Prosperity: Better Business Makes the Greater Good* (2019).

**Asking corporate boards of directors to make important strategic business decisions while considering the interests of all corporate stakeholders imposes a decision-making burden on the institution that we cannot and should not expect boards to carry. Moreover, taking away companies' clear, single-minded objective function of increasing long-run shareholder value raises real accountability problems. Without such an objective, what will guide boards when making the difficult tradeoffs among stakeholders that effective oversight and management require? – Robert Jackson**

There are three issues I want to talk about today that we're facing at the SEC, and that I really think are going to be most important on our agenda in 2019. But these issues all relate to two themes that I want you to keep in mind as we have this conversation over the next hour.

The first is that all good ideas that I've ever had or will have, and that I'm trying to turn into policy at the SEC, I have stolen from people here. I am an unabashed thief.[4] I give footnotes and no more,[5] and I have found that the ideas in these conversations have been absolutely invaluable to the policy conversations we're having in Washington.

I'll talk a little bit about whom I've stolen from in this room—it's basically everyone—and why I'm so committed to this theft, but the fundamental thing to understand is that the conversations you're having today are informing the way that folks like me are thinking about what the future of securities law policy should be. I'm very proud of the fact that a lot of what has come out of conversations in rooms like this one has become or is becoming policy in the United States securities markets.

The second thought I'll leave with you is that we should stop pretending as a Nation that the decisions we make in our markets do not have significant social implications. When I was a scholar and a professor, I used to teach corporate law just across hall here at Columbia Law School. On the first or second day, I would say, "For purposes of this course, we're going to do the following exercise. We are going to maximize what I refer to as Kaldor-Hicks efficiency.[6] We're going to just maximize the size of our economic pie, and all these other social questions we're going to leave for your other professors because they're smarter than me and have more intelligent views on the subject."[7]

Looking back at it, I think I was cheating. I think it was easier to teach a world where we just do that one thing, and to encourage myself and my students not to worry about the implications for the rest of society. But it was not the right way to think about the task I now face as a policymaker. I think what we've learned as a Nation in the last decade or two is that those choices have significant implications, like the ones Jeff Gordon was just talking about—the risks employees face working for large public companies that are increasingly being pushed to earn profits at almost any cost.[8] And this means that we need to think seriously about the social bargain we have struck between

4 *Compare, for example,* Commissioner Robert J. Jackson, Jr., *The Middle-Market IPO Tax* (remarks at the Ohio State University Greater Cleveland Middle Market Forum, April 2018) (citing Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. Fin. 1105 (2000)) with Commissioner Robert J. Jackson, Jr., *Perpetual Dual-Class Stock: The Case Against Corporate Royalty* (remarks at the Berkeley Law Symposium in San Francisco, California, January 2018) (citing Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life Cycle of Dual-Class Firms* (working paper, January 2018)) *and* Commissioner Robert J. Jackson, Jr., *Stock Buybacks and Corporate Cashouts* (remarks at the Center for American Progress, June 2018) (citing Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. Pa. L. Rev. 801, 805 (2014)).

5 *See supra* note 4.

6 That idea was even less original to me than most of my policy proposals. *See*, *e.g.,* Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 11-12 (1991); *see also* Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. Times Mag. (Sept. 13, 1970).

7 *See, e.g.,* Columbia Law School, Faculty Profiles: Gillian Metzger (citing *Foreword, 1930s Redux: The Administrative State Under Siege*, 131 Harv. L. Rev. 1 (2017)); Columbia Law School, Faculty Profiles: Alex Raskolnikov (citing *Accepting the Limits of Tax Law and Economics*, 98 Cornell L. Rev. 523 (2013)); Columbia Law School, Faculty Profiles: Jessica Bulman-Pozen (citing *From Sovereignty and Process to Administration and Politics: The Afterlife of American Federalism*, 123 Yale L.J. 1920 (2014)).

8 *See* Jeffrey N. Gordon, *Addressing Economic Insecurity: Why Social Insurance Is Better Than Corporate Governance Reform*, Columbia Law School Blue Sky Blog (August 21, 2019).

those companies, their consumers, their employees, and their investors; we need to think about what our expectations are for the large investment funds that hold the savings and futures of millions of American families.

I think we can no longer pretend that there is such a thing as socially neutral corporate or securities law policy in that respect. The decision to do or not to do something in that area is fundamentally a social decision.[9] We should accept and embrace that fact and have the appropriate conversation—instead of pretending there's a way intellectually to avoid that part of the conversation, because it's too hard.

So that's my basic proposition. And I have three policy areas I'd like to talk to you about that, in my view, illustrate why economic choices are at bottom choices about what kind of society we want to live in. These are things that I now understand in a different way than I did when I taught across the hall. Then I'll wrap up and we can have a conversation about how to move policy forward in these and other areas.

## The State of American Stock Exchanges

So first let's talk about American stock exchanges. The history of U.S. stock exchanges is one that I hadn't spent a lot of time on—even though my Columbia Law colleague, Merritt Fox, has written some of the world's leading scholarship on the subject, and I commend it to you.[10] When I was on the law faculty here, I just let Merritt handle the complicated stuff. But what I have learned in Government is that the bargain securities regulators struck with our stock exchanges 15 years ago has fundamentally changed our markets, and in a way that I don't think is fully appreciated and that has real implications for American investors and public companies.

You all know the history of the stock exchanges. They used to be collectively controlled and owned by most of Wall Street, pursuant to the famous Buttonwood agreement.[11] Over the years the markets evolved in a fashion that called for new rules, and the Commission eventually enacted what is now known as Regulation NMS.[12] Those rules were intended to protect investors and make sure they got the best price when they dealt on the stock exchange. In many ways, the rules have helped achieve just that.[13]

But what followed was an incredible decade-long arms race in which investors paid millions of dollars for high-speed trading to address what is now known as "latency arbitrage."[14] It's hard to overestimate the amount of capital that has been invested in technology, lobbying, and legal fees to create and protect that franchise.

Now, if I were still an academic and you asked me whether that was a good thing, I might respond, "If price discovery is the goal, it may well be."[15] But I have since learned that the pursuit of price discovery in this fashion has very real costs. One manifestation of those costs can be seen by noting that we have 13 public, or "lit," stock exchanges in the United States. We've got 13 different venues to which an order that you place for shares can be delivered; and of those 13, 12 are owned by just three conglomerates.

I was in a prior life a legal and financial advisor on mergers and acquisitions, and my first reaction to learning this was, "That sounds like a weird M&A strategy: Let's buy all the units that do mostly the same thing, and then just have them compete against each other."[16] No CEO in a competitive industry would pursue that strategy. Why do the stock exchanges? One answer might be that the law encourages that outcome by permitting them to charge connection and access fees that investors pay for on a per-exchange basis.

Now we can debate whether that's a good thing or a bad thing, but what astonished me when I arrived at the SEC is that for years the exchanges had managed to extract those costs from American investors with very little public debate. That struck me both as an astonishing feat of lobbying, and something very troubling for American investors.[17]

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9 For a closer examination of this argument, published before I took office at the Commission, *see, e.g.,* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 Geo. L.J. 923, 964 (2013) ("[T]he SEC should not be deterred from acting to provide investors with information they need by the possibility that its actions might have implications for the political landscape.").

10 *See, e.g.,* Merritt Fox, Lawrence R. Glosten, & Gabriel Rauterberg, *The Economic and Legal Structure of the Stock Market* (2019); Merritt Fox, Lawrence R. Glosten, & Gabriel Rauterberg, *The New Stock Market: Sense and Nonsense*, 65 Duke L.J. 191 (2015).

11 *See, e.g.,* Commissioner Kara M. Stein, Remarks Before Trader Forum 2014 Equity Trading Summit (New York City, February 2014) (describing this history).

12 Securities and Exchange Commission, Concept Release on Equity Market Structure, Exch. Act. Rel. No. 34-61358, 75 Fed. Reg. 3594 (Jan. 21, 2010) (describing the genesis of Regulation National Market System and the market-driven innovation that followed its adoption).

13 *See id.; see also* Fox, Glosten & Rauterberg, *supra* note 10, at 204 (describing extensive benefits to investors derived from the market structure that emerged from this period).

14 For an engaging description of one example of this kind of arbitrage, *see* Michael Lewis, *Flash Boys : A Wall Street Revolt* (2015); for a more recent analysis of the prevalence of this kind of trading, I commend the insightful analysis in Robert P. Bartlett & Justin McCrary, *How Rigged Are Stock Markets? Evidence from Microsecond Timestamps*, J. Fin. Mkts. (forthcoming 2019).

15 *See* Fox, Glosten, & Rauterberg, *supra* note 10, at 207 (making a similar argument).

16 *See, e.g.,* McKinsey & Company, McKinsey Quarterly: Six Successful M&A Strategies (Spring 2017) (noting the common strategy to "[c]onsolidate to remove excess capacity from industry," but making no mention of acquiring and operating competing franchises in the same industry).

17 I made this argument most forcefully in public remarks at George Mason University in September 2018, *see* Commissioner Robert J. Jackson, Jr., *Unfair Exchange: The State of America's Stock Markets* (Sept. 19, 2018), shortly before the Commission took several steps related to those policy questions, *see, e.g.,* Rob Daly, *SEC*

When I have this conversation with people, they say, "This sounds really technical, and not very interesting from a social point of view." My point to you today is that that's wrong. When you talk to an ordinary American investor—and part of my job is to talk with retail investors across the United States—and you try to explain to them why there are 13 stock exchanges, and why 12 of them are owned by three conglomerates, they get the sense that this is yet another way in which the financial system is designed to profit somebody else at their expense. I'm very proud of the SEC's work in this respect; for the first time in two decades, we have gotten very serious about examining these issues. I gave a speech on the subject at George Mason University back in September and have been joined by my colleagues on a number of policy initiatives that I'm very proud of. These initiatives are all bipartisan and have been unanimously adopted at the SEC.[18]

We'll soon hopefully have a transaction fee pilot in which we test the effects of certain payments that the exchanges make to attract volume.[19] I'm happy to talk more about the details, but for now I just want to say that taking on that subject—the notion that our stock exchanges have concentrated power that they use to extract excess fees from American investors—is an important conversation that we need to have as a Nation, and I'm proud to be a part of it.

### Concentration of Corporate Ownership

Second, I want to talk a little bit about the role of institutional investors. There's a broad public conversation we're having right now about the degree to which common ownership of public companies is affecting competition in this country.[20]

My own view, with great respect to the exceptional scholars in this field, is that that conversation is important but misdirected. As I explained in recent testimony before the Federal Trade Commission, this issue strikes me as a challenge not of market competition but of corporate governance.[21]

I say that because of the astonishing and understudied role that these institutions play in the outcomes of corporate elections.[22] This is an enormously important task that we've charged institutional investors with. Corporate lawyers in the room who advise boards will tell you that most contested questions in corporate America today are decided by just a few large funds. Persuade them, and you carry the day.

Now, again I'm not prepared to say that this is necessarily a good or a bad thing. It's just something that deserves our attention. And as I said early on, I'm a really excellent thief. When I testified on this subject, I based my testimony largely on a tremendous paper by John Coates at Harvard, who explains why it's possible to imagine a corporate world in which a dozen or fewer individuals have that kind of control over our economic destiny.[23]

The reason that's important to understand is the same reason that Chief Justice Leo Strine, who's here today, has pointed out: namely, to the degree you feel that corporate America has let you down and done something that isn't fair—like spending dark money on politics—it's time to call to account the institutional investors who sat silently by while that happened.[24] So I think Leo's right about this; it won't do to blame corporations by themselves on this issue.

I think we've got to be candid and look large institutional investors squarely in the eye and say, "You guys have overseen this; where have you been?" As a society, in the public conversations we've had about corporate America, we really like to blame corporations. It's really great to have somebody to point to and say, "It's your fault." But everyone in this room knows that assigning responsibility for today's economic and social problems is a much more complicated task than blaming corporate America alone. Companies have a broad range of constituencies, and we all bear responsibility for where we are as a Nation.

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*Rules for SIFMA in Market Data Case,* Markets Media (Oct. 16, 2018) ("The U.S. Securities and Exchange Commission has set aside [exchanges' requests to approve certain] depth-of-book fees."); *see also* U.S. Securities and Exchange Commission, *SEC Adopts Transaction Fee Pilot for NMS Stocks* (Dec. 19, 2018).

18 *See supra* note 17; *see also* Joint Concurring Statement of Commissioners Hester Peirce and Elad Roisman Regarding Application of SIFMA for Review of Action Taken by NYSE Arca, Inc. and NASDAQ Stock Market LLC (Oct. 16, 2018) (noting my colleagues' thoughtful "vote[] to support this decision" while "rais[ing] a critical policy question underlying these proceedings").

19 The pilot study described *supra* at note 17 is currently subject to litigation; exchanges have sued in the D.C. Circuit to block the Commission's study of these matters.

20 *See, e.g.,* Jose Azar, Martin C. Schmalz, & Isabel Tecu, *Anticompetitive Effects of Common Ownership,* 73 J. Fin. 1513 (2018); *see also* Einer Elhauge, *Horizontal Shareholding*, 129 Harv. L. Rev. 1267 (2016); Eric Posner, Fiona Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors,* 81 Antitrust L.J. (2019).

21 *See* Commissioner Robert J. Jackson, Jr., *Common Ownership: The Investor Protection Challenge of the 21st Century,* testimony before the Federal Trade Commission Hearing on Competition and Consumer Protection (Dec. 6, 2018).

22 For an important and early examination of the joint role of large institutional investors and activists in contemporary corporate governance, *see* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights,* 113 Colum. L. Rev. 44 (2011).

23 *See* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (working paper, Sept. 2018) ("In effect, indexation is concentrating power over all public companies in the hands of one [small] group.").

24 *See* Chief Justice Leo E. Strine, Jr., *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, New York University School of Law Distinguished Jurist Lecture (Nov. 29, 2018); see also Leo E. Strine, Jr. & Antonio Weiss, *Why Isn't Your Mutual Fund Sticking Up for You?,* N.Y. Times (Aug. 23, 2019) ("[C]orporate governance reform will be effective only if institutional investors use their voting power properly.").

That's why, when I've talked about this subject both publicly and privately at the SEC, I've pushed people to answer those questions in a way I could explain to an ordinary American investor. Trying to explain to them why corporations participate in politics to the extent they do, and why they make the choices they do about executive compensation, is not easy. Explaining why large institutions vote ordinary investors' shares in favor of spending American families' money this way is even harder. It's time to ask ourselves whether the fact that we can't explain these things to ordinary investors tells us something important about the state of corporate America.

### Stakeholder Theory and the Law

Third, I want to talk about the fundamental idea that the solution to part of our social problems might be to allow corporations to consider the interests of constituencies other than their shareholders when they make major business decisions. The notion that you might have a wise council of individuals who will consider all these things and come up with the right answer and solve these problems for us is a very tempting idea.[25]

But I'm unconvinced. The reason is that asking boards of directors to make such important decisions while considering all these different interests imposes a decision-making burden on the institution that we cannot and should not expect boards to carry. Look, I've been in those boardrooms. They're filled with good people who are trying to do the right thing. But the fact is that corporate boards do not hold the keys to our environmental future, or to ending inequality. They don't have the authority or knowledge or resources to solve those problems.

And expecting them to do that is a prescription for profound unhappiness for millions of families who rightly feel let down by modern corporations. Moreover, taking away companies' clear, single-minded objective function of increasing long-run shareholder value raises real accountability problems. Without such an objective, what will guide boards when making the difficult tradeoffs among stakeholders that effective oversight and management require? I worry that, without an obvious goal to pursue, we'll end up feeling that boards have failed both investors and stakeholders.

And that's why I think Chief Justice Strine is so right to point to the responsibility of other corporate constituents for some of today's problems.[26] Even if we're worried about the degree to which corporations do or do not take those kinds of considerations into account, it does not follow that we should adopt a rule that invites managements and boards to consider other stakeholders in major strategic and business decisions. The dangers of this kind of managerialist approach are clear, as Jeff Gordon just told us, to anyone who's studied the corporate conglomerates of the last century.[27]

What I think we should do instead is ask whether addressing social and environmental problems should be part of the obligations of *all* the constituents of the corporation; the investors, the board, and those who represent them. In other words, I think we want to understand the responsibilities of being a large institutional investor in this world better than we do today.

Let me give you an example of what I mean. For those of you who are interested in this subject, are you confident that we understand the degree to which large institutional investors actually vote in a way that reflects the preferences of the underlying investors whose money they're voting? Do you feel we have a good empirical understanding of the degree to which large institutional investors vote their shares in the way the ordinary underlying retail investor would want them to?

I don't think we know that. And I think we should, because as Chief Justice Strine and others have pointed out, if we're really going to have a conversation about what we want corporations to achieve and what investors want from them, then we should understand the way underlying investors think about those issues and whether or not the votes that are getting cast reflect those interests. That, to me, is part of the intellectual enterprise of understanding what we're asking corporations to do and why. The fact that we haven't explored it strikes me as a notable and actually telling omission. It makes me wonder whether the question we're really asking is whether corporations are doing what their individual shareholders want them to do, or whether we're really playing a different game.

So my request for all of you would be to begin those conversations today. And the goal here is not just to come away with an answer to the decades-old question about whether boards should be able to consider interests other than investors' when making important

25 *See, e.g.,* Business Roundtable, Statement on the Purpose of the Corporation (Aug. 19, 2019) (purporting to "redefin[e] the purpose of the corporation to promote an economy that serves all Americans"); *see also* Plato: Five Dialogues (2d ed. 2002) (providing the seminal thesis that "philosopher kings" might be the best trustees of a society's future).

26 *See* Strine, *supra* note 24 (asserting that institutional investors should be held to account for the degree to which corporate resources are used in a fashion inconsistent with ordinary investor interests).

27 The claim that corporate law should defer to managerialist judgments about the needs of certain "constituencies" should be familiar to any serious student of corporate law. George Santayana, *The Life of Reason: The Phases of Human Progress Volume 1*, *Reason in Common Sense* ("Those who cannot remember the past are condemned to repeat it.").

decisions. Yes, that's important, and I'm happy to keep having that conversation. But we also want to explore more generally whether we should set before corporations alone the task of solving our broadest social problems. If we're going to do that, shouldn't we be asking the same thing of the largest institutional investors in America, and be prepared to hold them responsible for the choices they've made over the last 30 years that have brought us to the place we're in as a Nation?

And now let's have a conversation. Thanks so much for having me and for having this important conversation. Tell me what's on your mind. And tell me what you've learned today about the most pressing policy issues before the Commission.

### Discussion with the Columbia Audience

**Coffee:** As you heard, Rob just gave us three big topics he wanted to discuss. The first was competition among stock exchanges. The next was institutional investors, and the potential dangers of consolidation. The third is the degree to which boards and others should be able to take account of ESG—environmental, social, and governance—considerations in their strategic and operating decisions.

Let's take these one at a time. I'm going to ask for questions first on the stock exchange issue. As you will recall, Rob has said that of the 13 public stock exchanges, 12 are owned by three entities. By the way, those three owners are NASDAQ, ICE, and the CBOE. He also makes the point that generally, when companies acquire lots of other companies, they typically consolidate their operations. But this hasn't happened in the stock exchange industry, perhaps because the exchanges seem to love charging fees for sending orders back and forth. And, as Rob has argued, that looks anticompetitive.

In any event, that's the backdrop. Now, as Rob also mentioned, Columbia Law's Merritt Fox is one of the world's leading experts in this area. Merritt, what do you think about Rob's argument?

**Fox:** I think Rob's right that there's the potential for anticompetitive problems with the industrial organization of the trading industry. On the other hand, we are also seeing trading costs that are much lower than they've ever been before. Now maybe we could do even better, but the significant reduction in spreads and commissions—and thus in the total costs borne by people making trades—have all gone down over the past ten years. And that makes me question whether there's really a problem.

**Jackson:** Let me say two things about that. First, there's no better place to hide rents than in markets with falling prices, because we don't know the counterfactual—that is, what costs would have been in a more competitive landscape, what the costs would have been otherwise. The question is, how fast should those prices be falling?

But put that completely to one side. I want to propose that just having the structure we do—that is, having the deepest, most liquid capital markets in the world structured in a fashion that makes little theoretical economic sense is, by itself, costly. The idea that our stock exchanges are set up to send orders around New Jersey to maximize private profits—the fact that funds exist for no other purpose than to trade stocks at breathtaking speed—these are hard things for us to explain to people who are wondering why they can't make their rent. And it's a challenging thing to explain to American investors.

Now I understand that part of the explanation has to do with price discovery, which we all know is socially valuable. But I also think there are needless costs associated with having this structure. More fundamentally, I think we need to think about whether our system for trading stocks is the best we can do for ordinary American investors. I'm not convinced that the answer is yes.

**Jim Millstein:** Rob, we now have estimates that 50% of stock trading volume is going on in dark pools. What's your reaction to the impact of the structure of public exchanges on that increasing trend?

**Jackson:** Before I answer, let me say I had the very great privilege of having Jim as my boss, when he was the chief restructuring officer of the Treasury Department.[28] For a long time Jim was the only thing standing between AIG and a Nation in total catastrophe. He was astonishingly successful in restructuring AIG while preserving its value in incredibly difficult operational and political circumstances. Far too few Americans know this, but thanks to Jim, taxpayers earned more than $5 billion on their investment in AIG.[29]

But back to Jim's question. First of all, as Merritt has taught me over the years, dark pools tend to provide price improvement to investors at the margin. So there's an argument that investors do a little better by dark pools. But that

28 *See, e.g.,* Barry Ritholtz, *Jim Millstein and the Restructuring of AIG, The Big Picture* (Oct. 28, 2018) (describing Mr. Millstein's crucial role in restructuring the company during the United States Treasury's exceptional rescue of the firm); Serena Ng, *Treasury Restructuring Chief to Exit*, Wall St. J. (Feb. 24, 2011) (describing Mr. Millstein's successful conclusion of his work just two years into his appointment).

29 *See* United States Department of the Treasury, Investment in American International Group (AIG) (Dec. 9, 2013) (noting that, following Treasury's sale of AIG common stock in a 2012 public offering, taxpayers' return on their investment in the company exceeded $5 billion).

said, I do have a concern. Dark pools have sucked so much volume off the exchanges that I worry about the degree to which the price discovery we get on the exchanges is correct. I worry about this especially at the close of trading.[30]

What the exchanges tell me is that that's not a critical concern yet, but that we could easily end up in a place where it would be. That would be one of the things we'd have to figure out if we're going to do something different on exchange regulation. And just to be clear, although I've been hard on the exchanges today and in the past, they provide a very valuable service in terms of that price discovery, especially at the close. That's something we need to preserve.

**Doug Chia:** I'm Doug Chia from the Conference Board. In your comments on the monopoly of stock exchanges and the rents they extract from all of us, it seems to me that what has to happen—and probably will happen at some point—is for some kind of disruptor to come into that industry. Just as we've seen in so many industries today, an Uber or a Netflix just comes in and changes the game entirely. So much of that—when it happens—is about disintermediation.

In order for that to happen, there has to be new technology; and there also typically has to be changes in the regulations. The stock exchanges are the way they are today and don't have a lot of competition because they're regulated by the SEC. You do have attempts to come up with alternatives from time to time, but they have to go through this regulatory vetting process.

All that said, does it make sense for the SEC to really think about encouraging that type of innovation in the system and not preventing some of the really good ideas from being crushed at the beginning because they just realize it's going to be too damn expensive for us to get through that process?

**Jackson:** Doug, you're absolutely right about this. We aren't creating the kinds of incentives we need for people to create new technologies that can compete on the margin. But that said, you're also right to say that they've created the system they did because it's within the rules we set up, and it maximizes their profits under those rules. I try hard in life not to get angry at people for following the incentives we give them. The problem in such cases is really not the people; it's the incentives. This is my problem, not theirs. That's why I've been proud to be a part of looking carefully at those regulatory incentives.

If you take one thing away from my talk, this is the idea that I want to share with you. When we make that kind of choice, it may feel narrow; it may feel small. But it isn't; it's a choice about the kind of system we want to have, the kind of market we want to have, the kind of country we want to have.

I'll give you another example. Another former boss of mine, Trevor Norwitz from Wachtell, Lipton, often comes to these events; in fact I think I see him now. He raises his hand, and he says, "You have to do something about activist investors; they're a parasite upon the Nation."

**Trevor Norwitz:** The word I like to use is "scourge."

**Jackson:** Ok, "scourge." And I say, "Well Trevor, you know, it's complicated. The agency costs associated with corporate managers can be significant." I think what I've become persuaded of by Trevor and others in the space is that the securities law we have is a choice about the role those people should play in the agenda setting and investments in American society. What you've been pushing me to do is to ask myself if that's the right choice for the Nation. That's the view I've come to, having been in this job for a little while—and that's really the question I should have been asking myself all along.

## Costs of Common Ownership

**Coffee:** I'd like to move on now to the second topic, which is common ownership. As I indicated in my introduction, and as you confirmed, you've been reading a lot the work of John Coates and others. They've been arguing that, as we see great consolidation among institutional investors, there's the chance they'll get together and agree on anticompetitive behavior.

John Coates has been putting more emphasis on the political impact. We've heard that 12 people or fewer can influence corporate elections, but Jeff Gordon wants them to influence Congress as well, and that gives me pause if 12 people can push that heavily. So against that backdrop, what questions do we have about the role of institutional investors?

**Eric Orts:** I'm Eric Orts from the Wharton School, and I'm really happy to hear about really great people who have high grades from the Wharton School making such a huge public statement. My question has to do with finance.

**Jack:** Well, excuse me. If you feel that way, are you going to publish Jackson's grades?

**Eric:** No. [Laughter.] Anyway—so my question has to do with the increasing power of the financial services industry

30 In August 2019, trading issues did develop near the market close, although the effects of those issues on ordinary investors are not yet known. *See, e.g.,* Yun Li, *A Trading Issue Impacted US Stock Quotes Late in the Day as Dow Flatlined Into the Close,* CNBC Markets (Aug. 12, 2019).

in terms of its lobbying clout. I think we know that finance is the highest lobbying group, and there's increasing concern about the influence of finance over our political system. In the 1950s, finance was just 2% of GDP. In 2008, it was 8% or 9%.[31]

So my question is about the concentration of the financial services industry. What is the SEC doing to curtail the influence or at least making public disclosure of what the finance industry is doing politically? A long time ago, lobbying was even illegal. If there's really the public interest that's at stake here, should the SEC take some more forceful approach on this?

And, finally, I think we need to figure out what kinds of investors we're really regulating for. When I raised the idea of retail investors in an MBA class recently, someone put up their hand and said, "The whole idea of a small investor these days is a joke. It doesn't really exist." So, maybe we should get away from that model of who we're trying to protect.

**Jackson:** Let me get back to the small investor point in a moment. Let's talk first about the first question you asked, Eric, because it's a good one. You asked: Should the SEC be doing more to provide transparency with respect to the effects of this lobbying? The answer to that question is clearly yes. And I've been advocating forcefully for that.

When I first joined the Columbia faculty, I published an article with Lucian Bebchuk in the *Harvard Law Review* on that subject.[32] When we later petitioned the Commission to take up rules requiring transparency of the kind Eric is asking about, my co-signers on that petition included Jack Coffee, Jeff Gordon, Ron Gilson, and others in the room.[33] We urged the SEC to make rules that would require more transparency in this respect. And some 1.2 million people have since written to the SEC to urge them to adopt those rules.

But, we can't do it right now; and the reason is that Congress passed a law saying we can't. There's an appropriations bill that says that we can't spend any money to finalize a rule in that respect.[34] But I think it's something that we should be considering when the law permits, and for the reasons that you've given.

Now, what about your question about the concentration that we see in the financial services industry, and its costs for ordinary Americans? At a minimum, I've said that we should be pushing industry to explain and account for the possible costs of that concentration. In one of my first speeches as an SEC commissioner, stealing again from academia, I pointed to a phenomenon that has existed since I was a banker: namely, when a banker brings a company public, and that company is worth less than $1 billion, 97% of the time the banker charges a 7% spread—not 6½%, not 7½%, but exactly 7%.[35]

I called it a "tax" and said that it's hard to understand why that price is still the same as it was when I was a banker. It was a very different time. It was dialup internet. I was one of the guys who was taking companies public during the dot-com boom. But Wall Street has provided no price improvement to small IPOs. And I have to ask whether or not the concentration we see in the industry is a driver of that.

So, one of the things I've been trying to do in office is to shine light on concentration in the markets we oversee and what the SEC can and should do about it. And I've gotten this very strange reaction, which is that competition simply isn't in the SEC's ambit. Now, reasonable people can and should disagree about policy in this area. But the claim that it's outside the SEC's jurisdiction is just wrong.

In a talk I gave a little while ago to the Open Markets Institute, I documented the history of the SEC's work regarding competition.[36] As I pointed out there, when the securities laws were first enacted, there was no Securities and Exchange Commission. The '33 Act, when first passed, charged the Federal Trade Commission with oversight of the securities laws.[37] It wasn't until Joe Kennedy persuaded

31 *See, e.g.,* United States Bureau of Economic Analysis, Gross Domestic Product by Industry (July 19, 2019) (providing an industry-by-industry breakdown of contributions to gross domestic product, and noting that, in the first quarter of 2019, the finance and insurance industry added significantly to growth in GDP).

32 *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?,* 124 Harv. L. Rev. 83 (2010).

33 *See* Committee on Disclosure of Corporate Political Spending, *Petition for Rulemaking to Require Disclosure of Corporate Political Spending to Public-Company Shareholders* (Aug. 3, 2011). Professor Jackson was a principal draftsman of the petition, which has since been the subject of more than 1.2 million comments urging the Commission to take action—more than any proposal in the Commission's history. *See* Securities and Exchange Commission, Comments on Rulemaking: Petition to Require Public Companies to Disclose to Shareholders the Use of Corporate Resources for Political Activities, File No. 4-637; *see also* Letter of Former SEC Chairman William Donaldson, Former Chairman Arthur Levitt, and former Commissioner Bevis Longstreth to Mary Jo White, Chair, SEC (May 27, 2015) (bipartisan letter of former high-ranking Commission officials referring to the petition's proposal as a "'slam dunk' for the Commission").

34 *See, e.g.,* Ning Chiu, Spending Bill Prohibits SEC from Any Political Contributions Disclosure Rulemaking, Davis Polk Briefing: Governance (May 3, 2017) ("Similar to prior appropriations bills, the proposal continues to prohibit the SEC from using any funds to issue rules or regulations regarding the disclosure of political contributions.").

35 Commissioner Robert J. Jackson, Jr., *The Middle-Market IPO Tax* (remarks at the Ohio State University Greater Cleveland Middle Market Forum, April 2018) (citing Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. Fin. 1105 (2000)).

36 Commissioner Robert J. Jackson, Jr., *Competition: The Forgotten Fourth Pillar of the SEC's Mission* (remarks at the Open Markets Institute, Oct. 11, 2018).

37 *See id*. (citing Letter of Harvard Law School Professor Felix Frankfurter to Franklin D. Roosevelt, President of the United States (May 23, 1934).

FDR that we needed a separate agency that the '34 Act was passed, and that the SEC was created. Even back then, when the birthplace of the SEC was in the FTC, a competition agency, it was thought that competition was essential to the agency's mission.

How do I know that? Because the statutes that empower us to make rules require examination of concentration when we make them—though we ordinarily don't do it.[38] I've been trying to move the agency in that direction to fulfill our statutory mandate, but also to grapple with the reality we face, which is that the rules we adopt have the effect of concentrating power in this country, and we should be held accountable for that.[39]

**Coffee:** You got us into the topic of investment bankers and common fees and limited competition, but the area that people talk about most is the growing concentration among institutional investors. Three of them in particular—Vanguard, BlackRock, and State Street—now account for about 20% of the stock of all publicly held corporations. What does that mean for corporate governance and the issues we've been discussing today?

**Ron Gilson:** What I actually wanted to comment on—but I'll talk about that as well—is Rob's suggestion that the votes cast by institutional investors and their asset manager don't really reflect what their shareholders want. I want to take a pretty aggressive position on that. The answer is, nobody's got a clue. But it's worse than that. Given the way shares are held these days, it would be easier to figure out whether Al Gore won Florida than find out who the beneficial owners are; there are so many layers of intermediaries that, for most of the companies, most of the fund managers don't know who their shareholders are—let alone what they think. It would make the CDOs during the financial crisis look transparent. So my point is simply not that it wouldn't be a really great idea to know, but without a major kind of restructuring that isn't feasible, I don't think it's knowable.

**Jackson:** So that's a good point that Ron's making, and it's consistent with a statement I issued a few months ago on corporate voting.[40] That system is such a complete mess that it's very hard to even think about what the answer might be. At an SEC roundtable six months ago, after watching the P&G proxy contest, I said that if an ordinary American investor wants to know if his vote was counted in the election in which he voted, he's not legally entitled to get that answer. That's an astonishing thing. And I hope we'll soon fix that at the SEC.

**Gilson:** The problem I'm talking about is slightly different. For investors who care about how their votes get cast, their best bet is probably to find special purpose funds. But there's also likely to be a huge cost to that, because the fund may well sacrifice returns to achieve its social goals.

But let's go back to the broader question Jack was raising: how and when do we want those votes to count? The complexity of the restructuring and the privacy issues associated with getting the funds access to those shareholders are complex and troubling. And the first step in this process may be figuring out what it is we want those votes to do.

**Jackson:** I was making a slightly different point, which is just the very basic first step of knowing what votes were counted in a contested election. Given that people are rationally apathetic about casting their votes, it's hard to see why we should impose the additional cost of them not even knowing whether their vote will be counted in a close case.

To me it's very important that the SEC step forward and take a position on this. I've advocated that if an investor wants to know whether their vote in a corporate election was counted, they can get an answer to that question. And I'm actually very optimistic that the SEC will take that step.

**Coffee:** So, you've touched on the question about what ballots count. Another question that's hiding behind that is whether the middle managers at mutual funds who actually vote the shares are voting the way the ultimate owners want, or the way the CEO or companies would prefer. In cases where asset managers stand to gain from access to CEOs and senior management, the managers are likely to vote shares in favor of companies even when their shareholders might prefer otherwise. That brings us back to the old debate about short-term versus long-term, because if you're compensated on the short-term rise in the portfolio as a middle manager, you may look at what

38 *See id*. n. 17 ("All four [of the Commission's enabling] Acts contain the following language: 'Whenever … the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.'" (citing 15 U.S.C. §§ 77b(b), 77b(f), 80a-2(c), 80b-2(c))).

39 *See, e.g.,* Commissioner Robert J. Jackson, Jr., Dissenting Statement on Proxy-Advisor Guidance (Aug. 21, 2019) ("[B]ecause we have not more deeply examined the implications of today's guidance for competition in corporate voting, I respectfully dissent.").

40 *See* Commissioner Robert J. Jackson, Jr., Statement on Shareholder Voting (Sept. 14, 2018) ("[T]here is broad agreement that the Byzantine system that makes it impossible to know whether investors' votes are being counted must be fixed." (citing Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting,* 96 Geo. L.J. 1227 (2008) and David A. Katz, Wachtell, Lipton, Rosen & Katz, *Proxy Plumbing Fixes Are Desperately Needed* (Aug. 31, 2010)).

short-term stock prices are going to do. So, how do we determine whether or not middle managers' votes follow anything other than the expected effect on their compensation?

**Jackson:** That's a great point. I think one of the hardest things for me to see in my new job is how little change there has been in the incentives of senior managers with respect to short-term versus long-term stock prices. The world's leading scholar on executive compensation, Jesse Fried—who's here with us, by the way—wrote a paper in the *University of Pennsylvania Law Review* about a decade ago where he recommended ways to adjust compensation to encourage long-term performance. In particular, he said that companies should force CEOs to keep their stock. It's a great paper with great suggestions for change. But we're not following them. Dodd-Frank, for example, contains a number of provisions that would help corporate boards and managers understand and disclose to investors whether or not they're taking those steps. Of all the thousands of regulatory initiatives in Dodd-Frank, there are four rules that remain unfinished. And all of them have to do with executive compensation.

**Coffee:** And they never will be finished.

**Jackson:** Right, and that's not a coincidence. One of the most troubling things I've seen as a Commissioner is that many of the corporate behaviors that are most challenging, or most hard to understand, are driven by short-term incentives. As I said earlier, I try hard not to be mad at people who do what they get paid to do; I try instead to change the regulatory framework that affects how they get paid.

I'll give you an example. I did a speech about a year ago on stock buybacks, a subject that's gotten a lot of attention. It's very clear in the data that on the day executives announce stock buybacks, they engage in more stock sales on that day than any other day, something like three times as much. I said that this practice is worthy of attention, because it gives managers incentives to do stock buybacks—whether or not those are long-run beneficial for the firm—because they can cash out their shares today.

Jack, we have been talking about executive compensation and long-term incentives as a Nation for a very long time. And far from solving that problem, we haven't even come close. We have a lot of work to do on that issue.

## Should Companies Aim to Address Social Problems?

**Coffee:** The third and last of our three topics is whether corporate managers should be considering environmental and other issues, or is that some kind of political determination that's beyond their competence and expertise?

**Cynthia Williams:** I'm wondering if it makes sense for us to finesse or sidestep the shareholder versus stakeholder debate just by emphasizing one of Colin Mayer's points: the importance of measuring corporate performance in terms of increases in—or depletions of—not only physical or financial capital, but also of human capital, social capital, and natural capital—which are all of course critical inputs into the firm. If companies were required to disclose more information of this kind, we might be able to avoid the shareholder versus stakeholder debate. By so doing, we would be asking corporate managers and boards to measure and disclose the effects on all important stakeholders of the actions that they are taking, regardless of whether they consider the ultimate beneficiary of their fiduciary duties to be shareholders, or the other stakeholders as well.

**Jackson:** That's a good question, Cynthia. In fact, Jill Fisch, who's here today, signed an ESG petition not long ago that I was very impressed by.

**Jill Fisch:** Cynthia wrote that petition.

**Jackson:** I didn't know that! It's a great petition, important work. I wouldn't oppose such a rule; but since we're at a law school, I want to push back a little. Suppose companies were required to make disclosures about different forms of human capital. Now, is your thinking that such disclosures would encourage corporate managers to do a better job of thinking through, say, their human capital investments by being held accountable for such investments?

**Williams:** Possibly, but not necessarily.

**Jackson:** That's, I think, what Colin would say, too. While favoring such disclosures, he would probably also say that, in cases where shareholders and managers agree that what might be best for long-run shareholder value ends up hurting employees—say, shutting down an unprofitable plant—they will continue to agree to pursue the value-maximizing course. All disclosure does in such cases is provide transparency with respect to that agreement.

Now, I think Colin might push for something more in such a case; he might want boards to intervene and maybe say no to such decisions. So, even when managers could agree with their shareholders in perfectly transparent terms that it would make sense to shut down a plant and lay off workers, managers would be prevented by their boards from making such a decision as a matter of fiduciary obligation to consider all stakeholders.

**Williams:** We don't even have to go that far into the fiduciary duty argument. Boards and managers are already making decisions that affect social capital; and by disclosing such effects, they would be forced to explain and perhaps justify them to markets, and in the court of public opinion. I also think such accounting could help solve Jeff's political problem, which is to persuade Congress to agree to a new social insurance scheme. And, finally, we might be providing accounting firms with a new business opportunity from providing new or better measures of these kinds of implications and more information.

**Jackson:** I think those disclosure proposals are important steps forward. But what I want to avoid is holding up a potential solution as complete when it's not. My goal with this kind of disclosure is that it be designed to encourage companies to make the investments that we know they are making and should continue to make. The challenge would then be coming up with measurement devices, and that would be an interesting debate. And I'm sure the accountants would be happy to help us.

## Curbing Shareholder Activists?

**Trevor Norwitz:** Rob, you've expressed concern about the concentration of power in the hands of too few people. But I think we need to remember that these are not just ordinary mortals. What we're talking about here is a race of supermen. We have one person who at the moment is trying to take over the board of directors at Magellan and Dollar Tree, who did take over Papa John's Pizza, and tried to take over the board of Bristol-Myers Squibb and stop a big transaction. This is a person who knows not only how many breadsticks should go on a table, but which molecules a major pharmaceutical company should be investing its R&D dollars in.

And what's important here is that the institutions seem increasingly inclined to support these people. Though BlackRock now votes only 20% of the time with the activists, that number is going up. Vanguard votes with activists 30% of the time. And for T. Rowe Price the number is 50%.

The government obviously also believes in their "superhumanness," in part by giving them lower tax rates than any other working Americans. And it allows them to circumvent rules like 13D that were put in place to ensure people know when they're sneaking up on companies.

So, since everyone recognizes that these people are really a master race of people, should we really be worried that they are asserting so much power? We're basically giving it to them.

**Jackson:** Trevor, I think the concerns you're raising are very real, and I want to be specific about the way in which they're real. In my second year on this faculty, Jeff Gordon and Ron Gilson wrote a paper about the degree to which hedge funds have increasingly been setting the agenda that gets in front of investors. Though first published in the *Columbia Law Review* about five years ago, it was just reissued as the lead article in the Spring 2019 issue of the *Journal of Applied Corporate Finance*—and I strongly recommend it.

The question raised by this article—and the one that we have to ask ourselves—is whether the hedge funds are the folks who should be setting that agenda. Should they be the people asking the question about breadsticks or molecules? I think that's a really valid question to ask, and I'll leave it to all the smart people in this room to help answer. But, as Jeff and Ron point out, the hedge funds, by virtue of the large positions they take in individual companies, may well be the only outside investors with the incentives and capabilities to ask those questions. As Ron and Jeff show, the large institutional investors, and especially the indexers like Vanguard and BlackRock, have very weak incentives, and limited capabilities at best, to do the kind of fundamental analysis that gives them the confidence to take such large positions in individual companies.

But all that said, Trevor, you're not wrong to point out that our securities laws are set up in a way that these folks can and do take advantage of. And as a Nation, I think what we should be asking is, are those the folks who should be setting our corporate agendas? I think it's a question to which the answer is not obviously yes.

**Coffee:** We've reached the end of our time. Now that we've heard Rob speak, how many of you agree with me that he should go after the big prize?

COLUMBIA LAW SCHOOL SYMPOSIUM

# Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)

## SESSION IV: THE LAW, CORPORATE GOVERNANCE, AND ECONOMIC JUSTICE

**Columbia Law School | New York City | March 1, 2019**

Leo Strine
Chief Justice,
Delaware Supreme Court

Jill Fisch
Saul A. Fox Distinguished
Professor of Business Law,
University of Pennsylvania

Eric Talley
Professor of Law,
Columbia Law School

Bruce Kogut
Sanford C. Bernstein and
Company Professor of
Leadership and Ethics at
Columbia Business School

Mark Roe
David Berg Professor of Law,
Harvard Law School

**The three panels we heard this morning have discussed significant aspects of this emerging movement toward the idea of stakeholder- as opposed to shareholder-focused governance. But this is hardly a new debate. …You can easily trace today's shareholder vs. stakeholder debate at least as far back as the 1930s. – Eric Talley**

**Eric Talley:** Good afternoon, I'm Eric Talley, one of the co-directors of the Millstein Center. I teach and do research in corporate law, M&A, corporate finance, contracts, and business stuff generally. And it's a great pleasure to moderate this panel here this afternoon.

We've decided to do things a little differently, and to ask each of our four panelists to make statements before we start mixing things up. Before we get started, let me run through a brief set of introductions.

In the power stool here is Chief Justice **Leo Strine** from the Delaware Supreme Court. As well as a good friend, Leo is a leading light of corporate law, well known to practitioners, academics, other judges, and regulators and legislators. And more important, by wearing jeans for this event, he's effectively given us all the right, had we chosen to use it, to ditch business attire for the panel.

After Leo will come **Mark Roe**, who is the David Berg Professor of Law at Harvard Law School. Mark's teaching and research focus on corporate law, governance, and bankruptcy. Many of you know Mark because he cut his teeth and his checks here in Morningside Heights for many years as a member of the Columbia Law School faculty. So notwithstanding that improvident move north, welcome back to the fold, Mark. It's great to have you here.

To Mark's left is **Jill Fisch**, the Saul Fox Distinguished Professor of Business Law, and co-director of the Institute for Law and Economics, at the University of Pennsylvania. Jill does extensive work in corporate law and governance as well as securities regulation. Jill and I have known each other for over 25 years, having first met when we were green, young professors.

**Jill Fisch:** You were green.

**Talley:** Well, I guess so. But for the record, we were both only 10 years old at the time.

And then to my left is **Bruce Kogut**, the Sanford C. Bernstein and Company Professor of Leadership and Ethics at Columbia Business School. Bruce is a leading national expert on corporate governance and ethics from the business side. He teaches a course in governance at the business school, as well as a new class in business strategies for solving social problems. And having sat in on that class, I'm a big fan of his teaching as well as his research.

So, now that you've been introduced to our cast of characters, we're going to kick off the panel with Chief Justice Strine. And I want to be a little bit of a provocateur before I get you rolling, Leo, because I know I won't have much of an entrée afterwards. The three panels we heard this morning have discussed significant aspects of this emerging movement toward the idea of stakeholder- as opposed to shareholder-focused governance. But this is hardly a new debate. Even the Milton Friedman contribution in 1970 was really just a weigh point along the road. You can easily trace today's shareholder vs. stakeholder debate at least as far back as the 1930s.

But for me personally, the debate goes back to an academic symposium nearly two decades ago, where I was a panelist alongside some dude named Vice Chancellor Leo Strine—and it was on exactly the same topic. And to prove it, let me just quote from the article Leo published from that symposium, in 2002 I think it was:

*The predominant academic approach to the purpose of the corporation holds that it exists primarily to generate stockholder wealth and that the interests of other constituencies are incidental and subordinate to that primary concern. The school is dubious of allowing corporate boards of directors to consider values other than the best interest of their current stockholders.*

*Another string of thought, however, has deep roots as well and sees the corporation as a societal institution with responsibilities larger than the provision of returns to the current stockholder base, a base that often comprises largely transient equity holders with no long-term stake in the* *fate of any particular corporation. In this conception the corporate board of directors owes duty to the corporation itself rather than the shareholders, and in weighing any appropriate course of actions, the board is entitled to think about the well-being of other constituencies.*

*These competing arguments are appealing because they make us feel better about whichever of the two models we tend to favor. Best of all, they provide courts and other decision makers with a way out of a basic conflict. If a board of directors can plausibly claim that the decision to reward employees with a pay raise now will pay off in the long term, and provide a return for shareholders, the need to side with one of the two approaches magically disappears.*

To me, Leo, that passage can be read to make a sly type of defense of old-school shareholder primacy doctrine. And so, my question to you is, what if anything has changed during the last 15 to 20 years since you wrote that? Why is this debate coming up again and again? And is it now different from the way it's come up during all the years you've served on the bench and in practice?

**Leo Strine:** I think the debate's never gone away, and I'm not sure it's different today than in the past. But the scope of the issue, and the consequences of getting it right, have both gotten bigger.

But let's start with three words we haven't heard yet today: "The New Deal." I'm not talking about the *Green* New Deal, although I support aspects of that. I mean the New Deal. And I want to mention two other words: *Citizens United*. It's surprising to me that here we are at 2:00, well past the midpoint of a full-day meeting, and we haven't heard either of those mentioned.

I also want to go back a little bit in the history of the corporations, and of corporate law, but not nearly as far as my learned friend Colin Mayer does. But I'm guessing that most people in this country have forgotten what the word "general" means in "Delaware general corporations." When corporations got their start in this country—though don't tell the late Justice Scalia or Chief Justice Roberts this—there was no such thing as general corporation statutes. The government chartered all corporations for a specific purpose that a very long charter spelled out. And the *ultra vires* doctrine had teeth, which meant that companies could only take actions that were related to their state-sanctioned purpose.

But then, between 1880 and the 1920s, general corporation statutes emerged that, though using a basic template, had lots of provisions allowing specific acts. One common one said that, if you wanted to do a merger, you had to get the unanimous vote of your shareholders. And the *ultra vires* doctrine stayed in effect, ensuring that companies were prohibited from taking actions not explicitly allowed by their charter or by law.

When the general corporation law statutes emerged and corporations were allowed more flexibility, one of the first reactions was to regulate the corporation's ability to act on behalf of society. Really anti-business people, like the New York business people who supported Teddy Roosevelt, were among the first to support regulations banning political contributions by corporations.

But that brings us to the great debate between Adolph Berle and Merrick Dodd, which has often been misunderstood. It was a "gotcha game"—one familiar to academics—where you take a part of your opponent's thinking and try to score a point by taking it out of context and distorting it.

In the early 1930s, when he was still a professor at Columbia Law School, Adolf Berle wrote an article saying basically the following: We have not yet had a New Deal. There's now a group of people down in Delaware working with New York lawyers on corporate law. Our general corporation statutes are getting more and more general and less particular. And we're concerned about this phenomenon because corporations are less closely held and the people who own the equity have less of a stake in a particular corporation, corporate managers may feel more free to act in ways that hurt their investors, and other people too. So, Berle's article basically concludes by saying, "We better keep corporate law and require that companies stick to their knitting by putting their shareholders first; because if we allow managers and boards to do anything other than that, they will then justify their actions by claiming the greater social good, and they will end up being accountable to no one."

So into this debate comes Merrick Dodd, a Harvard Law prof who looks like a lib when he points with approval to the head of General Electric's statement: "We're not simply about our stockholders. We're about society and everybody else, and why shouldn't we be able to balance all these interests?" Well, that sounds kind of "woke," to use today's word. But what was Dodd really arguing for?

Again, it's important to remember that this is the early '30s. Dodd was arguing that we, the business elites, have learned our lessons. And we know how to fix the things that brought you this Depression, and the height of inequality—and I'll come back to this, because we're now seeing levels of inequality we have not seen since that era.

So, here's Adolf Berle, the brain truster who wrote the key campaign speech about the economy for

In terms of the ESG movement and everything we have to do, I think we ought to be very careful not to forget, or confuse, what the Securities Acts were about. It's important that everyone understand what corporations do—both what they *are* supposed to do for society, and what they *are not* supposed to do. That's something everyone should know, whether they own publicly listed securities or not. – Leo Strine

Roosevelt—and I'm not going to pretend that the framers of the New Deal knew exactly what they were doing at every moment because Roosevelt was an experimenter. But in his debate with Dodd, Berle was basically saying, "BS on you. I'm a supporter of the idea that the corporation should operate within a structure—and we're now in the process of creating that structure. And the reason we need that structure is that we can't just trust economically powerful people to do what's best for everyone else; people with economic power should act with economic accountability—with power comes responsibility."

Another clear lesson from the 30s—something I also like to focus on—is that power drives purpose. So, what happened in the U.S. when we adopted the New Deal? For all its imperfections, it got us through a time of rising authoritarianism, a time when Communism had an appeal—even within our borders. We had people like Father Coughlin and Huey Long. People forget this. I got quoted using the "C" word the other day. I can't be political, of course, because I'm a judge. But it's pretty obvious who I'm going to support in the next presidential election, and it's not Bernie. It's the person I've supported since I was nine years old.

But when mentioning Bernie the other day, I had to point out that, although Bernie will embrace the term "socialist," he has never called for state control of the means of production. What he has said is that there are places in the world like Scandinavia and Germany where market economies have succeeded while taking into account the needs of the many. European social democracy is the descendant of the New Deal. There's a great biography of Clement Attlee showing that he was a huge admirer of the New Deal and that his Labour government—and by the way, no government was more anti-Communist and more anti-fascist than Attlee's—put in place many of the elements of the economic security program adopted by the New Deal. And much of this was later adopted by the EU.

There's also a period of French history called the Trente Glorieuses—the 30 glorious years—that I think is worth talking about. What was that about? Well, think about what the New Deal accomplished. The scope of the American economy had become nationwide, but the regulatory framework had to be extended to address the new realities that came with that kind of economy. The New Deal provided that scope. And as things turned out, Franklin Roosevelt and others—including Adolf Berle, who was involved in the State Department by then—had the vision that allowed the New Deal to go worldwide.

What happened was a period of American and European, or OECD, hegemony where people thought that you didn't actually need binding protections. So we had this period of economic security in Europe. Because of Adolph Berle and his Delaware colleagues, businesses have continued to operate within a structure. And Berle himself actually said something like this in the 1960s: With my arguments in corporate law so focused on stockholders, I think we can now actually relax some of the legal protections for shareholders a little bit because I feel more comfortable now that businesses are operating within constraints.

When Marty Lipton wrote his article in the *Chicago Law Review* in 1978, he said that it's got to be passé to think that businesses will focus only on profit, because they can't any longer; they have to focus on the safety of consumers. They have to focus on the environment. As I was saying to

Colin, we no longer have foggy London because of government regulation; foggy London was pollution.

But I also want to give some credit to Milton Friedman, even though I don't really agree with anything the man said. But in the context in which he wrote his famous article, his ideas are not nearly as extreme as they're now viewed by students. And here's the reason. He wrote that in 1970, when there were very strong regulatory protections for workers—not just in the EU, but even in the United States. If a union got elected and you didn't recognize them, the NRLB would actually do its job, kick your butt, and make you bargain with them. So when Friedman wrote that business should stick to its knitting, while staying within the rules of the game, that may not have been so bad—because the rules of the game were actually quite vibrant then.

But what's happened since then? Well, in international trade we have worked to open borders. That was part of the vision, right? But what did we globalize? We globalized the power of mobilized capital. We made countries open up their markets. But did we provide global protections for working people? No, we did not. Did we therefore expose workers in our communities to competition from other places that treated workers less fairly? Yes, we did. Did we shift jobs to places where people could externalize their environmental costs in a way that you couldn't in the USA? Sure we did.

We also allowed countries, states, and municipalities to get played off against each other and shift the tax revenue burden away from business and toward ordinary people. Look at the share of school taxes and other things paid in the United States. We also allowed hypocrisy. What's the world's most famous Dutch rock band? It's U2. U2 is Bono, and Bono suggests stuff for everyone to do. And you know what *he* did? To avoid paying his taxes, he's become a *Stichting*, a Dutch limited liability corporation that ensures he pays as little income tax as he can.

And that brings me back to the question of economic inequality. What's happening now is what I call the "re-aggregation of capital." I've written and talked about the "separation of ownership from ownership" for a long time. What is the most federally subsidized industry in the United States? It's money managers. Why do I say that? Because for everyone of us who works and pays taxes, some of our money is going to money managers every week. And they hold it till we're 60. If we save for retirement, or to send our kids to schools like Columbia, then part of your paycheck is going to a money manager who gets fees for managing it.

Now, when your money goes to a money manager to buy shares, you don't have any control over how your shares get voted. The intermediaries do. And over time, regulation—the rules of the game—have gotten weaker. The things that protect workers have gotten weaker. Particularly in the United States, the bargaining power of workers has gone down. Where we've seen moderately less inequality in some OECD nations, that's because even at companies that don't have unions, they have mandatory work councils that give labor power in those societies that we don't.

So, with the increase in the power of capital over corporations, the gain-sharing between workers and the equity holders has shifted profoundly toward capital. I recently heard some billionaire hedge fund guy say the real problem since the financial crisis is that the "economic pie" hasn't grown fast enough. Well, sure, I'd like a bigger pie, too. But if the people with the capital shared the same frickin' amount of the pie that used to go to the people who sweat, there'd be a lot less inequality. The fat cats at the top grab a bigger share of the pie, and the representatives of ordinary people—the money managers who hold our equity capital for us—have been in some ways part of the problem.

Take corporate California. I love California, but California started to have a problem with social underinvestment during the years when they had to have referenda to pass anything. Institutional investors have made public corporations into the same kind of referendum-driven institutions. When you subject the boards of directors to the immediate whims of the marketplace, increase proxy votes on all kinds of proposals, and the market puts pressure on them, boards are going to respond to that pressure. And one of the biggest effects of that market pressure is, again, this shift in gain-sharing from the people employed by, and who sweat for, corporations to the people who supply the capital.

So with that said, I think we have to talk about Colin's question of power and purpose. My only disagreement with Colin is this: Do I think there's an insight to be had in the design of corporate law about the purpose of the corporation? Sure I do. But when corporations were founded, most of them weren't all over the globe. When corporations did well and expanded, they tended to create jobs in the communities in which they operated. And the people who worked for the corporation, managers as well as employees, often lived in the community where it operated. So there was more of a connection to a particular community and social setting, more gain-sharing as a matter of course. But with the globalization of the economy, and all the overseas investment, a lot of those connections have eroded—and that's created a problem for the corporation.

The answer of the institutional investor community to this problem has been to rely on what I call "the thermometer." And the thermometer is the "independent director." The independent director acts as a thermometer of the market. Independent directors are defined as people who have absolutely no connection to the company that would give them any reason to favor one corporate constituency over another; they're supposed to be resolutely impartial in that sense. But they are supposed to represent the long-run interests of the shareholders; they do this by acting as an instrument that recognizes what's going on in the market and making sure that the market's view is understood by management and the rest of the board.

But if that's the corporate purpose, what about corporate power? Eddie Cochran wrote a great song called "Summertime Blues" in which a teenager, after complaining he can't get the car to go out with his girlfriend, says, "Well, I called my Congressman and he said, quote: 'I'd like to help you, son, but you're too young to vote.'" In the American polity, corporate law says that the only constituency with the right to vote or do things is the stockholders. At the governmental level, our polity doesn't stop society from deciding to make contributions to the environment, social responsibility, the arts and cultural activities and from prioritizing these things. But within the corporate polity, the people who are the citizens, the people who really matter and have a vote, are the stockholders.

But all that said, there's been no Delaware case in the last 20 years that prevents the board of directors of a prospering corporation from allocating a larger share of that prosperity to the workers—that is, the same share as would have been allocated in 1975 or 1965. These decisions that favor capital have all been done by these boards of directors and their managements. Do I think that's because they're evil? No, it's because they operate within a power accountability structure and they're answerable to one constituency.

Milton Friedman's argument that corporate law should stick to its knitting—focusing on the relations between managers and stockholders—and leave the rules of the game that protect other constituencies to be set by the political process—is no longer as credible as it once was. And this is where *Citizens United* comes in. And here, Jeff, I want to take issue with your use of the term "asset owners." These people are mostly not the asset owners; they are direct fiduciaries, intermediaries, of American investors. Most Americans don't own Google and Apple directly. Their shares are held—or controlled and voted—by Vanguard and Fidelity. Fidelity, which has a lot of my money, is now the third-biggest indexer. And indexers are not asset owners; they're just as much an intermediary as anyone else. The asset owners are the actual working people whose money goes into the system.

Now, in terms of rules of the game, we have *Citizens United v. Federal Election Commission*, which expanded political spending by corporations, and an interesting case called *Burwell v. Hobby Lobby Stores*, where the Supreme Court ruled that owners of the stock of a family-owned corporation can't be required to pay for insurance coverage for contraception under the Affordable Care Act when it violates their religious beliefs. We had a corporation that actually provided four types of contraceptives for its workers as part of its healthcare plan. But when our Congress passes a bill providing for these contraceptives, suddenly it becomes a religious issue and women are prevented from having a healthcare plan where an employee wants to use a form of contraception that the controlling stockholders consider against their religious beliefs. Well, whose pay was it that went towards those contraceptives? Can controlling stockholders keep employees from receiving key, legally required healthcare benefits just because the controllers object? But the *Hobby Lobby* ruling shows that we have a court system that puts the rights of the few above the many.

Now, I've had a little argument with some of my friends who cited that case to say, "See, corporations can be about more than stockholders." And my response is, "That's a weird case to cite for anything good, because it's a bad case." And here's why it's bad. Why could the owners of a company prevent their employees from having access to contraceptives through their company health plan? Because they are the stockholders. This decision wasn't about a larger purpose. It happened because some particular people control that corporation.

But, now let's talk about *Citizens United*. Jeff, the third thing you didn't mention about the asset owners is that no one invests in index funds so that the ultimate companies can spend your money for political purposes. Whether you're a conservative who doesn't want those Silicon Valley folks talking their good game about whatever they think is the cool social issue of the day, or whether you're somebody who doesn't want the people who brought us carbon and who suppressed the research about it controlling our environmental policy, there's pretty much a consensus that we give the money over because we have to save for retirement, and we don't want corporations using our money to take political stands we might not agree with.

But what have we done? We've freed our creation to actually act on the rules of the game. And the people in the middle who are talking a good game—they abstain. They won't even vote: BlackRock, Fidelity, and Vanguard will give them a pass. Now they will vote on issues like disclosure. But they all know that no one authorized their vote. They also know the better CEOs don't want the ability to give because a legal prohibition on giving allows them to stay out of that business. But when you can give, you can get steamrolled into doing it. We now can't even trust the rules of the game to be set because if the Leviathan that we've created can actually take our money without accountability and use it, then guess what they use it on: to influence the very rules of the game that the other constituencies are supposed to rely upon.

And let me finish by giving a shout out to my friend Judy Samuelson at The Aspen Institute. A lot of us have been working on things that are not one-dimensional. I do not disagree at all with the idea that corporate governance alone is not a solution. But is it important? Is the way in which people vote, and the space that the investors give to the people running corporations to operate in a sustainable, responsible way important? Sure it is. And is there something to the idea that the longer-term interests of workers are actually consistent with those of most human investors, and that higher long-run returns to stockholders depend on our doing a better job of protecting the interests of workers in society?

I think there actually is. Because shortcuts get cut out over time. Externality costs are borne by all universal owners, as Colin says. I agree with him fully on that. If you can operate in a sustainable way, you can actually treat your workforce better. But things are going to be a lot harder if you've still got to compete with the WorldComs that engage in fraud, or with energy companies like Massey that operate with too few people—all because the punk-ass analysts are calling you up and asking why you can't replicate the performance of scum, and you don't have a credible answer—or you get beat up for giving your workers a 4% raise, which we've seen these analysts do.

But there are also things that we need to do on the government side. And organizations like Aspen are working on it, asking questions like: Can we tax in a smart way? Should we reduce speculation? Can we actually give more breathing room to the asset managers to think long term? How about a graduated capital gains tax? Or a fractional trading tax to stop fund hopping? How about investments in infrastructure?

We will not solve this problem just by looking within the domestic U.S., or within the EU alone. We cannot shut our eyes and our hearts and souls to the need for the developing world to move forward. But we don't have the time to learn the history lessons as slowly as we learned them before. If we allow the kind of environmental destruction that we had in the 19th century, if we allow ten more years of that to go on, we won't have a planet.

We shouldn't have to be debating minimum wages any longer. We know they make sense. We should not be debating child labor laws. We know they make sense. We know that working people need economic security. All the OECD nations agree. What we actually need to do then is to come up with better rules of the game, with policies that make sense across borders—and not allow the kind of arbitrage that we have, not compete with our basic values, and not pretend that any of the prosperity we have was solely the result of functioning markets.

That experiment's been done. That's when we had child labor, and no limits on pollution. That's what caused the rise of fascism and communism—the failure to address the problems of a system that's solely focused on lucre. We would not have the Internet if it were not for Al Gore. The government invented the Internet—and Al Gore passed a bill that gave it to the private sector. The industry in California could not make chips if they couldn't wash them in water, and they wouldn't have had water if it weren't for government.

In the case of many of the drugs that save people, much of the research in basic science has been funded by government. Our most effective form of philanthropy is when we pay our taxes. A billionaire who pays an effective tax rate of less than 10%, but then gives 1% to charity and gets feted, is socially irresponsible compared to a working person who pays an effective tax rate of 20%. So I think we need to talk about all these dimensions, but we cannot talk about the purpose of corporations without considering the power structures within which they operate.

So, Adolf Berle was a realist. He's one of my heroes, and so is George Orwell. If we want to do good things, we have to be clear-eyed about what we're doing and how we're doing it. That's a tradition at Columbia Law School, and I'm proud to be here—and I probably took too much time. But that's my counter-narrative. And I'm wearing Levi jeans, which, last time I checked, were

The economy-wide evidence does not point to stock-market-driven being a big problem... There's something else going on.

– Mark Roe

still being made in the United States of America.

**Eric:** Now, we will hear from Mark Roe, who, as I told you earlier, is the David Berg Professor of Law at Harvard Law School. Mark, take it away.

## A Closer Look at Stock-Market-Driven Short-Termism

**Mark Roe:** Thanks, Eric. When Jeff asked me to be on this panel, he suggested that I look through Leo Strine's published work in the law reviews to identify the big themes. I teach one of Leo's articles every semester in a corporate law seminar. And so I've got good familiarity with them and know their big-picture themes.

Two major issues keep coming up in Leo's work, one of which we heard a lot about in his presentation just now. The second one Leo mentioned only briefly in his talk, but it plays a big role in his writing.

The first of the two big themes is that to be a successful institution, the public corporation has to work for the average person, and it has to be *seen* as working for the average person. The second theme is that stock-market-driven corporate short-termism, with all the relentless trading and hedge fund interventions, deeply damages the American corporation and economy, and we've got to do something about it.

Those are two big-picture topics that we could talk about for my 10 minutes. I'm not going to talk about the first issue because I agree on the essentials with Leo. If Leo were campaigning for office, he would get my vote on these issues—because I share most of Leo's vision of what's wrong and what needs to be fixed. I'd just add that in looking for solutions, we should be guided by the utilitarian principle of seeking the greatest good for the greatest number. Most of us are, I think, but we can disagree on how to get there. Even Milton Friedman's shareholder primacy view, which Leo criticized, was justified by the expectation that it produces the greatest good for the greatest number.

The second big theme in Leo's writing is corrosive corporate short-termism. The theme of this conference is "narratives and counter-narratives." But here the question of what is the narrative and what is the counter-narrative lacks a clear answer. The most common narrative is that short-termism is rampant and a deep problem, and Leo strongly believes that. So what I'm now going to provide is thus a counter-narrative: namely, that the economy-wide data does not point to stock market short-termism being a deep problem.

Short-termism has been seen as a deep problem for a long time, with there being something close to a consensus now that market-driven short-termism is one of the major economic problems facing the U.S. economy today. For example, Marty Lipton, in his 1979 *Business Lawyer* article on takeover bids, said that "It would not be unfair to pose the policy question whether the long-term interests of the nation's economy should be jeopardized to benefit speculators." And Joe Biden recently wrote a *Wall Street Journal* op-ed stating that "Short-termism is a problem. It's a problem in the way it hurts employees and workers." And from the business community we've heard similar statements from Warren Buffett and Jamie Dimon in the *Wall Street Journal*.

Justice Strine is in this consensus camp. One of his articles has the title, "Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Think in the Long Term?" In another article, Leo states that "directors are increasingly vulnerable to short-term objectives, sacrificing long-term performance for short-term shareholder wealth."

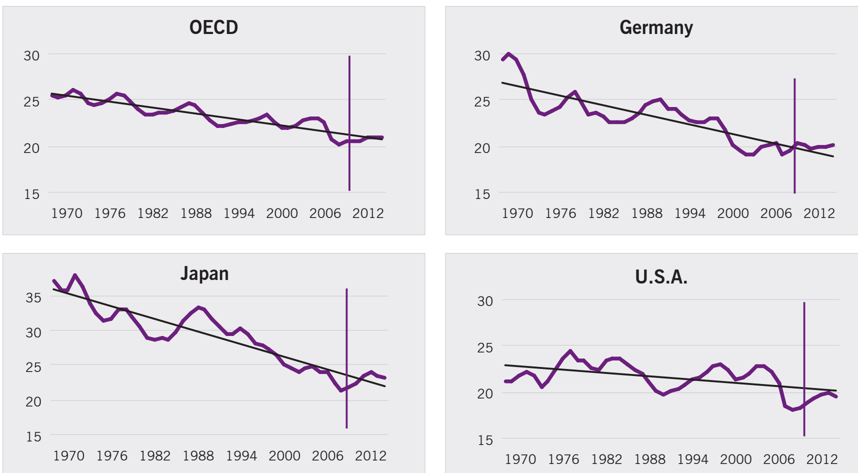
## Four Strands of the Short-Termism Argument

When I took a comprehensive look at the literature on the subject, including Leo's, I found that there are four main, interrelated consequences associated with stock-market-driven short-termism. One focuses on cutbacks in corporate capital expenditures. A second is that pressure on companies

*Slide 1*

**Economic Change: Capex Is Down throughout the OECD**

The Similar Capital Expenditure Trends *throughout* the OECD




Source: The World Bank National Accounts, gross fixed capital formation (% of GDP), https://data.worldbank.org/indicator/NE.GDI.FTOT.ZS?end=2016&start=1960&view=char (accessed Jan. 2, 2018).

for distributions—that is, dividends and stock buybacks—is starving companies of cash. The third is that these cash shortages are leading to cutbacks in research and development. And fourth, and perhaps most troubling, is the claim that stock markets in their obsession with near-term profit don't support longer-term innovation by giving innovative companies full or fair valuations.

The overall consequence of these four elements is that we suffer from a much weaker economy than we would have otherwise. And let's just look at each of these four complaints—the four big themes of the short-termism literature.

*Capex*. Start with the decline of corporate capital spending. And it is declining as a percentage of GDP, there's no doubt about it. But why is it declining?

The dominant hypothesis has been that stock market trading and activist interventions have forced companies to cut back on productive investment to generate higher near-term earnings and returns on capital. But there are simpler, and more plausible, alternatives. One, we've just come through a weak recovery from the financial crisis, and the recent big drop in corporate capex is likely a lingering effect of the crisis. But there's another possibility we've got to look at—that there's something much more fundamental that is happening in the economy that's causing companies to use hard assets less and soft assets more than ever before. And these soft assets don't get recorded on the balance sheet.

Here's a slide that I think is worth looking at again and again (Slide 1). As you can see in the bottom right, capital expenditures as a percentage of GDP in the United States have been falling for the past several decades. But when you look at the rest of the OECD over the same period, the slope of their decline in capital expenditure is actually sharper than it is in the United States. Capital expenditures to GDP in Germany and Japan, where the stock market plays a much less important role in corporate finance than in the U.S., have declined *more* sharply than in the U.S.—the country where, with the possible exception of England, companies rely most heavily on the stock market.[1]

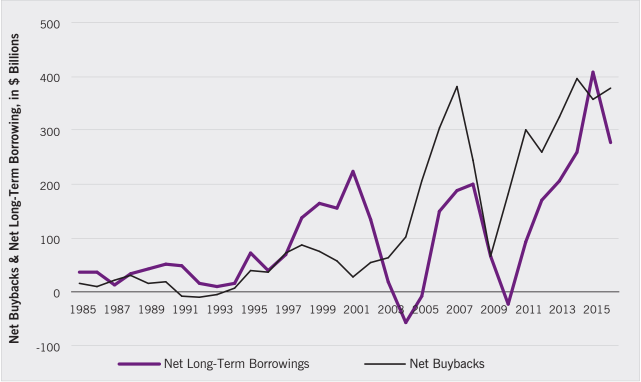
So, is the stock market the likely culprit? Maybe. But I'd suggest instead that companies now operate in a post-industrial economy that is fundamentally different from the prior, hard-asset-intensive economy. Today's companies are also making more efficient use of capital equipment than in the past. The comparative data should at least give us pause before jumping to the conclusion that the American stock market is causing capital expenditures to decline.

*Buybacks as draining cash?* But what about the second charge? Are corporate distributions via stock buybacks leading to a cash shortage? Stock buybacks are, of course, one of the castigated consequences in the current debate. And there's no doubt that there's been a significant increase in buybacks by the largest U.S. companies—say, the S&P 500. But what many of us fail to recognize is that there's also been a comparable increase in net borrowings by the S&P 500 companies over the same period. In fact, it looks as if since the financial crisis, the entire large corporate sector has maintained roughly the same level of total capital while recapitalizing itself, replacing equity with increasing debt. And with interest rates at near zero from 2009 until now, this would appear to be a sensible thing

1 The underlying sources for the graphics and data in this talk can be found in Mark J. Roe, "Stock Market Short-Termism's Impact," *University of Pennsylvania Law Review* 167:71–121 (2018).

*Slide 2*

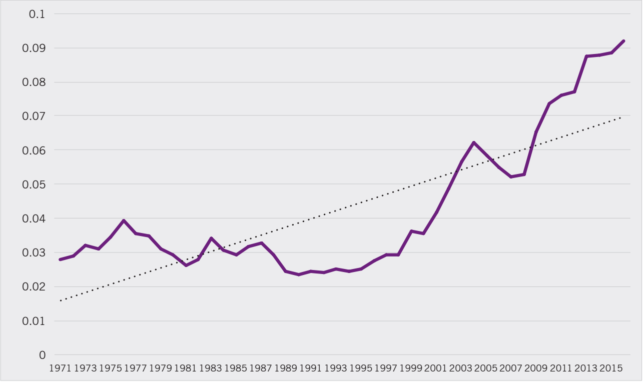
**Rise in Both Net Stock Buybacks and in Net Borrowing in the S&P 500, 1985-2015**




Source: The Compustat database was the source for the buyback and cash-on-hand data. Compustat Industrial [Annual Data], Standard & Poor's [accessed various dates in Jan. 2018]. Retrieved from Wharton Research Data Service.

*Slide 3*

**S&P 500 Cash-on-Hand as a Portion of GDP, 1971-2015**




Source: The Compustat database was the source for the buyback and cash-on-hand data. Compustat Industrial [Annual Data], Standard & Poor's [accessed various dates in Jan. 2018]. Retrieved from Wharton Research Data Service.

to do, firm by firm. Debt has become cheap, and companies have been issuing debt to buy back equity.

This recapitalization may not end up being good news for shareholders and the economy. It could be bad news if we have a recession in 2021 in which thinly capitalized companies are forced to struggle with heavy debt loads. But, again, this is not a buyback issue in the sense that buybacks are starving the firms of cash; the companies are changing their capital structures, not getting rid of capital.

What's more, any shortage of cash from buybacks or other payouts are unlikely to be causing cutbacks in capital expenditures for the simple reason that the cash balances of the S&P 500 companies have been *rising steadily*. The cash balances might be even higher without the buybacks, but U.S. companies are not starved for cash.

*R&D*. The third prominent complaint about the short-termism of the stock market is that it's killing corporate R&D. The reality, however, as shown in Slide 4, is that research and development expenditures have been going up in the American economy noticeably more sharply than the GDP is growing. True, this kind of economy-wide increase does not amount to an irrefutable rebuttal to the short-termism argument. We don't know whether we might have had even more R&D in the absence of such stock market pressures. But we know that hedge fund activism has gone up dramatically during this period, yet we see no sign that such activism and increased market trading have been reducing R&D from what it was.

*The stock market fails to support innovation and the future.* And this brings me to the fourth and final claim about short-termism—the stock market's failure to recognize and properly value corporate innovation and innovative companies. If the stock market were failing to value future-oriented companies, we wouldn't see that in 2018 the five largest stock market caps in the United States are Apple, Amazon, Microsoft, Google, and Facebook. Now, maybe we should expect to see *all ten* of the largest companies be future-oriented companies. But this doesn't look like a shortsighted stock market to me.

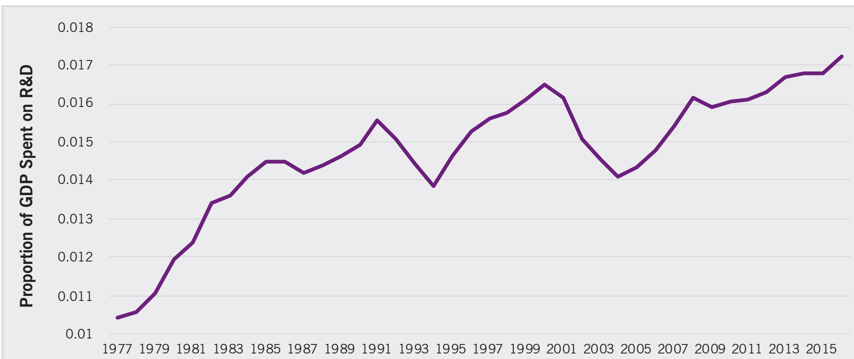
So, to summarize what I've just said, there is little evidence to support the widespread consensus that we have a serious stock market short-termism problem that is destroying critical aspects of the economy. And there is no evidence that it's killing research and development or starving firms of cash.

Why, then, is short-termism such a prominent issue? I suspect it ties into the first aspect I mentioned as one of Leo's two big themes. There's a widespread sense that the large corporation is not delivering the goods for the average person, and that something's gone wrong with capitalism.

My worry here is about the consequences of continuing to believe that stock market short-termism is the cause of big problems in the economy, when there's little or no economy-wide evidence to support the proposition. If we persist in believing that short-termism is the problem, we're going to have some seriously misdirected

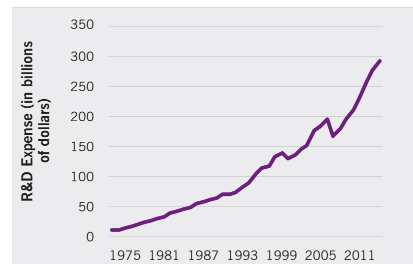
*Slide 4*

**R&D Spending in U.S. as a Proportion of GDP, 1977-2015**

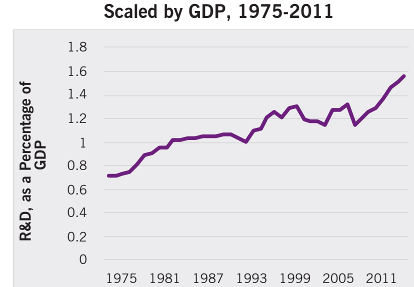



The R&D data is from the Department of Commerce's Bureau of Economic Analysis, a standard government source of economy-wide data. Bureau of Econ. Analysis, U.S. Dep't of Commerce, National Income and Product Accounts, Table 5.6.5, lines 2 & 6 (2017), http://www.bea.gov/itable/ [https://perma.cc/HM9A-7XM3].

**R&D Expenditures in the Non-Financial S&P 500, 1975-2011**




**Scaled by GDP, 1975-2011**




remedies. For example, if we take a managerial perspective that Marty Lipton's talk provided us earlier today, and if we identify stock market short-termism as a deep problem, one of the remedies might be to give managers and boards even more discretion than they have now. And I think that would be the wrong way to go.

Or, what if basic problems in the economy attributed to stock-market short-termism result from *other* difficulties; for example, what if there's too little competition in the economy right now? Too little competition will frequently show up in declining investment in assets. An oligopoly tends to invest less than a more competitive industry. If that turns out to be true—I'm not saying it is, even though there's more evidence of significantly increased concentration in the United States in the last 25 years than of stock-market-driven short-termism—then the corporate governance remedies that we would think about aren't going to help with the problem. If the fundamental problem with buybacks is not so much the buybacks themselves, but the tremendous buildup in debt that will be destabilizing in the next recession, then we should be focused on reducing the debt, and probably on eliminating or reducing the deductibility of interest instead, of criticizing buybacks or holding up some other corporate governance solution as the cure.

So, maybe this is a good news as well as a bad news story. The cardiologists of the world have come in and looked at the patient and said, "You're really sick. We've diagnosed you as having a significant short-term cardiac problem and we're going to need to operate." But then another doctor comes in and says, "You actually don't have much of a cardiology problem. You've got a problem, but it's not a cardiology problem. It might be a cancer problem, it might be Alzheimer's, it might be Parkinson's; but we've got to look more carefully, and the solutions don't seem to be easy ones."

What I think we can say is that, based on the economy-wide evidence, we don't have much of a stock-market-driven short-termism problem. There's something else going on, and we need to figure out what it is and how to fix it. Thank you.

**Talley:** Thanks, Mark. Before we ask Leo to comment, I think it probably makes sense to go through all of the presentations. So I want to move straight to Jill Fisch. Jill, as I told you earlier, is the Saul A. Fox Distinguished Professor of Business Law, and co-director of the Institute for Law and Economics, at the University of Pennsylvania.

## Is There in Fact a Corporate Governance Problem?

**Jill Fisch:** Thanks, Eric. It's a great pleasure to be here. And Mark's lead-in is perfect because I'm not sure whether I see the glass as half full or half empty. There's certainly something in the glass.

But in terms of the theme of counter-narratives, I guess I want to question how much of a problem we have at all. The title of our panel directs us to think about the role of those who have power in the corporation and their capacity to affect corporate purpose. But let me start by asking the question that Colin teed up this morning: Is there some urgent need to rethink corporate purpose? We have heard a lot of really smart people this morning who have had a lot of different things to say. I think rethinking is generally a good thing, but in terms of an urgent need to change, I guess I'm not sure that I see the emergency.

So why don't I see a need for change? Let me start by asking the question: how do we know when we need a change? Presumably the first step is to identify a problem in the way corporations are currently behaving. So what is our data set?

Josephine Nelson talked earlier about the Volkswagen emissions scandal as an example of the problem we have with respect to ESG. Volkswagen concededly was a tremendous environmental problem—one that was made worse by the greenwashing that went on. But it was also an outright fraud. My point is that we tend to hear about "the outliers"—the cases of egregious corporate misconduct—and to extrapolate from those cases to believing that they are representative of corporate behavior generally. I think that is a mistake.

My own experience suggests that we've seen tremendous progress in corporate efforts to identify and deal with environmental risk. Corporations are paying serious attention to these issues and changing or modifying the ways in which they operate. Could they do more? Maybe—and there's obviously a question with respect to identifying the appropriate benchmarks by which to evaluate their performance. But corporate officers and directors are paying attention to environmental issues, and so are shareholders. We see this reflected, for example, in the shareholder votes at Exxon, Occidental Petroleum, and other companies asking for greater disclosure and board oversight about sustainability, climate change, and environmental risk.

The greater focus of shareholders, in particular, on these questions is part of the rationale behind the petition that Cindy Williams and I submitted to the SEC to require issuers to make sustainability disclosure. I see that petition as an effort to force corporations to become not only more sustainable, but more transparent about what they're doing—and for corporate boards to engage in greater oversight of ESG efforts and to provide shareholders with more information in order to evaluate corporate behavior. I think the most effective way to accomplish this is for the SEC to set norms and expectations with respect to sustainability disclosure in the same way that it has done for many other disclosure issues. The advantages of SEC rulemaking are standardization and accountability, but federal disclosure guidelines also reduce the potential burden associated with having to comply with the claims not just of shareholders but also non-shareholder stakeholders. So I see limited SEC rulemaking in this area not as an attempt to mandate greater social responsibility by corporations or greater stewardship by investors, but as a tool for generating data that enables a range of decision-makers to evaluate accurately what corporations are actually doing.

Another social issue that has received extensive attention in today's discussion is the problem of wealth and income inequality. Leo Strine's comments mentioned an increase in the minimum wage as a possible response to this problem, and a higher minimum wage was a high-profile topic of debate in the last presidential election. Of course the results of that election have not led to an increase in the federal minimum wage.

But what have we seen since the election? We've seen a substantial number of corporations privately raising the minimum wage that they pay their workers. Notably, they are taking this initiative *without* a national minimum wage requirement; they're doing it voluntarily. And despite the rhetoric we hear about the shareholder primacy norm, the shareholders of these corporations are not hauling them into court in Delaware and claiming this is a breach of their fiduciary duty. In fact, in many cases, the shareholders seem to be applauding. So again, while I agree that inequality is an issue that requires attention, what's important is the fact that, without a "new paradigm" or a "counter-narrative," corporations are paying attention to these issues and engaging in an ongoing dialogue about the responsibilities they have to their employees and their customers. Today's debate about inequality is thus another example of a compelling social problem, but not, I think, of a crisis in corporate culture.

## Rising Expectations

Why, then, all the hype over the need to rethink corporate purpose? I think our expectations for what business is supposed to do and what business can do are changing. And there are a number of factors that have led to heightened expectations. Businesses today are bigger than in the past. Bigger corporations have greater potential impact—they affect more people, they provide more jobs, they create bigger risks to the environment, use more natural resources, etc. Bigger corporations also have greater resources, which leads us to expect them to do more. Shareholders, customers, and the public at large may be unwilling to hold the family-owned grocery store on the corner accountable for evaluating and addressing issues in its supply chain. But when it's Amazon that's running the grocery store, it's a different story. We reason that if a company earns $11 billion in profits, it can have a meaningful role in addressing broad social concerns.

At the same time, the fact that businesses are global makes it more difficult for them to sort through and respond to these increasing expectations. They need to make choices about how to balance the different cultures, the different norms, and the compelling needs in a variety of jurisdictions. And that makes the question of determining the scope of their responsibility a lot harder.

Complicating the issue is the fact that corporations are also political actors. Justice Strine's latest article talks a lot about corporate political activity. He and I differ to a pretty big degree about the legitimacy of corporate political activity. But we do agree that because corporations are so big and global, they have more political influence, and that influence is something to which we should pay attention.

Corporations are subject to the demands of an increasing number of stakeholders—in addition to their shareholders—these stakeholders include their employees, customers, suppliers, creditors, and the communities in which they operate. For a corporate officer or director, this variety of stakeholders and the varying interests that they have with respect to the corporation's operations raise the question, "How do you balance the different stakeholder interests?" My view—and Marty Lipton and I share this view—is that corporations and corporate actors generally try to do the right thing, both with respect to their obligations to shareholders and the broader group of stakeholders. I've had any number of corporate executives approach me and ask the question: "We face pressure to consider this societal objective or interest, and we take it very seriously. But we also have the obligation to protect the interests of our shareholders. How do we strike a reasonable balance, and where do we look for guidance on those points?"

The corporation's obligation to consider broader societal interests is further complicated by the fact that corporations are interconnected. What one corporation does affects what other corporations do; it affects jobs, prices, and practices elsewhere. And finally, in this Internet era, corporations have access to so much information. In turn, access to information fuels the demands that we impose on corporations. As a society, we have the idea that, if you can find something out, if you can identify a problem with your suppliers or the living conditions in a community in which you operate or the effect of your business on the environment, you have a responsibility to do something about it.

## Problems with Reframing Corporate "Purpose" to Address These Concerns

These increased demands and expectations for today's corporations present a lot of challenges. And so our intuition is to reframe corporate purpose—to move away from shareholder economic value as the sole objective and instead have corporations embrace a broader social purpose. That is the premise behind Colin's proposal. The counter-narrative Colin defends would have corporate decision-making guided by a common purpose among corporate stakeholders that Colin sees as more closely aligned with societal welfare.

I guess I would urge restraint in accepting this premise, in large part because I am not sure that the idea of defining a single social purpose for today's large corporations makes sense.

First of all, who is going to choose the corporation's purpose? Will it be the board of directors? The executives? Representatives of the largest shareholders? Representatives of labor? These are all people who have some degree of decision-making power, but that power extends to different issues and they exercise that power in different ways. One clear trend over time has been shifts in the balance of power within the corporation—from the autonomous corporate managers of the Berle and Means corporation to the independent directors, to shareholder activists, and now, increasingly, to large institutional money managers. We might be worried about these shifts because they essentially allow different stakeholders to have different amounts of say about what the corporate purpose is.

But how do we reconcile differences among those different stakeholders? How do we deal with questions of competence and expertise? For many years, academics argued for greater shareholder power as an antidote to managerial empire building and other types of agency costs. Colin's book follows this trend. According to Colin, intermediaries such as asset managers, mutual funds, pension funds, and other big institutional investors should be engaged in more active stewardship. But what do we mean by stewardship? Does that mean institutional investors are not supposed to focus on the economic bottom line—which has been the traditional way we expect them to reduce agency costs? Does it mean instead that they are somehow

**If it is difficult even to figure out what a rational shareholder would prefer, how do we expect the average mutual fund to develop meaningful positions? And if we do not have a strong theory of rational preferences on the part of either the intermediary or its beneficiaries, what is our basis for challenging their current behavior? – Jill Fisch**

responsible for *compelling* corporations to consider non-shareholder value? The Department of Labor has instructed pension funds that they are not permitted to focus on non-economic social welfare, that their job as fiduciaries is to maximize the economic value of the fund in the interests of their beneficiaries.

Even if the Department of Labor is wrong, can institutions play an effective role as stewards for society? Commentators have recently begun examining the behavior of the large institutional investors who exercise that power, and many have argued that they have inadequate information, poor incentives, and agency problems of their own.

This presents enough of a challenge when the intermediary is tasked with stewardship directed to maximizing economic value. But to the extent that stewardship means things that are unrelated to or even in conflict with economic value, where do asset managers get the insight into which of those things are important, and how do they navigate the trade-off among competing priorities? Indeed, even the concept of shareholder value is problematic. Is shareholder value itself purely an economic concept, or can shareholders say, "Look, we care about the environment, and we want some kind of balance between preserving the environment and maximizing corporate profit? If shareholder value itself includes non-economic considerations, who makes that choice when the shareholder is an institutional intermediary?" Who gets to choose what those values are?

When we talk about shareholder power today, the new players are the big asset managers. Some people call BlackRock, State Street, and Vanguard the "Big Three" and we should probably add Fidelity to that list. But asset managers aren't shareholders, they're intermediaries that manage pools of assets for the benefit of their customers or beneficiaries. How does an intermediary decide what to do? Asset managers have their own incentives, their own objectives. I don't think we can reasonably expect them to operate their for-profit businesses with the goal of maximizing *social* values. But do we truly understand their incentives and interests when they engage in stewardship at their portfolio companies?

So, by way of example, Larry Fink at BlackRock has received a lot of attention for addressing some of the topics that are at the heart of this conference, for publicly pushing corporate management to consider a counter-narrative. But my question is this: when Larry Fink writes a letter to the CEOs of the big public companies telling them that they must have a social purpose, who is he speaking for? Is he speaking for himself? Is he speaking for BlackRock? Is he speaking for the shareholders in BlackRock's mutual funds? And how do we decide what any of those constituencies—who all have some degree of power in this counter-narrative story—how do we actually find out what they value and therefore how they seek to hold corporations and corporate purpose accountable? Do we go to the people whose money is in the retirement funds and say, "How much of a hit on the return, on the size of your pot of gold for retirement, are you willing to take in favor of the environment, or water conservation, or the supply chain?"

The agency problems stem, of course, from the fact that the large money managers are not owners but intermediaries; they exercise their power on behalf of the economic interests of the mutual fund beneficiaries, people that Jay Clayton refers to as "Mom and Pop 401(k)." One debate I continue to have with Rob Jackson is that if we assume we could somehow finesse all of the technical issues that Ron Gilson is rightly worried about, and could actually find out how the workplace-only investors who have their money in Fidelity and BlackRock and Vanguard funds would vote on some of these shareholder proposals, would we then necessarily want those votes to guide the decisions that corporate executives and directors make? I'm not so sure. Some of my work has focused on studying the financial literacy of retail investors. First of all, it is not very good. Second, when it comes to the subset of retail investors who own a substantial proportion of mutual fund shares—people I call "workplace-only investors" and who would likely be responsible for a lot of the votes by the big mutual funds—their financial literacy is actually as bad or worse than the average person who doesn't own any equity at all.

These limitations on the capacity of the so-called true economic owners to exercise shareholder power effectively are potentially problematic. Now one can respond by arguing that financial literacy is a different and narrower skill set. Even if these investors do not understand compound interest, they know how they feel about important issues like corporate political spending, executive compensation, and ESG. But I think that the kind of priorities and policy choices inherent in these questions—questions with business ramifications—are quite complex. And investors are not being called upon to take abstract policy positions, but to make these choices in the context of concrete proposals.

Consider the issue of how mutual funds vote. Recently I've read some criticisms of mutual funds for not supporting sustainability shareholder proposals such as those advocating greater board diversity or better environmental policies. The challenge is that understanding a specific proposal and how it would impact the company is more complex than one might think. It is arguably rational for a shareholder who supports board diversity to vote against a diversity proposal when he or she thinks the company already has a strong diversity policy. It would be a mistake to treat all diversity proposals as equivalent, regardless of their specific terms. A shareholder may reasonably distinguish between proposals advocating greater gender diversity, racial diversity, and ideological diversity. If it is difficult even to figure out what a rational shareholder would prefer, how do we expect the average mutual fund to develop meaningful positions? And if we do not have a strong theory of rational preferences on the part of either the intermediary or its beneficiaries, what is our basis for challenging their current behavior?

In conclusion, I think the defense of the counter-narrative, the call for institutional investor stewardship, and a more expansive corporate purpose, is appealing at a level of aspiration and theory. As with many reform proposals, however, the devil is in the details. When it comes to practical guidelines for decision-making by the big corporations that have such a pervasive societal impact and the institutional investors who are being called upon to influence those corporations more, I think we have quite a bit of work yet to do.

**Talley:** Thanks, Jill. And now Bruce Kogut is going to seize the power chair. Bruce, as I said earlier, is the Sanford C. Bernstein and Company Professor of Leadership and Ethics at the Columbia Business School, and a national expert on corporate governance and ethics.

### Thoughts on Corporate Governance and Ethics—and the Role (and Competence) of the State

**Bruce Kogut:** Thanks, Eric, for the kind words. And thanks to the Law School, and to Jeff Gordon and the Millstein Center for inviting me to take part in this discussion.

Jeff gave me a package of seven or eight articles by Judge Strine a few weeks ago, in the midst of a busy teaching period, and I read most of them. I had read others by Judge Strine, and I'd like to tell you a little of what I learned from this reading.

Some of it has to do with my personal sense of the author that I get from his writings. The judge is clearly a good man with a clear normative vision of how the world ought to be. At the same time, he's also got a strong judicial pragmatism that governs his decision-making. And as I read his work, he sees the law largely in conflict with these norms. And I would think that's a terrible situation to be in unless I guess you're made of strong stuff, which I suspect he is. But as anyone who's read his work will tell you, Judge Strine also writes with humor—which always helps—and occasionally audacity.

But the Judge has got me nervous because even in the business school, ever since Bruce Greenwald started teaching less, students have been sliding more and more in the direction of socialism. And I'm concerned that eventually we're all going to end up walking one after another underneath that Jacques Lipchitz statue on the plaza with a guillotine. No matter how good our hearts, we're going to suffer for the sins revealed in our writings.

At any rate, I'm not going to revisit the evidence for whether or not shareholder capitalism is bad. That's a healthy debate that will continue for a long, long time. I'd rather pick up what I understand is the underlying current here—namely, that there is something terribly wrong about the distribution of wealth in this country and other countries. Because as the size of the economy and stock market have been going up, labor's share of the economy, as the Judge pointed out, has been shrinking over time And those are the things that have moved students, including our business students.

But now let's turn to the yin and yang of Judge Strine's statements and take a look at some of his positions. Perhaps most surprising to many is his stated interpretation of the law that corporate directors should not pursue objectives outside of the shareholders' interest. And consistent with that position, Judge Strine also puts a lot of emphasis on how corporate law limits what boards can do in furthering stakeholder interests.

But however much I agree with both of those positions, I also think that we probably haven't spent enough time thinking about the powers that investors have and what investors may want. This is increasingly an interesting territory, the existence of a gap between boards' objectives and what investors actually are looking for. Along with competitive returns, large institutional investors show signs of a more active engagement with companies in which they invest to monitor for compliance on a number of social metrics, such as female directors on boards.

From his comments this morning, we know that Ron Gilson is also skeptical about the ESG movement—and I suspect that's because ESG questions don't always fit within the normal issues of board governance. But we also have to recognize the wider pressure on intermediary fiduciaries like BlackRock and others to respond to this growing concern among the population about the environment, equality, and gender diversity and fairness that we now see hitting boards and governance. For boards, it's quite a challenge to process all of these concerns, much less respond in a confident way.

### Toward a Coasian Bargain between the Private and Public Sectors

But let's take a step away from this board-centric view of governance, and look at the question from a broader social perspective—one that I think may be the only way to get out of this problem. There was an interesting discussion in one of the Judge's papers about DuPont and the activist Trian that I liked very much. In thinking about that case, I believe I understood that Judge Strine felt that DuPont ended up getting too good of a deal—that after fighting and prevailing over Trian and its demands, DuPont then turned to the state and said, "Subsidize me, otherwise I will leave." So, we're left with the odd sense that after this fierce governance contest beween DuPont and an activist investor that wanted to break up the company and move headquarters out of Wilmington, the corporation's now going to ask for a subsidy from the state itself or else move from Wilmington.

But however much I sympathize with his unhappiness with DuPont for playing off the state and local communities against the activists, I'm going to argue that Judge Strine's framing of the problem is too narrow, too critical of DuPont's management. (And before I tell you why, let me also say that if you read Judge Strine's article on inversions, you can really start to feel the heat of his anger at corporations that get a lot of subsidies—and then want to run away.)

The way I read these cases, the important thing to recognize are all the complementarities between the public sector and private sector companies—the mutual benefits that can come from a cooperative, but arm's-length arrangement. There's a set of mutual investments and cost-sharing by private companies and the state—that is, by governments at all levels, local and state as well as federal. We like to talk about Coasian bargains between private parties, but there's also a public Coasian bargain between the public sector and business about the best, most pragmatic way of sharing of the joint costs as well as benefits that result from the interaction of public and private activities. And, again, its important to recognize that there are not just negative externalities, but all kinds of *positive* externalities from this interaction of public and private. And because of all these positive externalities, it seems to me that there is lots of room for reaching a win-win arrangement. Viewed in this way, DuPont's tax subsidies may well prove to be a key part of what turns out to be a socially valuable bargain.

To me, however, the big unresolved issue here in this debate between the *is* and the *ought* that Leo Strine discusses in his papers is that we don't have a good positive theory of the role of *the state*—of what government does, and is supposed to do, to make the private sector function not only more efficiently, but more fairly or humanely. This is why we have such an impoverished discussion of this issue in the U.S. and elsewhere.

For example, it seems to me that when you look at Mr. Cuomo this morning making his case for his deal with Amazon, one of the really critical things that government does is to try and strike a bargain between what corporations are going to do and what the states want to do, and to find a win around that. And a lot of that negotiating also happens at the community level, which I think is extremely important to consider—namely the democratic voice of those living in proximity to the new facilities and how they are affected. Now in this area there's also going to be non-state actors. There's going to be civil society. And we can look at Amazon and say, "Where the heck was the civil society in this particular discussion?" But they also play a role in this debate and are reportedly part of the explanation for why it failed. So, if you look at the wider issues, the first level of governance in terms of the ultimate social charter or license to operate, we need to decide what are the obligations of both parties to the social contract, the public as well as the private sector.

## Understanding Corporate Political Activity

Now I want to switch to the subject of campaign contributions, which Jeff warned me not to go too deeply into because they are so fascinating, if not very uplifting. We all get to see how much effort goes into being able to pay more and more money to win friends and influence people. Of course, the Supreme Court has made that easier in the past few years—and I very much appreciated Judge Strine's Harvard Law Forum piece on corporate governance where he says that Scalia's argument on "originalism" in the *Citizens United* case is "more original than the originalists'." In fact, after reading that, I told my students that "personhood" is not in fact a really weird concept. Corporations are people because contracts have to be signed and corporations get sued and you need that concept.

The debate in *Citizens* is really about "quid pro quo," about acceptable levels and forms of influence, as well as the issue of First Amendment rights. And then eventually we get to this bit about corporate governance and whether companies should engage in political activities that may go against the preferences of many shareholders. But what really surprises me about all these things is that I have no idea how much of this activity—in a quantitative sense—has to do with *quid pro quo* dealing or partisan politicking.

We know that corporations give money to corporate PACs. In 2016, it was about 6% of overall campaign giving in the U.S. That's probably because *Citizens United* kept it low. Corporations don't have the same liberty as individuals, since individuals are limited in how much money they can give to corporate PACs, and corporate PACs are also limited in how much they can give to political campaigns.

But there's an interesting question here about where the money is really coming from. And what our research in fact shows is that the money is coming from individuals, not corporations. Corporations are much more bipartisan than individuals in the sense that they are willing to give their money to incumbents, whether Republican or Democrat. They seem to be buying incumbents, regardless of their policy positions.

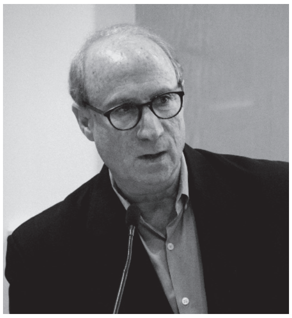
But for individuals who are either directors or CEOs, the corporate elite if you will, you can see here that the giving is very extreme. Now these are the same people who sit on the boards of the corporations that are dividing their donations in the middle, and these boards are acting in a bipartisan way. But when it comes to their own personal giving, it's quite extreme. They go either to the left or the right; it's not at all bipartisan.

So, given that individuals tend to behave so differently than corporations, this already tell us that maybe political influence is not so much a corporate governance issue as an expression of the demands and preferences of the corporate elite themselves, what motivates them and who they actually are. In a recent piece of research, we showed that if you're a director or a CEO after *Citizens United*, you are most likely, if you are both rich and ideological, to be giving a lot of money. That's the top one. So it's just rich, knowledgeable people who really get involved. And the good news for our research is that you can actually name them. There's only a few hundred people who fall in this category, and they're giving a huge percentage of campaign donations to the country—all of which is completely outside of the original debate over the *Citizens United* case.

So, based on our findings, the courts appear to have failed to focus on the real action—which doesn't appear to have much to do with a corporate governance issue at all. What's more, it doesn't appear to be a case of influence-buying or corporate quid pro quo either. The main effect of these decisions has been just to increase the amount of money that a few rich and ideological individuals can give. And that's why I'm saying that this is ultimately an issue about income inequality and power, not corporate governance.

I am not saying that unregulated blockchain is a great thing. I'm saying it's an expression of where we are right now in our economy when it comes to regulation: both on the left and the right, there's this deep, deep distrust of the competence of the state.

– Bruce Kogut



## Co-Determination for U.S. Companies?

Finally, Jeff asked me to say a few words about Elizabeth Warren's proposals on corporate governance, especially co-determination. I've long admired her work on bankruptcy and elsewhere, and her personal work as well.But in thinking about having significant representation of labor on boards, I would argue that this imposition requires a major step toward Europe and Germany in particular, where labor law and corporate governance law have always been much closer together; it is highly unlikely in this country where they tend to be separate.

To give you some idea of the difference, take the case of a recent vote to unionize an auto plant in Tennessee that is owned by Volkswagen. Volkswagen, which is partly owned by a German state, did not oppose the union vote; but what it really wanted was to establish work councils at that plant. Such councils, which are common in European and in a different form in Japanese plants, but are not common in American plants, are believed to increase productivity.

The problem for VW, though, was that under U.S. law, management cannot put a work council into a plant; that can be done only by the union itself. So, you have to have the union first in order to have the work councils. When I consulted my colleague Tom Kochan at MIT, I thought he would be enthusiastic about getting a union into the VW plant; but he said that, although it's a great idea in theory, it won't work unless you change the federal law. And that's something else that would be very difficult to do in the context of American politics.

Now, when you look at the experience of labor and co-determination in Germany—and I lived there for a few years—the work councils appear to work well. On the other hand, I don't think the research provides consistent support for co-determination. Some studies suggest that it has some benefits, but most say otherwise. As one example, a case study of the Mannesman merger with Vodafone by our colleagues Kurt Millhaupt and Katharina Pistor showed that most of the labor representatives on the board—and they're supposed to make up half under co-determination—had no prior experience in a complex mega-transactions of this unsolicited takeover. Partly for this reason, the UAW chose an ex-investment banker to be their representative to the GM board during the financial crisis. The issue the board was faced with was whether or not to accept an offer by Vodafone, which already owned 34% of the company, of 125 billion euros, which was huge by European or American standards. The deal got caught up in a tangle of lawsuits, and the small payment that they had to give over to their unions became part of the complaint in the suits themselves. This kind of decision-making was beyond their expertise given their life experiences compared to the experience of their business partners on the board.

So, I don't think that co-determination is going to be the issue that Elizabeth Warren ends up focusing on. And as we all know, you can't just pick off the menu what institutions you want and think they're going to work somewhere else. Though I think she's great, there is not a very strong argument for labor representation on boards. But it represents the background times we're living in and what people actually want to hear.

## What Blockchain Is Really Telling Us

One last comment—on schizophrenia. It's not something that's unique to Judge Strine; we all have it. It's the conflict or tension, as I said earlier, between the *is* and the *ought*.

The subject came up interestingly in the case of possible remedies, or reactions, to innovations that might be helpful. We had a recent seminar here at the law school on blockchain, and what the SEC should do about it. It was a great seminar, an amazing paper by David Hoffman and his colleagues. But because of the regulatory context, people forgot why we were talking about blockchain in the first place.

A decade ago, we had a nuclear meltdown of the financial system in this city, with lots of people put out of jobs. And among some populations here, it may amaze you to know that there are still many who are pissed off about that particular event and what they actually had to go through—and the people feeling this way are well represented on both the left and the right.

So along comes blockchain, this so-called autonomous, decentralized technology that allows people to bypass the government in order to do these transactions. Some of these transactions are illegal; a lot of the initial coin offerings are "soft junk," and there's more than the usual amount of hype. But over the time, we are likely to find some tremendous successes that offer people a way to bypass the government as well as the SEC.

But the irony of all this—what really struck me about this seminar—was that the only topic of discussion in the room was how much *good* the SEC could bring to this problem of regulation of blockchain—because there's so much fraud going on. Why, I kept thinking to myself, weren't we also asking these representatives of the SEC other questions, such as: "What did the SEC regulators do during the financial crisis, except to put so many rules and fines on the banking industry of America and elsewhere that now every banker in the world thinks that doing something which is against the interests of the public and illegal is simply a cost of business. And since it's simply a cost of business, there is no ethical clout or stigma whatsoever attached to such rules and fines. So, again, when regulations don't make sense to the regulated, it becomes simply a cost of doing business.

At any rate, I am not saying that unregulated blockchain is a great thing. I'm saying it's an expression of where we are right now in our economy when it comes to regulation: both on the left and the right, there's this deep, deep distrust of the competence of the state. And we're being hurt by that because the state is so often a necessary partner to what we want to get done.

Now, having said all that, I don't know if I have saved us all from the guillotine. But if not, don't worry; I'll be right there with Judge Strine and colleagues, until we narrow the gap between the *ought* and *is*.

Thank you very much.

**Talley:** Thanks, Bruce. I'm now going to invite Chief Justice Strine back up to the power seat to respond to the last three panelists.

## The Judge Responds

**Strine:** I just have a couple responses. One part of Mark's presentation that got my attention is that corporations are now sitting on plenty of cash. Why hasn't some of that cash gone to the workers? Could it be because the stock market opposed that use of capital?

On the question of shareholder activism, I'm not actually against it; if you read my writings, I talk about some rebalancing of power between shareholders and boards. And I also point out some basic facts about wealth distribution. It's only when you get to the top 1% that it's even close to true that most of people's wealth is not derived from their own labor. The reality for basically 99% of people is that what you get to live on is attributable to your job. And so, for most people, what you get to invest is also attributable to your job. And let me just mention that the Coalition for Inclusive Capitalism is working with leading accounting firms to try to look at ways that investments in human capital can be rebalanced.

Now these are proposals for incremental change. I am not a revolutionary. But part of what we should always remember is that we haven't had a revolution in this country because we have always been able to evolve—we've adapted in different dimensions.

One way I see to improve things is through better shareholder voting on proxies. Ron Gilson and Jeff Gordon have a good paper—in fact, it's the one that Rob Jackson just mentioned at the end of his presentation—about the role of large institutional investors in voting on and sort of refereeing the proposals put forward by shareholder activists. Well, that kind of voting is something that, as Jill can tell you, I've been talking about for 15 years. And I'm really glad to hear that the Big Four—and they are now four, because I think Fidelity just passed State Street in indexing—are making better use of their vote.

But at the same time, Mark, the studies also show that the gains from activism also involve transfers from workers and from debt holders to equity. And debt doesn't get much of a say until it's in distress. So, we need to try to limit or at least compensate people for these transfers.

On the political side and vote-buying, I agree with Bruce's point that it's as much a problem of individuals as corporations. But the tendency of corporate donations to be bipartisan should not hearten you for this reason. Corporations are giving to people who influence their businesses. Democrats and Republicans alike are beholden to interests who give them money, and on regulatory policy that's important to politicians of both sides; they will go with the people that give them money. Democrats get money from lawyers and from hedge funds to accomplish the same things that Republicans do.

I also think we don't know a lot about corporate money. But we do know that even before *Citizens United*, labor and environment groups were far outgunned by business. The reason why, of course, is that if labor had more money, they would be what class? *They* would be capital. The tilting of the playing field in terms of the rules of the game has gotten worse. And by the way, some of those individuals look much more like corporations. Much of the spending by the U.S. Chamber of Commerce and other groups, which has gone up a lot, actually comes from corporations and it's not disclosed.

Now, as for the question of schizophrenia, I've never understood psychiatrically whether that's having two different identities, or some other disorder. But whatever I have, I don't think it involves any confusion between *is* and *ought*. I have a very strong view of what *ought* to be. My view, which is consistent with that of Berle, Orwell, Roosevelt, and other clear-eyed people, is that if you want to get to *ought*, you have to understand *is* and how *is* has to be changed to get to *ought*. If wishes were horses, I could ride away down past Penn Station and all the way home to Delaware without anybody getting in my way.

And I think that's what we now all have to talk about, about how we get from here to where we want to be. For example, Mark, if we want say on pay votes, wouldn't it make more sense that we have them every four years instead of every year, and that they actually be thoughtful? If someone's running a hedge fund campaign and they're planning to make an important change in the business that could take 10 to 20 years to pay off, shouldn't the investors voting in that campaign be told that the fund itself has to wrap up in three years, and so it actually can't stay invested longer than that? Shouldn't the voters have that kind of information when they know all the other things about what's going on inside the companies?

So, again, I think there are a lot of incremental things that we can do to make things better. But, in terms of the ESG movement and everything we have to do, I think we ought to be very careful not to forget, or confuse, what the Securities Acts were about. It's important that everyone understand what corporations do—both what they are supposed to do for society, *and* what they are *not* supposed to do. That's something everyone should know, whether they own publicly listed securities or not.

As for the Warren bill, I think one of the things Senator Warren did that was absolutely right was to make it apply equally to private as well as public companies. I worry that if we make just public companies make ESG disclosures, it will have the perverse effect of narrowing our prism on the economy because more companies will simply go private. The size of the economy that we don't have any window on will increase, and that's not what we want. And I'll stop at that.

**Talley:** Thanks, Leo. And thanks to all the panelists for taking part in this discussion.

COLUMBIA LAW SCHOOL SYMPOSIUM

# Corporate Governance "Counter-Narratives": On Corporate Purpose and Shareholder Value(s)

## SESSION V: MACRO PERSPECTIVES: BIGGER PROBLEMS THAN CORPORATE GOVERNANCE

**Columbia Law School | New York City | March 1, 2019**

### Bruce Greenwald

Robert Heilbrunn Professorship of Finance and Asset Management at the Columbia Business School; Aademic Director of the Heilbrunn Center for Graham & Dodd Investing.

### Edmund Phelps

Winner of the 2006 Nobel Prize in Economics, and the Director of the Center on Capitalism and Society at Columbia University



### Joshua Mitts

Professor of Law, Columbia Law School

**Joshua Mitts:** Good afternoon, I'm Josh Mitts, a second-year professor here at Columbia Law School, and I have the great pleasure of introducing our next two speakers.

We will hear first from **Bruce Greenwald,** who holds the Robert Heilbrunn Professorship of Finance and Asset Management at the Columbia Business School and is the academic director of the Heilbrunn Center for Graham & Dodd Investing. Described by the *New York Times* as "a guru to Wall Street's gurus," Bruce is an authority on value investing, with considerable expertise in productivity and the economics of information. He has been recognized many times for his outstanding teaching abilities as the recipient of numerous awards, including the Columbia University Presidential Teaching Award. His classes are consistently oversubscribed, with more than 650 business school and non-business school students taking his courses every year in subjects that include value investing, the economics of strategic behavior, the globalization of markets, and strategic management of media.

After Bruce, we're going to hear from **Edmund Phelps**, winner of the 2006 Nobel Prize in Economics, and the director of the Center on Capitalism and Society here at Columbia. Edmund has written quite a number of books, on subjects such as growth, unemployment theory, recessions, inclusion, rewarding work, dynamism, and innovation. His work can be seen as a lifelong project to put people as we know them into economic theory. His most recent work is an attempt to provide economics with a new foundation of Renaissance, or "individualistic," values. In this view, innovation is identified as the primary driver behind the accomplishments and prosperity of the advanced economies. Higher income and wealth matter less, as he argues in his book, *Rewarding Work*, than less tangible satisfactions, such as the psychic rewards that come from total engagement in projects, and the successes—and prosperity—that sometimes come with it. His latest book, *Mass Flourishing* views the experience of discovery on an unfolding voyage as an extended metaphor for the economic progress of the race. And as the book begins by observing that, although even cavemen had the ability to imagine new things and the desire to want to create them, it took a human culture intent on liberating and inspiring the dynamism that would ignite a passion for the new to bring about such innovation and progress.

It's hard to think of a more fitting end to our day than these perspectives that we're now going to gain. And with that, I'm going to turn it over to Bruce to get us started.

## Global Economic Dislocation: Causes and Consequences

**Bruce Greenwald:** I'm going to start by responding to something that Mark Roe said earlier—namely, that today's problems and challenges have a lot more to do with things going on around the world that are well beyond the scope of corporate management and governance than with corporate governance itself. The challenges are associated with what I would describe as a *global economic dislocation*.

First of all, I think it's clear that unhappiness with economic performance is now a global phenomenon. I've just come back from living in Paris for four months and from visiting Japan for the first time. Whether you are talking about Northern or Southern Europe, Japan during the last 25 years, or the United States, there is a widespread sense that the global economy is not working well. Even in China these days, there seem to be emerging tensions.

This tells you something very important about the limits of what can be accomplished through effective corporate governance alone. Whereas technological and structural economic change tends to be global, corporate arrangements tend to be local or national. That suggests to me that we're not going to solve this global problem with a local solution. So, let me start by saying that the solution does not lie in new or better corporate governance; governance is not the problem here. The problem is a global economic transition; and by fiddling with corporate governance in individual countries, where different governance regimes work with different degrees of effectiveness in different social contexts, we're much more likely to make things worse than better. There are much more useful tools to use in this transition than governance reform. So, from the point of view of the topic of this conference, my talk will be a disappointment.

I want to start by talking about economic dislocations in an historical context. The dislocations I will be talking about are quite different from ordinary business cycles, which are invariably self-correcting and consist of short, sharp contractions followed by much longer, restorative expansions. The situations I will address are generally not self-correcting; they involve extended periods of bad economic performance and disappointing recoveries. Fortunately, they are also rare. In modern economic times, there have been only two, the Great Depression and the developments associated with the 2008 financial crisis, many of which surfaced well before 2008 and persist today. Both situations are associated with the transformative demise of an economically and socially important sector of the global economy; it was agriculture in the 1930s, and it's manufacturing today.

Thus, the difference between the current situation and that of the 1930s and 1940s is that we must manage a transition to a place that is not a happy destination. What's more, this is a global problem. And it is such a difficult problem because we have to do something about both productivity growth and the distribution of income.

– Bruce Greenwald

In both cases, there are issues associated with managing the transition and with the consequences of the post-transformative economy. In neither case are there "bad actors" whose behavior could have been "corrected." Agriculture died because long-term agricultural productivity growth, then at roughly 5% per year, far outstripped growth in the demand for agricultural products, which was perhaps only 2% per year. Manufacturing has been dying and will continue to die for the same reason. Manufacturing productivity growth is far higher than global growth in the demand for manufactured products. Given these underlying forces, these situations will not be significantly improved by changes in discretionary corporate behavior.

### The Role of Agriculture in The Great Depression: How Productivity Gains Lead to Falling Prices and Massive Overcapacity

To illustrate the nature of these global economic dislocations, it will be instructive to look first at the Depression, because we know how that worked out, and then look at where we are today. Recall that a normal business cycle typically consists of a six-to-nine month contraction followed by three years or more of healthy recovery.

The Depression worked nothing like this. The second half of 1929 was bad; 1930 was worse; 1931 was terrible; and 1932 and early 1933 were also bad. This is a very long, continuous contraction. It was followed by an unusually slow recovery which, in the U.S., was interrupted by a sharp recession in 1937-38. Some countries never fully recovered from the Depression. Argentina, for example, was a fully developed economy through the 1920s and had a standard of living not far below that of the U.S. But after 1929-1932, it fell far behind the North.

The heart of the problem during the painful years between 1929 and 1933 was the difficulty of moving increasingly unnecessary farm workers out of rural agricultural jobs into urban industrial ones. The years from 1900 to 1920 were prosperous ones for agriculture. As a result, when farm prices fell sharply, as they did in 1920-1921, marginal farmers had the wealth necessary to finance their own movement to urban areas and retraining for industrial jobs.

During this episode, the historical data show major farm out-migration during the farm recession years. Over the course of the 1920s, however, continuously low prices undermined the financial position of farmers. When farm prices fell sharply in the summer of 1929, marginal farmers could no longer finance their movement to the cities and preparation for industrial jobs. Net outmigration from agriculture in 1929-1932 fell to zero. Farmers stayed on their farms where rising productivity enabled them to increase the supply of agricultural goods. The increase in supply in the face of inelastic demand further reduced prices and farm incomes, which in turn increased the difficulty of financing outmigration to the industrial sector. The result was a downward spiral that reduced U.S. farm incomes by fully 80% between 1929 and 1932.

Given that roughly one third of the U.S. population in the early 1930s was dependent on agriculture, this 80% income decline had a catastrophic impact on the demand for industrial goods, bringing the overall economy down with the farm sector. Even if farmers had been able to move, there were thus no industrial jobs available. The decline in the overall economy was then amplified by the financial consequences for businesses of falling sales and incomes relative to existing debt levels. Overleveraged balance sheets forced sharp reductions in investment, employment, and output—so-called "debt-deflation effects." And much the same developments took place around the world, mirroring the U.S. pattern and creating a global depression.

The policy response to those difficulties reflected many of the actions being taken today. Governments' first instincts were to try to solve the problem of surplus farm production by increasing exports. For example, big agricultural producers like Argentina and Australia devalued their currencies in the face of falling farm prices in the summer of 1929—and thus before the 1929 stock market crash—or in early 1930. Each individual devaluation led to increased exports—and reduced imports—which helped stabilize both agricultural and overall economic activity. But, collectively, these efforts were doomed to failure. The global sum of all net exports must be zero. What one country exports, another country must import. When the U.S. and other producer nations responded with high tariffs and their own devaluations, any initial beneficial change in demand evaporated. Further reactions by still other countries only spread the problem. The final result was global deflationary pressure, as countries sought to reduce their export prices and discourage imports, with no net benefit and the overall depressing effect of the trade wars that we are likely to experience again today.

Other New Deal programs, like the AAA, which were designed to reduce farm production and, ideally, raise farm prices were equally unsuccessful. As long as 35% of the U.S. population remained unproductively in agricultural production—now under AAA crop limitation programs, and producing less than before—the economy was unlikely to recover. Moreover, reductions in U.S. domestic production were generally offset by the impact of higher prices on global output.

### The Solution: World War II and the Relocation and Industrialization of the Work Force

Without the demand stimulus provided by World War II, it is not clear how the Depression would have ended. However, even that would not have been enough except for a second unremembered, but critical aspect of the War effort. Keynesian economists in Washington and Europe were certain that, as war-related production demand disappeared, the Depression would return. Fortunately, this did not happen. World War II had the global effect of moving huge numbers of people off the farm into the industrial sector at government expense, either directly or with an intermediate step in the armed forces. World War II, except for countries like Argentina that did not participate, inadvertently achieved exactly the labor force relocation that was essential to the structural transformation of the global economy.

Once that transition had taken place, three aspects of the industrial economy created a highly favorable economic environment, leading to several decades of unprecedentedly high growth and prosperity. First, in contrast to decentralized farm production, industrial facilities are large and centralized. Big factories can support large numbers of managers, engineers, and other technical resources concentrated on generating continuous productivity growth. These efforts benefit from economies of scale and the cumulative effect of a stable institutional base. In the U.S., Western Europe, the British Dominions, and Japan, war productivity growth occurred at the highest observed levels in economic history.

Second, workers in these large institutions tend to operate collectively with relatively narrowly defined individual jobs. In this context, it is hard to identify and reward the contributions of individual workers. Thus, industrial wages are heavily dependent on average—not individual—productivity, which led to a significant flattening in the post-war distribution of income.

Third and finally, industrial goods—like farm products but unlike services (an important difference as we shall see)—tend to be sold in large global markets. Because these markets are too big to be dominated by any small number of firms, they have always been highly and increasingly competitive. Thus, the post-war period saw no significant increase in profits at the expense of wages—if anything, the relative share of profits declined over time. The result was unprecedentedly rapid growth in post-war wages that tracked the rapid growth in productivity. In moving from agriculture to manufacturing, the transition was difficult but the post-transition economic environment was highly desirable.

### The Long, Slow Death of Manufacturing—and the Global Financial Crisis

The current transition from manufacturing to services has been less difficult than the shift from agriculture to manufacturing since there is much less geographic relocation involved. But the destination is far less attractive. Still, the transition has been slow and painful. Just as the decline of agriculture involved the elimination of jobs with significant economic and social value—think of the "yeoman farmers" of Thomas Jefferson's ideal republic—the demise of manufacturing has taken place in the context of a powerful commitment to sustaining manufacturing jobs, with its imperative of actually "making things." There is a large global population of manufacturing workers whose human capital will be destroyed in the process. Many individual countries have particularly strong national commitments to manufacturing.

In Germany, specialized manufacturing firms have been models for German economic success. They and their associated unions have enormous political power. Japan has regarded itself as a resource-poor country whose resource imports are essential to national survival. As a result, the Japanese have always sought to have a large margin of safety of exports over imports. Because exports have of necessity consisted largely of manufactures, Japan has developed a focused expertise in manufacturing; and Japanese manufacturing productivity has historically exceeded U.S. manufacturing productivity by 30%. And like Germany, Japan has a politically and socially dominant manufacturing sector. More recently, China has pursued an export-led growth strategy built around manufacturing production that has so far been a critical source of domestic income and employment for workers migrating from rural areas.

And just as during the Depression countries sought to sustain their agricultural sector with international trade surpluses, China, Japan and other Asian countries have sought for the past 30 years to do the same for manufacturing. They have all run large and persistent trade and current account surpluses using a combination of exchange rate controls—in the case of Germany, by adopting the Euro, which has eliminated the effects of the formerly rapid appreciation of the mark—trade barriers, and direct subsidization of manufacturing firms—as in the case of Airbus.

But given the zero net surplus nature of international trade, these strategies are no more sustainable today than they were in the Depression. Countries like Korea, Malaysia, Indonesia, and Thailand once ran significant current account deficits. But the borrowing of foreign currency necessary to finance these deficits undermined confidence in their currencies. This in turn led to the collapse of local currency values (during the Asia Crisis of 1997-1998), reduced abilities to service foreign currency debts, widespread bankruptcies, and deep, long-lived contractions.

Since then, however, declines of 50% or more in the values of these currencies have moved their trade and current account positions from deficits to surpluses—surpluses that, given their unhappy experience with deficits, they have worked very hard to maintain. The problem with all this "neo-mercantilism," as Jeff Gordon called it, is that other countries have to "eat" both the existing surpluses as well as these new ones. Ultimately, the U.S. and a handful of other countries have become the importers or consumers "of last resort." But their leakage in spending overseas has meant that the deficit countries suffer from chronic deflationary pressure, which leads to reduced demand growth throughout the global economy. With no sign that the surplus countries are willing to abandon their surpluses and shrink their manufacturing employment, this deflationary pressure and the associated slow rate of global growth is unlikely to end any time soon.

### Global Productivity Problems in Manufacturing

Moreover, as manufacturing countries like Japan and Germany direct their managerial, technical, and capital resources to a shrinking and ultimately dying sector, overall rates of productivity growth will suffer, further undermining global growth. The case of Japan is instructive here. Before 1990 Japan's economy grew about 3% per year more rapidly than that of the United States. Today, it grows about ½% per year more slowly. The standard explanation for this change is demography and deficient demand—attributed mainly to the widespread existence of "zombie" firms and banks in the wake of the 1990 crisis. Both factors should operate by reducing both the supply of and demand for Japanese labor, as measured by hours worked. But this cannot be the explanation for the deterioration in Japan's growth rate relative to that of the U.S.

Whereas Japanese hours worked pre-1990 grew 1.5% per year more slowly than U.S. hours worked, Japanese hours worked since 1990 have grown only 1.4% more slowly than U.S. hours worked, which is a slight improvement in relative growth. The decline in relative performance can thus be explained only by the decline in Japanese productivity growth relative to U.S. productivity—as measured by output per hour worked—from a 3% annual Japanese advantage before 1990 to a ½% annual U.S. advantage today. This is the result of an increasing misallocation of human and other resources by an otherwise extraordinarily effective business-government productivity machine to ever diminishing manufacturing employment.

Similar problems have affected other G7 countries. Since 2000 U.S. productivity growth has been the highest in the G7, for the first time since World War II. Overall, however, G7 productivity and wage growth rates have fallen well below the thirty-year average rates of the post-war period, and there is unlikely to be any improvement any time soon. The overall difficulties of transitioning to a service economy—slow demand and productivity growth—while less severe than in the Depression, are likely to be with us for a long time.

A further aspect of the transitional

global regime of slow growth and stagnant productivity increases should be mentioned. The vast increase in manufacturing capacity in China and East Asia has exacerbated the problem of declining manufacturing employment in the developed world. But this is a secondary part of the story. Technology-driven productivity growth has always played a larger role in manufacturing job loss than exports, whether from China or elsewhere. In 1992, when Presidential candidate Ross Perot talked about "the giant sucking sounds of jobs going to Mexico," only 15% of the U.S. manufacturing jobs lost during the previous 11 years were lost to imports; the other 85% were lost because of advances in technology. Today those numbers are one third due to globalization, two thirds to technology.

Finally, the structural trade imbalances associated with the desire to preserve manufacturing jobs have had significant negative financial market consequences. [continue PP]

When the U.S. runs a deficit of $600 billion a year with China and Germany, their $600 billion surplus must sooner or later be invested in the United States. Foreign money is almost always uninformed money, and so there is $600 billion in fresh, relatively unsophisticated, demand for new Wall Street products. The surplus countries started out investing their surpluses safely in U.S. government instruments, which helped drive down U.S. interest rates. When they indicated they were not happy with low rates, Wall Street provided them with higher yielding mortgage-backed securities. The relatively high default rates on these securities was one of the triggering mechanisms for the financial crisis. And, to the extent the decline of manufacturing led to the international payments imbalances that in turn played a major role in the financial market dislocations of 2007-2008, the global financial crisis itself can be seen as one fairly direct consequence of the demise of manufacturing.

### The Outlook for a Global Service Economy: Low Productivity and More Inequality

What's more, the service economy toward which the world is headed, and at which the U.S. has largely arrived, has three characteristics that make it much less attractive than the industrial world we are leaving behind.

First, and perhaps most important, service institutions, like farms, tend to be small and decentralized. Increasing productivity across many stores, schools, doctor's offices, or restaurants is much harder to achieve than productivity growth at a single large factory. In the U.S., there are some large service companies like Wal-Mart or McDonalds that have managed to do this. In Europe, Japan, and other East Asian countries, few such firms exist. Slower productivity growth will almost certainly be a feature of a service economy once manufacturing has been reduced to the status of agriculture. At the moment, the U.S. has an advantage in this area; and since 2000, as I mentioned, it has enjoyed the highest productivity growth among the G7 economies. But even U.S. productivity growth is well below that of earlier post-war levels.

Second, service workers tend to operate individually rather than collectively. To illustrate what this will mean, consider the differences between service and industrial jobs today. To cite one example, the U.S. economy today has 140,000 non-professional extractive workers—coal and other miners, oil platform workers, and so forth. Mines and oil platforms are big facilities in which workers necessarily work together. Identifying the contributions of individual workers is hard, and wage differences therefore are relatively small. At the same time, the U.S. economy employs 260,000 professional athletes, coaches, and referees. These workers' individual performances are considerably easier to identify and distinguish; and, as a result, they receive vastly different paychecks. Movement from industry to services has led—and will continue to lead—to greatly increased income inequality.

Third, services tend to be locally produced and consumed. Local service markets are relatively small and can be dominated by single firms or small numbers of firms; think of a one-store or a two-store town. These dominant firms benefit from scale-related competitive advantages that enable them to control competition and earn supernormal profits. Profits in a service economy receive a generally greater share of national income—relative to wages—than in an industrial economy with robust competition. Between the late 1980s and today, the share of profits in the U.S. national income has increased from about 8.5% to more than 14%. And this is not related to higher levels of investment. Business investment as a share of U.S. national output has fallen over the same time period.

A service economy will therefore grow relatively slowly and with increasing income inequality and wages suffering relative to profits. By most standards, this is not going to be a happy outcome and, given the structural factors at work, is not going to be improved through better corporate governance.

Thus, the difference between the current situation and that of the 1930s and 1940s is that we must manage a transition to a place that is not a happy destination. What's more, this is a global problem. And it is such a difficult problem

More broadly I would argue that operating on the economy is not a solution. It's necessary to restore to the people the good values that once brought rapid economic growth and thus the good life and, perhaps, to extirpate the values that obstruct economic growth. If we do that, we can hope to see rapid growth again.

– Edmund Phelps

because we have to do something about *both* productivity growth *and* the distribution of income. I think I'm a better Marxist than anybody else in this room, but you don't want governments futzing around with this one. You want to have a massive earned income tax credit, which is governed by fixed long-term rules that are universally applied.

This is preferable to a non-work-related governmental national income.

If you have a guaranteed national income, many people who work are going to be really pissed off, as they are now in Europe by all their retirees. Also, we are going to need institutions to improve productivity growth in services, maybe the way the U.S. Agricultural Extension Service did in the agricultural sector. This is going to be a long, difficult process. My concern is that if you distract businesses from making this transition by mandating things that interfere with management's efforts to increase productivity, you're going to make these very pressing problems even worse.

**Mitts:** Thanks, Bruce. Now let's hear from Edmund Phelps.

## Other Contributors to the U.S. Productivity Problem: Failure of Values

**Edmund Phelps:** Well, it's a great pleasure to be here, and it's always stimulating to hear Bruce Greenwald expound for us his latest ideas on the downturn.

**Greenwald:** Mine and Joe Stiglitz's.

**Phelps:** Yes, yours and Joe's.

Bruce speaks of economic performance as having three elements: growth, distribution, and job satisfaction. And I think that's kind of a convenient way to organize things.

And when talking about the causes of the decline, he speaks about the advantages of collective work over individual work, about fewer jobs for strong-back labor, and about monopolies sprouting up. As for corporate governance—which is the principle topic of this meeting, and a major cause of the economic problems in the minds of many people here—Bruce is skeptical that corporate governance has gotten any worse.

But, I don't think Bruce's long-cycle argument really explains why the economy has been driven off the rails. I don't see the causation? Bruce says manufacturing employment is dying, but I'd like to hear more about why it's dying. What is new about competition from abroad? There were eras in which the United States had plenty of competition from abroad.

Clearly, productivity growth matters, but I thought that's what we're here to explain: Why has productivity growth slowed down? In my book, *Mass Flourishing*, I cited a large set of developments, social as well as economic, that in my opinion help to explain the great productivity slowdown of the American economy. As just one possibility, I pointed to CEOs whose retirement pay would suffer heavy losses if their corporation undertook a venture that failed.

Like this one, most of my hypotheses are instances of my general thesis that innovation is a major contributor to economic growth and what I call "economic performance." By economic performance I mean job satisfaction, participation, and a variety of non-material "modern values" that I argue are essential contributors to productivity and prosperity.

And my contention is that if this nation of ours still had the right values, we would be having rapid growth and high job satisfaction.

Now this leads straight to a couple of themes of my work. First, there are likely to be ways to repair some malfunctions in the economy that play some part in the slowdown. For example, the government could get serious about low wage employment subsidies in order to pull up participation rates and wage rates at the low end. The government might cut tax rates on corporate profits, in the belief that such cuts would induce increased business investment.

I favor low wage subsidies; but as an economist, I have to say that such employment subsidies are only a one-off measure that might double wage rates at the very bottom of the wage scale. But that's no match for the rapid growth that we used to have, which doubled wage rates every 24 years, for a very long period of time. Corporate tax cuts may well stimulate business for a while, but such effects cannot be permanent, owing to the law of diminishing returns. Even if you keep on investing, and piling ever more capital into the economy, if you don't have any innovation to provide improving techniques, you're going to run into diminishing returns. As any good elementary economics textbooks will tell you, it's not just labor that runs into diminishing returns on a fixed plot of land; capital runs into diminishing returns when limited to use of a fixed set of people and technologies.

More broadly I would argue that operating on the economy is not a solution. It's necessary to restore to the people the good values that once brought rapid economic growth and thus the good life and, perhaps, to extirpate the values that obstruct economic growth. If we do that, we can hope to see rapid growth again.

Another theme of mine has to do with the social strife that seems to have come with the economic decline in the west, particularly in the U.S., the U.K., and France. Take the discontent expressed by the *gilets jaunes*—the yellow vests—in France, and by the working class in rural America opposing immigration, and the northerners in Britain favoring exit from the EU. What accounts for these feelings?

In the U.S. the growth of real average labor compensation per worker has slowed from two to three percent per annum in the 1960s to around one percent or less since 2005. Real interest rates, which are a pretty good proxy for the rate of return to investment, have fallen from two or three percent decades ago into what looks like negative territory now. Finally, and very important, data show that reported job satisfaction has declined appreciably since the data started in 1972.

I don't think it's been adequately recognized how absolutely extraordinary this decline has been. One would have to go back, perhaps, to Britain in the 1960s and '70s, or even the Weimar Republic from 1918 to 1933, for a comparable decline in the West. With this background, I think it is clear that the people who saw their wage rates stagnate, or at least fail to go up with the incomes of others, feel considerable pain and embarrassment. The great economist Adam Smith and the great philosopher John Rawls would have agreed.

I think that these people also feel frustrated that their many years of hard work have not brought them appreciable wage gains in an *absolute* sense, regardless of what others are now earning. So it's a double whammy. Two things are going on that are very serious. Had western societies not been hit by the severe economic decline, it seems unlikely that these members of the working class would have been so angry. Had they been getting ahead, they would not have been so put out by the success of others.

So we need to find ways to restore innovation, not only for the economic growth and even the job satisfaction it could be expected to generate, but also for the restoration of wage growth among others who would experience no wage growth at all for some time. Thank you.

## Questions & Answers

**Jeff Gordon:** Edmund, Bruce told us that firm-level governance solutions are not likely to advance the cause, and that focusing on such solutions will only distract us from the important structural issues. Do you agree with that?

**Phelps:** I think I agree with it, but Bruce's basket of structural factors are different from my basket.

My basket is all about individualism from the Renaissance. From Cervantes, Shakespeare, and onward, there's a rich palette of values that came bubbling up in the west. But it's run into competition with a lot of antithetical, collectivist kinds of values that don't prize individualism, don't prize experimentation, discovery, exploration. In the four or five years when I was writing *Mass Flourishing*, everything I saw resonated with what I was writing at that time. I don't think the situation has changed much.

**Greenwald:** I think it's *all* these other things have to change, not corporate governance.

**Gordon:** Let me just add a kind of editor's note. Many of us here are governance specialists. We have to figure out what governance can do, what it can't do; and other places where maybe we should be looking. Colin, do you have a thought here?

**Colin Mayer:** Edmund's perspective places a lot of emphasis on values, one of the issues that underlies this conference. Should the values of modern society be focused purely, or so heavily, on financial returns? In that regard, what Edmund has just been talking about is absolutely central to the debate that we've been having.

**Greenwald:** Productivity growth is the fruit of what you're talking about. But I think it's important to recognize that most productivity gains don't come from movements in the production possibility frontier, but rather from movements within and toward the frontier. The most efficient firm in an industry—even in an industry with essentially the same labor force, the same level of capital, and seasoned technology—tends to have a cost structure that is a third to a half of the industry average.

So, if you look at the process of productivity growth at the individual company level, it all comes from movements to that frontier; not in movements in the frontier. That is a managerial function. And if you distract managements from the kind of innovation that produces these productivity gains, I think you're going to forfeit all the beneficial things that Edmund is talking about.

**Unidentified Observer:** Mr. Phelps, you mentioned the need for innovation to help the American worker, especially the workers whose wages are currently stagnant. I think there's at least a plausible argument that innovation, particularly in the tech sector, is actually a driver of income inequality. So can you elaborate a little bit on how you see innovation helping those workers whose wages are currently stagnant?

**Phelps:** I think you are touching on the point that not all innovations are homogeneous and beneficial to all workers. I agree that the future is unknown, and so we can't be entirely confident that innovations will make a difference for the better for most people. It's too bad, but it's the way the world is. I do feel confident, though, that if we don't try to nourish more innovations on a wide scale, then we won't get out of the mire that we're in now.

**Greenwald:** I think you're absolutely right. Today's innovations are empowering and extending the influence of individuals, not organizations. It starts with the personal computer—and then the Internet. What an individual can do now with those innovative things is extraordinary compared to what you could do in the days when you had to go to the library to collect data. You can do in minutes what took weeks before.

This will exacerbate the differences in ability between individuals. The successful societies, I think, are the ones where those individual differences get attenuated rather than exaggerated. Unfortunately, this is a global problem not just a U.S. problem. The services transition is really global; it's going on everywhere; and countries that haven't done it have suffered much more in productivity growth, by the way, than the United States. But technology is going that direction, too. I don't know how you're going to stop that with corporate governance.

It is the corporate and the national cultures that Edmund is talking about that are far more important than the specific rules of governance. I'll say that in slightly different terms. Progress comes from specialization. The problem with boards of directors is that they're not specialized.

And the problem with a lot of these shareholder activists, or interveners, is that not nearly enough of them are specialized. When you see a highly specialized intervener, like Paul Hilal, who made such a difference at Canadian Pacific, the results are extraordinary; but that's not something that corporate governance addresses directly. In the four years after Hilal got involved at CP, its value nearly quadrupled. That was because he had immersed himself in the operational details of railways, understood what changes needed to be made and who the CEO ought to be—and it was a very effective operator named Hunter Harrison.

So, to be successful, corporate governance regimes must take advantage of the power of specialization and the power of culture or you're not going to get the sort of thing that Edmund is talking about.

**Alan Schwartz:** I think that Bruce's suggestion about an expanded earned income tax credit is something we know how to do; because we've had it, and we can expand it. In a way it's easy to follow Bruce's concrete suggestion, but, Edmund, how do I make concrete your high-level analysis, even if I'm persuaded by it?

**Phelps:** Well, people who had contrary values were able to promulgate those values rather effectively. So why can't we get back to the earlier values? I think it's almost a case where wanting something is half of the battle. We can change the school system so that it celebrates adventure, creation, imagination, exploration, discovery, night and day, all the time. In a couple of decades I would think that would be felt in society and reflected in the economy.

**Gilson:** I want to come back to Bruce's most recent comment that two thirds of the companies in a particular industry are badly managed. Are there mechanisms that may cause the other two thirds to accomplish something they have the capacity to do but, for some reason, aren't doing it?

**Greenwald:** I think that's a really important point. But you have to understand that there are useful shareholder interventions and there are dysfunctional interventions. You can imagine opening channels for outsiders to intervene; but the question is: are those outsiders going to be a distraction, or are they going to be the Paul Hilals of the world—someone who's changed the operations of two railroads in ways that have been beneficial for everybody associated with them?

My sense, as a professor of investment management, of the investment community out there, is that they're mostly ADD troublemakers. The Paul Hilals of the world you can count on one hand. Does that answer your question?

**Gilson:** So the question then becomes, can we design an intervention system that allows somebody to readily and credibly distinguish between the useful and dysfunctional interveners? I view that as a governance task that we're not doing now; but it's not obvious to me that it can't be done.

**Greenwald:** I think it can be done under the present governance rules. I'm chairman of a hedge fund in Europe that has a very, very concentrated portfolio. We buy into one kind of company in only four countries, and we know exactly what we're going to do when we take it over.

It's not hard to do. You can take over a company in Europe with basically 30% of the voting stock. If you know that industry well enough to know which executives have historically done extremely well with these very special kind of companies; and they agree to join you, you will be successful.

But it's the supply of people with special expertise like that—it's not me, it's the person that actually runs the hedge fund—the Paul Hilals of the world—that are important, not the rules, because their value added is so large.

**Gilson:** But for our purposes, the rules aren't what is getting in the way. It's the lack of imagination—and how to make the most of the governance system, and the talented managers and employees, that we have.

**Greenwald:** I agree.

**Mitts:** Ok, let's leave it there.

# Is Managerial Myopia a Persistent Governance Problem?

by David J. Denis, University of Pittsburgh*

A growing chorus of commentators, ranging from politicians to prominent investors to academics, argue that U.S. corporations are myopic: that is, they are overly focused on short-term profits at the expense of long-run value. These critics often attribute such behavior to flaws in executive compensation arrangements that tie executive pay to measures of near-term performance (or value), or to pressures from short-term investors like activist hedge funds. As a result, so critics say, managers have the incentive to underinvest in projects that would produce long-term value, particularly if such investment would depress measures of near-term performance.

As I will summarize below, these critiques of U.S. corporations are not new; similar criticisms of myopic capital allocation practices in U.S. companies can be found at least as far back as the 1970s. To the extent such criticisms have merit, they would imply a massive governance failure in which there has been decades of underinvestment with little adjustment on the part of managers, boards, or the market for corporate control.

In this article, I evaluate the economic underpinnings of these criticisms and analyze their implications in the context of empirical evidence on corporate investment policies produced over several decades, the outcomes of corporate control events, investor horizons, and the market pricing of companies with little if any earnings. Based on this evidence, I argue that there is little systematic evidence to suggest that short-termism is a pervasive problem plaguing U.S. companies. If anything, the body of evidence seems to point towards overinvestment being a larger concern.

## Who Is Worried about Myopia?

Concerns about myopia date back at least to the 1970s. Noted attorney Martin Lipton argued back in 1979 that:

> *It would not be unfair to pose the policy issue as: Whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested … only in a quick profit …?*

Such concerns were echoed in an indictment of the U.S. system of allocating capital by Harvard Business School corporate strategist Michael Porter in 1992:

> *[T]he U.S. system of allocating capital both within and across companies is failing… many American companies invest too little, particularly in those intangible assets and capabilities required for competitiveness.*[1]

In recent years, an increasingly wide variety of commentators has expressed concerns about the short-term tendencies of U.S. companies. For example, several politicians have pushed for corporate reform based on the premise that corporate short-termism has been crippling the competitiveness of U.S. companies. Late in his term as vice president, Joe Biden warned that:

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1 Michael E. Porter, "Capital Disadvantage: America's Failing Capital Investment System," *Harvard Business Review*, September 1992.

*Short-termism—the notion that companies forgo long-run investment to boost near-term stock price—is one of the greatest threats to America's enduring prosperity.*[2]

And U.S. Senator Elizabeth Warren has argued that:

*[F]rom 1990 to 2015, nonfinancial U.S. companies invested a trillion dollars less than projected, funneling earnings to shareholders instead. This underinvestment handcuffs U.S. enterprise…*[3]

What's more, such arguments have not been limited to politicians. Prominent investors and financiers such as BlackRock CEO Larry Fink, JPMorgan Chase CEO Jamie Dimon, and Berkshire Hathaway's Warren Buffett have issued similar critiques. Fink, for example, has written a series of open letters to U.S. CEOs urging "resistance to the powerful forces of short-termism afflicting corporate behavior."[4] And in a joint editorial, Dimon and Buffett stated that:

*In our experience, quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability.*[5]

In support of these claims, a recent McKinsey Global Institute report provides evidence that companies with longer horizons outperform their shorter-term peers on a variety of measures of economic performance.

Finally, even some academic studies have been interpreted as consistent with myopic managerial behavior—investment decision-making distorted by a short-sighted focus.[6] In sum, an increasingly wide and vocal set of commentators, policy makers, and academics now believe that corporate short-termism is an issue of critical importance that must be addressed either through the regulatory system or through fundamental changes in corporate governance and capital allocation processes.

## Is It Possible for Myopia to Persist in a Competitive Corporate Control Market?

Under the classic market efficiency view that underlies traditional corporate finance theory, it would be illogical to expect myopic policies to persist in equilibrium. Under this view, as long as corporate managers have a stake in the company's stock price—whether in the form of direct ownership or incentive compensation—and that stock price is a function of investors' expectations for all future cash flows, managers would have no incentive to pursue shortsighted or otherwise inefficient investment policies. Moreover, because of improvements in information technology that have reduced the cost of acquiring corporate information, capital markets are, if anything, more efficient today than they were 40 years ago. Furthermore, most measures of governance quality suggest that corporate governance has improved over time among U.S. corporations. Taken together, these developments make it difficult to see how the problem of short-termism would be worse today than it was back in the 1970s.

Nonetheless, there are academic theories that predict managers will pursue myopic policies precisely *because* they have a stake in the company's stock price. The most prominent of such theories was laid out by Jeremy Stein in a 1989 article published in the *Quarterly Journal of Economics*.[7] In Stein's model, myopic policies follow from two primary conditions: (1) current earnings convey useful information about future earnings; and (2) managers aim to maximize a weighted combination of the company's current stock price and its future stock price. The first condition guarantees that stock prices will respond favorably to an unexpected increase in earnings, while the second gives managers the incentive to pursue policies that increase current earnings *even if* doing so might be harmful to the future stock price. One way to boost current earnings is to cut back on investment.

This theory thus predicts that systematic short-termism and, therefore, underinvestment, is more likely when conditions (1) and (2) are more prevalent. This is likely to be the case for companies with highly uncertain earnings streams, and when managers and investors have shorter horizons (thus increasing the weight that managers will put on current stock price versus future stock price.) The latter condition is more likely to be true when executive compensation contracts have shorter vesting periods, when shareholder turnover is greater, and when companies have a greater need for external equity.[8]

Although such theories of myopia predict persistent underinvestment, it is important to recognize that these predictions contrast sharply with the free cash flow theory

2 See *Wall Street Journal*, September 26, 2016.

3 See *Wall Street Journal*, August 14, 2018.

4 *Business Insider*, February 2, 2016.

5 *Wall Street Journal*, June 6, 2018.

6 See, for example, Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, "The Real Effects of Share Repurchases," *Journal of Financial Economics* 119 (2016), 168-185; Alex Edmans, Vivian Fang, and Katharina Lewellen, "Equity Vesting and Investment," *Review of Financial Studies* (2018); and John Asker, Joan Farre-Mensa, and Alexander Ljungqvist, "Corporate Investment and Stock Market Listing: A Puzzle?" *Review of Financial Studies*, 2014.

7 Jeremy Stein, "Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, *Quarterly Journal of Economics* 104 (December 1989), pp. 655-669.

8 It is also likely that managers will behave myopically if investors have behavioral biases that lead them to overinflate the current period's stock price. Both Stein's analysis and my discussion ignore this possibility. For a discussion of this issue, see Wei Jiang, "Who are the Short-Termists?" *Journal of Applied Corporate Finance* 30:4 (2018).

## THE CASE OF GOODYEAR TIRE AND RUBBER

Goodyear represents a clear example of the use of a leveraged recap to increase value by limiting the company's ability to pursue value-decreasing investments. In 1983, the tire manufacturer announced a diversifying acquisition of Celeron, a natural gas producer and distributor, which provoked a sharp negative market reaction that reduced Goodyear's value by nearly $250 million. In response to a hostile takeover threat from Sir James Goldsmith, who intended to reverse the company's diversification strategy, Goodyear initiated a recapitalization that involved a debt-financed repurchase of more than one-third of the company's shares. The transaction produced shareholder wealth gains of over 20%, amounting to over $750 million, while the debt service requirements forced the company to cut back its annual investment from $1.7 billion prior to the recap to less than $670 million after.

advanced by Michael Jensen in the 1980s.[9] Under Jensen's theory, managers without significant equity stakes have a natural tendency to cause their companies to grow beyond the size that would maximize the wealth of their shareholders. This tendency stems from the increase in managerial power that comes with growth, the fact that managerial compensation often increases with the size of the firm, and the preference exhibited by corporations to reward middle managers through promotion rather than monetary compensation. The net result, as Jensen argued, is an organizational bias toward growth that leads companies to overinvest—that is, to take on low-return projects, such as diversifying acquisitions or efforts to gain market share in mature and even saturated markets.

So, managers of U.S. companies may be systematically underinvesting, as Stein's model suggests; they may be systematically overinvesting, as Jensen argues; or since these possibilities are not mutually exclusive, both of these problems could be at work in many companies. Whether companies tend to systematically underinvest or overinvest, is, therefore, an empirical question that can be answered only by looking at the evidence.

### Early Evidence from the 1980s and 1990s

If managers systematically misallocate capital, either through underinvestment or overinvestment, outside parties can create value by initiating transactions that reduce managerial control and install more efficient investment policies. The late 1980s witnessed a boom in leveraged buyouts in which managers, often with outside third-party investors, took companies private by borrowing substantial sums and buying out the shareholders. In a pioneering study of these transactions, Steve Kaplan observed that these transactions were typically accompanied by large reductions in capital investment.[10] The fact that the LBOs that Kaplan studied were also accompanied by gains to shareholders and operating improvements suggested that the reductions in investment had the effect of increasing value—and that, before the buyouts, such companies had been overinvesting, and perhaps operating with more capital than they needed.

In 1993, Diane Denis and I published a study of 29 leveraged recapitalizations (recaps) that confirmed this interpretation.[11] More specifically, we studied recaps in which public companies borrowed substantial sums and used the proceeds to make large payouts to their shareholders. Like Kaplan's study of LBOs, we found that recaps of this type created substantial value for shareholders—on the order of 26% in the average case—and were typically followed by significant reductions in investment. What's more, in this study we were able to tie the increases in shareholder value directly to the reductions in investment by showing not only that the recapitalizing firms invested more than their peers prior to the recap, but that announcements of major investments in the pre-recap period typically met with negative stock price reactions. Following the recap, the investments of the recapitalized companies were constrained by the debt taken on in the recap, and what new investments were undertaken by these companies were no longer received negatively by the market.

Both Kaplan's study of LBOs and our study of recaps support Jensen's view of systematic overinvestment prior to the onset of such highly leveraged transactions in the early 1980s. Of course, these transactions represent only a small subset of the universe of companies, and so evidence of overinvestment

9 Michael Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76:2 (1986), 323-329.

10 Steven N. Kaplan, "The Effects of Management Buyouts on Operating Performance and Value," *Journal of Financial Economics* (October 1989).

11 David J. Denis and Diane K. Denis, "Managerial Discretion, Organizational Structure, and Corporate Performance: A Study of Leveraged Recapitalizations," *Journal of Accounting and Economics* (January 1993).

in these companies does not, by itself, imply that overinvestment was a more general problem than underinvestment in the late 1980s and 1990s. Nonetheless, it is worth pointing out that the difficulty of identifying *any* studies in which transactions that reduced managerial control, all of which are associated with shareholder wealth gains, led to *increases* in corporate investment.

To cite another example, Diane Denis and I studied forced changes in top executives at U.S. companies between 1985 and 1988.[12] We reasoned that if managers were systematically underinvesting due to pressures for short-term performance, boards would have the incentive to fire the CEOs and install new executives who would put in place more farsighted investment policies. But what we found was that rather than increasing investment, the new CEOs typically decreased corporate investment. Following forced dismissals of CEOs, which were typically greeted with positive stock price reactions, companies cut their capital expenditures by more than 30% relative to their industry peers while increasing their operating income by more than 20%. These findings further support the view that prior to the management change, companies were investing too much, not too little.

The bottom line, therefore, is that the evidence from transactions in the late 1980s and early 1990s provides little support for the view that U.S. companies systematically pursued myopic investment policies that resulted in underinvestment. If anything, the evidence is more consistent with overinvestment being the principal governance problem of the time.

## More Recent Evidence

But what about more recent evidence? As noted above, concerns about myopia have become, if anything, more widespread in recent years. I consider four types of evidence that speak to these concerns: (1) the demands of shareholder activists; (2) whether shareholders have become more short-term oriented; (3) whether there is evidence of reduced investment; and (4) whether the market appears to shun, or discount the value of, companies that fail to produce positive earnings.

## What Do Shareholder Activists Want?

As argued above, if companies are systematically underinvesting, outside parties would benefit from purchasing a stake in the underinvesting companies, and then forcing those companies to adjust their capital allocation practices towards greater investment. Hedge funds represent perhaps the most important activist investors and a large number of recent studies analyze the impact of hedge fund activism on corporate policies and value.[13] What evidence we have, however, suggests that hedge fund activists typically seek *reductions* in investment along with increases in payouts to shareholders.

Is it possible that the hedge funds themselves are just responding to market incentives for short-term gains at the expense of long-run value? Here, again, the evidence seems to point to the opposite conclusion. First, as shown in Figure 1, there is evidence of both short-run and long-run performance improvements following successful activist campaigns—that is, those campaigns in which the goal of reduced investment was accomplished. Second, a recent study of innovative activity following hedge fund activist campaigns shows that such activism leads to a decrease in the quantity of innovative investment (as measured by R&D spending), but an increase in innovation efficiency (as measured by patent counts and citations) over the five years following the activist campaigns.[14] Taken together, these findings imply that the changes in investment policy pursued by activists typically reduce investment, but lead to more efficient, and value-increasing, allocations of corporate resources. The fact that we rarely observe activists encouraging companies to increase investment suggests that the activists do not perceive underinvestment to be a systematic problem.

## Have Investors Become More Short-Term Oriented?

Another way to assess whether short-termism has become a more pervasive problem is to examine the behavior of investors themselves and ask whether there is evidence that they have become more short-term oriented. On the surface, the answer appears to be yes. As reported recently by Wei Jiang, shareholder turnover has increased from an average of around 10% in the mid-1970s to over 350% in 2016.[15] This implies that average holding periods have fallen from roughly ten years to just three or four months.

However, this evidence is misleading in the sense that it is driven by the large volume of trade by high-frequency traders; and, more importantly, it masks a substantial shift towards more long-term investors. In a recent study, Paul Edelman, Wei Jiang, and Randall Thomas showed that the percentage of investors with long horizons (defined as those with turnover less than 33%) has more than doubled over the

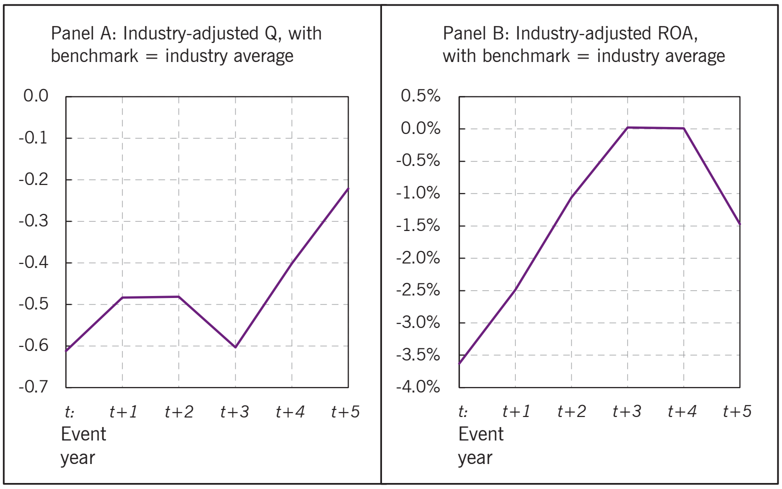
12 David J. Denis and Diane K. Denis, "Performance Improvements Following Top Management Dismissals," *Journal of Finance* 50:4, (December 1995).

13 See, in particular, Brav, Jiang, Partnoy, and Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance* 63 (August 2008), 1729-1775.

14 Alon Brav, Wei Jiang, and Xuan Tian, "How Does Hedge fund Activism Reshape Corporate Innovation" *Journal of Financial Economics*, forthcoming, (2018).

15 "Who are the Short-Termists?" *Journal of Applied Corporate Finance*, (2018) 30:4, 1-18.

*Figure 1*
**Performance improvements following successful hedge fund activism**




Industry adjusted q-ratio and return-on-assets for targets of successful investment-limiting hedge fund activist campaigns. Source: L. Bebchuk., A. Brav, and W. Jiang, "The Long-Term Effects of Hedge Fund Activism," *Columbia Law Review* 115 (June 2015), Figure 3.

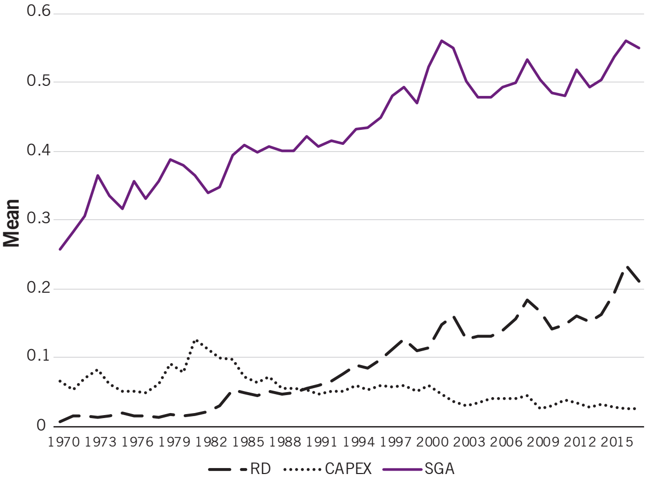
past two decades, so that long-term investors now make up approximately 60% of the investor population.[16] Moreover, this group includes the five largest U.S. funds—BlackRock, Vanguard, Fidelity, State Street, and Capital Research—whose combined assets now account for 30% of all assets under management. So if anything, the evidence seems to point to a decline in short-term pressure from investors over time.

## Is There Evidence of Reduced Investment?

Perhaps the most direct way to assess the claims of systematic myopic investment policies is to analyze measures of investment themselves. Figure 2 plots average investment rates as a percentage of total assets for publicly traded U.S. companies since 1970. The plot for capital expenditures highlights the evidence that is often used to support claims of systematic underinvestment due to short-termism. Since hitting a peak of around 13% in the early 1980s, capital expenditures as a percentage of total assets have declined to the point where they now average less than 3% of total assets in most years.

While such evidence could be viewed as consistent with short-term pressures constraining investment, the evidence is incomplete in that it ignores other forms of corporate investment that have been surging in recent years. In particular, many authors and commentators have pointed out that the U.S. economy has undergone a dramatic shift from an economy dominated by investments in tangible assets such as property, plant, and equipment to investments in intangible assets that take the form of knowledge and human capital, IT infrastructure, and brand-building. As intangibles, these

*Figure 2*
**Average investment rates for U.S. companies since 1970**

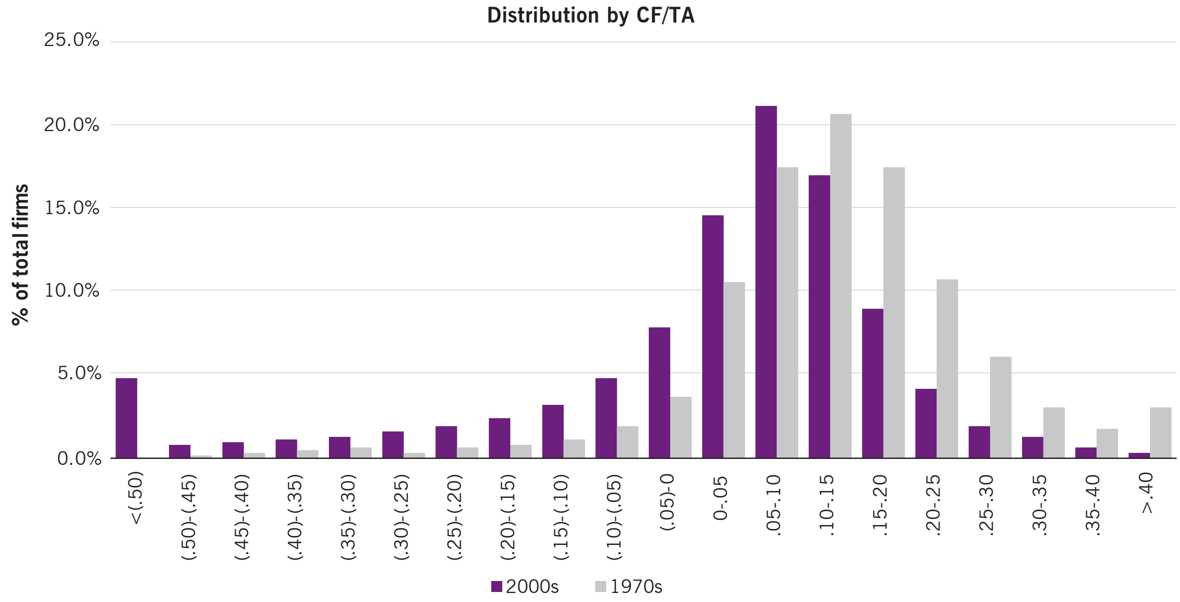



Evolution of average rates of capital expenditures (CAPEX), research and development expenditures (RD), and selling, general, and administrative expenditures (SGA). All are expressed as a percentage of total assets.

Source: "Persistent Negative Cash Flows, Staged Financing and the Stockpiling of Cash Balances," David Denis and Stephen McKeon, Unpublished Working Paper, 2019.

16 "Will Tenure Voting Give Managers Lifetime Tenure?" *Texas Law Review* 97 (2019), 991-1029.

*Figure 3*
**Operating cash flow for U.S. companies, 1970s vs. 2000s**




Distribution of cash flow from operations (CF) scaled by total assets for the 1970s vs. the 2000s.

forms of investment do not show up in financial statements as capital expenditures, but rather as expenses under categories like R&D and SG&A.

As can also be seen in Figure 2, R&D and SG&A expenditures have exploded in recent years. For example, average R&D expenditures have grown from less than 1% of total assets in 1970 to more than 20% of total assets in the last few years. Similarly, average SG&A expenses have grown from 25% of assets to 55% of assets over the same period. While a portion of SG&A undoubtedly represents normal operating expenses, it is not clear why this portion would have increased over time. It is more likely that this remarkable growth in SG&A is being driven by spending categories such as marketing and promotion, and human and brand capital—precisely the types of investment in intangible assets described above. So, the most plausible explanation for the growth in SG&A is that it reflects companies' increasing replacement of tangible with intangible investments and assets.[17]

It is instructive, therefore, to examine the sum of capital expenditures, R&D, and SG&A over the period depicted in Figure 2. In 1970, the sum of these three categories of corporate spending averaged 33% of total assets for U.S. publicly traded companies. By 2017, they averaged 78.7% of total assets. It is very difficult to conclude from this data that U.S. companies are spending less on investment in recent years. Instead, the data support the view that investment has dramatically increased.

And perhaps most telling, this increase in investment seems to have a remarkably high correlation with—to the point where it seems to mirror—the long-term upswing in stock prices. In other words, the market appears to be pricing companies as if they have substantial growth opportunities and companies are investing accordingly. It is also noteworthy that the large upswing in investment is driven by precisely the types of intangible investments that critics argue are being shortchanged by short-termism.[18]

## Does the market shun less profitable firms?

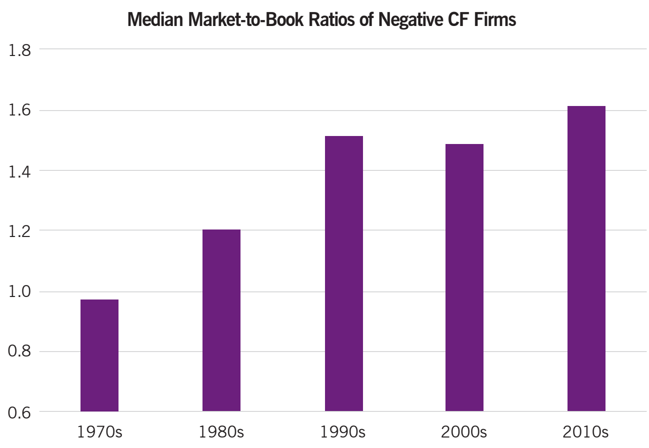
If companies exhibit myopic investment policies because of market pressures to show short-run profits, it follows that the market systematically penalizes companies that do not show such profits. As suggestive evidence in support of this view, the number of U.S. companies listed on public exchanges

17 To be clear, this data does not necessarily imply that individual companies are substituting intangible for tangible capital. It is likely that there has been a shift in the composition of companies making up the publicly traded universe such that a greater proportion of publicly traded companies are characterized by high rates of intangible investment.

18 See, for example, Michael Porter, "Capital Disadvantage: America's Failing Capital Investment System" *Harvard Business Review*, September 1992.

*Figure 4*

**Market-to-book multiples for companies with negative operating cash flow**




Median market-to-book multiples for companies with negative cash flow from operations.

has declined nearly 50% since 1996.[19] It is possible that younger, less profitable companies are choosing not to list on public exchanges because the short-term orientation of public markets places a low value on unprofitable companies.

However, in a recent study, Stephen McKeon and I report several findings that are at odds with this view.[20] First, we find that companies reporting negative operating cash flow have become far more pervasive in recent years. Moreover, these negative cash flows are much larger (as a percentage of total assets), and far more persistent, than they used to be. For example, Figure 3 depicts the distribution of operating profits from two periods of time: the 1970s and the 2000s. From this chart, it is evident that average operating cash flows have declined over time, and that a far greater proportion of public companies have large negative operating cash flow. In fact, in the 2000s, a striking 5% of the firm-year observations have negative operating cash flow that is greater than 50% of total assets.

And perhaps even more telling is the fact that as negative operating cash flows have become more common, the valuations of such companies have continued to skyrocket. As shown in Figure 4, negative cash flow companies in the 1970s were generally viewed as troubled companies and had market-to-book ratios that were typically below 1.0. Over time, however, the market multiples for these unprofitable companies have risen so dramatically that by the 2010s, the median market-to-book ratios of companies with negative operating cash flow had grown to approximately 1.6. In other words, companies with negative cash flow are now viewed as growth companies and are accordingly characterized by high valuation multiples. Such evidence strongly contradicts the notion that the market shuns unprofitable firms.

## Bottom Line

Based on my reading of several decades of research, there is little data in support of systematic underinvestment on the part of U.S. corporations. If anything, the evidence points toward overinvestment as the larger concern. Although corporate managers might have some incentive to boost earnings at the expense of productive investment in certain situations, there seems to be little systematic evidence to suggest that short-termism is a pervasive problem—pervasive enough to compromise the competitiveness of U.S. firms.

While traditional capital investment in tangible assets has declined, this decline has been dwarfed by the substantial growth in intangible investment. Even though these intangibles are typically expensed and therefore reduce near-term profits, there is no evidence that the stock market exerts pressure on companies to avoid such investment. In fact, the high valuation multiples of companies with high intangible investment suggests the opposite.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19 See Craig Doidge, Andrew Karolyi, and Rene Stulz, "The U.S. Listing Gap" *Journal of Financial Economics* 123 (2017).

20 David Denis and Stephen McKeon, "Persistent Negative Cash Flows, Staged Financing, and the Stockpiling of Cash Balances, Unpublished Working Paper, 2019.

# The Case for Maximizing Long-Run Shareholder Value*

by Diane Denis, University of Pittsburgh

**During the past 200 years, the publicly traded corporation has become the dominant form of large-scale business not just in the U.S. and U.K., but in all developed—and some developing—economies. Perhaps the greatest advantage of the public corporation is that its defining characteristics—limited liability, tradable shares, and status as a separate legal entity—allow and indeed encourage the separation of the ownership and control of business enterprises, and the specialization of management and risk-bearing that such separation makes possible. This specialization in turn allows management teams with well-established capabilities and experience to raise the equity capital needed to build "scalable" companies, even if the managers' personal wealth and appetite for risk are limited.**

At the same time, such equity ownership gives the providers of financial capital the opportunity to spread their capital across many enterprises in a variety of industries (and perhaps different parts of the world), thereby combining the financial benefits of productive investment with liquidity and diversification. And despite growing challenges from such alternative forms as private equity, PIPOs, S-corps, and other "pass-throughs," these benefits continue to play an important role in the durability of the public corporate form.

Despite their importance to the world economy—or perhaps because of it—corporations, especially large ones, frequently arouse skepticism, mistrust, and even outright hostility. Criticism of corporations abounds in scholarly works, the popular press, the political arena, and the entertainment industry. In "Wall Street and Vine: Hollywood's View of Business," an article published in *Managerial and Decision Economics* in 2012, corporate law and economics scholar Larry Ribstein provides numerous examples of popular films that present negative views of business and the profit-seeking capitalists who control them. Such portrayals extend to the world of children's entertainment, where the evil corporation run by a despotic megalomaniac has long been a stock feature. Consider as just one of many examples the 2014 blockbuster hit *The Lego Movie*, in which the antagonist, "Lord Business," a tyrant bent on world domination, succeeds in transforming himself into a conglomerate CEO called "President Business."

What's more, such characterizations, and the attitudes that have given rise to them, are by no means a recent phenomenon. In an engaging history of the corporation that came out in 2003, *Economist* editors John Micklethwait and Adrian Woolridge indicate that criticism of the corporate form as we know it dates back to its establishment by the Companies Act in 19th-century Britain.

The fundamental objections to the corporate form are likely to be rooted in the very benefits that have led to its growth and longevity. In the minds of many, companies' ability to grow into large institutions results in dangerous accumulations of power, while their executives are able to avoid accountability for many of their misdeeds by hiding behind the "corporate veil." Among the greatest popular

*This essay draws on and extends my article, "Corporate Governance and the Goal of the Firm: In Defense of Shareholder Wealth Maximization," *Financial Review* Vol. 51, 2016, which in turn is based on my keynote address at the 2016 annual meeting of the Eastern Finance Association. I thank David Denis, Ken Lehn, Mark Walker, Srini Krishnamurthy, Richard Warr, seminar participants at the Eastern Finance Association annual meeting, and the editor, Don Chew, for very helpful comments and suggestions.

grievances against corporations are the growing social and economic inequality often attributed to high corporate returns to capital and outsized executive pay, the role of corporations in environmental decay, and the perceived persistence of fraud and corruption among corporate executives.

In the pages that follow, I suggest that some very basic misunderstandings about the traditional "agency-based" law and finance definition of corporate governance have played a surprisingly large role in the widespread negative social perceptions of and attitudes toward corporations. Under this traditional definition, corporate governance comprises the set of mechanisms that encourage the managers of public corporations to make decisions that maximize the long-run value of the shareholders who are said—somewhat misleadingly—to "own" those corporations. There are many other "stakeholders" in corporations: employees, customers, suppliers, communities, and society as a whole. Many of these parties appear to have more meaningful stakes in the long-run success and staying power of a corporation than do its typical shareholders, who are not involved in the day-to-day activities of the firm, derive only small portions of their wealth from any given firm, and can quickly and easily transfer their financial capital to alternative investments.

On the surface, then, the proposition that managers should aim to maximize shareholder value appears to suggest that no one matters but "the people with the money." To the extent that the public makes this inference, it is not surprising to hear the words "soulless" and "greedy" routinely applied to corporations. Nevertheless, this inference represents a serious misunderstanding of what public companies must do to create long-run value for shareholders.

## Alternatives to Value Maximization

While shareholder value maximization remains the primary governance model among academics in financial economics, an alternative "stakeholder model" of corporate governance has evolved in management disciplines. Proponents of the stakeholder governance model argue that the goal of the corporation—and thus of its managers—is to serve the interests of *all* its stakeholders rather than the interests of shareholders alone. Moreover, many such models emphasize an overarching responsibility of corporations to the general social welfare.

Extensive debate over these seemingly competing models of corporate governance is carried out in a wide variety of arenas, outside of as well as within academia. A recent Google search of the phrase "shareholder stakeholder governance" resulted in over 28 million hits, while "corporate social responsibility" returned 715 million. The debate is broad in scope, and the issues involved are many and complex. My goal in this essay is to explore the pursuit of shareholder wealth maximization as it bears on other stakeholders, with the aim of showing that these two systems are neither mutually exclusive nor—when properly understood—even in competition with one another.

In making my case, I focus on two primary issues. First, critics of the value maximization model of governance often fail to understand, or at least to acknowledge, that shareholders are "residual claimants"; that is, their claims to corporate cash flows and assets come at the very end of the line. This has important implications for understanding the relationship between shareholder and stakeholder interests and welfare. My second main argument begins by noting that the corporation does not exist in a vacuum. The actions of corporate managers are effectively governed by "external" parties whose aims may have little to do with—and are often indeed in conflict with—corporate value maximization. I discuss the role of two important external corporate governance mechanisms: media and government.

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To say that shareholder wealth maximization is the corporate goal does not suggest in any way that only shareholders matter.

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## Value Maximization and Corporate Stakeholders

To say that shareholder wealth maximization is the corporate goal does not suggest in any way that only shareholders matter. Shareholders' position as residual claimants to the cash flows produced by the firm means that all other stakeholders with direct claims on the company—employees, suppliers, creditors, tax collectors—get paid before the shareholders are entitled to any cash flow. Maximizing shareholder value is thus equivalent to maximizing the amount of cash flow that remains after all other claimholders receive their due.

A seeming flaw in this argument is that, because any funds *not* paid to stakeholders ahead of them in line accrue to the shareholders, managers acting on behalf of shareholders may have incentives to undercompensate the other stakeholders. However, companies must entice direct stakeholders to contract with them in relatively free product and labor markets in which the rule of law ensures that contracts are enforced. Consider the case of employees. To the extent companies want to attract people to become and remain productive employees, companies must offer compensation and non-pecuniary benefits that exceed those of the workers' next best alternatives, including the alternative of not working at all.[1]

On the other side of the equation, however, companies should be willing to hire and retain *only* those workers whose expected value to the firm is equal to or greater than the cost of employing them—that is, workers whose expected marginal products are greater than or equal to their marginal costs. A model in which companies continue to employ workers whose marginal cost is greater than their marginal value to the firm is not sustainable. Ultimately, such companies will cease to exist. But as long as employees' value to the firm is at least as great as what they are being paid—and assuming there are no other employees who would do an equivalent job for less compensation—shareholder value is maximized by retaining those employees.

This is not to say, however, that value-maximizing companies have no incentive to offer employees anything more than the absolute minimum amount necessary to keep them at the firm. An employee's marginal product is not necessarily fixed. Because people respond to incentives, the combination of higher wages, better working conditions, and more fulfilling work has the potential to raise the marginal product of a company's workforce, whether because the company is able to attract employees of greater talent or because their employees have more incentive to work hard. To the extent that the benefits of increases in productivity exceed the costs of achieving them, managers who are intent on increasing shareholder value should aim to provide their employees with such incentives.

The discussion above is meant to illustrate and underscore the fact that the corporation is best viewed as a legal mechanism for coordinating the relationships of all its various stakeholders. As Michael Jensen and William Meckling wrote in the most cited article in the corporate governance and finance literature, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," corporations are "simply legal fictions which serve as a nexus for a set of contracting relationships among individuals." When viewed this way, corporations begin to look less like individuals, or even single-purpose organizations, to which virtues or failings can be attributed.

## Conflicts between Shareholders and Stakeholders

A model of governance with shareholder wealth maximization as its overriding goal serves the interests of other direct stakeholders of the company up to the level of their value to the firm and in the broader marketplace for their services. Therefore, for a stakeholder-based model of governance to be different from a shareholder-based model of governance, it must present the possibility of compensating non-shareholder stakeholders at levels that exceed either their value to the firm or the levels required by competing alternative providers.

There are two fundamental problems with such a model of governance. First, it does not provide corporate managers with a clear prescription for decision-making. For example, all other things equal, it will be in employees' interests to receive as much compensation as they can negotiate. Nevertheless, any compensation to employees beyond what is required to retain them at the desired level of productivity reduces the cash flows available to shareholders—and so reduces shareholder value. And if management chooses to ignore labor market values when setting employee compensation, how should they determine how much value to take away from one set of stakeholders (the shareholders) and give to another (the employees)?

The decisive advantage of market prices is that they represent the intersection of supply and demand by all interested parties. Once we leave market prices behind, what alternative decision rules should managers use to determine which interested parties receive above-market rewards, and at the expense of which other parties? There will be at least as many different opinions about this as there are interested parties. Whose opinion will prevail?

The second fundamental problem is that a system of corporate governance in which companies do not respond primarily to market forces is not sustainable in an economy in which companies compete with one another in markets for customers, factors of production, and financial capital. Customers will choose to purchase goods and services from the companies that offer the most advantageous combinations of price, quality, convenience, and whatever else is important to potential customers. The companies able to offer the most advantageous combinations will be those that employ the set of factors of production—including employees—that offer the most advantageous combinations of price, quality, skill, and whatever else it takes to produce the goods and services that potential customers demand. Thus, a company that overpays its employees relative to its competitors will not be able to compete on price, while a firm that offers lower wages than its competitors will attract lower-quality employees and be unable to compete on quality. Ultimately, neither company will be able to survive.

1 I define compensation as anything employees receive because of their job for which they can easily measure value in monetary terms: wages, benefits, etc. Non-pecuniary benefits are things that have non-monetary value to employees: satisfactory working conditions, the ability to do fulfilling work, personal respect, etc.

## The Market for Factors of Production

Factors of production in a free market will move to where they are most highly valued. The relative bargaining power associated with any factor of production is greater the more other opportunities there are for its use and the easier it is to redirect them to such alternative uses.

While not traditionally thought of as a factor of production, the financial capital provided by shareholders is essential to the production of goods and services. Just as the prices of goods, services, and the factors required to produce them, are set in the market, so too are the prices of shares of stock. Furthermore, there are a great many companies, private as well as public, that the holders of financial capital can invest in. Shareholders of publicly traded companies can quickly and economically remove their resources from one firm and invest them elsewhere. For this reason alone, shareholders arguably have greater relative bargaining power than other stakeholders. A company that investors do not expect to provide a competitive risk-adjusted rate of return on its equity will not be able to raise the financial capital needed to run its business.

It is important to note, however, that shareholders' greater bargaining power does not suggest that they can expect to earn "economic rents" in the form of above-market returns. To the extent that a company's current share price implies an expected return that is higher than the appropriate risk-adjusted rate of return, excess demand by investors is expected to drive the share price up until it equates to an appropriate expected return.

The relative ease with which shareholders can remove their resources from publicly traded companies also contributes to negative attitudes toward shareholder wealth maximization. While such arguments take a number of forms, a basic objection stems from the idea that shareholders are "short-term" participants in the firm, able to remove themselves at a few moments' notice, while the interests of most other stakeholders are longer-term in nature. Why, then, should shareholders' interests be of primary importance?

There are at least three points worth noting related to this issue. First, by virtue of how the market prices stocks, shareholders' interests in the companies whose equity they hold are long-term in nature, regardless of how long they expect to hold the stocks. At any given moment, the value of a company's stock is the present value of *all* of the company's expected future cash flows, not just those cash flows expected during the shareholders' holding periods. Second, stock prices react quickly to news of changes in companies' circumstances. While shareholders can depart quickly and easily when the company gets into trouble, the reduced price for which they can sell their shares will already reflect such trouble. Finally, although we tend to talk of shareholders and other stakeholders as if they are mutually exclusive groups, there is in fact considerable overlap between them. The ease with which shareholders can invest in and divest themselves of stocks makes the benefits of stock market investment available to anyone who has even a small amount of money they wish to invest, provided they also have the willingness to bear the risk of loss that comes with equity investments.

In sum, committing to value maximization as the corporate goal is in no way equivalent to saying that only shareholders' interests matter. In a reasonably free-market economy such as the U.S., all economic agents are free to offer their resources—their time, skills, abilities, financial resources, etc.—to whichever companies offer them the best combination of returns on those resources. Because other direct firm stakeholders receive their returns before the shareholders do, maximizing shareholder wealth means maximizing the net present value of the entire stream of expected future cash flow that remains. Furthermore, it is in shareholders' interests that the stakeholder claimants ahead of them actually receive their appropriate compensation. Stakeholders who doubt whether they will receive what is owed to them will "price-protect" themselves up front by demanding higher compensation. In this sense, it is the shareholders, as the residual claimants to corporate cash flows, who effectively bear the higher costs associated with stakeholder uncertainty and risk. A model of governance in which important stakeholders receive *either below-market or above-market* returns on an ongoing basis is not sustainable in a competitive global economy.

## Externalities, Frictions, and Alternative Forces

The foregoing discussion presupposes an economy in which we can rely completely on market forces to protect the interests of everyone who has any stake in how corporations are run. However, as economists have long pointed out, "externalities" associated with corporate operations and frictions in the markets in which they operate can create situations in which there are no effective market solutions.

In my discussion to this point, I have focused on *direct* corporate stakeholders—those who willingly enter into relationships with individual firms by purchasing their products, working for them, selling raw materials to them, and so forth. However, there are also *indirect* (or involuntary) corporate stakeholders: parties who do not directly enter into relationships with individual companies but are nonetheless affected by corporate actions. To the extent that the effects of such externalities on stakeholders are negative, they represent a situation in which stakeholders may be unable to fully protect their own interests against those of corporations.

Consider, for example, a company whose operations produce air pollution, which they could at least partially control by installing pollution abatement equipment. Strict shareholder governance—with its charge to management to maximize shareholder wealth—might not support the installation of such equipment. Its cost would be fully borne by the shareholders, as residual claimants to the firm's cash flows, while the majority of the benefits would accrue to the residents who live near the offending plants.

The existence of frictions in the market can disadvantage even stakeholders who do enter willingly into relationships with individual firms. Consider, for example, the issue of monopoly power. If a corporation prices a product such that it earns economic rents, there is incentive for other firms to enter the market, thereby increasing the supply and lowering the price of that product. However, to the extent that there are sufficient frictions in the form of barriers to entering that market—for example, high start-up costs—the corporation can continue to earn rents at the expense of its customers. Because such rents accrue to the corporations' shareholders as its residual claimants, the pursuit of monopoly power may well be consistent with shareholder wealth maximization. However, when viewed from a broad social perspective, the surplus lost by the consumers exceeds the surplus generated for the shareholders, resulting in a deadweight loss to the economy.

Nevertheless, the existence of externalities and market frictions does not imply that something other than shareholder wealth maximization should drive managerial decision-making. Corporations, as I indicated earlier, do not operate in a vacuum. Instead, their collective prominence in our lives ensures that they attract considerable attention from forces outside the direct corporate sphere.

Let's now look at two of the most prominent such forces: media and government. My aim in doing so is to point out that market forces and shareholder governance in the U.S. are not absolutes: there are broader influences on managerial actions that often protect or favor stakeholders other than shareholders. At the same time, I will also discuss the implications of such deviations from strict shareholder wealth maximization for the economy.

## Constraints on Market Forces

Critics of corporations point to their considerable power. However, government and the media are also powerful forces in the U.S. economy. A large body of empirical and anecdotal evidence suggests that these two institutions together exert considerable influence on the actions of corporations. In terms of their incentive and ability to influence corporate actions, both government and media are motivated in large part by the desire to please broad and diverse constituencies. Corporations are one very important constituency for both groups—as potential donors to political campaigns and as potential advertisers in media outlets. However, other constituencies of government and media—particularly voters and potential consumers—exert considerable influence as well. For evidence of such influence, we need only look to the spectacle of would-be 2016 and 2020 presidential candidates competing to express the greatest hostility to big business. In addition to being influenced by their constituencies, media and government play important roles in shaping the desires of the general public.

## Media

Especially in an information age, the media are a force to reckon with. They exert influence on corporations through their ability to disseminate information and shape opinions. Along with traditional outlets, such as newspapers, magazines, and television, today's media also include a growing online and social media presence. This allows anyone with a computer or phone to share information or opinions with a potentially broad audience, without even leaving the sofa. In this way, the media serve to generate and transfer information across parties in the economy.

What are the effects of such activity? One is the potential to increase market efficiency by reducing uncertainty and information asymmetry in the market. In addition, it provides stakeholders, both direct and indirect, with means by which to seek to influence corporate actions. The extent to which such efforts are successful will depend on the extent to which their messages resonate in the marketplace. Corporations must consider and, in some cases, confront those ideas that are popular enough to have potential implications for their ability to attract the employees, customers, and investors they must attract if they are to maximize firm value.

## Government

The media's influence on corporate actions, though powerful, is largely indirect. It cannot force corporations to take or avoid particular actions. The government, on the other hand, has considerable direct influence on corporate actions by virtue of its ability to regulate. Consider, for example, the corporate pollution of air and water I identified earlier as a prime example of a market externality. The U.S. federal government, under the auspices of the Environmental Protection Agency, exercises considerable control over corporate emissions. The fact that it takes 465 pages to enumerate all of the requirements of the Clean Air Act, and another 234 pages for the Clean Water Act, strengthens the EPA's regulatory hold over even the most compliant corporations. Thus, while strict shareholder wealth maximization may not lead manufacturing corporations to protect the interests of those indirect stakeholders who live near their plants, the government is an overriding force in ostensibly providing such protection. Similarly, the U.S. government exercises considerable control over corporations' ability to amass market power by imposing antitrust laws.

The media, too, play a role in mitigating the negative effects of market frictions and externalities generated by corporations. The potential effects of widespread information (and deliberate misinformation) about negative corporate actions on corporate reputations can interfere with such companies' ability to attract customers, high-quality employees, and other direct stakeholders.

In addition to governments' ability to impose regulations, its ability to tax its constituents—companies as well as individuals—provides the government with further tools with which to influence corporate actions. Consider, for example, the wide variety of tax deductions and credits available to businesses that engage in green energy initiatives, whether in terms of their own energy usage or of the production of green products for sale to consumers. Add to such business incentives the tax credits available to consumers who purchase green products—electric cars, solar energy systems, and many others—and we have a system in which the government has a considerable impact on both the demand for and supply of green products.

Critics may well argue that the ability of the government to protect those stakeholders whose interests the corporate pursuit of shareholder wealth maximization does not sufficiently protect is limited by the fact that corporations—in particular large corporations—have an undue amount of influence over government. There is merit to this argument, to the extent that such influence results in outcomes, such as higher corporate profits or prices to consumers, that deviate from what we would observe in a competitive market. Many corporations are significant donors to political campaigns or employ lobbyists to exert influence on government. In addition, the government may be reluctant to risk corporate outcomes that would adversely affect significant numbers of corporate stakeholders. In such situations, the government may go so far as to bail out corporations rather than let them fail.

We should not view this, however, as an indictment of the corporate form. Such outcomes are better viewed as reflecting the interplay among the varied and often conflicting motives of government agents: their individual opinions about what is best, the election-based need for money and votes from a wide variety of constituencies, and their desires for personal power and financial gain.

The idea that there are situations in which the greater social good warrants departures from strict shareholder wealth maximization is quite reasonable. The problems arise, however, when trying to define the precise circumstances under which this is true. Government influence over corporate actions replaces the consensus decisions of a broad marketplace of stakeholders employing their own resources to act in their own interests with decisions made by a much smaller group of government officials with complicated incentives and control over resources generated by others. Such replacement is warranted only when effective market solutions do not exist. Furthermore, there must be clear and compelling reasons in such cases to think that the government is able to make better decisions than the market about any particular issue. If the government is, in fact, overly responsive to those with great wealth and power, that can hardly inspire confidence in their decision-making.

What are appropriate roles for government with respect to corporations? This is a loaded question, and I will not attempt to provide an exhaustive list of even just my own thoughts on the matter. However, I will propose two categories of such roles, while urging that we exercise care even within these categories.

First, I believe there is an important role for government to play in the protection of stakeholders from the negative effects of corporate externalities and market frictions. Unchecked pollution has potential adverse consequences for many in society who are not in a position to contract on the matter with the offending corporations. However, we must carefully weigh the social benefits of regulating against any externality or friction against the social costs. Zero pollution, for example, is not a realistic goal. At some point, further reductions will require that some products that many consumers value either cannot be produced at all, or not at a price consumers can afford to pay. The great challenge for policy makers and regulators is *identifying the point at which the social costs of regulation outweigh the benefits*. Meeting this challenge requires that the government truly has at heart the interests of society as a whole, as opposed to those of favored interest groups.

Second, I believe there is an important role for the government to play in identifying and remediating corporate wrongdoing. If market forces are to protect the interests of direct corporate stakeholders, they must be able to contract with corporations with the expectation that both sides will act in good faith and as they agreed to do. Similarly, if governments are to protect stakeholders from externalities and frictions for which market solutions are insufficient, appropriate rules must be set and followed. This requires that governments hold all corporations, and their relevant individual decision-makers, to the terms of their contracts and the rules that are set, regardless of the degree of their political influence. Corporate fraud and corruption not only harm individual stakeholders, they also contribute to negative social views about corporations. The challenge, of course, lies in defining what constitutes corporate wrongdoing. Rule-makers must balance the intended benefits of potential rules against their costs, including those arising from unintended consequences.

It would be difficult to overstate the importance of restricting government involvement in the affairs of corporations to the arguably limited situations in which the benefits of such involvement outweigh the drawbacks. And there are many drawbacks. First, as noted above, government involvement effectively replaces the will of the many in the market with the will of the few in government. Second, government regulations are by nature one-size-fits-all solutions to complex problems. Government regulations that are ill-suited to individual corporations can limit their ability to follow the most beneficial course of action. Furthermore, regulatory prescriptions can reduce a corporation's incentive to carry out the analysis needed to determine its own appropriate course of action. As one example of what can go wrong when businesses rely too heavily on regulation, the Titanic carried on board the government-regulated number of lifeboats; but because it was considerably larger than any ship before it, this was only half the number of lifeboats needed. Finally, government involvement invariably has consequences beyond the government's presumed intentions—unintended consequences with the potential to harm individual economic agents. Perhaps worse, they may lead to further ill-advised regulation designed to blunt their impact.

As an example, consider the issue of corporate risk-taking. Risk is inherent in business operations. Corporate investment in appropriately risky projects benefits the economy as a whole by providing employment, goods, and services. A publicly traded corporation operating in a free market maximizes its long-run value by taking on appropriate risks and avoiding the risks for which the expected return is not high enough to justify them.

Suppose, however, that government policies essentially break the link between risk and return. Take the case of banks, deposit insurance, and too-big-to-fail policies. Depositors, when protected by deposit insurance, provide banks with funds at below-market cost. In addition, big banks expect that government will step in with public capital if they get into enough trouble. As became clear during the last crisis—and indeed repeatedly throughout U.S. history—this combination gives rise to a classic moral hazard problem in which banks maximize their own expected value by taking on risk that the market would be unwilling to finance at the given expected return without government backing. This added risk is effectively financed by the taxpayers—a group that includes the same investors who would be unwilling to finance these additional risks if they were given any choice.

The intended consequence of government bailouts of large institutions is to avoid the temporary chaos in the market that would result from such a failure. The increase in corporate risk beyond what is financially justified in the market is a serious unintended consequence. To the extent that the government is concerned about this increase in risk, it may interfere further in the workings of corporations—say, by dictating how much cash or equity companies must maintain, or how much or in what form they must pay their employees. The government, however, lacks the specific knowledge needed to determine appropriate policies and risk levels for individual corporations. Invariably the one-size-fits-all mandates they impose will lead some firms to avoid taking on taking on appropriate risks, thereby depriving the economy of valuable growth and development. Government involvement in corporations is a very slippery slope.

### Shareholder Wealth Maximization and Social Welfare

Recent years have witnessed an explosion of interest in how corporations do—and should—affect social welfare. Terms like ESG (environmental, social, governance), CSR (corporate social responsibility), and sustainability are commonplace in corporate boardrooms, corporate marketing, investor relations communications, and the popular press. Underlying each of these concepts is the idea that corporations have a responsibility to pursue environmental and social concerns, in addition to financial concerns. This is the so-called triple bottom line, sometimes referred to as planet, people, and profit. I will refer to them collectively as ESG.

Proponents of ESG vary in their prescriptions for corporate behavior and the resulting implications for shareholder wealth maximization. At one end of the spectrum, proponents make the case that attention to social welfare can and should be used to maximize company value—that well-designed, cost-conscious environmental and social policies have financial payoffs in the form of more loyal employees, suppliers, and customers. Under this view of ESG, there is no conflict between shareholder and stakeholder governance mechanisms. A growing body of research evidence provides promising—if somewhat mixed—evidence that companies that score highly on measures of ESG perform better financially, on average.

At the other end of the ESG spectrum is the view that corporations have a moral obligation to use their considerable power and resources for the social good, even at the expense of shareholder value. For example, corporations that commit to "the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose" can become Certified B (for "benefit") Corporations. This certification is granted—in return for an annual fee—by the U.S. nonprofit B Lab. As of March 2018, 35 states and Washington D.C. had passed legislation that allows a company to incorporate as a benefit corporation, as an alternative to a traditional C corporation.

Finding solutions to such vexing problems as inequality and poverty are admirable goals. And to the extent that some investors are willing to sacrifice financial return for such pursuits, some B Corporations may be able to privately raise the capital they need to do business. However, it is likely that the set of such investors—and therefore the number of B Corporations they can finance—will remain small. Corporations that compete in public capital markets must commit to maximizing long-term value to attract the capital they need to do business. For those companies that undertake ESG investments without the expectation of a payoff for investors, the likely outcome is unwanted attention from shareholder activists, or even private equity investors, who can create value simply by "undoing" such investments. And if such external forces fail to materialize, corporations that persist in overinvesting in ESG are likely to end up jeopardizing their existence as independent companies and, along with it, the continuing stream of social benefits realized by all their stakeholders in the normal course of corporate activity.

## Finding the Balance in the Governance of Corporations

Where then does all of this leave us? Is the modern corporate form of organization in jeopardy? Are corporations as a class doomed to be social pariahs: underloved and over-regulated? Or can we find an appropriate balance—one in which corporations are allowed and can be trusted to maximize the economic well-being of society? Finally, what role can financial economists play in addressing these issues? While it is beyond the scope of this essay to do justice to these questions, I provide a few thoughts in closing.

The modern corporate form of organization has survived, prospered, and expanded around the world during its more than 150-year history because it provides for and encourages the efficient use of society's economic resources. Thanks to limited liability and the tradability of shares, managerial/entrepreneurial talent and financial capital can come together even when they do not coincide in individual economic agents. When we allow such combinations to operate in relatively free markets, we get business enterprises that provide members of society with the goods and services they need or desire, the ability to earn their livelihoods, and the opportunity to earn financial returns that provide them with better futures. Because such benefits are considerable, it is difficult to imagine that the basic corporate form is in danger of disappearing.

Traditional ideas about the appropriate goal of the corporation, however, are increasingly in danger. In 1970, Milton Friedman proposed in *The New York Times Magazine* that the social responsibility of business is to increase its profits. The traditional definition of corporate governance, with its goal of shareholder wealth maximization, effectively reflects Friedman's views. The publication of his views set off a firestorm of debate that continues to the present, and criticism of shareholder wealth maximization comes from many corners of society.

As I see it, the main source of such criticism is a misunderstanding of value maximization: how it is accomplished, what it entails, and what its implications are for other stakeholders. Reducing value maximization to the proposition that "only the shareholders matter" gives the misleading impression that the good of the corporation and the good of the rest of society are in conflict. In truth, however, companies maximize shareholder wealth by providing other direct stakeholders with market-determined returns on their contributions to firm value. When the returns to all stakeholders, including shareholders, are set in a free market, economic outcomes reflect the collective decisions of economic agents acting in their own interests using their own resources. Thus, under normal circumstances, and in the vast majority of cases, what is good for a corporation is also good for society. Until this proposition is well understood, corporations are likely doomed to be underloved and over-regulated.

Public discontent with large corporations is an important impetus for excess government involvement in corporations. For this reason, widespread misconceptions about corporate motives, goals, and ways of achieving them are dangerous for society's economic well-being. Individual corporate stakeholders, be they consumers, employees, or shareholders, generally have both the ability and the incentive to make decisions that are in their own interests. Corporations who seek to maximize shareholder wealth follow a clear decision rule that most often results in market-based returns to all of their stakeholders.

Governments, by contrast, typically have neither detailed knowledge of the interests of individuals or corporations, clear decision rules for determining whose interests to maximize, nor their own resources at risk. How, then, can the government be expected to make superior decisions? The government's role in the workings of the corporation should be to step in when market solutions truly do not exist and to enforce the terms of the nexus of contracts that constitute the modern corporation.

What can financial economists do to improve the reputation of the corporation in society? First, we can work to educate the population about the implications of shareholder wealth maximization and about the important role that corporations play in social well-being. Second, we can be part of the dialogue on how to identify and address those situations in which the good of corporations and the good of society are legitimately in conflict. And, finally, on a more personal level, as our children and grandchildren are exposed to movies and stories about evil corporations, we can make sure they hear the other side of the story.

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# A Tribute to Joel Stern

by Bennett Stewart, Co-Founder and Former Senior Partner, Stern Stewart & Company

Joel Stern was Managing Partner of Stern Stewart & Company and its successor, Stern Value Management. He was previously President of Chase Financial Policy, a global consulting arm of the Chase Manhattan Bank, where he founded a predecessor of this journal called the *Chase Financial Quarterly*. He died on May 21, 2019.

Joel Stern was brilliant and driven—and the funniest and most charming person I have ever met. His combination of financial knowledge and penetrating insights, peppered with some of the most outrageous—and outrageously funny—anecdotes, was irresistible.

He was a teacher and a translator. He could simplify and illuminate abstruse concepts in finance and economics and make them fun, lively, and accessible. He had a limitless passion for thinking through corporate finance issues—parsing them, debating them, refining them—and tried to instill that same passion and commitment in his clients, colleagues, and students.

He was a staunch free marketeer—an intellectual disciple of Milton Friedman, Merton Miller, and Gary Becker, who were his professors when he attended business school at the University of Chicago. He loved his business school alma mater and always referred to it affectionately as the mother church.

Perhaps most significant, Joel developed the foundations of Economic Value Added, or EVA, and inspired generations of business practitioners to measure and reward performance in ways that create value for shareholders. He literally invented the terms NOPAT and Free Cash Flow, which of course are still widely used today (although not always as he defined them).

I first met Joel in 1976 when I joined a consulting group he had formed at the Chase Manhattan Bank. Known as Chase Financial Policy, the group's goal was to translate the best academic research and insights into business practice. It was—and is—a noble purpose, and was especially needed at the time. Major new finance theories were percolating out of the business schools, led by a constellation of future Nobel laureates and the advent of computers and databases that enabled researchers to test the theories and sort truth from myth. There were many sacred cows to be slaughtered, and Joel led the way, as no one else could, and always in a manner designed to be provocative. He saw finance as a Manichaean struggle between the light of the "economic model" of value and the darkness of an "accounting model" of value. Finance can be esoteric and dull—but then came Joel.

## First Principles

*"I claim that the mom and pop running the corner grocery store know more about corporate value than most business executives," he asserted. "Why? Because they do not have a P&L and balance sheet to confuse them. They have a cigar box. The cash goes in, the cash goes out, and as long as the lid on the cigar box is rising, the value of the business is going up."*

He reduced this thought to an aphorism: "Earnings per share don't count, it's Free Cash Flow that really matters." He had a tie clip engraved with those words, a gift from the CEO of Union Carbide. Joel wore that clip every day. And if someone questioned his model, Joel would walk up to that person, ask him or her to read the tie clip out loud, and then announce, rather severely, "Do you think I would have *that* on my tie clip if it wasn't true?"

He conducted two-day management forums on corporate finance for hundreds of companies all over the world. In his opening remarks, he would declare, "Would you believe that all the reputable research in finance demonstrates conclusively that accounting measures of value, such as earnings, earnings-per-share, earnings growth, and profit margins, simply do not matter?" One prominent CEO's response: "Joel, I am very happy to hear it, because we are not having a very good year."

Joel would single out a company's controller—and the accounting profession in general—for special opprobrium. It all began, he declared, when he took a required course in accounting at Chicago. On the first day of class, the professor went around the room to each student and asked, "What is the best way to measure a company's performance?" The answer in every case was some variant of earnings, net income, or EPS—until he got to Joel. Joel's answer: "It definitely cannot be earnings! I read ahead to the chapter on inventory costing. If a company takes coal out from the top of the coal bin, that is Last-In, First Out, or LIFO, and from the bottom, that is First-In, First Out, or FIFO. Although the coal is all the same, in a time of rising prices, LIFO costs are higher than FIFO costs, which will reduce reported earnings, but by paying lower taxes on lower earnings, the company has more cash in the bank. Which would you rather have—the greater book profits of FIFO, or the greater cash flow of LIFO?"

"Joel," the professor responded testily, "in this class, I am the one asking the questions. And for our purposes, the answer is earnings. So I ask you again: how do we measure corporate performance?"

Joel, without hesitation, responded, "Earnings!" When asked why he had changed his mind so suddenly, Joel said that in the economics department they teach that there is a price for everything, and he wanted to get out of the accounting course alive.

## All Growth Is Not Equal

Joel developed a simple example to show why EPS growth is a poor measure of company value. Two companies, X and Y, have the same earnings growth. They are the same in every way, except that company X has to invest a lot more capital each year to produce the same earnings growth as Y. Which company is more valuable?

Joel's answer: Y, because it generates more Free Cash Flow—more economic earnings net of investment. It also earns a higher ROI—a higher ratio of earnings to the capital employed in the business. Joel darkly suggested that if success were measured by earnings growth, managers could simply spend their way to success by pouring capital into uneconomic projects.

In the 1960s and 1970s, conglomerate acquisitions were all the rage. In many cases, companies manufactured EPS growth by acquiring companies selling for lower PE multiples, which automatically gave EPS a boost. Joel maintained that this made no sense and dubbed it the "AB-BA fallacy."

Company A trades for 20 times earnings, and company B for 10. Company A issues its higher-PE shares to acquire all of B's lower-PE shares to form a company called AB. The question is, what *always* happens to company AB's earnings-per-share relative to company A's? Joel would point out that "always" is rare in corporate finance, but in this case, if you got the wrong answer, you were definitely wrong.

The answer was that company A's EPS *always* go up. The earnings of companies A and B are additive, but there will be fewer low-PE B shares outstanding in the form of the higher-PE A shares, and so EPS will go up—regardless of the identity of the two companies, regardless of the potential for synergies, regardless of whether the merger makes any sense at all. The increase in EPS is simply arithmetic.

To put the nail in the coffin, Joel asked what would happen if we turned the deal around, and B acquired A to form company BA. The math reverses. Company B must issue a larger number of its lower-PE shares to retire the higher-PE shares of company A, but once again the earnings are additive, leaving company B with lower EPS in the wake of the deal. Joel would ask, rhetorically, "How can it be good for A to buy B but bad for B to buy A, when AB and BA are the same company?" His insight was that because AB and BA will have the same combined earnings and the same combined value, they will have *the same PE multiple,* somewhere between A's and B's original multiples of 10 and 20. As a matter of pure arithmetic, the buyers' PE ratios will have to converge just as surely as their earnings-per-share will diverge.

"This is how markets work," Joel asserted. "Earnings-per-share really doesn't count. But management won't see it that way if their compensation is tied to EPS. They will let the accounting tail wag the business dog."

Joel's prime nemesis was dividends. "I cannot understand why any company, anywhere, anytime, has ever paid a dividend! Companies are valued for what they do, not for what they don't do. Paying a dividend is an admission of failure—management's failure!—to find attractive ways to reinvest the money," he would rail. "Your investors want dividends? They can invest in bonds as well as non-dividend-paying stocks or sell shares and pay a capital gains tax only on the gain." It was a tour de force in applying withering logic to slay another sacred cow. He would reiterate, "Earnings don't count, growth doesn't count, dividends don't count!" Joel's tongue-in-cheek conclusion: "*Nothing matters!*"

## The Proof Is in the Pudding

Once, during one of Joel's management presentations, an attendee had the temerity to ask how part of a formula was derived. In those days—pre-computer and PowerPoint—Joel made his presentations on a 25" by 30" easel pad and an assortment of oversized markers. Every time he made a presentation, he had to totally recreate each page, but he was very well rehearsed at this.

His response to the client: "I am sorry, I no longer do derivations, and let me tell you why. When I was younger, I thought I had to *prove* that my formulas were right. I was asked to give a presentation to the management committee of the Chase Bank. Sitting in the front row was the senior executive poohbah of some department of the bank. This fellow had a reputation for sleeping in meetings, so they put him right in the front row.

"I began my talk," continued Joel, "and soon enough, I dove into my derivations. At the third easel page flip, I notice the senior executive's head starting to roll and his eyelids growing heavy. I spoke faster and wrote more dramatically to grab his attention, but his head only spun more wildly out of control and then his eyes closed. The next thing I knew, he fell completely out of his chair and his head landed right on top of my shoe!"

As Joel told it, he turned and asked, "What do I do now?" And the answer, from none other than David Rockefeller, was, "Joel, speak softly."

This story never failed to get a laugh, and completely settled any need for a derivation.

He had done all the derivations, of course. And to his immense credit, he was eventually able to translate the famous Miller-Modigliani ("MM") valuation model into a much more accessible format—and without the need for formal proofs. He'd become a Ninja, a true black belt, riding on a higher plane of proficiency. I sometimes think he understood the models better than the inventors of the models did.

In their classic 1958 paper, "The Cost of Capital, Corporation Finance and the Theory of Investments," MM wrote the first term of their valuation formula—the value of a company's base business—as $\overline{X}$ over $\rho$. Literally, Greek.

Joel renamed $\overline{X}$ as NOPAT, or net operating profits after taxes—the earnings from the firm's existing asset base. He figured out how to estimate NOPAT from accounting data, something we had never learned in business school. NOPAT is in wide use today, and it's Joel's invention. He also renamed $\rho$ as "c," representing the cost of capital, or cutoff rate, which is the required rate of return to compensate for business risk. It is the rate used to capitalize the current NOPAT earnings to measure the value of the base business.

To build suspense, Joel purposely saved the computation of c, the cost of capital, until the conclusion of his two-day management forum. This segment was held to be so important that Joel described it as "the maxi crescendo," and played it up throughout the two days. From his initial failure as a wonky presenter, Joel had gone on to master the thespian skills. At times he would wind up to a roar, for a commanding emphasis, and at others his voice would melt into the softest sentences. It was mesmerizing.

So with half an hour left on the second day, Joel would at last announce that the Chase Manhattan Bank marching band was assembling outside to accompany this final and most important part of the forum, in which he would at last reveal how to calculate c, without which the model was useless.

ARE YOU READY FOR THIS, he would thunder at the top of his voice. AT THE CHASE MANHATTAN BANK, WE DO NOT KNOW HOW TO CALCULATE C. I WANT TO THANK YOU VERY MUCH FOR COMING. THIS IS THE END OF THE FORUM. GOODBYE. But then a minute later—and to everyone's relief—he would show a roundabout route he had developed to calculate c. The model is dead, long live the model. Joel had saved it.

One company was so enthralled with the prospect of the finale that the CEO arranged to pipe in "Stars and Stripes Forever" just as Joel began the maxi crescendo. It was magnificent. And he and his management team liked the presentation so much that they hired us to help them with the valuation of an acquisition. We frequently would get business this way because the clients were impressed by the clarity that Joel provided about how to create shareholder value—and frankly, the entertainment value was also a factor.

Joel loved the Chase Bank, which was as prestigious an institution as you could imagine in those days, and he used this to his advantage. He often told stories about people and companies, not always flattering, and to assuage a client's concerns that he might do the same to them, he would find an opportunity to say, "If I mention a company during our two days together, I want you to know that we have obtained their permission—or, at the Chase Manhattan Bank, we do not like their management!"

On the rare occasion that a jest fell flat, he would say, "During our time together, I will be relating seven pieces of worthless information, and if you are counting, that was number four." The way he would say this—the timing, the look, the audience reaction—it always worked. They say that people learn best when they are entertained, in a good mood, laughing. It opens and relaxes the mind. Joel was living proof. He was the master.

### Debt and Taxes

The second term in the MM valuation formula, as Joel explained it, is tD, or the corporate tax rate multiplied by the company's debt. There's a tax benefit to using debt because the interest is tax deductible. There are formulas to show this. But Joel would tell a story instead.

One day, so the story went, Joel and his father were walking companionably in the family apple orchard (which we've yet to definitively locate), each lost in his own thoughts. Suddenly Joel's father broke the silence.

"Son, I don't know how to tell you this, but…we don't pay any taxes."

The audience would immediately perk up because this is not the typical father-son bonding talk that they were expecting.

"How so?" asks Joel, in great Socratic tradition.

"Well, the apple farm earns a modest profit, but it's offset by the interest on the money we've borrowed. We owe no tax."

"But then how then do we live," Joel asks, "if we have no profit?"

"Simple, Son. We borrow against the increasing value of the land and pay it out as a dividend. We harvest the value tax free."

They walk on a little further, and then it occurs to Joel to ask, "But Father, who is going to pay off all the debt?"

Brief pause.

"Son, I'm sorry to have to tell you this, but…*you* will!"

Drum roll and cymbal, please.

Self-deprecating humor was a big part of why Joel was so successful. He liked to recall the time he asked a question of a man sitting way in the back of a large theater, who responded, "Sorry, I cannot hear you and I cannot see you," at which point, so Joel says, a man sitting right up-front calls out, "Well I can hear him and see him fine, would you like to trade places?"

There was a period when Joel was into tennis and took lessons with a top pro in Cape Town, South Africa, which was a country he loved to visit. When Joel got the bill for his first lesson, it was a whopper. Joel protested, "We only played an hour, but you charged me for two." "That's right, Joel. It's one hour for the lesson and one hour to get my game back." And remember, it's Joel telling this story.

## Stock-Picking and Lead Steers

People frequently asked Joel for stock tips, and occasionally he would oblige, but usually he would brush it off by saying "You don't want a tip from me. My portfolio is currently under intense scrutiny at the MIT Sloan School of Management—for its tendency to lead the market down and to barely hold its own during major market rallies."

In the 1970s, Joel was a rotating panelist on the television show *Wall Street Week,* hosted by Louis Rukeyser. It was an incredibly popular show featuring talk on the stock market; it was Bloomberg and Fox Business News way before their time. Joel claimed that his nickname among the panelists was Pluto, because he rotated the least frequently.

At one point, the show conducted a survey to explore the appeal of each panelist, and found that Joel's largest fan base was women over the age of 80. Joel said he cringed whenever he heard an emergency vehicle's siren, for fear he was losing one of his flock.

The show held an annual contest for the best stock picker. At the beginning of the season, each panelist got to pick one stock, and whoever picked the best-performing stock for the year was the winner. Most panelists would spend weeks doing research to make their pick. Joel would simply ask us to pick a stock for him with a very high beta, because if the market went up, as it more likely would than wouldn't, the highest-beta stock would go up the most. Joel won several times, certainly more than his share. The best part was watching him justify his stock on television.

If this seems disingenuous, it wasn't. It was entirely consistent with the so-called efficient market theory, developed at the University of Chicago while Joel was a student, which states that all public information is already factored into stock prices. You can throw darts to pick stocks because you are protected by research already conducted by smart-money investors, which ensures that companies are trading at their fair values. Back in those days, this idea was hugely controversial. Today, it reigns supreme, with indexes and ETFs replacing active managers. But how to explain this, way back then?

Joel did it by explaining why the price of apples is the same in two stores that sit across the street from each other.

"One possibility," he said, "is that all shoppers visit both stores to check the prices. But that's not really necessary. If just a few shoppers visit both stores, they will exert sufficient pressure to bring prices in line." At this point, you're nodding in agreement—but you've just been set up.

"*Even that is not really necessary,*" Joel declaimed with stentorian flair. "All that's *really* required is for the *store managers* to visit each other's store and check the prices—for *fear* that shoppers will."

Joel would continue: "Prices in the stock market, as in all markets, are set *at the margin* by the smartest, most informed, most motivated money in the game. Stock prices are not set by a polling technique in which all investors have a vote on value. There is a small group of savvy institutional investors—I call them the dominant, price-setting investors—that set the market."

This led to perhaps Joel's most inspired metaphor. Merrill Lynch at the time was running ads featuring its bull mascot on the run. Merrill brokers were referred to as the "thundering herd." Merrill was bullish on America. It was an extremely well-known brand and marketing campaign. Joel cleverly appropriated it. He started to call the dominant price-setting investors "the lead steers."

Joel loved to tell the story of the lead steers. "If you want to know where a herd of cattle is going, you don't have to interview every steer in the herd. Only the lead steers. It's the same with stocks." And people readily understood this.

One day, however, Joel was on a flight from Dallas to New York, when (according to Joel) an honest-to-goodness cowboy—spurs and all—sat in the seat beside him. So Joel started a conversation and the man confirmed that, yes, he was a big Texas rancher, and he was on his way to New York to meet his investment banker. Joel figured that this was the perfect opportunity to talk about lead steers, so he said, "Let me tell you how stock prices are set. You don't have to interview every steer in the herd, just the lead steer."

The cowboy chuckled, and said that it was a great concept. "There's only one problem, Joel," he said. "The steers don't lead the herds; the cows do."

Joel said later, "All I could think was that Merrill Lynch was in big trouble."

I was listening to Bloomberg radio recently when I was reminded of Joel. The question over the airwaves was, "Isn't there a lot of cash on the sidelines that could come into the market and drive it higher?" On the surface the question sounds reasonable. But Joel was fond of pointing out that for every buyer there must be a seller, and for every seller, a buyer. The only way a lot of cash can enter the stock market is if an equal and offsetting corps of investors are rushing to leave it. The cash that comes in is matched by the cash that goes out. Nothing has happened, on net. Trading volume simply indicates that value is uncertain, not that it's going higher. It's a simple, brilliant insight, and relevant even to this day.

## The EVA Legacy

It's time to circle back to the third and final term in Joel's version of the MM valuation formula. (I'm tempted to call for a marching band.) The third term is the value of profitable growth opportunities. The idea is that a company with a competitive advantage can earn more than an investor who owns a comparably risky stock and bond portfolio. The difference each year is what Joel called "Economic Value Added," or EVA. It's the value that the company can generate that investors can't replicate. And the present value of that extra EVA profit is the last term in the MM valuation model.

To illustrate, he created a simple example, which nearly ran off the width of his flip chart. Starting with $1,000, assume a company can compound returns at a 25% rate of return, while investors can compound value at only a 10% return by purchasing a stock and bond portfolio of the same risk. The difference, which reflects distinctive company assets and proprietary capabilities, is the firm's EVA profits:

| | | | | |
|---|---|---|---|---|
| Company earns 25%: | $1,000 | $1,250 | $1,563 | $1,953 |
| Market portfolio earns 10%: | $1,000 | $1,100 | $1,210 | $1,331 |
| Economic Value Added: | | $150 | $353 | $622 |

This simple example was the springboard that eventually led to a new financial management system and cottage industry that put Stern Stewart on the map and on the cover of *Fortune* magazine. EVA was, as *Fortune* said, "today's hottest financial idea and getting hotter" and "the real key to creating wealth." EVA was vigorously discussed and tested at business schools and adopted by legions of companies globally. At its peak, the Stern Stewart consulting organization that Joel and I founded in 1982 as a spinout from the Chase Bank employed hundreds of professionals in 16 offices globally. The EVA revolution has become a permanent feature on the corporate governance landscape—helping companies to structure compensation and allocate capital in ways that create value.

This is all Joel's legacy. None of it would have happened had it not been for Joel Stern blazing the trail. There will always be reasons to remember his insights, to recall his humor, and to wish that he were still with us.

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# A Look Back at the Beginnings of EVA and Value-Based Management

An Interview with Joel M. Stern, Chairman and CEO of Stern Value Management, January 16, 2014

**Joe Willett:** Let's start at the beginning—The Chase Manhattan Bank circa 1968. You had an idea, and you were successful in getting people to buy into that idea. The idea was that modern finance had something to say to CEOs and CFOs, as well as to bankers to some degree. Tell us a little about how you got started.

**Joel Stern:** I wanted Chase to differentiate itself by having a reputation for expertise in modern corporate finance. I wanted the commercial lending people to be able to talk seriously about topics that were helpful to the client, and to spot opportunities where Chase could provide advice. That idea resonated with members of Chase's senior management, and they gave me an opportunity to develop a financial consulting function. As we started meeting with different companies, some of the bankers were astounded at the level of interest on the part of their clients. They shouldn't have been surprised, though, because modern finance is fundamentally about what determines the value of an enterprise, which is a topic of critical interest to CEOs and CFOs.

**Willett:** At what point did you realize there was a business here? Were you at Chase, or was it before you got to the bank? What was the "aha" moment?

**Stern:** It was in the training program at Chase, where I met people who were being assigned to other locations around the bank. At the time, Chase was organized geographically. I had met the fellow who was eventually put in charge of Ohio and Pennsylvania, and he invited me to go with him to see the treasurer of Bethlehem Steel about doing a free cash flow valuation project. I should also mention that he stipulated that I do the project for nothing—even though my little group, Chase Financial Policy, was a profit center—if the treasurer reminded us about the balances that the company kept at Chase. Keep in mind that there was no interest paid on demand deposits at that time, so these balances were very profitable for the bank. At the end of my presentation, the treasurer said, "That's one hell of a presentation. We should definitely be looking at free cash flows as opposed to what we are currently doing. How long would your work take, and what would it cost?" I said, "About six months, and $10,000." "What about our balances?," he asked. I was sorely tempted to stick to my guns on the fee, but I said, "I have to admit something to you, sir. I'm here on a priority because of the balances that you keep with us. Otherwise I wouldn't be here." He signed me up on the spot. And that was our first project.

## Why Dividends Don't Matter

**Willett:** You were well known for saying that dividends don't matter, as a counterpoint to the widespread belief that raising the dividend was a surefire way to make the stock price go up. What was your reasoning?

**Stern:** Until the late 1950s, the predominant view was that if a company didn't pay cash dividends, its share price would never amount to anything. Even today, you'll come across the occasional money manager who says that the companies creating the most value are the ones raising dividends and doing share buybacks. But that view is completely contrary to what is taught at the premier business schools today—Chicago, MIT, the Simon Business School at Rochester, or UCLA. After all, dividends gained are equal to capital gains lost. They have to be because there are no free lunches in this world.

Of course, it's entirely possible that the share price will go down when a company initiates or increases its dividend if investors infer that the company no longer has as many value-creating investment opportunities. That's what happened to Intel in the early 1990s. Alternatively, a company's share price could go up when it disgorges surplus cash in the form of a dividend—because investors no longer have to worry about that cash being squandered on value-destroying projects; in other words, so-called agency costs have been reduced.

As an aside, I have to say that agency theory has never entirely resonated with me. I have the highest regard for Michael Jensen, who was a classmate of mine at the University of Chicago, but he never developed a theory to account for why management would tend to misbehave in the first place. There are two reasons why management should behave itself: the first is the threat of an unfriendly takeover, and the second is that boards of directors should design incentive contracts that lead management to maximize value in their own self-interest. In addition, research by Raghuram Rajan, Henri Servaes, and Luigi Zingales shows that there are dynamics inside the firm at the middle-management level that encourage value maximization. Middle managers aspire to senior leadership roles, so if the senior management attempts to engage in self-dealing or other value-destructive behavior, there is internal pressure from middle managers to cease and desist. The same argument applies with the threat of unfriendly takeovers—middle managers don't want the firm to be taken over because they aspire to senior management positions of their own, so they exert pressure on senior management to behave itself.

**Willett:** At the same time, there are incentives to misbehave, too, because much of this bad behavior simply isn't detected.

**Stern:** I don't disagree, but there's a cap on it, and here's why. Think about the premium you have to pay to gain control of a firm in an unfriendly takeover. Let's assume that the premium is 25%. If you multiply that premium by the cost of capital, which we'll assume is 10%, you get 2.5%. So 2.5% of the value of the firm is vulnerable to managerial bad behavior. More than 2.5%, though, exposes the management to an unfriendly takeover.

Of course, boards can't necessarily be counted on to hold senior management accountable. For example, the pooling method of accounting for business combinations, which was eventually eliminated by the Financial Accounting Standards Board, obscured the economic returns earned on an acquisition—so if incentive compensation were based on the accounting framework, it would not reward or penalize senior managers appropriately. However, proponents of an economic model of value would say that what matters is how much was paid for the acquisition, rather than how it is reported afterward.

## Why Earnings Per Share Don't Count

**Willett:** What in particular do you see as the failures of the accounting framework?

**Stern:** In general, I have two basic criticisms. The first is that it expenses intangibles in the current year. The main intangibles are research and development, long-term brand value, and employee training and development. For some companies, training their employees is their biggest capital expenditure. When I was at Chase, almost everybody below the level of middle management went to some type of training program every week. How do we hold managers accountable for the results of this training if it is expensed in the current year? What's more, tying bonuses to accounting profits encourages accounting manipulation by the senior management, because if they see a business slowdown there is a temptation to cut back on very important investments in intangibles in order to smooth out the earnings. The other aspect of this, of course, is the idea that "what gets measured, gets managed." At firms that are spending billions of dollars a year on R&D, who is going to remember what was spent yesterday, last year, or the year before? The answer is nobody. But it is in the shareholders' interest to make sure that management is held accountable by putting those items back on some sort of economic balance sheet that boards of directors look at.

My second basic criticism of the accounting framework is its failure to include a cost of equity capital. That is a very big problem because many companies are criticized for being "profiteers"—but if you include a cost of equity capital, reported profits drop tremendously to reflect the use of investor capital. Ideally, the income statement would report a number that reflects the shareholder value created, or what we call EVA for "economic value added" or MVA for "market value added"—although I would prefer "management value added" because management has been entrusted with a certain amount of capital and they should be held accountable for creating value above that amount of capital.

## EVA and Incentive Pay

**Willett:** The idea that management should be evaluated on the basis of its actual contribution to value is fundamental to the EVA system, correct?

**Stern:** Yes. The late Fischer Black maintained that much of what management does is due to simple luck, and he's not wrong in the sense that a company's performance is a function of the state of the economy in general, the state of affairs in the company's industry, and the discretionary performance of management. If you could filter out the economy, which accounts for about 50% of a company's share price performance, and the industry, which is another 25%, you would have a measure of what management has accomplished. By the way, that's why I question the use of restricted stock and stock options to motivate people—75% of the share price change has nothing to do with management.

But the first time I presented the concept of rewarding management on the basis of what they had actually accomplished, the CEO started laughing—because he was imagining a shareholder meeting in which his company had had an awful year, but he was asking for substantial bonuses for his management team because Joel Stern had analyzed the company's performance and found that in the face of a terrible economy and challenging industry conditions, management's performance had been quite good. He told me point-blank that no public company could get away with paying bonuses in a bad year on the basis of a model that filters out general economic and industry factors.

That's when we devised what we eventually called the "bonus bank," although at the time I called it a "deferred incentive compensation account," or DICA, because I wasn't smart enough to come up with a catchphrase like bonus bank—that's why I employ talented people. I telephoned that CEO and explained the bonus bank to him, and he hired us immediately.

**Willett:** At the time, did you define the bonus bank so that it could go both up and down?

**Stern:** Yes. Which means that it's not a bad idea to implement the bonus bank in a bad year, when managers would ordinarily not be getting bonuses. If you implement in a bad year, then you have only upside. But we are not actually paying bonuses in a bad year—the bonus is paid out over a five-year period.

That's an important difference between the bonus bank and a guaranteed deferred bonus. A deferred bonus is like restricted stock—there is retention risk, because if you leave the company you lose your bonus, but the actual amount awarded is not at risk. With the bonus bank, the employee is paid out over a five-year period, as long as the payments are based on sustainability of the improvement in EVA. Thus the deferred amount is at risk. By the way, the bonus bank is not for people below middle management because they don't have policy responsibility.

But it's also important not to implement at the *beginning* of a bad year. We did this in the early 1990s for a company in Atlanta called Printpack, and as soon as they went onto our program their results headed straight down because of the recession. At the end of the first year, everybody had a negative bonus bank. I pointed out to the CEO, Dennis Love, that there is no more cyclical an industry than packaging, and that with the end of the recession the company was about to have a gigantic leap back up, and all of the negative bonuses would be erased. But I realized that we might need to make a modification for highly cyclical companies, and that was when I came up with the idea of paying bonuses on the basis of improvements in performance in order to smooth out bonuses in highly cyclical industries. Normally, the bonus declarations would first have to offset any negative balance in the bonus bank, which might mean no payments for several years depending on the size of the initial drop. So we suggested paying one-third of any improvement in performance, with the remaining two-thirds applied to the negative balance in the bonus bank. That way everyone got bonuses when things started to turn around. This technique is important in highly cyclical industries, where performance goes down sharply and then rebounds sharply.

The main point, as I said, is to filter out the economy and the industry and reward management's discretionary performance. And I define a five-year period of sustained results as a reasonable approximation of discretionary performance. Virtually every company that has done it this way has had really tremendous outcomes. In fact, the most successful firm on EVA is Godrej in India, which implemented EVA with us in about 2001. Adi Godrej explained to me that his most important asset was the human capital in the firm, and he wanted to get their compensation right. Since implementing EVA, his stock price has gone up at a compound annual rate of better than 40%. Today, it is 68 times higher than it was in 2001.

## What Creates Value?

**Willett:** How did you first get started down this path?

**Stern:** I was very interested in the basic issue of the drivers of shareholder value. The most important paper for anybody who cares about value is the dividend policy paper by Franco Modigliani and Merton Miller, published in 1961 in the *Journal of Business*, called "Dividend Policy, Growth, and the Valuation of Shares." In Section I, they talk about basic issues of value—dividends and capital gains, which sum to TSR or total shareholder return—and they cover a lot of ground but it's a somewhat convoluted discussion. Section II, though, which is called "What Does the Market Really Capitalize?," is the whole ballgame. They compare four things: dividends, earnings, cash flow, and investment opportunities. And they show that all four are really the same.

When I teach this to my class, I start with return on investment, where investment in the denominator is the sum of debt plus shareholder funds at book value. The numerator is net operating profit because if the denominator is total capital, then the numerator has to be attributable to both lenders and shareholders—that is, before any payments to lenders. Next, we add back depreciation to get the gross cash flows. But if depreciation is equal to capitalized maintenance, then we are right back to net operating profit, which is just the free cash flow. The full credit for the concept of free cash flow definitely goes to Merton Miller.

In a world with no corporate income taxes and no superior-returning projects, it doesn't pay to invest more money. Of course, if you *do* have superior-returning projects, then it all changes, and you'll have to raise capital to finance growth. And that leads to another interesting question: Why is it that companies will not issue new shares to finance organic *de novo* growth, but they are willing to issue shares to acquire another company? The answer is that they're "EPS crazy." They don't want to dilute EPS—and if you are undertaking organic growth and financing it with equity, the EPS might not catch up for awhile because of start-up and other costs. It's very surprising to me how many companies still design incentives around EPS and end up forgoing profitable growth because it will hurt EPS in the short run.

Our basic rule from modern finance is that if you have a publicly traded company, you should run it as if it were privately owned and make the decisions you would make to maximize value as a private entrepreneur. If you explain to the markets what you are doing and why, then the market will fully appreciate what you are doing, and you will not see any loss of value in your share price. That's what Warren Buffett is really all about. Warren Buffett came to visit David Rockefeller at Chase back in the 1970s, and I was in the meeting, and he said, "Listen, we don't pay dividends, and we are never going to pay a dividend as long as I live." I remember Mr. Rockefeller's surprise— "What? Why not?"—and Buffett responded, "We can earn a much higher rate of return than our investors can on the outside."

I was working with a company in South Africa that was earning 32% after tax on capital employed, let's call it Company A, and because Company A was 40% owned by Company B, it paid a generous cash dividend to satisfy Company B, which relied on those dividends to boost EPS. It was Company B's belief that the market value of its shares was related to EPS, rather than to the value of Company A—which was also a publicly traded company, so everybody could see both companies' value on the stock market at the same time. I suggested that Company A give its shareholders a choice between cash dividends or a stock dividend, which is the equivalent of reinvesting back into the firm at no cost. In the U.S., where stockholders have the choice of receiving a cash dividend or a stock dividend, the stock dividend is taxed as an ordinary cash dividend, but in South Africa the tax law is different. The CEO of Company A maintained that his shareholders would all want the cash dividend—but in fact 96% of his shareholders went for the stock dividend. At that point, the CEO of Company B expressed concern that his proportional ownership in Company A would start to fall if he took the cash dividend. As I explained to him, that was the price he was paying for not maximizing value. So he announced to the market that Company B would also be taking the stock dividend, and his shares rose. It was one of those moments of complete vindication.

## The Question of Optimal Capital Structure

**Willett:** Let's talk about another subject related to value—the impact on shareholder value of debt versus equity financing.

**Stern:** Even if you go to a fine business school like the Simon Business School or any of the others that I mentioned earlier, the professors who teach corporate finance and valuation will tell you that debt is cheaper than equity because interest expense is tax deductible. I once attended a luncheon at which Eugene Fama was the guest speaker, and he said during his talk that he was not allowed to teach corporate finance at the University of Chicago because he didn't believe that there was any value created on the right-hand side of the balance sheet—not from dividends, not from buybacks, and certainly not from borrowing money. I agree with Fama. Why? As Merton Miller pointed out in "Debt and Taxes," his 1976 presidential address to the American Finance Association, if the interest tax deduction is legitimate and debt is really cheaper than equity, then the optimal debt ratio has got to be a lot higher than anything companies are currently doing, which is typically more like 30% debt and 70% equity.

Most people make the mistake of thinking that companies should load up on lots of debt in order to take full advantage of the tax-deductibility of interest. But the amount of the tax shield is limited by the company's return on investment. You want interest expense to equal earnings before interest and taxes (EBIT), which shelters all of the EBIT for tax purposes and thus maximizes value under the traditional view. Of course, that gives you an EPS of zero, but the market will know that you're creating value by taking advantage of the tax shield.

At the time, others tried to explain "suboptimal" debt ratios by citing bankruptcy risk if the firm is overleveraged, but Jerold Warner, a finance professor at the Simon Business School, showed in his PhD thesis that bankruptcy costs aren't nearly large enough to warrant that type of worry.

In his "Debt and Taxes" speech, Miller came up with a formula for the tax shield of debt that involved the corporate income tax rate and individual income tax rates on bonds and shares for personal investors. He showed that because the corporate income tax rate is roughly equal to the personal tax rate on bonds, the tax shield on debt is a function of the personal tax rate on shares, which is a pretty small number because the capital gains tax rate is low—and can be deferred indefinitely—and the tax rate on cash dividends is significantly lower than the regular income tax rate. So Miller concluded that debt is not cheaper than equity. I was there for the talk, and I was sitting next to a finance professor from the University of North Carolina who looked at me and said, "I am too old for another revolution in finance."

Frankly, when I teach my class, I present it much more simply. If we assume that there are only three players in the world—borrowers, lenders, and the government—and borrowers get a tax deduction for the debt, who pays for it? The government could pay for it by simply printing money, but that won't accomplish anything. What happens is that the lenders have to pay the tax, so they gross up the interest charge and shift the tax burden back to the borrower.

**Willett:** Wasn't that Miller's argument?

**Stern:** It is Miller's argument, though he did not present it that way.

Another company that I worked with in South Africa needed to raise about $100 million. The CEO asked me to go with him to the bank to ask for a loan. We met with the chairman of the bank, who said something astonishing—he said that my client could either borrow the money from the bank, or issue preferred stock to the bank, and the rate would be the same. I actually telephoned Merton Miller from South Africa—the call nearly bankrupted me—and he wasn't in the least surprised, although he said that the banker was making a small mistake in that the rate on the preferred should be a tiny bit higher than the rate on the loan because the preferred stock would be junior in the event of insolvency. But, essentially, debt isn't cheaper than equity.

Preferred stock has an advantage over equity in that it is always fairly priced—it sells on a yield-to-maturity basis like a debt instrument, and it will always command fair value. With common equity, you may be diluting your true value by giving the shares away at too low a price if there are information asymmetries, as can happen when management possesses information that is not yet available to the market. Preferred stock is a perfect substitute for common stock for financing growth opportunities.

**Willett:** Did the company in South Africa have any other debt?

**Stern:** It had some debt on the balance sheet already, yes.

**Willett:** So the claim in bankruptcy will be relevant. If you were able to issue preferred stock, and had a covenant that said you couldn't issue debt, then it's no different from debt.

**Stern:** That's correct. And the fact that debt is not cheaper than equity rules out that motive for borrowing money. But there's a little more to the story. In 1976, Michael Jensen and William Meckling wrote their paper on agency theory, and it had a very big impact. Jensen is a positive economist, which means he believes that markets get what markets want. If almost all companies have borrowed money for almost all of time, there has to be a reason. Jensen and Meckling argued that debt serves to monitor and discipline the management, which reduces the costs of managerial self-dealing.

Another argument was made by Stephen Ross of MIT. He says that the reason shareholders ask for dividends, especially in capital-intensive companies, is not that they want the money back but that they want the company to have to raise additional capital to fund the dividend payment, because in the course of raising capital the company will hire an investment bank that will have its reputation on the line and will therefore investigate the company and its projects before underwriting any sort of offering. In other words, the investment bank will *certify* the quality of both the company's management and its projects.

Those are the two arguments. Jensen took agency theory a step further in his 1989 article called "Eclipse of the Public Corporation," which is still one of *Harvard Business Review*'s largest-selling reprints. In that article, he says that publicly traded companies with few profitable growth opportunities—and hence little need for more equity capital—are going to disappear into KKR-type companies so as to bring ownership and management closer together.

**Willett:** To beat the agency problem?

**Stern:** Right, to beat the agency problem. Jensen's view of the world is that to prevent managers from squandering the corporate surplus, we'll build mountains of debt and use the cash surplus to pay down the debt, and when the debt gets down to a certain level, we'll take on more debt, and when we pay that down, we will do it again. Essentially, we are taking the present value of the stream of future dividends and paying a large part of it upfront. But in my view, that argument doesn't make sense because it is playing defense. We are trying to stop the management from doing bad things. What if, instead, we gave management an uncapped EVA bonus system? If they think the sky's the limit, they will reach for the sky. Not only that, the incentive structure should go right down to the shop floor, so that every employee will behave like a value maximizer.

By a stroke of luck, we were hired by Briggs & Stratton right around that time, and the big hero in this story is John Shiely, who was the company's general counsel at the time—he was the one who wanted to carry EVA right down to the bottom of the organization. No one had ever thought that way before. Fred Stratton agreed and communicated to his employees that they were now part of an EVA company. That's the secret—if the CEO sets the value-maximization focus and says, "This is important to me personally"—if the

CEO is an EVA champion—then there will be no game-playing. The employees will go for it. John Shiely eventually became the CEO and is still a very dear friend of mine. When we talk about this, he says that what we did was to explain in simple terms how to focus on value, and that everyone at the company always felt that they were maximizing the present value of the company's future because the EVA incentives had been carried right down through the entire organization. His was the first company to do it.

## More on Incentive Compensation

**Willett:** Why do you want the employee on the shop floor, or the salesperson dealing with the customer, thinking about EVA and not focusing on making the product or selling the product?

**Stern:** Excellent question. You are right—I don't want people being rewarded for company-wide EVA, I want them being rewarded for the part of EVA that they can influence. There are two reasons. The first is that the thing we are really up against is negotiation. The first thing a human being learns is to cry, so that mommy and daddy will pick the baby up—and from that point forward the baby is in charge of the family. That's called negotiation. People feel that their negotiating skills are strong enough that they can earn more through negotiation than by having to produce in order to generate the same compensation. Put simply, EVA removes the negotiation factor.

As an aside, that's the problem with the Balanced Scorecard. Number 1, it's not balanced, and number 2, there's no score. Why has it become popular? So management can divert attention away from the failure to create financial value in the organization; so they can say, "Listen, there are 15 variables here in the Balanced Scorecard, we got 9 right, and 6 not so much. Tell me, what's my score?" It becomes a negotiation.

To explain the second reason that I want people rewarded for their contribution to EVA, I have to tell you a story about a retailer in South Africa. About four years ago, I went to the company headquarters to have lunch with the CEO, and the receptionist in the lobby said to me, "I know who you are—I am on your EVA system. You did the training for us in our intranet training program." I was ecstatic! I asked her what impact it had had on her, and then she shocked me: "No impact whatsoever." I was taken aback, but I asked her to explain. She said that she had initially found the concepts interesting but hard to follow, and the numerical examples were hopelessly confusing—but she asked a coworker to help her, and eventually she caught on, although she still didn't really see how it affected *her*. Then one day she was sitting in the cafeteria having lunch and overheard somebody say that the company was going to hire an additional administrative assistant. She thought about it all afternoon and then wrote a note to the CEO telling him not to hire the additional admin. I asked her why she had done this, and here was her answer: "I want to be on the team." In other words, she wanted everybody to know that she could be a value-change agent, too. I told the CEO the story over lunch, and he observed that the big problem in management is what people do when the CEO is not watching. Are they imaginative? Are they creative? Do they try to think about ways to improve performance? Or are they talking about yesterday's soccer match? So the second reason that I want EVA implemented throughout the organization is that EVA puts everyone on the same team, and everyone on the team becomes a value-change agent.

Think about an airline. Next time you're flying somewhere, go over to where the flight attendants are standing and try to overhear their conversation when they're not working. They're not talking about ways to improve the performance of the airline at all. Wouldn't it be nice if they were? We could make a list of ten things that a flight attendant does and have the passengers evaluate them as satisfactory, unsatisfactory, or outstanding, and those assessments could be the EVA driver for the flight attendants. Then you would really notice some differences.

Whole Foods is on EVA. If you walk into Whole Foods and ask an employee where the salad bar is, he or she will walk you to the salad bar and make sure to point out all the specials along the way. At other supermarket chains, the employee will say, "Salad bar? Aisle 8." What makes Whole Foods so successful is that their employees are value-change agents.

The first company in South Africa to implement EVA was South African Breweries. At the time, the company also owned a hotel chain and an underperforming grocery chain. The CEO asked me to look at everything, and I recommended that he divest the hotel and grocery businesses and implement EVA in the core brewing business. That company is now SABMiller, one of the two largest beer companies in the world.

I had a similar experience at Coca-Cola. The first thing we convinced them to do was to get rid of Taylor Wines and Columbia Pictures. Coca-Cola is still on the EVA program, although they did go off it for a few years. They went back on because they did an econometric study that showed that EVA had the highest correlation of any measure of company performance to changes in the premium of market value to book value.

EVA is very straightforward—one of its best features is that it doesn't cause employees to maximize the wrong things.

When I was at Chase Bank, lending officers were compensated in part on the basis of loan volume. If you reward people for loan volume, you'll get loan volume. With an EVA system, loan repayments would also be part of the bonus calculation because loan repayments are part of the value calculus.

Again, it's not EVA bonuses, it's EVA drivers. We did some work for a large Chicago-based company some years ago, and I discovered that the accounts payable were being paid in 26 days. A company that size, with their suppliers—what were they thinking? After doing a little investigating, I went to the CEO to tell him why his people were paying early. He asked, "Is this going to be unpleasant?" "Very," I said. His people were being taken to Chicago Bulls games by their suppliers, who were getting favorable trade terms in return. I suggested that he have his people take the suppliers to the games and let them know that the new trade terms were 46 days.

In 1996, I made a presentation to the Board of Governors of the U.S. Postal Service. LeGree Daniels, who was the first African American to be appointed to Pennsylvania's Department of Revenue, was on the board at the time and heard my presentation. She came up to me afterward and said, "I will sign on for EVA on one condition only. You drill it right down to the shop floor. This is not meant for senior management. This is meant for everybody." Then she went to Marvin Runyon, who was the U.S. Postmaster General at the time, and told him the same thing. At the time, the Post Office was losing $2.4 billion a year. They implemented EVA, and within two years the losses had been eliminated.

A lot of companies have incentive compensation plans that are based on the consolidated results of the company. They're called profit-sharing plans. But if you're fairly low in the organization, you have no impact on the consolidated results. That only encourages what is called a free-rider problem. You want to have the individual business units, or what I call EVA Responsibility Centers, rewarded on the basis of what they can actually contribute. In order to make sure that it works firmwide, based on Ronald Coase's research, about 50% of your rewards should be based on how your local unit is doing, and the other 50% should be based on how other units are doing. That way, if you come up with good ideas for other units, you will share them because you still have 50% riding on how they do. Such an arrangement also provides internal diversification—so that when a unit is doing poorly, it will be supported by other units that are doing well. EVA programs recognize that employees are bearing the total risk of the enterprise instead of just the non-diversifiable market risk.

**Willett:** Are there any companies for which you can't design a good EVA program?

**Stern:** When we first started out, I didn't see how it could work for extractive industries such as oil and gas, mining, or forest products. So for a long time we didn't implement EVA at any of those companies. But then one of my partners pointed out that the value of the reserves is recorded in a footnote, so we could actually make the appropriate adjustments in order to make EVA work for extractive industries.

**Willett:** What about a company like Amazon?

**Stern:** That's a great example. Insurance companies are in the same situation. When insurance agents sell policies, they get two types of commission. The first is for landing the policy, which is a big commission. Then they get a commission each year, but it is much smaller. So the problem for a life insurance company in the early stages of its development is that all it has are losses, because it's paying huge commissions. But does it make sense to try to slow things down in order to generate accounting profits? That's the advice that Amazon has gotten. Remember our discussion of intangible assets? Amazon has three: start-up costs on the distribution centers, training and developing of its people, and marketing costs. All three are being expensed in the current year. If you took those expenses and put them on the balance sheet, and recalculated ROI, you would see that it is quite positive.

At the time, of course, I was subscribing to a number of academic journals, and I began to realize that academics were doing two things that were not good for CEOs and CFOs of companies. They were focusing on very narrow issues without putting them in the context of the big picture, and they presented everything in terms of mathematics, statistics, and econometrics. It struck me that their research would be much more valuable if it were written in simple English and if it provided a broader statement as to where the particular issue fit in with the overall scheme of things. It was in my early years at Chase that I wrote what became known as the "Blue Book"—it had a blue cover made from a vegetable dye that came off on your fingers, so you could tell if someone had actually been reading it. That book took some of the foundational research in finance and showed how it led to the free cash flow model. My contribution was recognizing that academics had worthwhile things to say to CEOs and CFOs of companies, but they had to speak in a language that would not be foreign to those CEOs and CFOs. We subsequently went on to start a journal, which is now the *Journal of Applied Corporate Finance*.

## Summing Up

**Willett:** As I think about the developments in modern finance, it strikes me that they mainly occurred between 1958 and 1978. What's happened since then?

**Stern:** Good point. Fischer Black left academia for Goldman Sachs, and became a partner there. When I asked him why, he said, "We've already done everything," he said. "Nothing major will happen in academia for at least a generation." That was his observation.

But here's what I would say. I've begun to realize that human capital management is a big part of what is called corporate finance. In other words, if you want to maximize the value of the firm, you mustn't look only at your physical capital decisions. No firm should want to have employees—they should want to have partners in the creation of value. When Brian Kantor was at the University of Cape Town, he was involved in some research that showed that changes in EVA are about 70% affected by management decision processes, whereas the stock price is only about 25% affected, as we have already talked about. So since EVA is more closely tied to what management can actually do over the business cycle, I began to realize that having all employees focusing on the contribution they can make to that process is really a fundamental requirement of maximizing the value of an organization.

**Willett:** Has your thinking on dividends changed at all?

**Stern:** My position is essentially the same. Why are dividends paid? Well, some people are afraid that management will squander those funds otherwise. But in my world, management doesn't squander. The reason they don't is because of pressure from the people downstairs—the argument of Rajan, Servaes, and Zingales that we discussed earlier. I agree with the view that there is tremendous pressure inside the firm—but I want that pressure to be even greater, and it will be greater if we have clearly defined incentives tied to sustainable improvements in EVA for each EVA Responsibility Center. My view is that by far the most motivated person in any firm, below the level of top management, is a salesperson paid on a commission basis. I want to pay people a commission for creating value as opposed to simply generating sales, and I believe that we can define how sustainable value is created at all levels of an organization.

**Willett:** Commissions can be a problem, though. The brokerage industry is a good example where it doesn't work. It pits the interests of the broker against the interests of the customers.

**Stern:** Yes, that's true. But an EVA system wouldn't reward brokers simply on the basis of churn.

**Willett:** Are there any negatives on EVA?

**Stern:** The big negative on EVA is that CEOs have to be willing to give up some of their decision rights. In other words, if you are going to hold the people downstairs accountable, then you have to be willing to give them enough rope to hang themselves. But there's another, more subtle negative. CEOs have to be willing to give up their "patronage" role. What do I mean by that? I made an EVA presentation to a media CEO, and at the end, he said, "Fabulous, but I'm not going to do it." Why? Because he liked being able to go around to people at the end of the year and shake their hands and tell them how much he had decided to give them as a bonus. As he put it, "Under your EVA program, I don't do anything at the end of the year except thank them for working in the organization." That's an overstatement, of course—because even in a company on an EVA system, managers still have to manage and CEOs still have to lead and provide vision. But the benevolence factor is removed because bonuses are awarded objectively and for sustainable performance.

**Willett:** Joel, thanks very much for sharing your thoughts. What's next for you?

**Stern:** We are forming a new company called Stern Learning Systems, and I'm going to create a series of lectures on EVA that we will make available on the Internet.

**Willett:** That's a great vehicle for you.

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# EVA, not EBITDA: A New Financial Paradigm for Private Equity Firms

by Bennett Stewart, Senior Advisor, ISS

Is EBITDA—cash operating profit—the best way to measure value and monitor a business? Should company managers be asked to increase EBITDA and be paid bonuses for doing that?

Private equity (PE) firms, as a rule, think the answer is "Yes," and not without cause. Many of them have been very successful using EBITDA (earnings before interest, tax, depreciation, and amortization) as a formula to measure and grow value. EBITDA is also a critical measure of the cash flow available to service debt, and the ability to service debt is usually a PE priority.

Nevertheless, EBITDA is less correlated to market value than is commonly thought, and it is riddled with omissions and distortions that make it a highly unreliable guide to how well a company is performing. We argue that there is a much better metric for valuation and management purposes—so much better that PE firms should consider adopting it to replace EBITDA or, at the very least, to complement it.

In this article, we explore the shortcomings of EBITDA by comparing it to EVA (Economic Value Added), which measures a firm's true economic profit after deducting a full, weighted-average cost-of-capital interest charge on the net assets used in the business.

EVA is effectively the exact opposite of EBITDA in the following sense: It is measured *after* taxes, *after* setting aside depreciation and amortization as a proxy for the cash needed to replenish wasting assets, and *after* ensuring that all investors—lenders as well as shareholders—are rewarded with competitive returns on their capital. EVA is the bottom-line profit score that directly discounts to value.

Our empirical review suggests that stock values are determined by the EVA profits that companies generate, and that EBITDA multiples are plug figures—that is, a byproduct of valuation, not a cause of it. In our analysis of the Russell 3000, for example, we find that whereas EBITDA explains only 9% of variations in Enterprise Value, EVA explains 22%. In a second test in which we examined the values of companies within distinct sectors, we found, here again, that EVA has greater explanatory power. Where the median $R^2$ in explaining Enterprise Value within 43 industry groups was 38% for EBITDA, it was 57% for EVA.

As these findings suggest, private equity firms that begin to use EVA will be able to value companies more accurately and with greater insight into the factors determining their value. They will also be able to use EVA as a better tool to monitor their portfolio companies and keep tabs on their performance and plans. Some PE firms may even decide to bring EVA in-house for some of their portfolio companies and use it to improve their decision-making. As the PE business continues to mature and become more competitive, smart firms will look for every advantage they can find. For some, EVA could make the difference between success and mediocrity.

## A Simple Example of Why EBITDA Is a Poor Measure of Value

Let's begin with a simple example that shows why EBITDA may provide a misleading measure of value.

Imagine two companies, call them A and B, that have the same EBITDA and projected EBITDA growth rate. If the two companies also have the same risk profile, then one would be forced to conclude that their value is the same and that they would trade for the same multiple of EBITDA because they are indistinguishable.

But now suppose that company B needs to invest less capital into its business each year to produce the same EBITDA as company A. Can we now say for certain that one of them is more valuable?

In fact, we can. Company B is unquestionably worth more than A. Its investors are entitled to the same EBITDA year by year while keeping more money in their pockets. Company B's "free cash flow"—that is, its cash flow from operations net of investment spending—is higher, which leaves it with more cash to distribute to investors. Put more simply and directly, company B gives investors a higher rate of return on the capital they've committed to the company. The ratio of EBITDA output per unit of capital input translates into a higher yield. And more to the point, company B earns more EVA. There's more economic profit that remains after deducting a lower cost-of-capital capital charge on a smaller capital base.

Company B is more valuable than company A and will trade for a higher multiple of EBITDA every year. Why would an investor pay the same value for company A when company B is worth company A plus more cash? If you follow the logic, then it makes no sense to think of companies as trading for *multiples* of EBITDA—otherwise, simple arbitrage opportunities would be plentiful. Everything else equal, a company that generates more cash flow, a higher return on capital, and more EVA is worth more than another company with the same EBITDA. The conclusion? EBITDA by itself is an unreliable way to measure value.

## EBITDA's Failures as a Management Tool

Because of its valuation shortcomings, EBITDA can also lead to bad decision-making. Among its worst shortcomings are these:

**EBITDA does not encourage discipline around soliciting or investing capital.** Managers need never worry about generating a decent return on capital or even a return of the original capital investment because capital, in the EBITDA world, is a free resource.

**EBITDA ignores the value of managing assets and accelerating asset turnover**, which results in the release of excess capital.

**EBITDA systematically understates the value of outsourcing.** Consider a company that sells its technology assets and converts to third-party cloud operations. Profit-and-loss (P&L) costs increase to pay for the outsourced services, which reduces EBITDA. But EBITDA ignores the benefit of selling the associated assets and releasing capital.

**EBITDA overstates the value of vertical integration.** Why ever farm out production or distribution, and give up some margin? The correct answer is that shedding capital may be worth more than losing the margin. But again, EBITDA is blind to that way of creating value.

**EBITDA favors higher-margin products and services, regardless of the additional capital those lines may need** when compared to lower-margin lines.

**EBITDA sees no benefit in lowering a company's tax bill** or deferring taxes or making use of loss carryforwards.

**With EBITDA, there's never a value to selling or exiting a business, as long as it has *any* cash profit.** In reality, selling or exiting poorly performing and time-sapping units and focusing attention on the remaining ones can add a lot value.

**EBITDA is distorted by bookkeeping rules that do not always reflect economic reality**—rules, for instance, that require the expensing of R&D outlays, or deducting reported pension costs.

**EBITDA, as we have already shown above, has no mathematically logical connection to value.**

Having told you all this, I will be the first to admit that PE firms are generally aware of these handicaps—they are, after all, among the world's most financially sophisticated investors—and they find ways to work around these shortcomings. For example, they put a heavy hand on spending capital—it's hard to come by—and they cover EBITDA's blind spots by tracking other metrics, such as working capital turnover, capital expenditures, or return on capital. But PE firms can do that only by overruling what EBITDA is saying, and thereby adding complexity and ambiguity to the management equation.

There is a better way. Instead of rationing capital, charge for it. Instead of following many metrics, start with a single, overarching score—namely EVA—and use other metrics to explain the factors that contribute to EVA.

## Why EVA Is a Better Management Tool

Start with this: EVA is directly linked to value by the basic finance concept of net present value. To be specific, the present value of a forecast for EVA is always identical to the net present value, or NPV, of the forecast cash flows. By deducting the capital charge, EVA automatically sets aside the profit that must be earned in each period to recover the value of the capital that has been invested or will be invested. And this means that EVA always discounts to the premium above, or discount to, the capital invested in the business. To increase EVA is, *by definition*, to increase a company's NPV, share price, and total shareholder return. Nothing of the sort can be said for EBITDA.

A goal to increase EVA thus provides managers with the correct incentives to create value—in any business—by going down any of these paths:

**Operating Efficiently:** The first imperative EVA trumpets is to cut costs and raise prices; that is, to find ways to raise profits without raising capital. Granted, there's no specific advantage to EVA here; almost all performance measures encourage such moves.

**Managing Assets Effectively:** EVA is the only profit performance measure that fully and correctly increases when balance sheet assets decrease. EVA calls on managers to streamline supply chains and accelerate asset turnover as a way to reduce capital. It tells them to prune marginal plants, products, and markets, and to exit businesses that aren't covering the cost of capital—even if this means forfeiting sales, EBITDA, or profit margin. EVA also disciplines managers to invest new capital carefully, conservatively, and imaginatively, because they face a continuous, ongoing charge for using it.

**Growing Profitably:** EVA also rewards managers that put more capital to work to innovate, scale, and fuel growth, *so long as the return on the capital exceeds the cost of raising the capital*. And unlike return on investment (ROI), EVA increases when managers pursue *all* profitable growth opportunities with returns above the cost of capital, even if those returns are projected to be lower than the ROI the firm is currently earning. EVA gets the incentives right, at the margin, on new investments and new decisions, and without the distortions arising from legacy decisions or legacy capital.

**Optimizing Tradeoffs:** Managers can also add value by making consistently better choices. EVA helps by distilling and combining all the pluses and minuses cutting across the income statement and balance sheet into a single net score of added value. It guides managers to decisions that might never occur to them if EBITDA—or EBITDA and a grab bag of other metrics—dominated their thinking.

As one example, EVA increases when outsourcing decisions reduce the total sum of operating costs and capital costs. EVA also rises when the proceeds from selling a line of business, invested at the cost of capital, produces more profit than continuing to run it. A manager can also choose strategies by their potential for EVA. For example, is a lower-growth, higher-rate-of-return strategy more valuable than a lower-return, higher-growth path? The answer is, whichever one is expected to generate the most EVA. Many companies find decisions like these challenging, and often reach the wrong conclusions. But EVA deftly navigates the crosscurrents and resolutely points to the right answers.

EVA widens its lead over EBITDA by systematically applying a set of corrective adjustments that are designed to repair defects in accounting.[1] Accounting rules, as already noted, require companies to expense research and development (R&D) outlays. This ultra-conservative treatment can deter managers from boosting R&D budgets even when profitable opportunities are in front of them, for fear of the upfront hit to GAAP profits.

Expensing R&D also ironically relieves managers of accountability for it. In most companies, R&D just gets factored into budgets at an established level, and managers can spend up to that level with no associated charges or penalties. Because accountants treat R&D as an expense, it gets managed as an expense.

With EVA, the treatment of such investments is totally different. A company's R&D is written off over a preset industry-specific period, and the cost of capital is applied as a charge to the outstanding accumulated R&D spending balance (which is added to capital). This way, managers are far more willing to increase their research budgets as they see promising and perhaps fleeting opportunities emerge—because they know they have the time needed to make the investment pay off. But in exchange, managers also know they are on the hook for recovering the investment and earning a decent return on it over time, because they are charged for it even into future periods. Managers accordingly start to manage their R&D and allocate resources to it as a strategic variable rather than setting it at a traditional budget level. Depending on the company, this approach can be a significant source of added value, while it also makes EVA an even better measure of performance.

Much the same applies to advertising and promotion expenditures—for example, those incurred to launch a business or build a brand. With EVA, these investments are also written off over time with interest charged on the balance. Managers who are paid to increase EVA suddenly start to spend marketing resources against the life cycle value of customers rather than against a preconceived budget. They eagerly and aggressively build valuable franchises rather than getting trapped into short-term thinking.

Consider one last example. When using EVA, restructuring charges are added back to earnings and added back to capital. With that rule, a restructuring adds to EVA if the benefits, in terms of streamlining costs and redirecting capital, exceed the cost of any new capital invested in the restructuring. A restructuring is no longer an admission of failure to be avoided. It can be a proactive opportunity to invest in a positive-NPV project, one that managers will eagerly pursue.

The adage "what gets measured gets managed" is true. By crafting a set of rules to remedy accounting illusions and measure EVA with greater accuracy, a PE firm can mold the behavior of its management teams in positive ways that create value and discourage them from pursuing suboptimal decisions. Teaching a management team about EVA and the rules used to compute it, and how they can move the EVA needle, does take some time and effort.[2] But it is a highly EVA-positive investment. It is a proven way to improve financial literacy and establish a common language across an organization—one

1 For a discussion of the rules and the decisions they induce, consult "The EVA Measurement Formula," by Bennett Stewart, available at https://www.issgovernance.com/solutions/iss-analytics/iss-eva-resource-center/.

2 A successful adoption of EVA also requires software tools to compute, analyze, value, and report on EVA, per the specific rules chosen to measure EVA. ISS licenses software solutions for just this purpose, which are easy to implement, configure, and use.

*Figure 1*

**Enterprise Value vs. EBITDA**


that speeds decisions, enhances communication, promotes teamwork, and supports delegating decisions to those closer to the action.

In sum, EVA, when set against EBITDA, is a far more comprehensive, cohesive, and value-based metric and management technique.[3] PE firms would be wise to use it to measure value, and to guide and motivate managers, in their portfolio companies.

## EBITDA versus EVA Test Results

EVA clearly trumps EBITDA as a management technique. But does it beat EBITDA as a measure of stock market values?

To test this proposition, we analyzed the relationships between EBITDA, EVA, and enterprise values for Russell 3000 companies as of March 12, 2019, excluding financials, real estate, utilities, smaller biotech firms, and companies with less than $100 million in sales. This left us with 1,773 companies.[4]

The correlation between EBITDA and EVA among those firms is just 30%. Put another way, a regression of EVA to EBITDA has an $R^2$ of just 9%. The two measures are only slightly correlated. For all the reasons outlined in the paper, there is a great difference between EVA and EBITDA. Our effort next was directed at determining if one of them is a better measure of value. We began by looking at the correlation between EBITDA and Enterprise Value in Figure 1, which plots EBITDA versus Enterprise Value; both variables have been divided by sales, which makes it possible to compare companies of different sizes.[5] It's a cloudy picture. The dispersion is so great that a regression of Enterprise Value to EBITDA produced an $R^2$ of only 9%. Companies plainly do not trade at any consistent multiple of EBITDA. Of course, analysts don't look at valuations relative to the whole market, but relative to an industry. We'll come back to that a little later.

To examine the correlation between EVA and Enterprise Value we need an intermediate step because, in theory, EVA

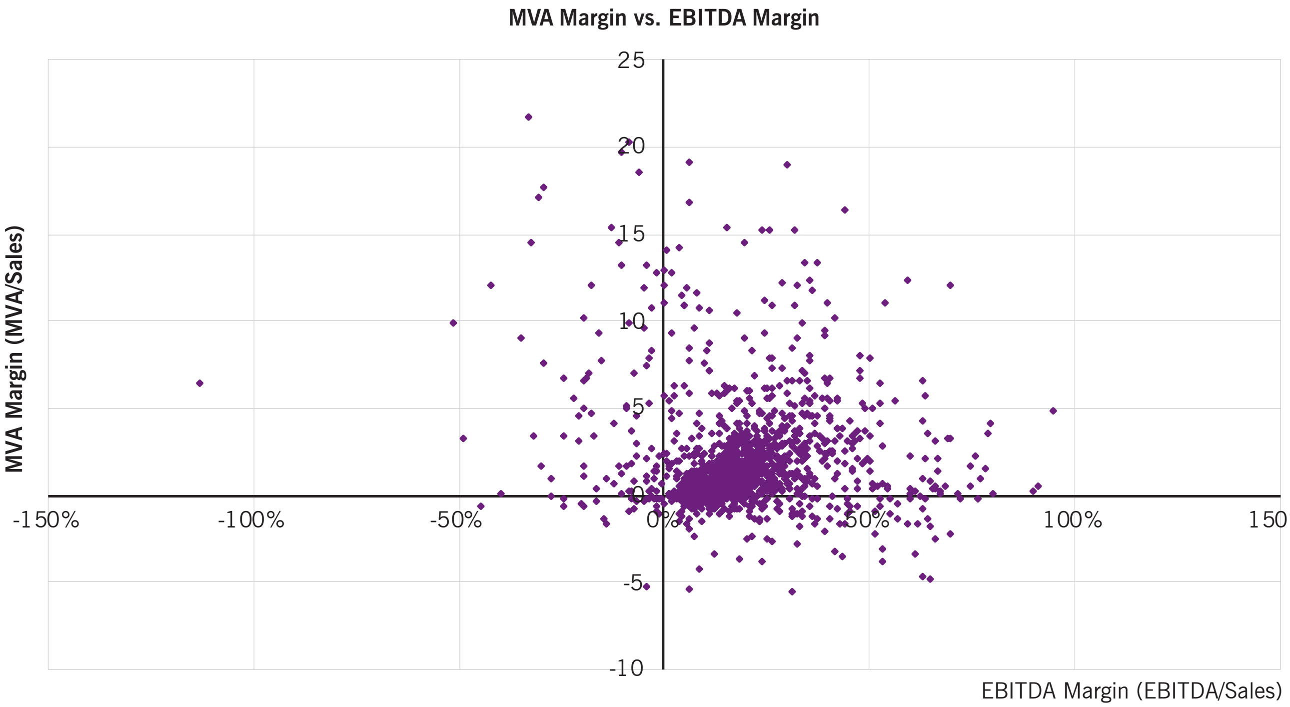
3 For a more complete description of the EVA management model, consult *Best Practice EVA*, a book by Bennett Stewart (at Amazon, https://www.amazon.com/Best-Practice-EVA-Definitive-Maximizing-Shareholder/dp/1118639383.

4 There were 2,975 companies in the Russell "3000" as of the test date. We eliminated 210 financial firms, along with 75 utilities, 211 REITs and real estate development companies, 219 biotech companies with sales under $1 billion, 138 companies with sales under $100 million, and 37 companies with bad or missing data.

5 Technically, the correlations and regressions were performed between the ratios of Enterprise Value/Sales and EBITDA/Sales. Dividing by sales was necessary to size adjust the variables and eliminate the spurious correlation that arises because larger companies tend to generate more EBITDA and trade for larger values. We also observed that Enterprise Value/Sales ratios tend to be smaller for larger, more mature firms. The regression model therefore also included a "Size" variable (the natural log of the average of sales and capital), which entered with a statistically significant negative coefficient.

*Figure 2*

**MVA Margin vs. EBITDA Margin**




does not discount to value per se. It discounts to the value added—that is, to the spread between a company's Enterprise Value and the Capital it has invested to produce the value. We refer to this spread as "MVA," or Market Value Added, where:

MVA = Enterprise Value – Capital

A company with a $1 billion Enterprise Value (market value of equity plus debt), for example, that has $600 million of total (book) capital on its balance sheet has an MVA of $400 million.

MVA is significant for three main reasons:

1. MVA measures the owners' accumulated wealth; it is the spread between the total money put into a business and the total value coming out of it.

2. MVA represents franchise value; it's the valuation premium above total invested capital resources that is attributable to the firm's distinctive organizational capabilities and other intangible assets.

3. MVA measures the firm's aggregate NPV. MVA is a summing up in the market's mind of the net present value of all capital projects, those a firm already has in place plus those projected to materialize down the road.

Increasing MVA is thus the real key to creating wealth, adding to franchise value, and increasing the firm's NPV, all at the same time. Increasing MVA is also the key to driving shareholder returns.[6]

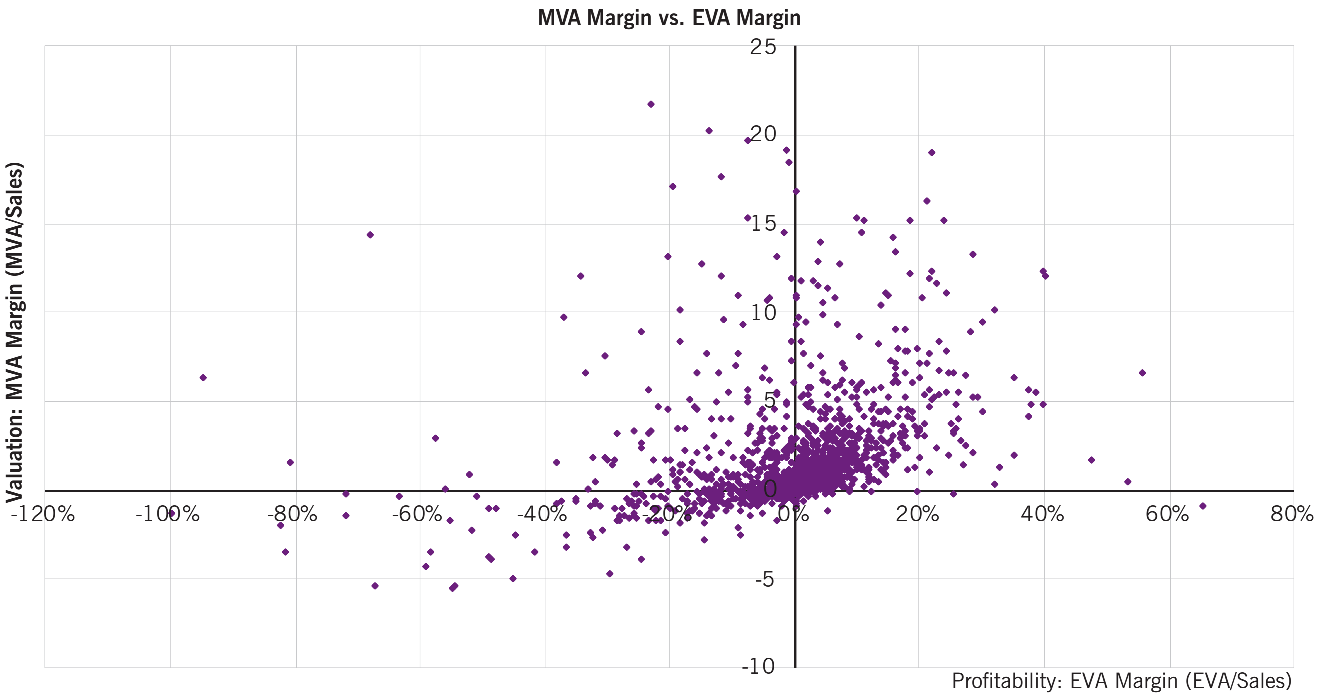
The truly important question, then, is not whether EBITDA explains Enterprise Value, but whether EBITDA explains MVA. The short answer is no, not at all.

A regression of size-adjusted MVA to EBITDA produces white noise, the scattered diagram shown in Figure 2, with an $R^2$ of just 4.8%. EBITDA is almost perfectly uncorrelated with MVA, just as finance theory predicts, because EBITDA ignores the capital side of the wealth equation.

We expect EVA to be much better at predicting MVA because, as mentioned, a company's net present value, or MVA, is mathematically equal to the present value of the EVA profit it is projected to earn. In the regression we used to test this proposition, we used a firm's prior year's EVA as a proxy for its projected EVA. In effect, we assumed that each firm's EVA will persist at its current level forever. It's a gross

6 The mathematical link between EVA, MVA, and shareholder returns asserted here has been derived and tested, and is available in a separate ISS white paper, "The Link Between TSR and EVA," available at https://www.issgovernance.com/solutions/iss-analytics/iss-eva-resource-center/.

*Figure 3*
**MVA Margin vs. EVA Margin**




simplification that ignores the potential for growth in EVA, but it shows how well EVA performs compared to EBITDA with the same constraint.

The regression of MVA to EVA,[7] as shown in Figure 3, shows an $R^2$ of 21.4%. That's not terrific—but this is a simple model, applied regardless of industry and ignoring growth potential. And the analysis demonstrates that EVA is fundamentally more correlated–-in fact, five times as correlated—with enhancing NPV and creating wealth than EBITDA.

The correlation between EVA and MVA, however, is much stronger and more interesting when firms are clustered into groups. In this analysis, we ranked companies low to high by their EVA/sales ratios, then we assigned them to 35 bins of 50 companies each, thus covering 1,750 firms (or all but the 23 companies with the very highest EVA-to-sales ratios). We then computed the median EVA/sales and MVA/sales ratios for each of the 35 bins and plotted the pairs shown in Figure 4, with the following conclusions:

First, note that once EVA turns positive, EVA multiplies into MVA along a straight line.

Second, when EVA is zero or near zero, MVA tends to be close to zero, too. Just as finance theory predicts, investors are unwilling to pay much if any premium value for firms that deliver only a basic, break-even rate of return on their capital. They will only pay for the book capital in the business. This shows that the cost of capital we have computed is a real cost, with a real market impact. Until a firm earns it, it does not create wealth and it cannot produce exceptional shareholder returns.

Observe also that the companies falling short of their cost of capital and that are producing negative EVA tend to trade for an MVA near zero, *no matter how negative EVA gets to be*.

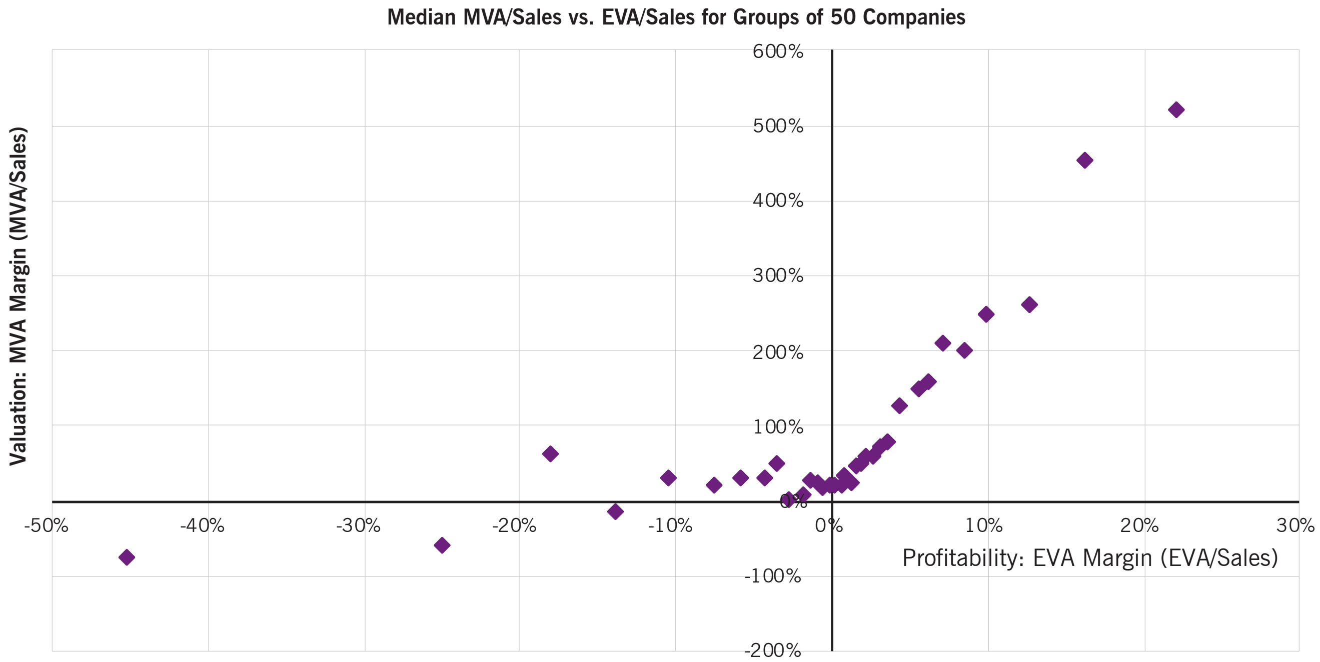
This last finding, surprising at first hearing, is a sign of market sophistication. Investors have learned from experience that managers in negative EVA businesses feel pressure and respond. They restructure operations, redirect resources, and rethink strategies, or they liquidate assets or sell the company. They manage to raise EVA to zero or near zero, or realize something close to the net book value of their assets in a sale.

There's something else going on, too. The negative EVA group also contains emerging start-up companies that are not yet covering their cost of capital but are forecast to reach that mark someday.

7 As with the EBITDA, the variables are common sized, by dividing by sales, and the regression model includes a term for company size, as MVA/Sales ratios tend to be smaller for larger, more mature firms.

*Figure 4*

**Median MVA/Sales vs. EVA/Sales for Groups of 50 Companies**




For whichever reason, the market sets a floor on the value of negative EVA companies considered as a portfolio.[8] This is another critical valuation insight that EVA gets but EBITDA does not.

Given this relationship, we reran the regression of MVA to EVA by setting the value for EVA to 0 whenever a firm's EVA was negative. In effect, we assumed that the expected long-run EVA of all negative EVA companies is zero. It's a bold assumption, but does it work?

The regression $R^2$ did drop a tad, from 22.4% to 21.9% (because there is, in fact, a slight valuation penalty as EVA becomes more negative), but in exchange, the coefficient on EVA increased from 17.6 to 18.5 and the t-statistic rose from 18.2 to 19.5 (99.9999% confidence). The new model is better. It more closely fits the actual line connecting EVA and MVA. It sets a more positive and significant slope to EVA when EVA is positive and sets the slope on EVA to zero when EVA is negative.[9] We use this version of the model in the industry regression runs discussed below.

## Valuations within Industry Groups

The regressions we've reviewed so far assume that investors assign the same multiples to all Russell 3000 firms regardless of industry. It's more realistic to assume that valuation multiples cluster within industry groups. We therefore assigned all 1,773 companies into 44 groups using standard industry classification (SIC) codes and performed the same regressions within each group.

As an example, here is the plot of size-adjusted EBITDA versus Enterprise Value for the 34 companies in the Aerospace and Defense industry. There is an evident upward slope connecting the dots.

The $R^2$ is 42%; the coefficient on EBITDA is 17.6, with a t-stat of 4.8 (significant at the 99.9% confidence level). Enterprise Values tend to increase as a multiple of EBITDA in this industry, as in many others. The statistics confirm it: clustering companies by industries makes sense.

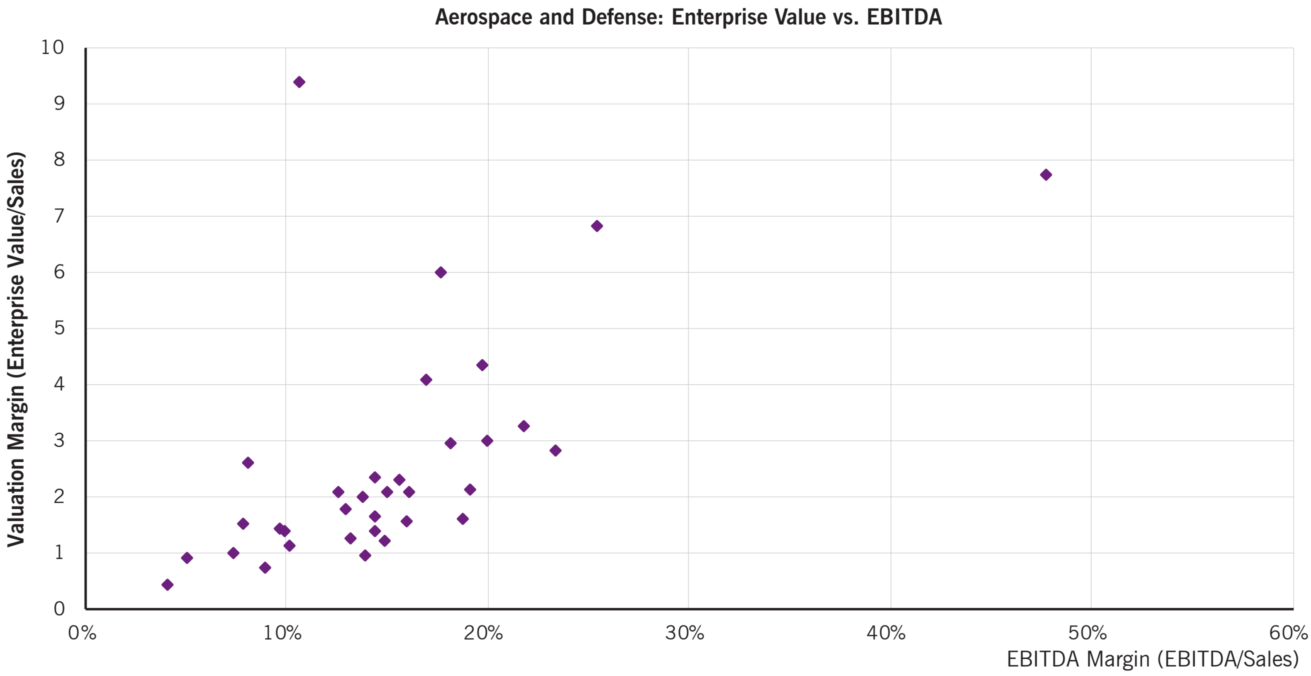
Good as that is, EVA is much better. A regression of size-adjusted MVA to EVA has an $R^2$ of 62%[10] with a coefficient on EVA of 32.8 and t-stat of 6.6.

8 This is not a new phenomenon or peculiarity of the current market. The relation between EVA and MVA documented in this study was also documented in 1991 with the publication of *The Quest for Value*, by Bennett Stewart. The assumption that negative EVA companies as a group will rebound, restructure, or sell and generate a long-run breakeven for EVA is apparently a permanent feature of the valuation landscape.

9 We also tested a second EVA variable that was set to zero when EVA was positive, in other words, it was populated only when EVA was negative. Adding it increased the $R^2$ a tad, but the coefficient and t-stat on it were much smaller and much less significant than on the EVA positive variable we chose to ignore it.

10 Technically, the $R^2$ of size-adjusted EVA with MVA was 58%, but it is 62% versus Enterprise Value because a portion of the portion of the variation in Enterprise Value is due to variation in Capital. Consult the Technical Appendix for more details.

*Figure 5*
**Aerospace and Defense: Enterprise Value vs. EBITDA**




EVA, note, packs almost twice the punch of EBITDA. A 1% increase in a firm's EVA/sales ratio tends to increase its MVA wealth premium by 32.8% of sales; a 1% increase in its EBITDA-to-sales margin increases Enterprise Value by only 17.6% of sales; it's half as helpful. But not only that, EBITDA increases a firm's Enterprise Value while saying nothing about how much capital was required to do it. EVA, however, increases MVA. It tells us how much the firm's Enterprise Value increased *above* the capital that the firm invested, which is a much more significant result.

We ran the same regressions for all 44 industries. As summarized in the Appendix, we found the following:

• Neither EVA or EBITDA performed well in nine industries, including Tech Hardware, Software, Pharma, Life Sciences, Internet Media, and Health Care Equipment and Supplies. In dynamic businesses like these, the percentage of Enterprise Values attributable to *current* earnings and cash flow—what we call "current operations value," or COV—tends to be pretty low (in some cases, as little as 25%), and the value attributable to what we call "future growth value" quite high. In such cases, the current levels of EBITDA and EVA are likely to fail to convey much information.[11]

• The median $R^2$ of the correlation with Enterprise Value across all industries was 32% for EBITDA and 47% for EVA. The EVA advantage is even larger—a median $R^2$ of 58% versus 38% for EBITDA—when we limit our analysis to the 29 industries that contain 20 or more companies and where EBITDA or EVA are significant valuation variables. In those cases, EVA thus has approximately 15% to 20% more explanatory power.

• EVA was more significant than EBITDA in 22 industries, and EBITDA in 8. And three of those eight industries contained very few observations: Biotech (with more than $1 billion in sales) was represented by only 12 companies, Internet Services by 11, and Wireless Communication by just 9.

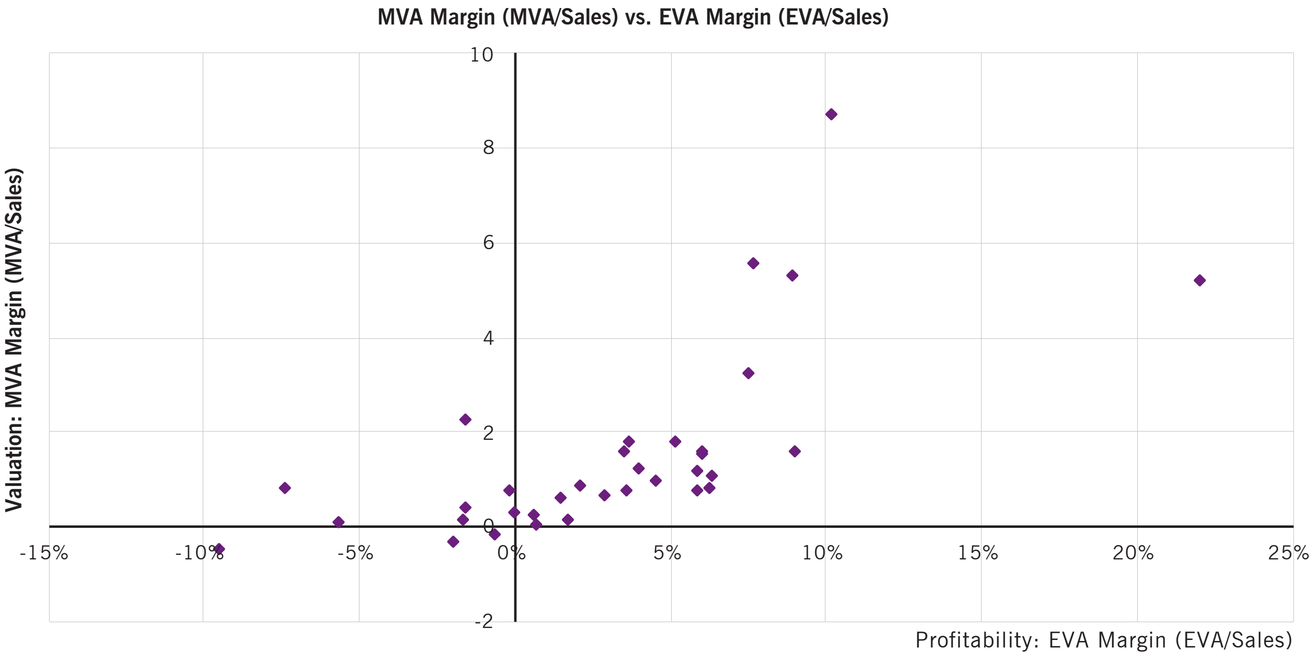
• EVA was significantly better in most capital-intensive industries, such as Auto and Suppliers, Oil and Gas, Media, Communication Equipment, Construction, Household Durables, Paper and Packaging, and Semiconductors. That's expected, because EVA explicitly recognizes the cost of capital.

• EVA also outperforms EBITDA in Commercial Services and Supplies, Food and Beverage Retailing, Specialty Retail, and Professional Services, which might be surprising; after all, these are businesses that aren't especially asset intensive. The

11 In the analysis for the tests for these nine industries with low COV and high FGV, we did not attempt to model future growth expectations. Had we done so, there is every reason to expect that EVA would significantly outperform EBITDA since EVA discounts to NPV while EBITDA does not.

*Figure 6*

**MVA Margin (MVA/Sales) vs. EVA Margin (EVA/Sales)**




cost of capital, though, can still be a considerable charge and an important valuation factor relative to the meager margins that these companies typically work with.

The finding that EVA dominates EBITDA as a measure of stock market value will no doubt surprise many. After all, sell-side research reports and the business media are rife with references to EBITDA and notably scarce on EVA. But our findings don't imply or require that investors literally compute or analyze EVA in determining value. Some investors do—ISS provides EVA-based research to an expanding clientele of institutional investors, for example—but many do not explicitly consider EVA. No matter.

As has been noted, the present value of EVA and the net present value of cash flows are mathematically identical. So long as most investors measure intrinsic value by analyzing and discounting cash flows (or indirectly, by looking at indicators that help them gauge the magnitude, quality, timing, and risk of cash flows), then EVA and MVA, and by extension, EVA and Enterprise Value, will be strongly correlated.

This is a very important point. One does not have to believe in "EVA" to think it is sensible to use EVA. As long as one subscribes to the view that valuations follow discounted cash flows, the significance of EVA as a valuation metric and the correlation to creating wealth that we have documented in this paper follow as a natural by-product.

## Using EVA to Determine Enterprise Value

Given that EVA is an effective valuation metric, how, specifically, can PE firms use it to measure value? After all, EVA does not discount to share price or market value per se; EVA discounts to net present value—that is, to MVA, which is a company's Enterprise Value minus the Capital invested in its business:

$$\text{MVA} = \text{Enterprise Value} - \text{Capital}$$

By rearrangement, Enterprise Value is:

$$\text{Enterprise Value} = \text{Capital} + \text{MVA}$$

And MVA, the company-wide NPV, is equal to the present value of EVA:

$$\text{Enterprise Value} = \text{Capital} + \text{The Present Value of EVA}$$

The formula says that the enterprise value of a business viewed as a going concern is the amount of capital money put into it plus the present value of the

EVA profit projected to come out of it. EVA is the reason, and the only reason, a company is worth more, or less, than the money put into it.

The capital part is easy: it's the firm's net assets as of the valuation date.[12] The present value of EVA is harder. An analyst begins by preparing a P&L and balance sheet projection, taking account of the developments they foresee for revenues, operating margins, taxes, working capital turnover, capital expenditures, and the like. The next step is to compute the EVA profits implied by the financial forecast, and then to discount the projected EVA to a present value at the firm's cost of capital. Putting the two together—the firm's capital and the discounted EVA value—yields the estimate of the firm's intrinsic Enterprise Value.

Once again, the EVA procedure produces the same valuation as discounting the cash flows. For a given projection, EVA does not give a new answer, it is the same answer—which is essential, of course. Still, there are very good reasons to prefer using EVA for valuations instead of cash flow.

For one thing, a projection of EVA reveals how much value is being added or lost *in each projection period*. If a forecast shows that EVA will be zero or close to it, for example, there is no value added over the plan horizon. No matter what any other measures suggest, an analyst will instantly understand why that business is worth just the book value of the capital put into it. And if an analyst models out several forecast scenarios, the one that produces the more rapid expansion in EVA is immediately recognizable as the one that is worth more, and, again, *irrespective of what any other measure may say*.

An analyst also can directly trace the forecast for EVA to its underlying assumptions. An improvement in working capital turnover, for instance, appears as a line-item reduction in the capital charge and thus as a directly measurable improvement in EVA. Whether the assumption covers P&L costs, or revenues, or capital utilization, the impact on EVA is clear, and thus the impact on value is clear, too.

In sum, EVA not only gives a valuation answer; it gives insights into why the answer is the answer. Thus the valuation is not just a black box; it reveals and quantifies the key factors that are determining the value. Perhaps the best way to describe EVA, then, is that it is the simplest and most effective way to estimate and understand a company's intrinsic cash flow value.

12 Net assets must be adjusted to reflect the corrective adjustments EVA applies. The net assets exclude excess cash, for example, and include the remaining balance of R&D spending carried over from prior years.

## EVA Is a Superior Management System

EVA can not only estimate value, but can also play an active role in helping PE firms to create value. How? By empowering the management teams in portfolio companies to make better decisions.

The idea, in a nutshell, is to get the teams to focus on increasing EVA as their paramount financial goal and to use it broadly. Managers should use EVA, first of all, to measure value and make decisions by projecting it and discounting it to measure NPV; second, as a check for reviewing performance and benchmarking with peers; and third, as a possible yardstick for metering bonus pay. Using EVA in this comprehensive way is what makes it simple, accountable, and adaptable.

It's simple because one metric threads through and unites all applications. There's no need for using cash flow calculations for valuations and capital budgeting purposes and other sets of metrics for other applications. That's a common solution that often needlessly complicates practice. By using EVA, measures like cash flow, ROI, and EBITDA can be retired. They are redundant and inferior to just keeping all eyes focused on the goal of increasing EVA.[13]

The EVA model also introduces much stronger accountability for results. If managers want more capital, and succeed in getting it, they must deliver more EVA, period. They must cover the cost of the capital they request and invest. When they find that they are so visibly responsible for making good on their promises, managers respond by scrutinizing decisions with much greater intensity and thinking about alternatives with much more creativity.

EVA also increases a company's agility. If the goal to increase EVA is paramount, then every other measure can flex (except for mission-critical goals, such as safety, health, environmental, and strategic objectives). Managers no longer are straitjacketed into meeting targets for micro-metrics. They can use common sense and adapt plans and adjust decisions as circumstances dictate. For example, they won't keep investing capital to meet growth or margin targets when the return on the incremental investment is no longer attractive. Instead, they will change course and drive the most value by creating the most EVA. In short, they will aim to win games, not mindlessly follow game plans.

13 EVA is nowadays a much more effective analytical tool since it's been converted into a series of performance ratios and a companion ratio analysis framework. It's described in detail in the book, *Best-Practice EVA*, available on Amazon, and at a high level, in the ISS white paper, "The Four Key EVA Performance Ratios," available at https://www.issgovernance.com/solutions/iss-analytics/iss-eva-resource-center/.

EVA thus differs from EBITDA in another, very important way. It is a technique that PE firms can adopt to accelerate the creation of value within their portfolio companies.

### A Special EVA Solution for PE Firms

For all of EVA's advantages, there are two caveats: PE firms are typically judged by the internal rate of return (IRR) of their investments; they also must ensure that their portfolio companies are able to service the debts taken when they are acquired. It may therefore seem that ROI and EBITDA or cash flow metrics are needed and would be superior to EVA given those constraints, but that is not so.

The optimal solution is still to use EVA for managing and valuing businesses, but with a simple modification: EVA should be measured using an artificially high cost of capital, a rate well above actual market expectations, as high as 12% or more, for example. Posting an after-tax charge on capital as great as 1% a month or more tells managers to work extra hard to sweat capital out of the balance sheet. A high hurdle rate also pushes back on projects that otherwise would be accepted, leaving only the very highest-returning investments to pass muster, and a lot of cash flow to repay debt in the wake.

Doing this is not without a sacrifice. Imposing an artificially high cost of capital chokes investments that would be favorably valued in the stock market. Still, if cash constraints are real, and if PE firms are judged by IRR, then that cost is unavoidable, and they must pay it with or without EVA. EVA, however, is the best way to recognize the cost and enable managers to work around it.

If applying such a high cost of capital rate turns what seems a profitable business into an EVA loser, that is of no consequence. The goal with EVA is always to *increase* it. Making a negative EVA less negative is just as valid a way to improve performance and create value as it would be to take an EVA that is positive and make it more positive. It's the change that counts, not the level.

The goal of increasing EVA can be applied to any business, regardless of its starting point, regardless of legacy assets or liabilities, regardless of how much or little capital intensity is required by the business model—another reason why EVA should hold great appeal to PE firms. They can use EVA to establish a common scorecard that will apply across their entire portfolio of businesses, no matter how diverse they are. No other measure, or set of measures, can do that.

### Closing Comment

For many, it is an article of faith that companies are worth a certain multiple of EBITDA. The evidence presented here strongly refutes that notion. Stocks trade on cash flow, net of investment—or better, on the prospects for EVA, for generating economic profit above the cost of capital—as economic logic suggests they should. Enterprise or EBITDA multiples do not determine value but are derived from it.

Despite the findings of this paper, it is unlikely PE firms will abandon EBITDA; there's too much institutional inertia behind EBITDA. But at the very least, PE firms should consider using EVA to complement EBITDA in due diligence investigations and company valuations, and for reviewing the performance, plans, and decisions of portfolio companies while they hold them.

The biggest payoff, however, is likely to come from encouraging portfolio companies to "adopt" EVA. By this we mean the management team is trained about EVA and how to use it. They are equipped with tools that enable them to evaluate the performance of the company and its lines of business, and simulate the value of plans and decisions, through the lens of EVA. An EVA-capable team is apt to make better decisions, surface more valuable plans and investments, react faster and more intelligently to changing circumstances, and accelerate the creation of value that is at the very heart of the PE mandate.

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*A technical appendix explaining the regression models and statistical tests is available from the author upon request at bennett.stewart@issgovernance.com.*

## Appendix 1: The Industry Regression Results

EBITDA regression:

Enterprise Value/Sales = a + b x EBITDA/Sales + c x SIZE + e

**EVA regression:**

Enterprise Value/Sales = Capital/Sales + a + b x EVA/Sales + c x SIZE + e

**Legend**

EVA better

EBITDA better

Neither better

Neither good

<20 observations

| | Industry Group | | # Companies | Adj $R^2$ | Variable | t-stat | Size | t-stat |
|---|---|---|---|---|---|---|---|---|
| 1 | Aerospace & Defense | EBITDA | 34 | 42% | 17.7 | (4.8) | -0.43 | (-2.5) |
| | | EVA | | 61% | 32.8 | (-2.7) | -0.37 | (6.6) |
| 2 | Airlines | EBITDA | 12 | 57% | 6.7 | (2.6) | -0.04 | (-0.5) |
| | | EVA | | 60% | 10.4 | (0.9) | 0.06 | (2.9) |
| 3 | Auto & Suppliers | EBITDA | 29 | 32% | 9.2 | (3.3) | -0.16 | (-1.4) |
| | | EVA | | 46% | 17.5 | (-1.1) | -0.11 | (3.9) |
| 4 | Biotech | EBITDA | 12 | 25% | -10.1 | (-2.0) | 0.49 | (0.6) |
| | | EVA | | 8% | -9.4 | (-0.6) | -0.49 | (-1.1) |
| 5 | Chemicals | EBITDA | 60 | 31% | 8.1 | (5.3) | -0.13 | (-1.2) |
| | | EVA | | 25% | 12.2 | (0.3) | 0.03 | (4.1) |
| 6 | Commercial Services and Supplies | EBITDA | 55 | 22% | 6.7 | (4.1) | -0.06 | (-0.3) |
| | | EVA | | 73% | 26.7 | (0.9) | 0.10 | (8.9) |
| 7 | Communication Equipment | EBITDA | 33 | 38% | 8.4 | (4.6) | -0.07 | (-0.3) |
| | | EVA | | 60% | 18.1 | (0.4) | 0.06 | (8.7) |
| 8 | Conglomerates and Machinery | EBITDA | 103 | 68% | 16.5 | (14.8) | -0.18 | (-2.9) |
| | | EVA | | 68% | 25.1 | (-2.2) | -0.13 | (12.1) |
| 9 | Construction | EBITDA | 62 | 68% | 16.1 | (11.1) | -0.09 | (-1.0) |
| | | EVA | | 76% | 26.9 | (-0.3) | -0.03 | (10.6) |
| 10 | Diversified Consumer Services | EBITDA | 19 | -3% | 2.8 | (0.4) | -0.83 | (-1.2) |
| | | EVA | | 14% | 14.4 | (-1.3) | -0.81 | (1.6) |
| 11 | Diversified Telecom Services | EBITDA | 15 | 57% | 11.7 | (4.6) | -0.49 | (-2.4) |
| | | EVA | | 79% | 30.5 | (-3.3) | -0.44 | (3.0) |
| 12 | Electrical Equipment | EBITDA | 26 | -9% | 0.1 | (0.1) | -0.03 | (-0.1) |
| | | EVA | | 33% | 3.2 | (-0.3) | -0.06 | (1.0) |
| 13 | Electronics and Office Equipment | EBITDA | 56 | 45% | 11.9 | (6.1) | -0.48 | (-3.1) |
| | | EVA | | 48% | 23.8 | (-1.9) | -0.29 | (5.4) |
| 14 | Energy Equipment and Supplies | EBITDA | 58 | 6% | 2.8 | (2.3) | 0.07 | (0.6) |
| | | EVA | | -36% | 21.4 | (-0.7) | -0.11 | (3.5) |
| 15 | Entertainment | EBITDA | 23 | 0% | 4.5 | (1.3) | -0.01 | (0.0) |
| | | EVA | | 29% | 28.9 | (-1.1) | -0.24 | (3.6) |
| 16 | Food and Beverage (ex Tobacco) | EBITDA | 52 | 65% | 18.9 | (9.8) | -0.42 | (-4.0) |
| | | EVA | | 73% | 26.3 | (-3.8) | -0.34 | (10.3) |
| 17 | Food and Staples Retailing | EBITDA | 21 | 41% | 12.0 | (4.0) | -0.02 | (-0.6) |
| | | EVA | | 66% | 29.4 | (-1.4) | -0.03 | (5.2) |
| 18 | Freight Transportation | EBITDA | 45 | 88% | 10.8 | (17.3) | 0.14 | (2.1) |
| | | EVA | | 61% | 20.8 | (1.2) | 0.16 | (5.2) |
| 19 | Health Care Equipment and Supplies | EBITDA | 70 | 4% | -2.4 | (-0.6) | -0.57 | (-1.5) |
| | | EVA | | 4% | 20.6 | (-3.0) | -0.96 | (2.6) |
| 20 | Health Care Providers | EBITDA | 63 | 17% | 5.0 | (1.3) | -0.73 | (-3.6) |
| | | EVA | | 49% | 37.5 | (-3.4) | -0.56 | (5.7) |
| 21 | Hospitality | EBITDA | 39 | 9% | 4.4 | (2.2) | -0.26 | (-1.6) |
| | | EVA | | 22% | 23.6 | (-1.4) | -0.21 | (6.1) |
| 22 | Household and Personal Care | EBITDA | 23 | 42% | 20.0 | (4.2) | -0.24 | (-1.4) |
| | | EVA | | 64% | 31.0 | (-2.5) | -0.30 | (7.4) |

## Appendix 1: The Industry Regression Results

*continued*

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 23 | Household Durables | EBITDA | 46 | 2% | 7.9 | (1.3) | -0.47 | (-1.6) |
| | | EVA | | 32% | 19.5 | (-1.6) | -0.38 | (2.2) |
| 24 | Internet Media | EBITDA | 16 | -13% | 0.2 | (0.0) | 0.22 | (0.3) |
| | | EVA | | -33% | -1.5 | (0.5) | 0.27 | (-0.2) |
| 25 | Internet Retail | EBITDA | 22 | 29% | 13.8 | (3.3) | -0.33 | (-1.1) |
| | | EVA | | 20% | 15.6 | (-0.5) | -0.18 | (2.3) |
| 26 | Internet Services | EBITDA | 11 | 74% | -32.0 | (-5.5) | 2.82 | (2.8) |
| | | EVA | | -47% | -64.4 | (-0.4) | -0.74 | (-0.4) |
| 27 | IT Services | EBITDA | 61 | 44% | 15.0 | (6.3) | 0.15 | (0.6) |
| | | EVA | | 54% | 23.0 | (0.9) | 0.19 | (6.3) |
| 28 | Leisure | EBITDA | 16 | -10% | 2.3 | (0.8) | 0.01 | (0.1) |
| | | EVA | | 1% | 15.0 | (-0.3) | -0.04 | (3.6) |
| 29 | Life Sciences | EBITDA | 21 | 6% | 6.8 | (1.7) | -0.38 | (-0.7) |
| | | EVA | | -1% | 6.5 | (0.2) | 0.10 | (1.1) |
| 30 | Media | EBITDA | 45 | 35% | 9.5 | (5.1) | -0.27 | (-1.4) |
| | | EVA | | 62% | 29.4 | (-1.5) | -0.21 | (9.8) |
| 31 | Metals and Mining | EBITDA | 33 | 59% | 11.1 | (6.9) | -0.27 | (-1.6) |
| | | EVA | | 47% | 9.6 | (-1.2) | -0.23 | (1.8) |
| 32 | Oil & Gas Exploration and Production | EBITDA | 99 | 29% | 5.1 | (6.2) | -0.14 | (-1.0) |
| | | EVA | | 52% | 34.9 | (0.3) | 0.04 | (3.6) |
| 33 | Paper and Packaging | EBITDA | 29 | 45% | 9.3 | (5.0) | -0.08 | (-0.8) |
| | | EVA | | 57% | 9.5 | (-0.6) | -0.05 | (3.2) |
| 34 | Pharmaceuticals | EBITDA | 30 | -6% | 0.9 | (0.6) | 0.04 | (0.2) |
| | | EVA | | -22% | 7.4 | (-0.9) | -0.17 | (3.0) |
| 35 | Professional Services | EBITDA | 38 | 32% | 14.9 | (4.3) | -0.10 | (-0.3) |
| | | EVA | | 43% | 26.4 | (0.3) | 0.11 | (3.4) |
| 36 | Restaurants | EBITDA | 36 | 66% | 22.2 | (8.4) | -0.77 | (-3.1) |
| | | EVA | | 57% | 27.9 | (-2.6) | -0.70 | (6.6) |
| 37 | Semiconductors | EBITDA | 64 | 16% | 9.7 | (3.6) | -0.52 | (-1.9) |
| | | EVA | | 26% | 18.4 | (-1.7) | -0.36 | (5.1) |
| 38 | Software | EBITDA | 107 | 0% | -0.7 | (-0.3) | -0.35 | (-0.9) |
| | | EVA | | -4% | 17.5 | (-3.0) | -1.07 | (2.6) |
| 39 | Specialty Retail | EBITDA | 92 | 17% | 5.5 | (4.6) | -0.08 | (-1.1) |
| | | EVA | | 60% | 23.6 | (-1.6) | -0.08 | (10.4) |
| 40 | Technology Hardware | EBITDA | 18 | 8% | 4.1 | (1.2) | -0.33 | (-1.9) |
| | | EVA | | -3% | 17.1 | (-1.6) | -0.26 | (3.0) |
| 41 | Textile, Apparel, and Luxury Goods | EBITDA | 24 | 46% | 16.3 | (4.0) | 0.07 | (0.5) |
| | | EVA | | 59% | 31.2 | (-0.2) | -0.03 | (6.1) |
| 42 | Trading Companies | EBITDA | 40 | 93% | 9.1 | (22.8) | -0.20 | (-2.1) |
| | | EVA | | 96% | 17.1 | (-3.4) | -0.23 | (6.3) |
| 43 | Wireless Communications | EBITDA | 9 | 58% | 11.4 | (3.4) | -0.55 | (-2.3) |
| | | EVA | | -122% | 398.6 | (-1.1) | -0.70 | (0.8) |

# Beyond EVA

by Greg Milano, Fortuna Advisors

In early 2018, Institutional Shareholder Services (ISS), the well-known proxy advisory firm, announced that it had acquired EVA Dimensions, an equity research firm that uses economic value added (EVA)[1] to measure corporate performance and estimate a company's intrinsic value. Following this acquisition, ISS also announced that in 2019 EVA would be featured in its research reports along with GAAP-based measures—and that in 2020 it would consider making EVA-based measurements part of the financial performance assessment methodology for its pay-for-performance model.[2] Those of us who have been studying performance measurement and compensation design for decades applauded the news.

But not all were as enthused about this development, as I recently found out when I attended a WorldatWork conference in Colorado focused on trends in executive compensation and performance measurement. Though many topics were discussed, a common thread running through many presentations was that EVA was undergoing a resurgence—and every expert warned that human resource professionals should be deeply concerned about its impending return. The most common complaint was about the complexity of the EVA performance measure, but some also cautioned against its tendency to encourage "underinvestment."

Yet, having implemented EVA with Stern Stewart for over ten years beginning in 1992, I can say with some confidence that EVA is a more effective way of guiding and motivating corporate managers to create value than traditional performance measures. It was a substantial step forward in the evolution of performance measurement in that it attempts to balance considerations about both "quantity" (or growth) and "quality" (rate of return, or profitability) within a single measure. Sure, there are improvements that can be made to simplify EVA and encourage better behavior, which will be discussed below. But it was a major advance in performance measurement when it was launched about 30 years ago.

But before getting into the specifics, let me provide some context for what follows. In 2001, when Joel Stern and John Shiely published *The EVA Challenge: Implementing Value-Added Change in an Organization*,[3] they asked me to write the epilogue, which came to be titled "EVA and the 'New Economy.'" The authors wrote the book during the dotcom bubble, and the epilogue was my early attempt to explain corporate valuation in situations where corporate investments more often took the form of R&D and marketing expenditures than traditional capital spending on buildings and machinery. As I wrote back in 2001, "Do not be distracted by the values of new economy companies. The share prices may be realistic or they may be a dream; we do not know. However, …[a]t any reasonable percentage of prevailing valuations, this would be an NPV-to-capital ratio that many 'Old World' companies would cherish."

A year earlier, in 2000, I gave a speech at Stern Stewart's second European EVA Institute in Fiuggi, Italy that was later adapted into an article titled "EVA and Growth" and published in Stern Stewart's *EVAngelist* magazine.[4] As I pointed out in my speech, although EVA theoretically encourages all good investments insofar as it rewards the delivery of returns above

1. EVA is a registered service mark of Stern Value Management, Ltd. (originally by Stern Stewart & Co. in 1994) for financial management and consulting services in the area of business valuation, and is registered as a trademark by Institutional Shareholder Services Inc. (originally by EVA Dimensions LLC in 2008) for a number of uses.

2. Karame, Marwaan, "Prepare for This Pay-for-Performance Measure," CFO.com, December 4, 2018. http://fortuna-advisors.com/2018/12/04/prepare-for-this-pay-for-performance-measure/.

3 Joel M. Stern and John S. Shiely, *The EVA Challenge: Implementing Value-Added Change in an Organization* (New York: Wiley, 2004).

4 Milano, Gregory V., "EVA and Growth," *EVAngelist*, Volume IV, Issue IV, Italy 2000, pages 9-13.

a weighted average cost of capital, with many clients I had witnessed EVA stifling growth investment and causing managers to place too much emphasis on cost efficiency and capital productivity. The speech and article were my first attempts, while I was still at Stern Stewart, at explaining the behavioral reasons for these unintended consequences of an otherwise good idea.

Then, in 2004, I joined the "Buyside Insights" Group of the Credit Suisse investment banking department shortly after they had acquired the HOLT® valuation framework.[5] HOLT is a highly sophisticated framework for valuation, which is to say that it's very complicated. It's great for investors, who tend to be a very numerate lot, but has proven to be cumbersome for corporate management teams. Worth noting here, though, is that HOLT is "cash-flow based," so it doesn't recognize depreciation as a cost and assets don't decline in value as they get older. It was during this period that I realized that depreciation was at the root of one of the biggest problems with EVA. By making new assets look more expensive than they really are, and by creating an illusion of performance improvements as those assets depreciate away, the conventional accounting for depreciation causes distortions in the timing of EVA—and of virtually every return measure, including ROE, ROIC, and ROCE. I will come back to this later, but for now, suffice it to say that depreciation was a key to solving the puzzle of why EVA appeared to be discouraging new investment.

It was these shortcomings of EVA that ultimately led our Fortuna Advisors team to develop a better economic profit performance measure when we founded our corporate shareholder value advisory firm in 2009. The process began with extensive empirical testing to refine our ideas and develop a simpler economic profit measure that does a better job of tracking total shareholder return and, more important, strikes a better balance between delivering current performance and investing in the future. The result was Residual Cash Earnings (RCE), which was introduced here in the *Journal of Applied Corporate Finance* in 2010.[6] We have implemented RCE for many companies since then, in most cases customizing the measure (and often renaming it after the company) to fit different businesses and industries.

In the sections that follow, I will explain how both EVA and RCE are calculated as well as how RCE differs from EVA by providing management with the performance indicators and incentives to pursue an optimal balance of profitability and value-adding investment.

5 HOLT® is a registered trademark of Credit Suisse Group AG or its affiliates in the United States and other countries.

6 Milano, Gregory V., "Postmodern Corporate Finance," *Journal of Applied Corporate Finance* 22, no. 2 (Spring 2010): 48-59.

## Overview of EVA

In the 1990s, EVA was all the rage. One would hardly have known that economic profit had been developed in academia over 100 years earlier. Of course, the formula for EVA reflected a specific definition of economic profit that was developed and popularized by Stern Stewart & Co. EVA is simply Net Operating Profit after Taxes (NOPAT) less a capital charge to reflect the expected return of the shareholders and lenders on the capital they have committed to the company. But to adjust for some of the idiosyncrasies of accounting, and presumably to improve the quality of the performance measure, calculating EVA requires a stream of adjustments to GAAP accounting that make the metric significantly more complicated to understand and implement. According to the Wikipedia page for EVA, there are over 160 potential adjustments.[7]

On the one hand, this plethora of adjustments in the hands of corporate finance departments has made EVA more comprehensive and robust—but at the cost of making the measure harder for managers to understand. And as a general rule, if people do not understand a financial measure well, it is much less likely to motivate their behavior—at least in the way it was designed to.

Along with the complexity, there is also a short-termism problem that is potentially far more destructive to the pursuit of shareholder value. To understand why EVA motivates short-term behavior, let's consider the three main ways that EVA leads managers to increase value:

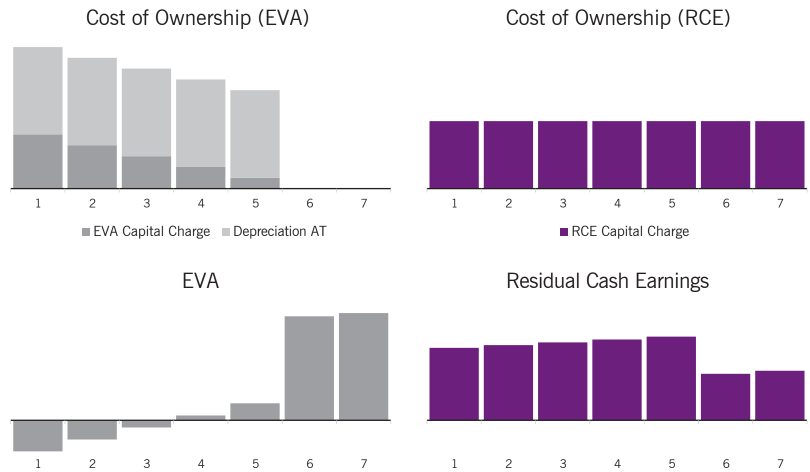
**Motivation #1:** Improving current performance by optimizing pricing, cost management, and capital utilization.

**Motivation #2:** Investing in all new projects that generate sufficient NOPAT to more than cover the capital charge.

**Motivation #3:** Harvesting low-return investments and diverting the resources toward EVA-enhancing activities.

7 Wikipedia contributors, "Economic value added," *Wikipedia, The Free Encyclopedia*. Accessed August 21, 2019. https://en.wikipedia.org/wiki/Economic_value_added. A list of common adjustments to EVA includes: (1) eliminating excess cash and the NOPAT impact; (2) adjusting NOPAT for the change in provision for bad debts; (3) converting LIFO inventory to FIFO; (4) removing all pension charges from NOPAT except the annual service cost, and treating underfunded pensions as debt (and vice versa); (5) capitalizing the present value of operating lease commitments and removing the financing portion of leases from NOPAT; (6) capitalizing and amortizing R&D and certain marketing expenditures; (7) removing unrealized gains/losses on hedging-related derivatives; (8) removing minority interest effects; (9) permanently capitalizing (and removing from NOPAT) unusual items including: a) impairment charges and asset write-offs, b) restructuring and nonrecurring items, and c) gains and losses on sale of assets; and (10) charging an adjusted cash tax amount by: a) applying a standard tax rate, b) adjusting for deferred taxes, and c) recognizing the tax benefit from deducting stock options.

*Figure 1*
**Comparing the Cost of Ownership of EVA vs. RCE**




In my experience, most EVA-driven companies do a fair job on the first and third motivations, but the vast majority underinvest in the business, and so the second motivation doesn't usually work out as intended. The result is often less profitable growth and a tendency to cut expenditures related to maintaining and upgrading aging assets. This is known as "sweating assets," and some finance managers commend such tactics. Unfortunately for shareholders, though, our research shows a negative relationship between sweating assets and TSR.[8]

## Beyond EVA

To build a better mousetrap, we sought a deeper understanding of the problems with EVA that we were trying to fix. It was obvious that the ideal measure needed to be simpler than EVA, with fewer adjustments to accounting; but it took me the better part of a decade to figure out the ways in which EVA was discouraging corporate investment. Now it seems so clear.

It is easiest to see the bias against capital expenditures by considering a single new investment of $1 million in an asset that has a five-year accounting life, and an average useful service life of about seven years. Let's assume that a conservative forecast of free cash flow for the investment indicates a positive net present value and an IRR that is 1.6 times the weighted average cost of capital. Finance theory suggests that this investment would add nicely to the market value of the company.

Under EVA, the cost of owning an asset is the sum of the depreciation and capital charge, which is highest in the first year and then declines as the asset depreciates away. This investment project contributes negative EVA for three years, slightly positive EVA in years four and five, and sharply rising EVA in years six and seven after the asset is fully depreciated—and is essentially free. If we had a seven-year-old asset being held together by rubber bands and shoelaces, we probably would want to replace it. But it would sure hurt to see all that EVA disappear, replaced by negative EVA that takes four years to turn positive again. So the natural response of many managers is to defer that replacement decision as long as possible, because that's what EVA is paying them to do. If they overcome this incentive to sweat old assets, they do so by putting the interests of the company ahead of their own (bonuses).

It's easy to illustrate how a focus on continuously improving EVA can stifle investment. The two graphs on the left side of Figure 1 illustrate the total cost of depreciation plus the capital charge (the top graph) and the EVA for this investment (the bottom graph).

The biggest difference between RCE and EVA is that RCE doesn't charge for depreciation—and because the capital charge is based on gross assets, it doesn't decline *over time*. As can be seen in the two graphs on the right side of Figure 1, the cost of ownership is lower at the outset but stays flat even after the asset is fully depreciated. As a result RCE is positive out of the gate and actually declines a bit in years six and seven when taxes rise (as the tax-deductible depreciation runs out).

With RCE, there is more incentive to replace old assets, while maintaining strong accountability for earning a return over time (RCE in years six and seven is actually much lower

8 Milano, Gregory V., "Be Cautious About Sweating Your Assets," *CFO.com,* October 16, 2017.

than EVA, which by then treats capital as essentially free, with the asset base having been depreciated away).

In addition to the predisposition to avoid replacing old assets, the same early negative EVA stands in the way of making new growth investments, such as capacity or geographic expansions. Even R&D investments work the same way, since although both EVA and RCE capitalize R&D, the EVA model amortizes the R&D, thereby frontloading the costs in the same way it does for capital expenditures. Because the RCE model does not amortize R&D, the cost of ownership, which is just the capital charge, remains flat—as it does in the case of capital expenditures—with less charge up front and no upward drift in performance as capitalized R&D amortizes away.

Acquisitions are a special kind of investment, since companies typically pay a premium on top of the stand-alone enterprise value of the acquired company, which can lead to not only more tangible assets, but also goodwill and other intangibles, on the books. In the case of one client that had evaluated the performance of its businesses using the spread between return on invested capital (ROIC) and the cost of capital—which is essentially EVA as a percentage of capital—we were asked to compare their acquisition analysis to an RCE-based analysis for two deals. Where their analysis showed ROIC not exceeding the cost of capital until years four and five for the two deals, respectively, our RCE analysis showed the same deals turning positive in years one and two. And in the late years of the company analysis, ROIC was over 50% with the assets mostly depreciated, while RCE was close to flat with a small upward drift.

This is not to say we want management to be excited about any old acquisition that comes along; but for clearly good deals, we'd like the measurement and incentive system to reward them sooner if they deliver decent cash returns. Just as in the case of organic investments, RCE provides more incentive to invest in the deal and more accountability for actually delivering a return over time.

Under EVA, then, acquisitions, R&D and other growth investments, and even asset replacements, all face similar short-term headwinds. RCE undoes these accounting effects in a way that encourages value-creating investments—while at the same time maintaining accountability for delivering adequate returns over the full life of the investment.

None of this is meant to deny that the net present value of EVA gives companies the right signals about value creation. But because the distribution of EVA by year typically shows a sharp downturn when an asset is new, and the benefits appear in later years, managers in EVA-driven companies are encouraged to emphasize the short term. RCE, by contrast, spreads the benefits out more evenly over time. With these differences between RCE and EVA, it is easy to see that a management framework focused on improvements in RCE for the overall business is likely to encourage a healthier balance in management's focus as it makes tradeoffs between growth and return, and between current and future performance.

Despite these drawbacks of EVA, there are companies that have been using EVA for decades, some quite successfully. The best example may well be a metal packaging manufacturing company called Ball Corporation, which began using EVA decades ago. From the end of 1999 through mid-2019, a dollar invested in Ball would be worth almost 12 times as much as a dollar invested in the S&P 500. They have invested heavily, both organically and through acquisitions. And since they have grown rapidly while also producing high returns on capital, the Ball management team shows no signs of succumbing to the common tendency of EVA-driven companies to underinvest.

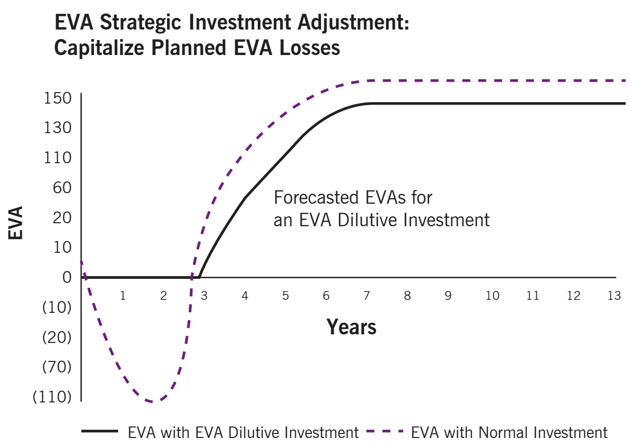
Scott Morrison, CFO, attributes Ball's success with EVA to the following:

> *… [K]eeping EVA simple and making sure everyone understands it. We challenge ourselves and our whole management team to not just drive efficiencies, but to always be looking for investments that help us grow. The status quo isn't what we are after, we are always looking for investments that will grow our EVA dollars. We are quite willing to give up some EVA in the short run, at times, in order to drive longer-term EVA improvement.*

The case of Ball shows that it's entirely possible for companies to embrace EVA and still invest in growth. But as the CFO's comments suggest, it is likely to require creating and reinforcing a culture that overcomes the natural tendencies of managers to limit investment when faced with such measures and incentive constructs.

Moreover, when so many companies declined to pursue such value-creating investments, Stern Stewart responded by developing a new EVA adjustment, known as the "strategic investment adjustment." The most common approach was to forecast the projected EVA for a large investment, such as an acquisition. And when the early planned EVA was negative (which was most of the time), the expected negative EVA was capitalized and treated as part of the investment. This provided the chance to reflect positive EVA, normalize rewards, and encourage managers to approve such investments in a way that EVA, without such an adjustment, would not. And since it was the *planned* negative EVA that was capitalized, if the result turned out to be worse than planned, the variance would still drag EVA down. (To illustrate this technique, Figure 2 shows a generic version of a slide from a client presentation to investors from the 1990s.)

*Figure 2*
**Strategic Investment Adjustment**




Though the strategic investment adjustment sought to smooth the EVA in the early years, and thus reduce or eliminate any disincentive to invest, it added computational complexity that many managers found hard to process. And especially for those managers that were not with the business when the investment was made, it was hard to accept all the strategic investment capital in year seven that was not on the balance sheet. What could they do to improve the productivity of that capital? So, to avoid adding too much complexity, most companies instituted thresholds that ensured they would use this approach for only very large (strategic) investments. And so the bias against small growth investments remained.

But worst of all, this strategic investment adjustment introduced a new element of negotiation, and thus yet another opportunity for the gaming of performance targets. Since the plan and financial forecast for the investment that was shown to the board for approval was now also used for adjusting the performance measure, management had an incentive to make the early years of the forecast seem even worse than they expected to build a cushion into the targets. They could always boost the out-years projection to protect the NPV analysis to ensure the investment would still be approved. It's easy to see how this gaming could be counterproductive—and so a better solution was needed.

## RCE Relates Better to TSR

When considering a performance measure, the primary objective is to ensure that the behavior being motivated when managers seek to improve the measure is consistent with increasing the long-run value (or in finance terms, the NPV) of the organization. In addition to testing how the measure responds to investments and other actions, as discussed above, it is important to know that there is strong alignment with total shareholder return (TSR), which measures dividends and share price appreciation in relation to the starting share price.

Why TSR? Why not try to explain a valuation multiple instead? Investors seek to increase the value of their investment and it doesn't matter if they own stocks with high or low valuations; all that matters is how much the value of their investment grows, and it is TSR that provides the best indicator of this growth. In fact, our research at Fortuna Advisors shows that companies with higher average valuation multiples tend to have lower TSR.[9] So, we absolutely don't want to maximize valuation *at any given point in time*—our aim is to improve value *over time*, while also accounting for dividends along the way.

When testing RCE's relationship with TSR, we began by denoting the change in RCE as ΔRCE; and to allow for comparisons among large and small companies over time, we measured the ΔRCE over a three-year period as a percentage of the Gross Operating Assets at the start of the three-year period. And to provide a rough control for differences in company characteristics and industry dynamics, we then sorted companies into 20 different industries[10] to be able to calculate the industry-adjusted median TSR of companies that delivered above-median ΔRCE to those that performed below the median level.

To evaluate the key differences between RCE and EVA, we constructed an EVA-like economic profit (EP) measure based on RCE, but with depreciation and R&D amortization charged to NOPAT, and with accumulated depreciation and R&D amortization netted against capital. By isolating these differences, this approach made sure the comparison was directly aimed at whether our treatment of depreciation and R&D amortization does or does not improve the relationship between ΔRCE and TSR.

In each of the 20 industries, we found that separating companies based on ΔRCE provided a stronger TSR indication than separating companies based on ΔEP. Consider the case of Media and Entertainment, which is the industry where ΔRCE showed the biggest advantage over ΔEP. For each three-year cycle, we first separated companies into

9 Milano, Gregory V., "Is a Higher Valuation Multiple Always Better?" CFO.com, July 27, 2017. http://fortuna-advisors.com/2017/07/27/is-a-higher-valuation-multiple-always-better/.

10 The study was based on the current members of the Russell 3000, excluding the financial, insurance, and real estate industries (where RCE would need to be refined). The data set is based on annual data going back to 1999 and companies were included over rolling three-year periods when there was full financial and TSR data for the full three-year period. The data from all periods was combined to show the relationship on average through all aspects of the business cycle.

*Figure 3*
**RCE Relates to TSR Better than EP in Media and Entertainment**

| | ΔRCE | ΔEP |
|---|---|---|
| Above-Median ΔRCE or ΔEP | 37.7% | 30.9% |
| Below-Median ΔRCE or ΔEP | 1.2% | 10.9% |
| Difference | 36.5% | 20.0% |
| | | |
| 3-Year Cumulative TSR Advantage | 16.5% | |
| **Annualized TSR Advantage** | **5.2%** | |

those above and below median on ΔRCE as a percentage of beginning Gross Operating Assets. Then we aggregated all the companies from all three-year cycles and measured the median TSR for each group.

The median three-year TSR for the high-ΔRCE media companies was 37.7%; for those with below-median ΔRCE, it was 1.2%, providing a difference of 36.5%. When we replicated this using ΔEP in place of ΔRCE, the high-ΔEP media companies had median three-year TSR of 30.9% versus 10.9% for the low-ΔEP group, for a difference of 20.0%. Thus, the TSR advantage of high- versus low-ΔRCE companies, as shown in Figure 3, was 16.5% higher than that for the ΔEP companies over the three-year period, or 5.2% higher on an annualized basis.

Some companies that make significant value-creating investments in the future will see their EP decline in the near term for reasons discussed earlier, moving them into the below-median ΔEP group. But if investors have confidence in those investments, their TSR is likely to remain high. And to the extent the market "looks past" the low EVA, the difference between the median TSRs of the high- and low-ΔEP groups tends to be smaller than in the case of the ΔRCE groups, reducing the explanatory power of EP relative to RCE. As shown in Figure 4, this RCE advantage can be seen in all of the industries we looked at.

*Figure 4*
**Annualized TSR Advantage of RCE vs. EP**

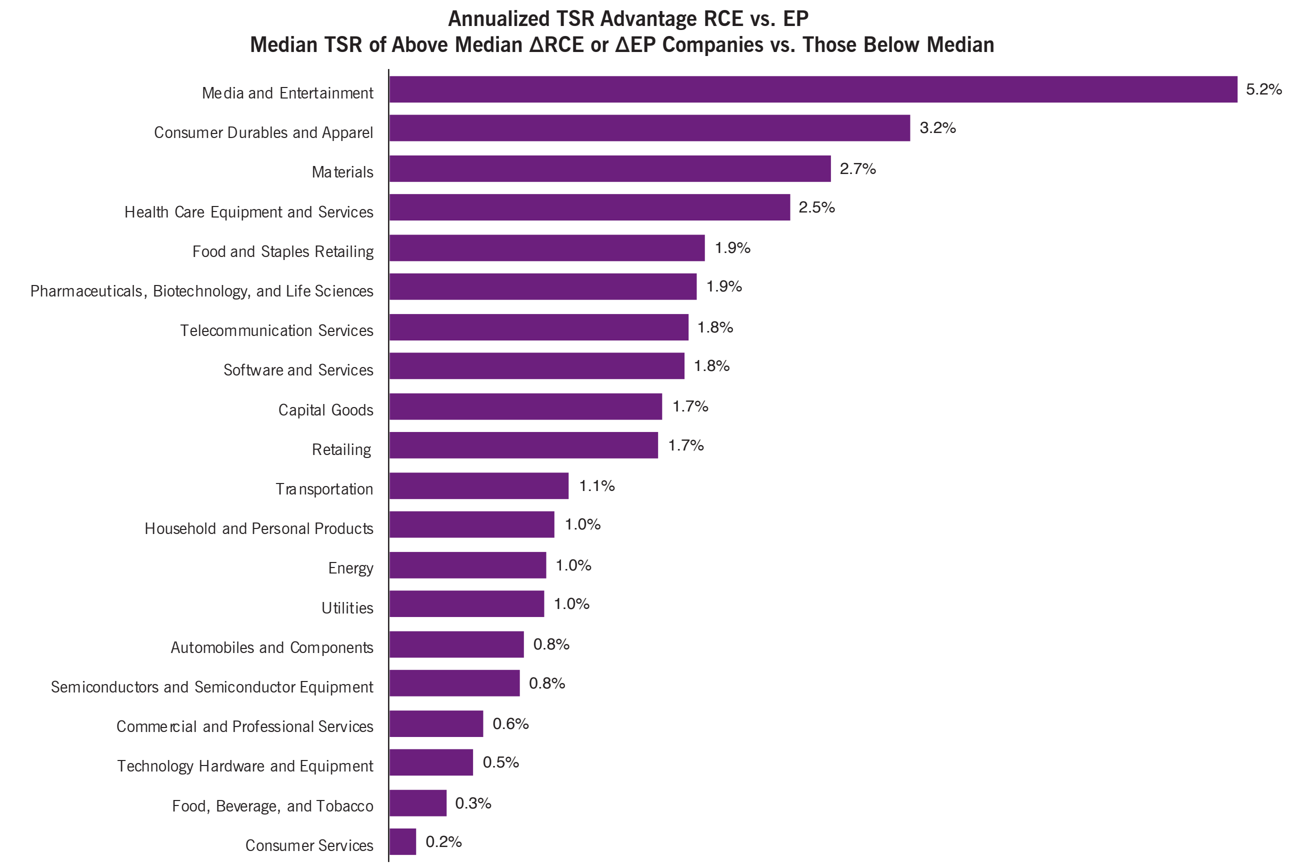
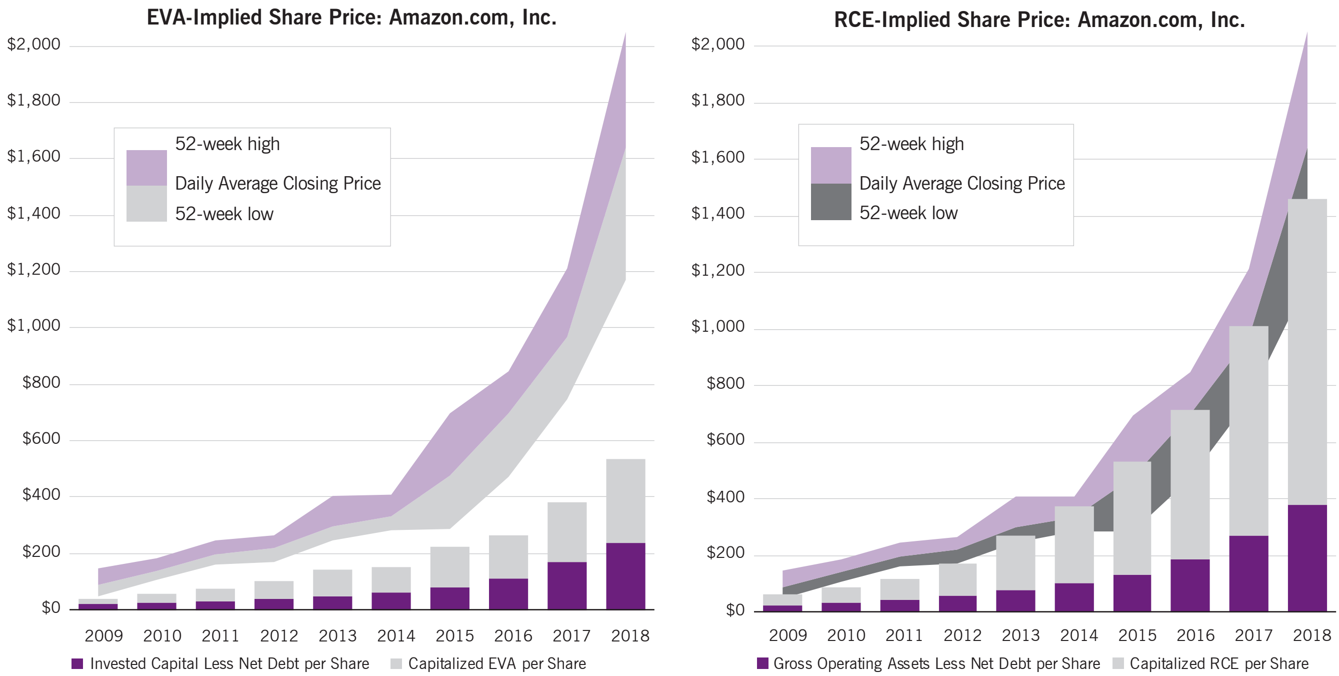


*Figure 5*
**Amazon's RCe-Implied Share Price vs. EVA-Implied Share Price**




These findings suggest that RCE is a more reliable proxy for value creation than EP (or EVA), and that one should feel confident that if management devotes its efforts to growing RCE, high TSR should follow.

## RCE Spotlight: Stop Seeing Amazon as Unprofitable

In the modern world, where growth in many industries is increasingly driven by investment in intangibles and R&D (as opposed to tangible, fixed assets), RCE is designed to reflect value creation in this environment. As a testament to this possibility, in 2017 the Fortuna team and I published an article in the *Journal of Applied Corporate Finance* on the valuation of high-tech companies that showed how RCE could be used to explain, among other things, the remarkable valuation of Amazon, then about $1,200 a share.[11] Here we have taken this analysis a step further to show how well RCE explains the 50% increase in Amazon's share price since then.

Using first EVA (based on the EP methodology discussed above) and then RCE, we estimated the value of Amazon shares over the entire ten-year period ending in 2018 by assuming that its current performance continues forever, thus providing investors with what amounts to a perpetuity of its most recent year's results. In the EVA literature, this calculation is referred to as a company's "current operations value" (or COV). Any difference between a company's current enterprise value and its COV is known as its "future growth value" (or FGV). FGV, at least in theory, also represents the NPV of expected increases in EVA.

The findings of our analysis are shown in Figure 5, which shows Amazon's 52-week high, low, and average daily closing prices for each of the ten years. In the graph on the left side of the figure, the lower stacked bar reflects the book value of the capital invested in Amazon, reduced by net debt, on a per share basis. The upper bar reflects the per share value of Amazon's EVA divided by the weighted average cost of capital, which is the present value of flat EVA in perpetuity. The right graph is similar, except the lower bar reflects the per share value of Gross Operating Assets less net debt and the upper bar reflects capitalized perpetual RCE per share.

During the 2009-2012 period, both valuations seem low, with meaningful growth assumptions—and hence large FGVs—baked into the share price.[12] But from 2013 through

11 Milano, Gregory V., Arshia Chatterjee, and David Fedigan, "Drivers of Shareholder Returns in Tech Industries (or How to Make Sense of Amazon's Market Value)," *Journal of Applied Corporate Finance* 28, no. 3 (2016): 48-55.

12 From 2009 through 2012, the EVA-implied value represented an average discount of 58% and the same statistic was 32% for RCE, so even during this period, the

2018, the measures give very different valuation impressions. On average, the RCE-implied valuation during this period is within 1% of the actual daily average closing price, while the EVA-implied share price sits at a 58% average discount. Amazon has been heavily investing in building an airline and a network of warehouses with trucks and other equipment; and the huge depreciation associated with this investment, along with the amortization of capitalized R&D, has constrained the growth in EVA, but not RCE. From 2012-2018, our estimates show that Amazon's RCE increased by over $38 billion while EVA improved by less than $11 billion (see the Appendix for the calculations).

This is an interesting case study that demonstrates the explanatory power of RCE versus EVA in new economy companies, and the implications are huge. There are many large traditional retailers that have attempted to compete with Amazon but few have succeeded in any meaningful way. This illustration raises the possibility that traditional financial metrics have discouraged Amazon-like investments and strategies. If Walmart, Home Depot, Best Buy, Macy's, and others had been using RCE to develop business plans, evaluate investments, and measure performance for bonuses, would Amazon now have more successful competitors?

## RCE Case Study: Varian Medical Systems

For over 70 years, Varian Medical Systems has helped lead the fight against cancer by innovating cancer therapies, and the company is currently the market leader in radiation therapy.[13] The number one priority of Varian management is to find new and better ways to increase access to cancer care for more patients across the globe.

Historically, Varian's competitive advantage has derived from a culture of innovation premised on and supported by significant R&D investment. But after a long run of innovation that both extended Varian's therapeutic reach and resulted in strong growth through the mid-2010s, the company's TSR began to sag. On closer inspection, the main reason for the stagnating share price was a slowdown in the company's release of new, innovative products to drive the market—and this meant that the company's capacity to reach patients was being undermined.

As management dug deeper into the company's investment decision-making and compensation processes, it became clear that some of these processes were subtly, and inadvertently, reducing management's motivation to invest in critical R&D and innovation.

As the centerpiece of a new way of thinking and running the business, Varian's management decided in 2017 to adopt a customized measure known internally as "VVA," or Varian Value Added, which is a customized version of RCE. One of the most important benefits of VVA over traditional economic profit is that it treats expenditures in R&D as investments rather than period expenses, as in standard GAAP procedures.

As Gary Bischoping, Varian's CFO, said about the company's new performance evaluation framework,

*This removes any incentive to cut R&D to meet a short-term goal, so it promotes investing in innovation. At the same time, since there is enduring accountability for delivering an adequate return on R&D investments for eight years, there is more incentive to reallocate R&D spending away from projects that are failing and toward those that project the most promising outcomes—for patients and shareholders.*

In parallel with the launch of new incentive designs, the company embarked on several layers of communication and training.

In the next step, Fortuna and Varian collaborated to understand the investor expectations that were baked into the share price and to estimate the amount of VVA improvement required to expect to deliver a top-quartile TSR among peers. This estimate in turn provided a basis for estimating how much investment was needed over time. Since one of the most common causes of growth shortfalls is underinvestment, this goal-setting process was designed to determine at the outset how much investment would be required to achieve the company's goals. This exercise led management to think of investments in a different and more productive way.

Planning has evolved at Varian as well, and is now designed to balance short- and long-term goals using parallel "run-the-business" and "change-the-business" frameworks that allocate resources to the most productive users and uses of capital. Whether growing current business lines or funding innovation for future products and services, the process seeks to find the best value-creation opportunities and dedicate more resources to these areas. The planning and budgeting processes have benefited from how VVA integrates the P&L with the balance sheet, and from the reinforcement of incentives that are no longer tied to budgeted goals.

Every major investment, including capital expenditures, R&D, and potential acquisitions, is now evaluated using VVA. Although the NPV of VVA is similar to NPV based on free

differences in value were large.

13 This case study is based on the article "How One Company Balanced Current Performance with Investing in the Future," published by *FEI Daily*.

Milano, Gregory V. and Gary E. Bischoping, Jr., "How One Company Balanced Current Performance with Investing in the Future," *FEI Daily*. June 26, 2019. https://fortuna-advisors.com/2019/06/26/how-one-company-balanced-current-performance-with-investing-in-the-future/.

cash flow, the benefit comes from the way the methodology ties directly to how management will be measured after the investment. The company evaluates NPV as a percentage of the investment, which is referred to as the "VVA profitability index" and can be compared to "margin of safety" hurdles. This approach provides a more reliable way to prioritize investment opportunities than using internal rate of return (IRR), which has a number of problems.[14]

This case study shows how a customized version of economic profit, derived from RCE, can be used to drive planning and motivate better investment decision-making. In the case of Varian, VVA helped clarify which businesses, markets, and acquisitions could create the most value, and even led the company to shift capital from its buyback program to more promising long-term investments.

## Conclusion

As many readers will be aware, this issue of the *Journal of Applied Corporate Finance* follows the recent passing of Joel Stern, co-founder (with Bennett Stewart) of Stern Stewart and co-inventor of EVA. In this sense, this issue is a tribute to, and celebration of, Joel's life and his enduring contributions to the study and practice of corporate finance. I am deeply grateful for the opportunity to have worked with and learned from Joel for so many years, and equally grateful for the opportunity to participate in this memorial to his life's work.

EVA was a game changer in the field of performance measurement—no question about it. It was the first measure to successfully combine aspects of both quantity (think EBITDA) and quality (return on capital) into one comprehensive, reliable measure of value creation. Yet for all of its benefits, EVA's success was limited by its drawbacks: too much complexity, along with the pressure to underinvest exerted by its frontloading of investment costs.

We at Fortuna Advisors are proud to carry the torch in pursuit of better performance measurement and more value creation—not just for shareholders, but for all stakeholders and society at large. None of this would have been possible without Joel's contributions to this effort. Thank you, Joel.

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14 The typical approach to prioritizing investments is to use the internal rate of return, or IRR; but four major flaws affect this approach. The first is that if a project has cash flows that flip direction more than once, there will be multiple IRR solutions. Which one do you use? The second flaw is that projects with different durations can have the same IRR and yet very different net present values, which can lead to poor prioritizations and underperformance. Third, IRR also assumes that cash inflows are reinvested at the IRR, while NPV doesn't. Finally, IRR doesn't indicate the dollars of value creation, whereas NPV does. This is important when thinking about prioritization under constraints, such as a limited number of managers or a fixed capital budget, because only NPV can be used to find value optimization.

## Appendix: RCE vs. EVA Calculations for Amazon

It is perhaps easiest to understand the differences between RCE and EVA by viewing the calculations, so the following explains the 2018 RCE and EVA calculations for Amazon.com. As in the body of the article, the simplified Economic Profit (EP) calculation is used as a proxy for EVA.

The first step is to calculate Capital and Gross Operating Assets, shown in Figure 6. Whereas invested capital, as used in the calculation of EVA, includes PP&E net of depreciation and net capitalized R&D, with the cumulative R&D amortization subtracted, the Gross Operating Assets used when calculating RCE is based on gross PP&E and Gross Capitalized R&D. Note that both measures include capitalized leases based on the present value of the reported minimum lease commitments.

*Figure 6*

### 2018 Invested Capital and Gross Operating Assets for Amazon.com

| *2018* | EVA (EP) | RCE |
|---|---|---|
| Net Working Capital (Operating) | ($25,456) | ($25,456) |
| Gross PP&E | 95,770 | 95,770 |
| Accumulated Depreciation | (33,973) | |
| Net PP&E | 61,797 | |
| Gross Capitalized R&D | 89,357 | 89,357 |
| Cumulative R&D Amortization | (36,083) | |
| Net Capitalized R&D | 53,274 | |
| Capitalized Operating Leases | 19,603 | 19,603 |
| Other Net Operating Assets | 14,389 | 14,389 |
| **Invested Capital** | **123,607** | |
| **Gross Operating Assets (GOA)** | | **193,663** |

The second step is to calculate the two measures of income: Net Operating Profit after Taxes (NOPAT) for the EVA calculation, and Gross Cash Earnings for RCE, which is shown in Figure 7. One of the two major differences between the two measures is that depreciation and R&D amortization are charged to NOPAT, while neither is charged to Gross Cash Earnings. The other difference relates to the treatment of leases, with EVA adding back the implied interest based on the amount capitalized, while RCE has the full rent added back to be consistent with excluding all depreciation.

We combine these findings to determine EVA (EP) and RCE, and we then use these estimates of EVA and RCE to determine the implied share price based on a perpetuity valuation. As shown in Figure 8, we determine the capital charge in each case by multiplying the average of the beginning and ending balance of capital or Gross Operating Assets by the WACC or Required Return, and this is subtracted from the NOPAT or Gross Cash Earnings. As can be seen, the amount of RCE is over three times that of EVA, and this difference is large because Amazon has generally new assets and the differences are quite material.

*Figure 7*

### 2018 NOPAT and Gross Cash Earnings for Amazon.com

| *2018* | EVA (EP) | RCE |
|---|---|---|
| Revenue | $232,887 | $232,887 |
| Cost of Goods Sold and Other Operating Expenses (incl R&D) | (220,466) | (220,466) |
| Operating Profit | 12,421 | 12,421 |
| Depreciation and Amortization Add-Back | | 15,341 |
| Rental Expense Add-Back | | 3,400 |
| Rental Implied Interest Add-Back | 1,082 | |
| R&D Amortization | (17,871) | |
| R&D Expense Add-Back (Technology & Content) | 28,837 | 28,837 |
| Adjusted Operating Profit Before Taxes | 24,469 | 59,999 |
| Taxes (Kept the same for simplicity) | (1,988) | (1,988) |
| **Net Operating Profit After Taxes (NOPAT)** | **22,480** | |
| **Gross Cash Earnings (GCE)** | | **58,011** |

Finally, we estimate the implied share prices by subtracting net debt from capital and Gross Operating Assets, on a per share basis. We then determine a premium above this by capitalizing the EVA and RCE on a per share basis, and this is where the real value shows up for Amazon.com. The EVA (EP)-implied share price only reflects one-third of Amazon's share price, indicating an enormous future growth value (FGV), especially for a company that already has $233 billion in revenue—how big are they expected to get? RCE implies a more modest FGV of 11% of the valuation.

*Figure 8*

### 2018 EVA (EP) and RCE, and Implied Share Prices for Amazon.com

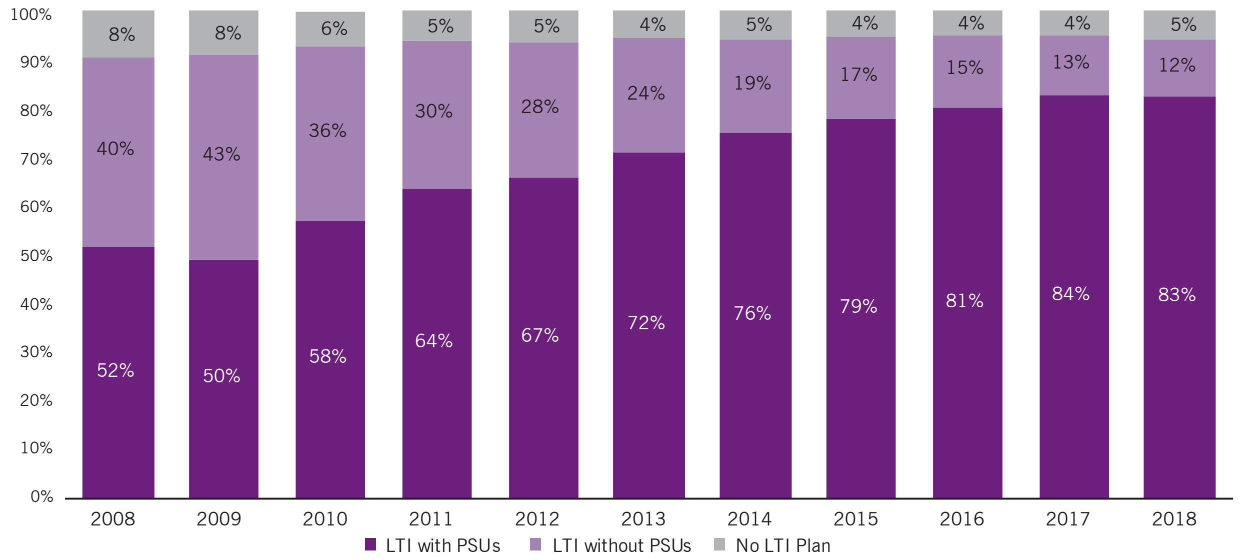
| *2018* | EVA (EP) | RCE |
|---|---|---|
| Net Operating Profit After Taxes (NOPAT) | $22,480 | |
| Gross Cash Earnings (GCE) | | 58,011 |
| Average Capital | 109,652 | |
| Weighted Average Cost of Capital | 8.7% | |
| Capital Charge | (9,587) | |
| Average Gross Operating Assets | | 168,674 |
| Required Return | | 8.3% |
| Capital Charge | | (13,973) |
| **EVA (EP)** | **12,894** | |
| **RCE** | | **44,038** |
| Shares Outstanding | 491.0 | 491.0 |
| Net Debt | 8,039 | 8,039 |
| Average Daily Closing Share Price | $1,641.73 | $1,641.73 |
| [Capital-Net Debt] per share | $235.37 | |
| EVA/WACC per share (reflects PV of a perpetuity) | $300.36 | |
| EVA Implied Share Price (COV) | $535.73 | |
| Premium (Discount) | -67.4% | |
| [GOA-Net Debt] per share | | $378.05 |
| RCE.Req'd Return per share (reflects PV of a perpetuity) | | $1,082.69 |
| RCE Implied Share Price | | $1,460.74 |
| Premium (Discount) | | -11.0% |

# Are Performance Shares Shareholder Friendly?

by Marc Hodak, Farient Advisors

Since the early 2000s, executive compensation has experienced a secular shift toward performance shares[1]—equity awards whose vesting is based on performance as opposed to time or service. In the past, for example, an executive might have been granted mostly restricted stock units (RSUs) that would vest over a three-year period; they simply had to stick around to get all the shares. Today, an executive is more likely to be granted over half their awards in performance share units (PSUs) that vest at the end of three years; in such cases, the number of shares that actually vest can be more or less than the nominal grant, depending on how well the company performs during that period. Ten years ago, less than half of S&P 500 firms awarded PSUs. Today, as shown in Figure 1, over 80% of them do, and PSUs have become an increasingly larger percentage of the long-term incentive (LTI) mix within those companies.

*Figure 1*
**Prevalence of PSUs in LTI Plans in the S&P 500**




1 Shares with performance-based vesting are generally awarded as "performance share units," or PSUs. This article uses "performance shares," "performance share units," and "PSUs" interchangeably.

This growth in PSUs has been driven largely by the efforts of influential institutional investors and their proxy advisors to promote what they believe to be a more shareholder-friendly award than restricted stock or stock options, which these investors have taken to calling "non-performance based." However, investors are by no means in complete agreement about how pay for performance should be implemented in companies. Fissures have begun to appear in the general sentiment about performance shares.

Perhaps most notable, in 2017 the well-known Nordic sovereign wealth fund, Norges Bank, came out with a widely circulated white paper that declared a preference for share awards *without performance conditions*, arguing that the use of complex performance criteria does not necessarily enhance alignment between corporate managements and their shareholders. Other investors have recoiled at the increase in the sheer volume of pay disclosures, which have been largely driven by descriptions of performance share plans. In fact, PSUs have evolved to the point of presenting significant structural and economic problems that should cause more investors to rethink them.

## Performance Shares Significantly Complicate LTI Plans

Time-based grants of restricted stock or stock options are easy; if the executive sticks around, the shares or options eventually vest. Notwithstanding their "non-performance" label, these types of equity awards can effectively align the interests of managers and shareholders by directly, transparently tying the personal net worth of the executives to the ups and downs of the stock price.

How effective is that alignment from the shareholder's perspective? Empirical studies have shown, with remarkable consistency, a significant positive relationship between management ownership of shares and the enhancement of shareholder value. Indeed, this is one of the most robust results in the peer-reviewed, corporate governance literature—one that has been replicated over several decades of scholarship covering many different nations and regulatory regimes.[2]

Compared to straight equity grants, performance shares introduce significant complexity into long-term incentives. To determine how many of the granted shares will vest, the plans must include performance measures and, for each measure, a scale of the portion of granted shares that vest across various performance levels, from threshold to target to maximum. These plans must be calibrated to yield rewards that make sense across the entire spectrum of possible performance outcomes. Further complicating matters, PSUs increasingly include additional "triggers" or "governors" designed to prevent unintended windfalls due to the uncertain relationship between accounting-based metrics, such as earnings or returns, and stock price over multiple years. Such complexity makes these plans much less transparent to even the plan participants, some of whom have dismissed them as "black box" reward mechanisms, thus casting considerable doubt on their actual incentive effect.

> Whether their end-of-year goals were set one year ago or three years ago is immaterial to the short-term behavior that the plan can drive.

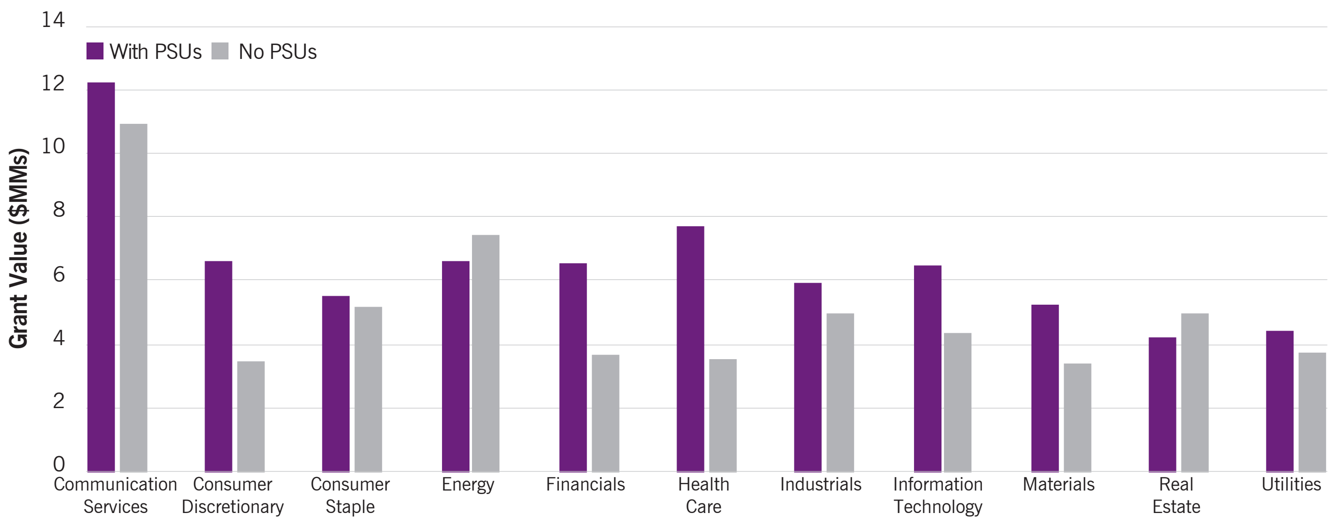
This complexity has also, not surprisingly, proved frustrating for investors trying to evaluate the plans. Working against investors' desire for "shareholder-friendly" incentive compensation plans, PSUs, with their exotic features in overlapping grant and performance periods, are often the most complicated parts of today's compensation disclosures. And since the inner workings of these plans are often poorly understood by internal as well as external stakeholders, it is almost impossible to explain counterintuitive pay results, even when such results were intended by the designers of the plan.

## Performance Shares Turn Out to Be More Costly, Too

In a recent study, my Farient colleagues and I looked at LTI awards across S&P 500 firms containing significant PSUs versus those containing only RSUs or stock options for each year over the ten-year period from 2008 to 2017. During this period, CEOs who received a significant portion of their LTI awards in the form of PSUs were awarded median grant values that were roughly 35% higher than those for CEOs who received only restricted stock or stock options. Moreover, as can be seen in Figure 2, in nine out of eleven sectors, the grant date value of LTI awards that included PSUs was materially higher than for those getting only RSUs and stock options. In the case of the average company switching from "non-

2 McConnell, John J., and Henri Servaes, "Additional evidence on equity ownership and corporate value," *Journal of Financial Economics*, 27 (1990) pp. 595-612; de Miguel, Alberto, Julio Pindado, Chabela de la Torre, "Ownership structure and firm value: new evidence from Spain," *Strategic Management Journal*, Volume 25, Issue 2 (December 2004) pp. 1199-1207; Von Lilienfeld-Toal, Ulf and Stefan Ruenzi, "CEO Ownership, Stock Market Performance and Managerial Discretion," The *Journal of Finance*, Volume 69, Issue 3 (June 2014), pp. 1013-1050.

*Figure 2*
**Median of Grant-Date Values of Equity in S&P 500 Firms from 2008-2017**




performance" equity awards to PSUs over the last decade, the median CEO received an approximately 40% increase in the grant date value of their award.

The most likely explanation for this increase in grant date values should make perfect sense to any investor—namely, that performance shares create greater compensation risk than an equivalent value of time-based equity, especially RSUs, and no one should be expected to accept greater risk without the prospect of a greater reward. Furthermore, our firm's experience in developing offers for senior executives suggests that they almost invariably view RSUs as more valuable than an equivalent, nominal value of PSUs, especially in periods of volatility. PSUs can also feel riskier than options to managers in a period of rising stock prices, as historically granted options increasingly find themselves "in the money." Tellingly, over the last ten years, relatively higher-risk sectors such as Financials, Health Care, and Consumer Discretionary saw the largest cost differences in grant values for "performance" vs. "non-performance" share awards, while lower-risk sectors such as Utilities, Consumer Staples, and Real Estate have had the most comparable grant values.

In light of these findings, it seems ironic that many investors have supported the use of performance shares with the expectation that the growing use of PSUs would have the ultimate effect of *limiting*, not increasing, overall CEO pay. Instead, CEO pay has stubbornly grown alongside the increasing prevalence of performance shares, despite the greater scrutiny to which their pay has been subjected. Of course, many factors other than PSUs could be, and likely are, contributing to this effect—but the basic risk-reward imperative that comes with PSUs is also almost certainly a contributor.

## Performance Shares Hurt Corporate Performance

Even if performance shares cost more, they may be worth it if they lead to better company performance. Given the proven benefits of management share ownership, it seems plausible that alignment may be improved by layering on performance conditions before allowing stock to vest. Not only would management have their personal wealth tied to the stock price by virtue of the change in value of whatever shares they end up with, but they would also have to have performed well to obtain those shares. This hypothesis is enhanced by the fact that managers see a more direct connection between their actions and the measures that often drive performance awards, such as earnings or revenue, than between their actions and the company's stock price.

Unfortunately, this theory runs up against another powerful strand of research into incentives: it is exceedingly difficult to find any relationship between the bonus rewards received by managers and value created for their shareholders. A number of reasons have been offered for why bonus plan outcomes correlate so poorly with shareholder value. A leading contender is that rewards based on a set of concrete metrics and goals to be achieved in a limited time introduce "short-termism" in management behavior. Knowing that the clock will strike midnight at the end of a plan year clearly focuses management on the particular metrics and goals being rewarded in that period. But, such focus also encourages less attention to potentially important things that are not being measured, or will not show up until after the plan year is over.

The existence and effects of "short-termism" have been documented in numerous studies. One much-cited Duke University survey of some 400 public company CFOs conducted in 2005 and repeated in 2013 included the question: Would you be willing to sacrifice economic value in order to hit an earnings target? Over three-fourths of the responding CFOs admitted that their companies would consider doing that. That, in a nutshell, is the inherent hazard of short-term plans.[3]

Since performance share plans are typically "long-term" plans, we might suppose that these effects would be much less relevant. However, managers don't distinguish short- from long-term plans based on how far into the future performance will be measured; they distinguish them based on the vintage of the goals for the coming year-end. Whether their end-of-year goals were set one year ago or three years ago is immaterial to the short-term behavior that the plan can drive.

This reality of managerial behavior brings up potentially important problems associated with short-term plans, while magnifying their likely effects:

The first is that long-term goals based on accounting results, such as earnings or return on capital, are likely to become stale as managers get nearer the end of the plan. More so than in annual plans, three-year plan targets are likely to be long-since achieved, or no longer achievable, well before the end of the performance period. Furthermore, any interim shift in the strategic landscape, which is highly likely within any three-year period, could make such goals no longer worth achieving. This would require the company either to renegotiate the goals, undermining the integrity of the plan, or to risk the rewards or penalties associated with meeting the goals of a plan that no longer drives shareholder value.

By contrast, share ownership is by its nature long-term and value-focused, and has no expiration date. And ownership without the added contingencies introduced by PSUs gives management the widest strategic range in pursuing opportunities as they arise. If managers have the opportunity to sacrifice some short-term earnings or returns in favor of significantly higher future earnings or returns, they will make the trade-off in favor of maximum value creation, consistent with the positive impact on their personal wealth. Performance shares can also provide that exposure, but with a significant dose of uncertainty about ownership. For example, if management is considering a major strategic investment just as a performance period is coming to an end, do we really want management to be weighing a near-certain 5% or 10% hit to the number of shares they may end up with due to the projected, negative effect of the investment on their PSU metrics against the expected, but eventual 2% or 3% gain in total shareholder returns (TSR) from going through with the investment?

So, the question arises: Which incentive effect dominates? Do the alignment benefits created by stock ownership, albeit at an uncertain level, outweigh the potential "short-termism" associated with the temporal bonus mechanism that determines the number of shares that one ends up with?

In a recent study, we looked at relative total shareholder returns (RTSR) during three-year periods over the last ten years for S&P 500 companies that awarded performance shares versus those that awarded solely "non-performance" equity. Notwithstanding the mix of stated preferences among investors, their market behavior spoke clearly. As shown in Figure 3, companies with PSU plans underperformed their sector peers, while companies making straight grants of restricted stock or options outperformed their sector peers in every three-year period we looked at.

What's more, the underperformance of PSU-laden plans and the outperformance of "non-performance" plans across this period were both statistically significant. In other words, "performance shares" don't appear to perform for shareholders.

### What Investors Want

These findings challenge us to reinterpret "what investors want" since investor preferences have been the main driver of the shift towards performance shares.

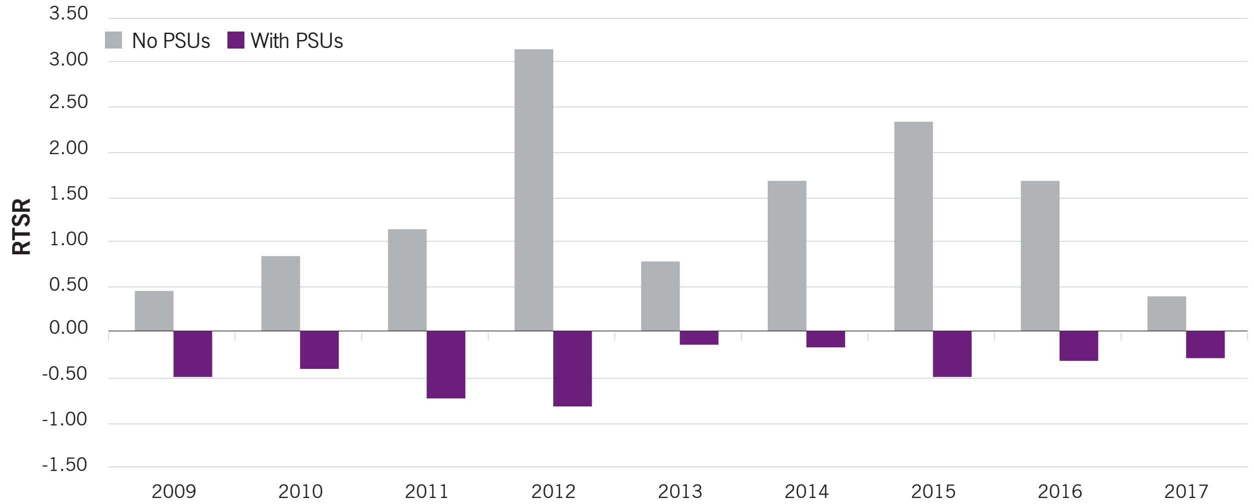
There continues to be a broad consensus in support of the basic idea of pay-for-performance for top executives. Boards and the executives themselves, as well as investors, generally agree with that principle. But how pay-for-performance manifests in incentive plans is open to a wide range of possibilities. Performance shares are one manifestation, and may well be the best choice for long-term incentives for certain companies—for example, those where performance metrics reliably capture changes in long-run corporate values. But the idea that companies should uniformly be implementing performance shares as their dominant LTI vehicle is likely to be counterproductive to the interests of those promoting them.

Unfortunately, knowing that PSUs may increase compensation cost and hurt performance does not absolve companies from having to reckon with "what investors want," especially

3 Graham, John, Campbell Harvey, and Shiva Rajgopal, (2005), "The economic implications of corporate financial reporting," *The Journal of Accounting and Economics* 40 (1-3):3-73.

*Figure 3*

**Three-Year TSR Relative to Sector Peers for S&P 500 Firms**




Note: Companies "With PSUs" awarded at least 20% of their long-term incentives in performance shares. "No PSUs" firms awarded only restricted stock or stock options (or a combination) without performance conditions.

as distilled by their proxy advisors. As long as ISS and Glass-Lewis continue indiscriminately to endorse and push all companies to make the majority of their LTI awards "performance-based," boards will continue to implement PSUs on an ever-growing scale.

Boards can, and some do, push back against "best practices" that don't line up with their sense of what is best for *their* companies. But given the business model of proxy advisors and the influence they wield over public companies, the trend towards performance shares is unlikely to be arrested without pressure from more large investors re-evaluating what is truly shareholder friendly when it comes to LTI plans. In light of the evidence of how performance shares are actually affecting corporate performance, it may be time for more investors to join the growing backlash in their ranks against PSUs, and to begin communicating a more nuanced view and expectation of their adoption by companies in their portfolios. It may also be time for proxy advisors to look at the evidence on PSUs and shareholder value in shaping their standards, and adjust their advice accordingly.

MARC HODAK is a Partner at Farient Advisors, an independent executive compensation and performance consultancy. Also contributing to this article was Eric Hoffmann, Vice President and Leader, Farient Information Services.

# Why EVA Bonus Plans Failed—and How to Revive Them

by Stephen O'Byrne, Shareholder Value Advisors

Most top executives and operating heads run their companies or businesses, set their goals, and reward their employees using earnings-based measures of performance. But the focus on earnings has two critical weaknesses that can undermine the alignment of earnings-based pay with shareholder wealth. First, it's often easy to boost current earnings by "underinvesting"—that is, by making shortsighted cuts in advertising or R&D that end up reducing future earnings. But less obvious is the reality that growth in earnings per share can also be achieved by "overinvesting"—pouring additional capital into projects with expected rates of return that, although well below the cost of capital, are higher than the after-tax cost of debt.

Stock compensation has been the conventional solution to the first, or "underinvestment," problem because stock prices are supposed to reflect discounted cash flow values; and significant stock holdings, to the extent they reward promising long-run investment, should discourage management from actions that sacrifice future earnings. Economic profit, or "EVA" in its best-known version, was once the most common answer to the "overinvestment" problem associated with earnings because EVA charged operating managers for the use of equity as well as debt capital. And because it includes such a capital charge, EVA, unlike GAAP earnings and most widely used performance measures, can be linked directly to the discounted cash flow value that gets reflected in stock prices.

But neither of these conventional solutions appears to have worked very well in practice, at least not for operating heads. Stock compensation, besides failing to reflect the performance and value of specific business units, often fails to provide the intended incentives for the (many) corporate managers who believe that meeting or beating current consensus earnings is more important than investing to maintain future earnings. EVA bonus plans have been tried by many companies, but the vast majority of these plans have been abandoned. Many if not most public companies adopted EVA-like bonus formulas (with charges for total capital) in the first half of the 20th century, but all of them eventually dropped fixed sharing of such EVA and adopted pay programs based on "competitive pay" concepts.[1] Stern Stewart & Co. was successful in creating a second wave of EVA use in the 1990s, but a 2009 study by David Young and me found that only six out of some 66 Stern Stewart clients using EVA in 1999 were still using it in 2008.[2]

EVA is ideally suited to and has tended to be used in multi-year comp plans that promise managers a fixed share of their business's EVA, increase in EVA, or some combination of the two.[3] As a result, any perceived deficiencies in how EVA is measured or used to set performance targets make it difficult for directors (or investors) to insist on the use of

1 For more detail on this transition, see O'Byrne, Stephen F. and E. Mark Gressle, "How Competitive Pay Undermines Pay for Performance (and How to Change That)," *Journal of Applied Corporate Finance*, Vol. 25 No. 2 (Spring 2013) and O'Byrne, Stephen F. and S. David Young, "The Evolution of Executive Pay Policy at General Motors 1918-2008," *Journal of Applied Corporate Finance*, Vol. 29 No. 1 (Winter 2017).

2 O'Byrne, Stephen F. and S. David Young,"Why Capital Efficiency Measures Are Rarely Used In Incentive Plans, and How to Change That," *Journal of Applied Corporate Finance*, Vol. 21 No. 2 (Spring 2009).

3 Fixed sharing plans are more demanding than competitive pay plans because, unlike the latter plans, they don't increase sharing to "make up for" the impact of poor performance.

these more demanding pay practices instead of falling back on conventional bonus plans that commonly treat investor capital as "free." My aim in these pages is to describe improvements in both the measurement of EVA and its use in designing targets that have the potential to contribute to a revival of the modern EVA bonus plan, one with the promise of providing not only a much stronger alignment of pay and performance than conventional plans, but a way of overcoming the charge of short-termism that is now so often directed at EVA plans.

In this article, I will start by showing that the one largely unrecognized fundamental challenge in EVA performance measurement is that the increases in current EVA that are rewarded by such plans are more often than not associated with declining expectations for *future* EVA increases (or what I'll later call declining "future growth values"). The EVA bonus plans of the 1990s were typically designed to reward increases in EVA over and above the expectations for such "EVA improvement" that were reflected in their stock prices at the start of the plans. But because such plans made no effort to capture any changes in investor expectations from that point onward, managers were often effectively rewarded for EVA improvements that may well have been achieved at the *expense* of future growth opportunities. In other words, the EVA increases being rewarded by such plans may have resulted from margin improvements at the expense of growth or from managers' decisions to pass up positive-NPV growth projects that would have reduced their current EVA.[4]

As one potential solution to this problem, I close by suggesting the possibility of developing current operating measures—based on factors such as revenue growth, dollar profit margin from capital growth, and increases in R&D and capital spending—that provide reasonably reliable proxies for future EVA improvement. Such proxy measures could provide the basis for "dynamic" EVA improvement targets that are raised when managers increase EVA by increasing margins (instead of growth) and are adjusted downward when managers make growth investments that typically reduce current EVA, with the aim of counteracting and even eliminating the EVA bias toward "short-termism."

## A Brief History of EVA Bonus Plans

The earliest EVA bonus plans gave managers a fixed share of their operation's EVA. In 1918, General Motors adopted an incentive plan that gave its senior management team 10% of the company's dollar profits above a capital charge equal to 7% of net assets.[5]

The program was remarkably durable—undoubtedly the world's longest-lived EVA bonus plan—lasting from 1918 to 1982. Similar plans were adopted by many public companies during this period, though few lasted beyond the 1960s, mainly because of the rise of "competitive pay practices" that rewarded companies for growth (in EPS as well as sales) rather than profitability.[6]

When I joined Stern Stewart & Co. to run its incentive comp practice in the early 1990s, most of the EVA plans still in existence had evolved into plans that gave management a share of not only EVA, but also the *increase* in EVA—with the latter aimed at providing stronger incentives for low-profit, but improving businesses. But this structure made it difficult to achieve a key objective of compensation plans: providing "market" compensation for executives when, and only when, there was enough EVA improvement to ensure that investors would earn a cost-of-capital return on the company's market value at the start of the plan.

In response to this challenge, we developed the "modern EVA bonus plan" that made the bonus earned equal to a target bonus plus a fixed share of what we called "excess EVA improvement." Our analysis shows that a company's current stock price implies a certain level of expected increase in its current EVA; and a company's excess EVA improvement was the difference between the actual increase in EVA during the performance period and the "expected EVA improvement," or "EI." Our estimate of EI was the annual increase in EVA that, given the company's stock price at the start of the plan, was required to provide investors with a rate of return on market value equal to the company's cost of capital

And since excess EVA improvement could—and often did—turn out to be negative, the managers' share of excess EVA improvement, and the total bonus earned, could also be negative. Negative bonuses were recorded as entries in a "negative bonus bank" that had to be recouped before additional bonus was paid. The target bonus was set so as to provide a market level of total compensation. The point of this design was to ensure that executives would earn competitive compensation in the labor market when and only when investors earned competitive returns in the capital market.

4 EVA improvement from underlying business growth normally has a more positive effect on future growth value than EVA improvement from margin improvements (e.g., price increases and cost cuts). When managers shift EVA improvement from business growth to margin improvement, expectations of future EVA improvement typically decline.

5 The minimum return was 6% from 1918 to 1922 and 7% from 1922 to 1947.

6 See O'Byrne and Young (2009) above.

*Figure 1*
**Capitalized EVA and FGV for Apple**

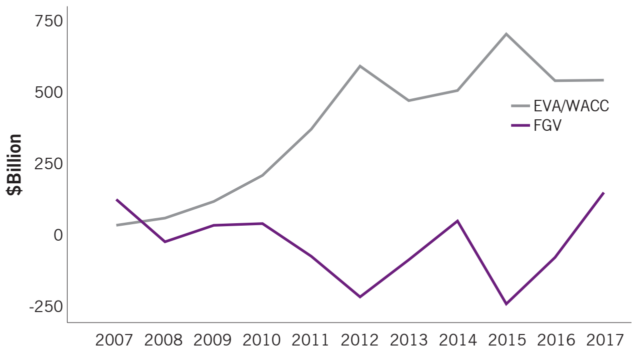
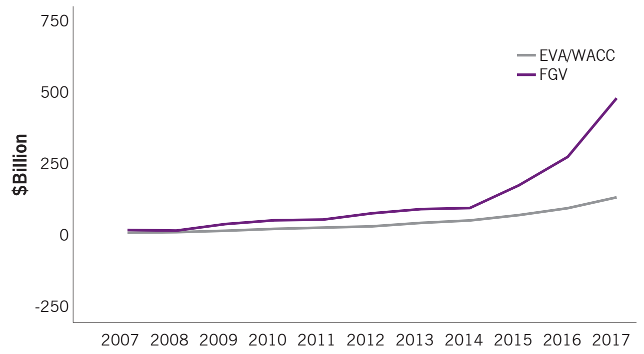



*Figure 2*
**Capitalized EVA and FGV for Amazon**




## Future Growth Value Often Falls When Current EVA Goes Up

To understand why current EVA improvement is frequently associated with declines in expected future EVA improvement, let's take a look at the "EVA math."[7] The first component of the EVA math says that a company's current enterprise value—the market value of its equity plus its debt—can be broken down into three components: (1) book capital (which can also be viewed as a rough proxy for the amount of capital that (debt and equity) investors have put into a company); (2) the capitalized (or perpetuity) value of its current EVA (assuming it remains at that level forever); and (3) what we refer to as its "future growth value," or "FGV."

A company's FGV can be calculated in two different ways. First, and most straightforward, since FGV is the part of a company's market enterprise value that cannot be explained by its current capital and EVA, it can be calculated just by subtracting the first two components—book capital plus the capitalized value of current EVA (EVA/WACC)—from its current market enterprise value. The alternative is to view—and attempt to quantify—a company's FGV as the discounted present value of expected future increases in EVA. The sum of the first two components of market value—book capital plus capitalized current EVA—is what we call a company's "current operations value," or "COV." And so a company's market enterprise value can also be thought of as the sum of its current operations value (COV) and its future growth value (FGV).

One reason this distinction between COV and FGV is important, as discussed in more detail below, is that the steadily growing importance of intangible assets in today's economy has caused FGVs to account for ever larger fractions of corporate enterprise values, at least on average, during the past two or three decades.

## An Aside on MVA as the Corporate Goal

But that said, Stern Stewart has long advocated an alternative way of viewing a company's market enterprise value—namely, as the sum of its book capital and its "Market Value Added" (or "MVA"). When viewed as part of the EVA math, MVA is the sum of the second and third components of market enterprise value—capitalized current EVA and FGV. And as its name suggests, Market Value Added has long been cited by Stern Stewart as both the most definitive measure of investors' wealth gain—that is, the value of their ownership in excess of the cost of their investment—and, as such, the most reliable measure of management's cumulative, long-run success.

But as I show in the Appendix, MVA is a potentially highly misleading proxy for what really matters to investors—what I call their "dollar excess return." And more important for purposes of this article, a focus on MVA obscures the negative correlation of the two components of MVA—current EVA performance and future growth value—which I show below has proved to be a critical problem in EVA performance evaluation.

To see where the problem originates, Figures 1 and 2 show the relationship between the two components of MVA—the capitalized value of current EVA and FGV—for two very well-known companies, Apple and Amazon, over the years 2007-2017.

Figure 1 shows Apple's experience of what is in fact a very common pattern: the two components of MVA often moving in opposite directions. In fact, in six of the ten years we looked at—2008, 2011, 2012, 2013, 2015, and 2016—Apple's capitalized EVA and FGV went in opposite directions. And

7 A more complete discussion of the EVA math is available in O'Byrne, Stephen F., "A Better Way to Measure Operating Performance (or Why the EVA Math Really Matters)," *Journal of Applied Corporate Finance*, Vol. 28 No. 3 (Summer 2016).

though the annual change in Apple's capitalized EVA explains 58% of the variation in its annual FGV changes, the statistical relationship is in fact negative: on average, each additional $1 of capitalized EVA was associated with a $0.57 reduction in FGV. Amazon is a much more unusual case in that its FGV is consistently moving in the same upward direction as its EVA.

It's easy to come up with explanations why FGV would decline, as it's often done at Apple: investors expect slower growth or lower EVA margins, or the company is perceived as nearing the end of a finite period of competitive advantage. It's also easy to explain why FGV would even be negative, as it's been in six of the 11 years for Apple: it's a sign that investors don't believe that its current EVA can be sustained. That could be due to expectations of price cuts needed to meet competitive pressures or falling sales volume as iPhones and other Apple products capture a larger percentage of the potential market. It's more challenging to explain why FGV might increase continuously, as it appears to be doing at Amazon (and we'll use more of the EVA math below to do that).

The negative relationship between changes in FGV and EVA that we see at Apple is very common. In 66 (GICS) industries I looked at, the median correlation of ΔFGV and ΔEVA was -0.53.[8] The FGV "offset" was particularly large in the case of companies making improvements in negative EVA. The change in FGV associated with each $1 of capitalized improvement by negative EVA companies was -$0.49 or more negative in every industry except for one.[9] And the median change in FGV associated with a $1 increase in capitalized EVA for *all* companies with negative EVA was -$1.03. For companies with positive EVA, the change in FGV associated with $1 of capitalized EVA improvement was negative in 33 of the 66 industries, with a median value of -$0.49 for these 33 industries.

But now let's turn to those companies, like Amazon, where EVA and FGV have a positive relationship. For the 33 industries with positive ΔFGV associated with $1 of capitalized improvement in positive EVA, the median value is $0.41. And the five industries with the highest ΔFGV "multiples" of capitalized positive ΔEVA are Communications Equipment, Internet Software & Services, Software, Commercial Services & Supplies, and Specialty Retail. As one might expect, these are industries with strong growth trajectories; and, in such industries, every dollar of capitalized EVA improvement adds more than a dollar of future growth value.

## The Apple and Amazon Challenges to the Modern EVA Bonus Plan

Companies like Apple pose a challenge for the modern EVA bonus plan because the value of its positive EVA improvement is frequently offset by a negative change in its FGV. From 2007 to 2015, Apple's capitalized EVA increased by $674 billion, but its FGV declined by $368 billion, or offsetting more than half of the EVA improvement that would have been rewarded by an EVA bonus plan. And to the extent that managerial decisions that increase EVA actually *contribute* to the reductions in future growth value—say, by increasing prices at the expense of growth—a comp plan that rewards EVA improvement without any offset for the decline in FGV would make management's percentage pay premium far higher than investors' percentage excess return.

Amazon is also a challenge for the modern EVA bonus plan because it has created so much shareholder value that is not now captured—and would be difficult to capture—in the value of its capitalized EVA. In theory, both of these challenges could be addressed by carefully adjusting the EI.[10] For example, the expectation of positive ΔFGV associated with increases in current EVA could be accommodated by reducing the EI (or even making it negative), thereby boosting the bonus earned; conversely, an expectation of negative ΔFGV would call for raising the EI, which would reduce the bonus earned for a given level of EVA. These adjustments would raise the EVA bonus at Amazon and reduce it at Apple, bringing both more in line with investor excess returns.

But perhaps the biggest challenge in designing such plans is that the abrupt changes in FGV experienced by Apple and Amazon suggest the difficulty, if not impossibility, of precision forecasting of FGV. After all, Apple's FGV increased by almost $400 billion in the period 2015-2017 after declining by $368 billion in the prior seven years—and Amazon's FGV increased by $386 billion in the three years 2014-2017 after increasing by only $77 billion in the previous seven years.

According to one interpretation of the Apple graph, the modern EVA bonus plan can work well without any modification. This view says that the annual fluctuations in FGV are largely "noise," and that we should accordingly focus on the fact that the *cumulative* FGV change at Apple is trivial—amounting to only 5% of the cumulative change in capitalized EVA over the ten-year period.

But, as it turns out, the modest cumulative impact of changes in EVA on ΔFGV that we see at Apple is not representative of most companies. When I looked at ten-year

8 Based on 50,997 five-year periods for S&P 1500 companies ending in 1985-2018 and limited to GICS industries with at least 50 company five year periods available.

9 The negative EVA multiple for Construction Materials (GICS 151020) is -0.12.

10 The second component of the EVA math says that EI = WACC x FGV – expected ΔFGV, so higher expected ΔFGV leads to lower EI and vice versa.

*Figure 3*
**Capitalized EVA and FGV for Colgate-Palmolive**

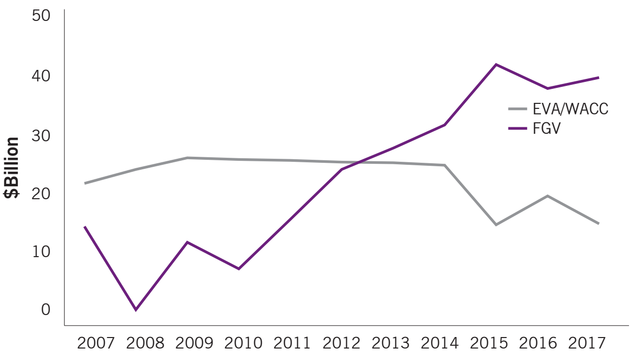
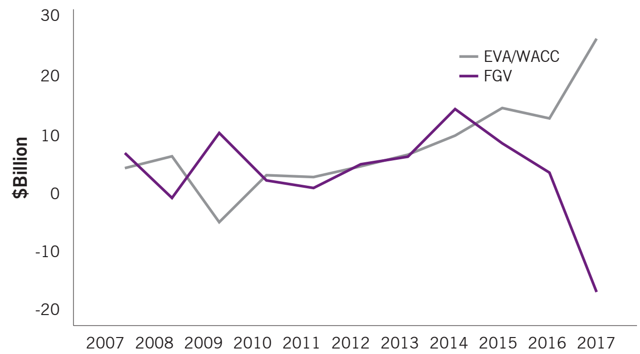



*Figure 4*
**Capitalized EVA and FGV for Kroger**




periods for S&P 1500 companies ending in 1990-2018, I found that the change in FGV was greater than 10% of the change in capitalized ΔEVA in about 95% of some 36,000 ten-year periods.[11] Ten-year changes in FGV moved in the same direction as ten-year changes in EVA at both Amazon and Apple, but that turns out to be unusual, too. For in fully 70% of the cases, ten-year ΔFGV and ΔEVA went in opposite directions.

## Two More Challenges to the EVA Bonus Plan

Figures 3 and 4 show two well-known companies—Colgate-Palmolive and Kroger—that are drawn from the bottom half of the distribution of capitalized EVA change to FGV change, where the ratios are all negative.[12]

Colgate-Palmolive and Kroger both pose major, though different, challenges for the modern EVA bonus plan. In the case of Colgate, the plan would effectively penalize the company's declining EVA by paying below-market bonuses while ignoring the company's rising FGV, which is likely reflecting investor optimism about future payoffs from the company's strategy. Since the increase in FGV is much larger than the decline in capitalized EVA, Colgate's investors will have positive excess returns while its managers get below-market pay—a case of underpaying for superior performance.

In the case of Kroger, the EVA performance looks great, but it's offset by declining FGV that is not captured in the bonus formula. And to the extent that Kroger's EVA improvement resulted from decisions that also contributed to the drop in FGV, the bonus formula would be overpaying for current EVA performance. This is where the modern EVA bonus plan has the potential to encourage short-termism.

The original EVA bonus plan—the General Motors plan mentioned earlier—took account of only the *level* of EVA. The modern EVA bonus, as developed at Stern Stewart in the 1990s, took account of the changes in EVA—and it also took account of the *initial* level and *expected* change of FGV. But it still misses a component of investors' excess return, which depends on three things: (1) the change in current EVA; (2) EI (which takes account of the initial level and expected change of FGV); and *(3) the unexpected change in FGV*.[13]

When the cumulative change in FGV is small, as it was for Apple (from 2007-2017), the modern EVA bonus plan can work reasonably well. But when the cumulative unexpected change in FGV is significant—as in the cases of Amazon, Colgate-Palmolive, and Kroger—the modern EVA bonus plan can lead to critical problems, such as underpayment of talented executives in cases like Amazon and Colgate, and rewarding short-termism in cases like Kroger.

To adapt the modern EVA bonus plan for these more challenging cases, we need to answer two questions: Is it possible to anticipate changes in FGV? And is it possible to find operating measures that are good proxies for unexpected changes in FGV? To answer these questions, we first need a better understanding of what drives FGV.

## Profitability and Growth Are the Drivers of Future Growth Value

To better understand the drivers of future growth value, let's work through a simple example of a profitable and grow-

11 Using absolute values for the changes in FGV and capitalized EVA.

12 Colgate-Palmolive is in the bottom decile of ΔEVA/ΔFGV ratios, roughly corresponding to Amazon in the top decile. Kroger is at the 30th percentile, roughly corresponding to Apple at the 70th percentile.

13 See O'Byrne (2016) for more detail.

ing business. Start by assuming the business has beginning capital of $1,000, ROIC of 15%, WACC of 10%, and capital growth expected to average 3% forever. EVA will be $50 [(15% – 10%) x $1,000] in year 1, $51.50 [(15% – 10%) x 1,030] in year 2 and $53.05 [(15% – 10%) x 1,060.90] in year 3. FGV at the end of year 1 will be the present value of future EVA that is greater than $50.

We can also express FGV as the capitalized present value of future annual ΔEVA, which makes it easier to calculate. ΔEVA in year 2 is $1.50 and grows at 3% a year thereafter. The capitalized present value of $1.50 growing at 3% is $235.71 [(1 + 10%)/10% x $1.50/(10% – 3%)]. When we do the same calculation at the end of year 2, we get FGV of $242.79. Thus, we can see that EVA increases by $1.50 in year 2 and FGV increases by $7.08.

This example shows that long-horizon FGV growth has two basic drivers: profitability and capital growth. With an EVA spread (ROIC – WACC) of 5% and a capital growth rate of 3%, we get FGV of $235.71 at the end of year 1 and $242.79 at the end of year 2, an increase of $7.08. If the EVA spread was 10% instead of 5%, we would get FGV of $471.43 at the end of year 1 and $485.57 at the end of year 2, an increase of $14.14. If the EVA spread was 10% and the capital growth rate was 5%, not 3%, we would get FGV of $1,100.00 at the end of year 1 and $1,155.00 at the end of year 2, an increase of $55.00.[14]

## Delayed Productivity of Capital Is a Big Reason Why ΔEVA Is a Poor Proxy for ΔFGV

Because EVA and FGV both increase with the profitability spread (ROIC – WACC) and with growth in investment, we might expect the change in EVA to be the most useful proxy for changes in FGV and excess return.[15] In practice, however, the change in EVA turns out to be no better than the change in NOPAT in explaining differences in excess return. In an analysis of 36,000 ten-year periods across 66 industries, I found that the change in NOPAT explained 44% of excess returns for the median industry, as compared to 39% for the change in EVA. And since the change in EVA is the change in NOPAT minus the change in the capital charge, this finding implies that inclusion of the capital charge actually *reduces* explanatory power when it should be adding it.

In earlier research, David Young and I found evidence that the underlying problem is what we call the "delayed productivity of capital."[16] When it takes several years for capital to be fully productive, the increase in the capital charge actually becomes a fairly reliable precursor of and proxy for business growth, not just an adjustment for the cost of investment.

## Better Proxies for FGV: Expected Dollar Margin from Capital Growth

As we saw earlier, when ROIC and WACC are both fairly constant, we can estimate ΔFGV as a multiple of the (ROIC – WACC) spread times the expected increase (in dollars) in capital spending. But at the same time, we found that, for most companies, changes in EVA are generally unreliable proxies for changes in FGV in practice.

In more recent research, we have gotten better estimates of ΔFGV by multiplying a company's expected capital growth (again in dollars) by a profitability "spread" that is calculated before WACC and before deducting expenses associated with what we call the delayed productivity of capital. In fact, our best results have come when using an ROIC measure that is calculated *before* depreciation, capital charge, R&D, advertising, and stock compensation. All of these expenses tend to have future period benefits, and hence cause a downward bias in the EVA spread when no adjustment is made for such benefits.[17]

We use industry models to estimate expected capital growth rates from historical growth rates, multiply the expected capital growth rate by the dollar capital base to get the expected dollar increase in capital, and then multiply that expected dollar increase in capital by the company's adjusted ROIC spread to obtain a measure that we call the "expected dollar margin from growth." For example, if a company with a capital base of $1 million is expected to grow its capital at 3% a year and its adjusted ROIC spread is 20%, then its expected margin from growth is $30,000 x 20%, or $6,000.

We use a second industry model to estimate the change in FGV from the change in expected margin from growth. Using these operating performance estimates of ΔFGV, we came up with significantly more accurate estimates of actual excess returns.[18]

As can be seen in Figure 5, when using industry models for S&P 1500 companies in 36,000 ten-year periods from 1980 to 2018, we found that, on average, the change in EVA explained 41% of the variation in excess returns. The addition

14 More generally, with constant ROIC, WACC and capital growth g, expected capital growth is beginning capital x g, ΔEVA is (ROIC – WACC) x expected capital growth and ΔFGV is (1 + WACC)/WACC x ΔEVA/(WACC – g).

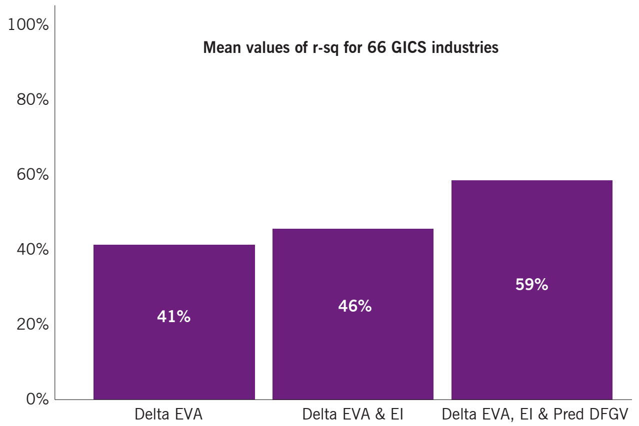
15 ROIC is rarely constant in practice. And since ΔEVA is equal to (ROIC – WACC) x capital growth plus ΔROIC x beginning total capital, we can think of ΔEVA as a weighted average of spread and ΔROIC, where the weight on spread is far less than the weight on ΔROIC.

16 O'Byrne and Young (2009) above.

17 For simplicity, we use a WACC of 0% instead of estimating a "grossed-up" WACC that captures average levels of all the missing expenses, including cost of capital.

18 Our industry models also use ΔEVA+ and ΔEVA – as explanatory variables.

*Figure 5*
**Excess Return R-Sq**




of EI, calculated at the start of each ten-year period, increases the r-squared to 46%. The addition of estimated ΔFGV—estimated using the change in expected dollar margin from growth—increases the r-squared to 59%.

While our operating models of ΔFGV thus provide an operating measure with significantly more explanatory power than ΔEVA alone, there is a great deal of room for improvement. Our models explain only 24% of the excess return variation that's not explained by EVA and EI.[19] The good news is that our operating models of ΔFGV don't go beyond operating margin and capital growth. More accurate models could, and no doubt will, be developed that make use of other variables. Among the most promising candidates are measures of customer acquisition, lifetime value, and satisfaction—and measures of employee satisfaction, turnover, and pay alignment with company value added.

One way to adapt the modern EVA bonus plan to the challenges of Amazon, Apple, Colgate-Palmolive, and Kroger cases is to incorporate a "dynamic EI." In each year, the operating model of change in FGV would be used to "true up" the EI to reflect the expected impact of the company's operating performance on FGV from the start of the plan.[20]

## Conclusion

EVA is the only financial performance measure that ties directly to discounted cash flow value, and the EVA math that divides all companies' value into current operations values (COVs) and future growth values (FGVs) can be used to provide critical insights for valuation, target setting, and performance analysis. EVA bonus plans have been tried again and again but without addressing a fundamental challenge—the tendency of increases in current EVA to be associated with declining expectations of future EVA improvement (or reductions in FGV)—and the converse tendency of decreases in EVA to be associated with increases in FGV.

One result of this negative correlation between EVA and FGV has often been excessive rewards for EVA improvement that comes at the expense of future growth opportunities—for example, from pursuing margin improvements at the expense of business growth or passing up positive-NPV projects that would reduce current EVA. The solution outlined here is designed to stimulate new research on better operating proxies for change in future growth value and a reinvigoration of EVA bonus plans using dynamic EI to help companies achieve better alignment of management pay with contribution to shareholder value.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19 (59% – 46%)/(100% – 46%) = 24%.
20 For additional discussion of "dynamic EI" see O'Byrne (2016).

## APPENDIX: Why MVA Is Not a Good Proxy for Investors' Excess Return

The excess return is the dollar difference between the return the company's investors actually earned on the capital they invested, and their expected return based not on the broad market return, but on the company's cost of capital. For example, if the cost of capital is 10% and investor's initial investment is $1 million, the investor's expected wealth is $1.61 million at the end of five years and $2.59 million at the end of ten years.[21] MVA—which, again, is the dollar difference between a company's current market enterprise value and its book capital—overstates the excess return achieved by negative EVA companies and understates the excess return achieved by positive EVA companies because it ignores distributions during the period. Two companies can have the same current MVA even though one company has earned and distributed a 40% return on capital over the last ten years, while the second company has earned a zero return on capital and distributed nothing over the last ten years.[22] The investors who received the 40% return distributions are far better off than the investors who received no distributions, even though their current MVAs are the same.

With different EVA accounting rules, MVA would be equal to the cumulative excess return. This would be the case if all positive EVA were treated as a distribution of capital and all negative EVA were treated as a contribution to capital.[23]

To get a better sense of the practical importance of this theoretical shortcoming of MVA, I looked at the correlations between MVA and dollar excess return across 39,000 ten-year periods for S&P 1500 companies. When I divided the sample in half based on MVA as a percentage of year 10 expected investor wealth, I found startling differences.

In the top half of the sample—where MVA is 149% of year 10 expected investor wealth, on average, MVA turns out to be a reasonably good proxy for the dollar excess return. MVA was only 6 percentage points higher than the excess return, on average, and it explained 91% of the variation in excess returns.[24]

But in the bottom half of the sample, where MVA was –11% of year 10 expected investor wealth, on average, MVA is a largely unreliable proxy for the excess return. MVA was 20 percentage points higher than the excess returns, on average, and explained only 6% of the variation in the excess return.

21 $1.61 million = (1 + 10%)^5 x $1 million.

22 Both companies would have the same current MVA if both now have the same ROIC.

23 See Young, S. David and Stephen F. O'Byrne, *EVA and Value-Based Management*, McGraw-Hill, 2001, p. 42.

24 In the bottom half of the sample, an incremental $1 of MVA adds only $0.60 of excess return, while in the top half of the sample, an incremental $1 of MVA adds $1.09 of excess return.

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