Are Dual-Class Shares Bad For Investors?

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The News Corp. phone hacking scandal has drawn attention to a class issue on Wall Street. Most traded companies have only one type of common stock. A small number of firms, including several media giants, issue two: one class for anyone who wishes to buy a stake and another with super voting rights that allows a privileged few to hoard operational control. Is that dual system bad for returns?

It should be in theory. Part of the stock market's implied deal, say experts, is that investors accept a share of the risk in exchange for a share of profits -- and the ability to vote for change if management fails to deliver returns. When ordinary investors lack this ability, insiders are left to oversee themselves, which can allow poor performance to go unchecked. Last month, the influential California Public Employees' Retirement System (CalPERS), which owns almost 7 million shares of News Corp. (which owns Dow Jones, parent of Smart Money), used the hacking scandal to renew its call for a change in the share structure. "We believe that the control of a company should reflect its ownership," said portfolio manager Anne Simpson in a statement. "Dual-class voting is one way to pervert the alignment of ownership and control." News Corp. declined to comment.

Some 6% of the large U.S. firms that make up the S&P 500 have multiple stock classes with different voting rights, down from 10% five years ago, according to data provided by GovernanceMetrics International. Supporters of the dual-class structure say it allows a strong leader to put the long-term interests of the company first, insulated from the whims of shareholders focused on this quarter's profits. Media firms, including the New York Times Company and the Washington Post Company, also use dual-class structures to protect their editorial vision from potentially hostile shareholders, says Guhan Subramanian, a professor at Harvard Business School and Harvard Law School who teaches corporate governance.

Dual-class structures are gaining popularity among Internet firms, too. "My impression is that the Google IPO, which was a dual-class structure, made it more OK for tech companies," Subramanian says. A few recent tech IPOs, like LinkedIn and Groupon (which hasn't issued shares but has filed paperwork suggesting it will), have set up two-tiered structures.

Shareholder advocates say that concentrating voting rights into a few hands gives management too much power and has been associated with abuses in the past. It might sound good when you're looking at a young company with charismatic founders, but in the long term it's bad for investors, says Ann Yerger, the executive director of the Council of Institutional Investors. It makes management less accountable to shareholders, because shareholders can't effectively replace the board that oversees management, says Charles Elson, the head of the Weinberg Center for Corporate Governance at the University of Delaware. "I think investors should think about steering clear of this structure," Elson says.

Corporate watchdogs may not like it, but little evidence exists to suggest dual-class shares are a bad deal. Some research shows that shares of a dual-class company are often cheaper those of a

single-share company, says Andrew Metrick, a professor at the Yale School of Management. That discount makes sense, he says: a share of a single-class company gives you a chunk of profits plus a vote on corporate affairs, while a share of a dual-class company just gets you the cash, without the vote. "There's really no reason your returns will be lower," Metrick says. If a dual-class company reorganized into a single-class company, your shares should suddenly be worth more, but investors would only profit if the controlling shareholders didn't demand too high a payout for agreeing to the reorganization, he says.

Investors should understand that by buying into a dual-class company they're taking the risk that the insiders who control the more powerful shares will make bad decisions down the line, or that those shares will be passed from a talented founder to someone less skilled, Subramanian says. Ultimately, Subramanian says, "the pro of dual-class is that the founder-CEO runs the show, and the con of dual-class is that the founder-CEO runs the show."