FORDHAM UNIVERSITY
THE JESUIT UNIVERSITY OF NEW YORK

More on
“The Shareholder Value Myth”

Frank M. Werner

Associate Professor of Finance and Business Economics

Schools of Business
Fordham University

ISE Breakfast Seminar Series
21 December 2012

“BUT WAIT, there’s more!”

- There is another concern with the current finance paradigm of Shareholder Value Maximization:

SWM contributes to an unsustainable world

SWM and **UN**sustainability

- Financial goals dominate current business practice
  - They define the objectives of almost all for-profit organizations
  - They shape most business activity
- But, financial goals have little if anything to do with sustainability
- So, pursuing financial goals is often at odds with pursuing sustainability

How to Maximize Shareholder Value

- Maximize revenues

- Minimize costs

- Convince the financial markets the company has a rosy future

Take Advantage of Externalities

- Any unpaid-for benefit or uncompensated cost associated with nature or the actions of others
- Examples:
  - Sunlight, the air we breathe
  - Lowered risk of disease when others are vaccinated
  - Worsened health due to second-hand smoke
  - The ability to pollute

- A major reason businesses damage the environment and/or society is because the damage is costless to the business (i.e., no cash flows), so it is ignored in decision making

The Result

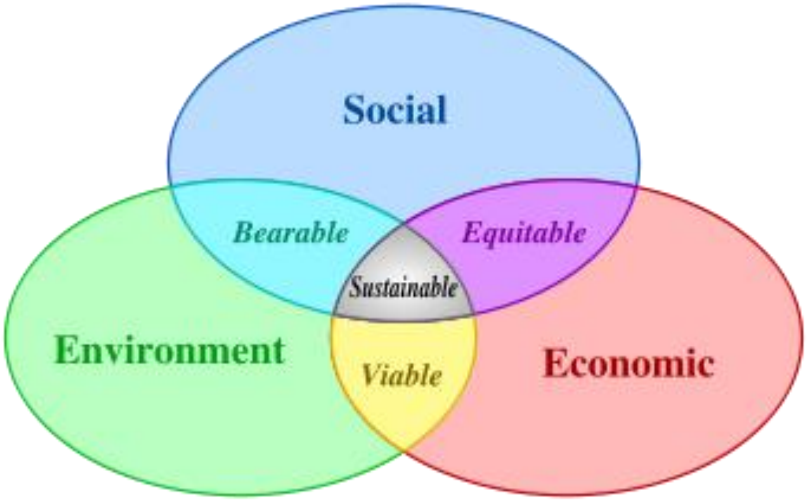
- Acceptable decisions
  - – add financial value
  - – take advantage of unpriced externalities
  - – pay no attention to sustainability

- It is only by chance that the existing business decision process supports sustainability!

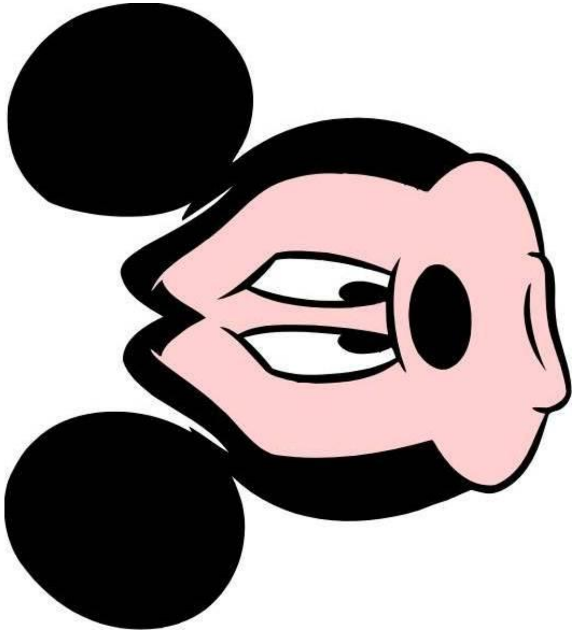
FORDHAM UNIVERSITY
THE JESUIT UNIVERSITY OF NEW YORK

Another Way to Say It

- The nature of a sustainable world (balanced)



- The impact of the current finance paradigm (unbalanced)



So, Where Did the Finance Goal Come From?

- Classical economists – profit maximization
  - Issue is efficient use of scarce resources
  - The scarce resource was capital, therefore
  - Maximize returns to capital by efficient use
  - Profit maximization provides the “invisible hand”

- 20th century – SWM replaced profit maximization
  - Profits increasingly harder to measure
  - Profits ≠ cash flows, ignore risk and timing
  - SWM integrates all factors

Beyond the Current Finance Paradigm

- Today, most for-profit firms consider actions that do not add financial value to be bad business decisions
- Even when they take such actions, firms typically only do so if they believe they really will add value, even if unmeasurable

Beyond the Current Finance Paradigm

- So how can we break through this very real barrier to sustainability?
- It may turn out that the real contributions of for-profit businesses to sustainable development come from actions that do not meet today's financial criteria

? ? ? ? ? ? ?

- Maybe it's time to revisit the SWM paradigm!

! ! ! ! ! ! !

Can Paradigms Be Changed?

- It's happened in the past!
  - Ptolemy → Copernicus
  - Flat world → Columbus
  - Creationism → Darwin
  - Newton → Einstein
  - Command and control → Quality management
- "Half of what I teach is wrong . . ."

Key Assumptions Underlying the SWM Goal

- The scarce resource to be optimized is physical/financial capital
- Capital markets are efficient – security prices accurately reflect economic opportunity
- People are rational when making economic decisions
- Following the finance goal gets you there
- Financial success = societal success

Challenging the Assumptions

~~The scarce resource is~~
~~physical/financial capital~~

Human Capital
Natural Capital

Human/Natural Capital

- SWM emerged in a world where the scarce resource was physical/financial capital
- BUT – human capital is now the scarce resource for many companies

  "Our employees are our most important resource!"

- AND – natural capital has become a major world concern
  - Climate change, air & water resources, etc.

Human/Natural Capital

- If, for some firms, human and/or natural capital is more important than physical/ financial capital, then . . .

Is share price maximization consistent with the most efficient use of scarce resources?

Human/Natural Capital

- Question – Should the goal of some (all?) firms be:
  - "**HCM**" – (returns to) Human Capital Maximization?
  - "**NCM**" – (returns to) Natural Capital Maximization?
  - A combination of all three forms of capital?

$$\max \ \mathrm{f}\left(r_{FC}, r_{HC}, r_{NC}\right)$$

  - Something else?

Challenging the Assumptions

~~Financial markets are efficient~~

Social Construction Theory

Social Construction Theory

- Social construction theory argues that societal institutions were created to meet social needs as much as to meet their stated needs.
- If financial markets were not created purely to be economically efficient:
  – What do share prices tell managers?
  – Is managing to increase share price meaningful?

Challenging the Assumptions

~~Rational economic behavior~~

Behavioral Finance

Behavioral Finance

- Behavioral Finance investigates markets and prices when some agents display “non-rational” behavior.

- If investors do not always act rationally, is share price maximization consistent with the efficient use of scarce resources?

Royal Dutch Shell

- Royal Dutch Petroleum and Shell Transport & Trading are independently incorporated in the Netherlands and England.
- Royal Dutch trades primarily in the U.S. and the Netherlands, and is included in the S&P500 and virtually every Dutch index. Shell trades predominantly in the U.K. and is in the FTSE.
- 1907 alliance: all cash flows, adjusting for corporate tax considerations and control rights, are split 60:40. The annual report clarifies these linkages.
- Royal Dutch is sometimes 35% underpriced, and sometimes 15% overpriced !!

Challenging the Assumptions



~~Following the finance goal gets you there~~


Multiple Goals Are Necessary

Built to Last

- Authors: Collins and Porras, 1994
- Companies studied:
  - 18 “visionary companies”
  - 18 “comparison” companies (similar business, founding dates) – good companies, not dogs

Built to Last

- "Visionary company" selection criteria
  - Premier company in industry
  - Widely admired (by CEOs)
  - Indelible imprint on our world
  - Multiple generations of CEOs
  - Multiple product (service) life cycles
  - Founded before 1950 (50 year minimum age)

Built to Last

- Performance measure (shareholder wealth)
- Measurement: return on $1 invested from Jan 1, 1926 to Dec 31, 1990
  - General market: $415
  - Comparison companies: $955
  - "Visionary companies": $6,356

Built to Last: Conclusion

- *Contrary to business school doctrine, "maximizing shareholder wealth" or "profit maximization" has not been the dominant driving force or primary objective of the visionary companies. Visionary companies pursue a cluster of objectives, of which making money is only one–and not necessarily the primary one. Yes, they seek profits, but they're equally guided by a core ideology–core values, and sense of purpose beyond just making money.*

Built to Last: Conclusion

- *Yet, paradoxically, the visionary companies make more money than the more purely profit-driven comparison companies.*

Good to Great

- Author: Collins, 2001
- Companies studied:
  - 11 Good to Great companies
  - 11 “direct comparison” companies (same industry, same opportunities, similar resources) but no leap from good to great
  - 6 “unsustained comparison” companies – short term shift from good to great but failure to sustain the trajectory

Good to Great

- Selection Criterion
  - 15 years of stock market returns at or below the market
  - Punctured by a transition period
  - Followed by cumulative returns at least 3 times the market over the next 15 years

Good to Great

- Performance measure (shareholder wealth)
- 15 years following the good to great transition point (take-off):
  - 6.9 times the general market return
- Cumulative stock returns on $1 invested 1965–2000
  - General market: $56
  - Direct comparison companies: $93
  - Good to Great companies: $471

Good to Great: Conclusion

- Does rewarding executives for maximizing share price really work?
- *We found no systematic pattern linking specific forms of executive compensation to the process of going from good to great. The idea that the structure of executive compensation is a key driver in corporate performance is simply not supported by the data.*

Challenging the Assumptions

~~Finance is the only success measure~~

Multiple Success Measures

Multiple Success Measures

- More and more companies are discovering the benefit of expanding their "management dashboard"
  - Quality measures to capture customer/employee satisfaction and process performance
  - The "Balanced Scorecard" to integrate metrics
- Analysts and observers are increasingly looking to a broad(er) set of measures when evaluating a company

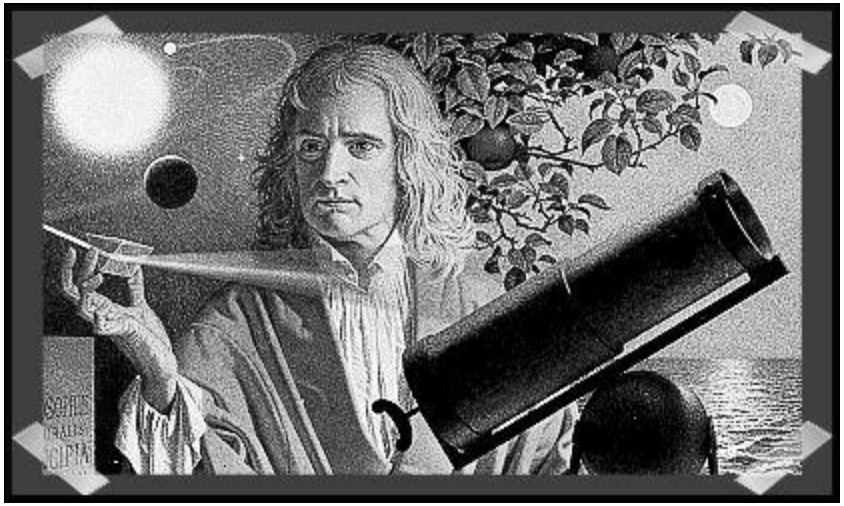
Quality Metrics

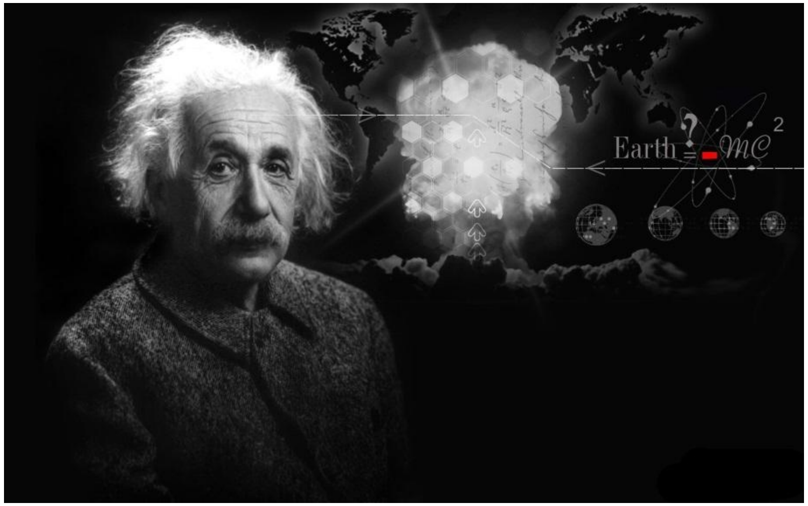
- Many companies have supplemented their financial measures with quality metrics
  - Widely used measures
    - Number of failures/defects
    - Six sigma
    - Cycle time
  - Company specific measures
    - Corning's Key Results Indicators (KRIs)
    - Federal Express's Service Quality Indicators (SQIs)
    - Solectron's Customer Satisfaction Indexes (CSIs)
    - Southern Pacific's Key Performance Indicators (KPIs)

The Balanced Scorecard

- Links performance measures on four dimensions/perspectives:
  - Customer (how do customers see us?)
  - Internal (what must we excel at?)
  - Innovation and learning (how can we improve?)
  - Financial (are we creating value for shareholders?)

Newton ➔ Einstein





- Why did Einstein's theories supplant Newtonian physics?

Newton → Einstein

- Newtonian theory
  - Developed to explain "slow speed" phenomena (gravity, planetary motions)
- Shareholder WM
  - Developed in a world of small proprietorships that had limited non-economic impact on the environment and society

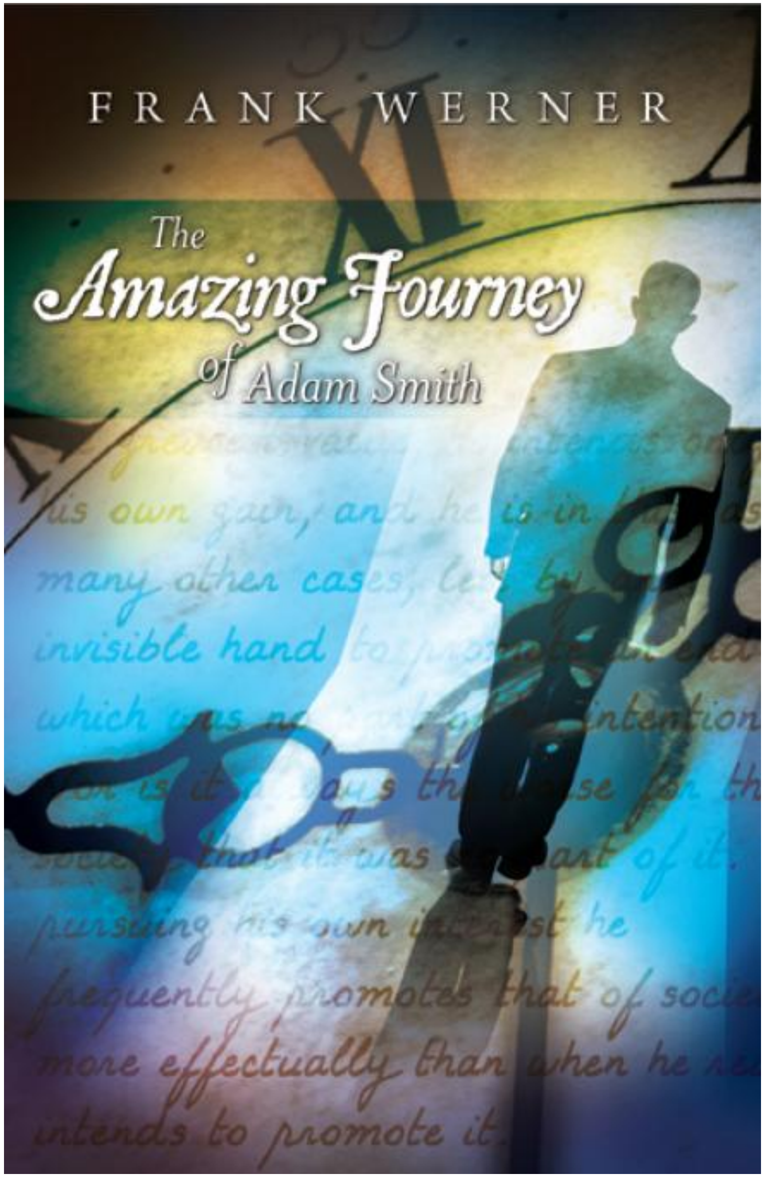
- Einsteinian theory
  - Developed to explain "high speed" phenomena (light)
- New theory
  - Needed for a world of large corporations that have significant non-economic impact on the environment and society

Newton → Einstein

- Newtonian physics is a subset of Einsteinian physics
  - Newton – valid at slow speeds
  - Einstein – valid at all speeds
- Shareholder WM is a subset of Societal WM
  - Shareholder WM – valid for small proprietorships
  - Societal WM – valid for all companies

Frank Werner:

The
Amazing Journey
of
Adam Smith



From *The Amazing Journey of Adam Smith*:

> *"Adam Smith was dumbfounded. Could he really be attending an event taking place at the start of the third millennium? Smith tried to concentrate on what the speaker was saying. Who was he? What was going on? And what was the meaning of the words of the painting?"*

So begins ***The Amazing Journey of Adam Smith*** as the father of modern economics embarks on a voyage through time to discover whether his famous conclusion in ***The Wealth of Nations*** remains valid today:

> . . . he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it.

More on "The Shareholder Value Myth"

Frank M. Werner

Associate Professor of Finance and Business Economics

Schools of Business
Fordham University

ISE Breakfast Seminar Series
21 December 2012