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What Good Are Shareholders?

by Justin Fox and Jay W. Lorsch

The path forward for corporate executives and shareholders appears blocked. Executives complain, with justification, that meddling and second-guessing from shareholders are making it ever harder for them to do their jobs effectively.

Shareholders complain, with justification, of executives who pocket staggering paychecks while delivering mediocre results. Boards are stuck in the middle—under increasing pressure to act as watchdogs and disciplinarians despite evidence that they're more effective as friendly advisers.

This deadlock has its roots in the 1970s, when power began to move in the direction of shareholders after a long period during which managers had called almost all the shots. The shift, although it had political and economic causes, was also enabled by the rise of a philosophy of shareholder dominance that grew out of academic research on the motivations and behavior of corporate managers. According to that philosophy, shareholders are the center of the corporate universe; managers and boards must orbit around them.

Corporate reality, though, has proved stubbornly uncooperative. In legal terms, shareholders don't own the corporation (they own securities that give them a less-than-well-defined claim on its earnings). In law and practice, they don't have final say over most big corporate decisions (boards of directors do). And although many top managers pledge fealty to shareholders, their actions and their pay packages often bespeak other loyalties. This gap between rhetoric and reality—coupled with waves of corporate scandal and implosion—has led to repeated calls to give outside investors even more say. If only corporations really did put shareholders first, the reasoning goes, capitalism would function much better.

This argument has great appeal, but it is hard to square with the facts. Our current muddle, remember, comes after many years during which shareholders gained power yet were repeatedly frustrated with the results. It's at least possible, then, that the problem lies with shareholders themselves. Perhaps they aren't really suited to being corporate bosses. Perhaps expecting them to govern and discipline corporations is doomed to disappointment. Or perhaps there are ways in

which shareholders can be effective and helpful—but we risk overlooking them if we concentrate on the need for shareholder primacy.

Our aim here is to focus on shareholders. Who are they? What are their incentives? What are they good at? What are they bad at? The body of research and discussion on these questions is growing. (For a summary, see "Are Institutional Investors Part of the Problem or Part of the Solution?," a working paper by Ben W. Heineman Jr. and Stephen Davis, published by Yale's Millstein Center for Corporate Governance and Performance.) Our contribution is to offer a framework for thinking about shareholders' role and to make some suggestions for changes. We've divided shareholders' contributions into three areas: money, information, and discipline.

1. Money

The most straightforward job of the shareholder is to provide funds. In practice, however, it isn't straightforward at all. Corporations do need capital to invest in growth, but they don't get it in aggregate from shareholders. Net issuance of corporate equity in the U.S. over the past decade has been negative $287 billion, according to the Federal Reserve. That negative number would be much bigger if we left out financial institutions and their desperate fundraising in 2008 and 2009. Factor in dividend payments, and we find a multi-trillion-dollar transfer of cash from U.S. corporations to their shareholders over the past 10 years. Established corporations tend to finance investments out of retained earnings or borrowed money. They don't need shareholders' cash.

Not all corporations have this luxury, of course. Many do need capital from equity investors. They are often the young, growing companies we all want to see more of. Without shareholders who are willing to take risks that a bank or a bondholder would not, these companies might remain stuck in low gear or never even get moving. The investors who provide this cash are usually granted clout commensurate with their contribution. Venture capitalists and angel investors get board seats and sometimes veto power over management decisions and appointments. Investors who step up in times of trouble are often favored over others and given a say in strategic decisions. Corporate governance disputes tend not to occur in such situations: Management effectively answers to the shareholders who provided much-needed capital—at least for a while.

But most shareholders and most corporations don't fit these descriptions. The funding role in a typical publicly traded corporation is filled less by shareholders than by the stock market as a whole. The market provides liquidity. Having shares that can easily be bought and sold, with prices that all can see, reassures lenders and business partners. It enables mergers. It allows early investors and employees to sell company shares and exercise options. It gives investors who come forward when cash is sorely needed a way to realize gains on their investments later. It greases the wheels of capitalism.

Those wheels have been getting ever greasier. In one study, Eugene Fama and Kenneth French found that from 1973 to 2002, a large and growing percentage of corporations issued shares each year. From 1973 to 1982, the percentage was 67%; from 1993 to 2002, it was 86%. What drove the increase? More stock-financed mergers and more employee stock options and other stock-based compensation. This isn't necessarily a healthy development. All-stock mergers tend

to destroy value. Many corporations have overused stock options as a means of paying employees—especially top executives (see the sidebar “More Say but Still Lots of Pay”). And more generally, market liquidity appears to have diminishing returns.

More Say but Still Lots of Pay

In the 1980s and 1990s, under pressure from governance activists, institutional shareholders, the financial media, finance scholars, and even the U.S. Congress, boards shifted the bulk of CEO pay from cash to stock and stock options, and became less patient with CEOs at struggling companies. The idea was to put executives under greater pressure to perform.

So what happened? CEO tenure is shorter. Pay is much higher. But the statistical correlation between CEO pay and corporate performance at S&P 500 companies is zero, reports Baruch Lev in his 2012 book Winning Investors Over. Returns to investors have been alarmingly close to zero in recent years as well.

One could spin this as a tale of wily, self-interested managers’ taking advantage of investors—because it is. But it’s also a case of shareholders’ pushing for change and then proving incapable of controlling it. The adversarial, stock-market-oriented approach to pay appears to have motivated executives to think more like mercenaries and less like stewards.

This situation might be workable if shareholders were willing and able to be effective policemen. But evidence from the latest development in executive compensation—“say on pay,” included in the Dodd-Frank financial reform legislation—suggests that they aren’t. As codified early last year by the SEC, “say on pay” requires companies to put their executive pay practices to a (nonbinding) shareholder vote at least once every three years. This has certainly resulted in more scrutiny: In the first six months under the new rule, Institutional Shareholder Services recommended a no vote on the pay packages at 289 companies out of the 2,313 it examined.

But a majority of shareholders actually voted no at only 39 of those companies, and that was mostly in the wake of significant share price declines or negative earnings; at just a few did large increases in executive pay seem inconsistent with performance. An interpretation: Shareholders are perfectly capable of expressing dissatisfaction with companies that perform extremely poorly. But they’re not so good at—or interested in—distinguishing good pay packages from bad ones.

To provide adequate liquidity, an asset market needs lots of fickle short-term speculators. A market composed solely of buy-and-hold investors wouldn’t be very useful. But a market composed mostly of short-termers presents its own problems. And short-termers have been taking over the stock market. In the 1950s the average holding period for an equity traded on the New York Stock Exchange was about seven years. Now it’s six months. Similar trends can be seen in other markets around the world. In a more recent development, high-frequency traders whose holding periods can sometimes be measured in milliseconds now account for as much as 70% of daily volume on the NYSE.

This shift to the short term has three causes: First, regulators in many nations have pushed successfully for lower transaction costs—most notably through the deregulation of brokerage commissions in the 1970s and 1980s, but also through initiatives such as price decimalization in the late 1990s. Second, advances in technology, in the form of financial engineering as well as computing and communications hardware and software, have enabled many new forms of trading. Third, the individual investors who once dominated stock markets have been pushed aside by professionals—and those professionals face incentives and pressure to trade much more frequently than individuals do.

In 1950 households owned more than 90% of the shares of U.S. corporations. Now institutions hold approximately 50% of the domestically owned shares of public companies (see the exhibit "The Decline of the Individual Investor"). Add in institutional owners from overseas (foreign ownership of U.S. shares isn't broken down between individuals and institutions) and hedge funds (which are counted mostly under households), and the true institutional share is probably closer to 65% or 70%. For the biggest corporations, the percentage is even higher.

The Decline of the Individual Investor

In 1950 households owned more than 90% of shares in U.S. corporations. Now they own only 30% to 40%.

Increasing institutional ownership has combined with other forces to transform the equity market landscape. Brokerage commissions have been lowered for everyone, but lowered most for institutional investors. Institutions also have the resources to take advantage of cutting-edge financial, computing, and communications technologies. And although individuals can pursue long-term strategies that ignore fashion and day-to-day market fluctuations, institutions that are

managing other people's money generally cannot: If returns trail the market for too long, customers will pull their money out.

The more influence short-term traders have on market prices, the more volatile those prices will be—because they are less rooted in the fundamental value of the corporations whose shares are being traded. Of course, some volatility is good. It gives people a reason to trade, thus keeping markets liquid. But past a certain point, volatility kills liquidity. Think of the financial crisis of 2007 and 2008, when uncertainty over prices halted trading in many mortgage-related securities. Or the Flash Crash of 2010, when shares in hundreds of companies suddenly lost half their value—and then regained it within a few minutes. Overall, as documented by the Bank of England's Andrew G. Haldane, stock market volatility in the U.S. and the UK has been much greater over the past two decades than it was before. There's no evidence that this has had a negative impact generally on corporations' ability to raise money or transact in their shares. But there are indications that certain companies—namely the cash-hungry start-ups discussed at the beginning of this section—are struggling in the new market environment. Initial public offerings have been on a downward trend for decades in the United States, interrupted only briefly by the internet stock mania of the late 1990s. The accounting firm Grant Thornton has argued in a series of research papers that more-frequent trading and superlow transaction costs are partly responsible, because brokers no longer make enough on commissions to justify research on young companies.

Yet modern securities regulation has been developed within a paradigm in which there is no such thing as too much liquidity, too much trading, or too much volatility. Lowering transaction costs is seen as an unalloyed good. The tax code is different: In most countries short-term trading is subject to higher capital gains tax rates than long-term investing. But the impact of this tax preference is lessened by the fact that in the U.S., many of the biggest investors (pension funds, foundations, endowments) are exempt from income taxes.

In the wake of the Flash Crash, the U.S. Securities and Exchange Commission is considering new circuit breakers and trading stops to be used in the event of sudden market volatility. That marks at least a modest change in direction, but it's time for a broader reexamination of rule making and legislation around trading. Market frictions have their uses. There is such a thing as too much liquidity. One much-discussed policy proposal is a small tax on all financial transactions, variously called the Tobin tax and the Robin Hood tax. The issues with such a tax go well beyond the purview of this article, but the possibility that it would decrease liquidity should not be seen as a slam-dunk argument against it.

2. Information

The stock market is one of the world's great aggregators of information. Since the 1960s, finance scholars have been documenting its remarkable ability to sniff out and assess information about companies. Event studies show that market prices react to news with staggering quickness—often moving even before the news is public—and tend to see through accounting conventions and subterfuges to the real economic value of a company's earnings.

This means that the next time you hear a CEO arguing that investors are failing to give his company adequate credit for improvements in its income statement, it's a safe bet that the market is right and the CEO and his accountants are blowing smoke. Also, while public stock markets are often assailed for short-termism and impatience, there is ample statistical evidence that stock prices—especially for companies in the early stages of growth—factor in potential earnings decades down the road.

But there's also evidence (again compiled by Andrew Haldane) that investors' willingness to look into the future is on the decline. And stock markets have never been anywhere close to infallible in their assessment of companies' prospects. If they were, rational investors and speculators would have no incentive to expend resources and intelligence trying to dig up information and outsmart the market. Financial markets need imperfection—"noise," to use the term popularized by the finance scholar Fischer Black—if they are to work. So how well do stock market prices reflect underlying corporate fundamentals? Black's guesstimate was that "at least 90%" of the time the prices prevailing on financial markets are "more than half value and less than twice value."

That may be adequate for the purposes of capitalism, but it's way too large a margin of error for executives and boards seeking information and guidance. Sometimes they get pure misinformation: In a study described in the January–February 2012 issue of HBR, the executive recruiter James M. Citrin found that companies whose stock prices dropped sharply upon the naming of a new CEO subsequently outperformed—by a lot—those whose prices rose sharply when a new CEO was named. Also, comparative stock price movements (how Coca-Cola performs relative to Pepsi, for example) are usually more informative than absolute price movements, for which macroeconomic factors and market psychology tend to rule the day. Financial markets, the late economist Paul Samuelson said, are microefficient and macroinefficient.

When shareholders are widely dispersed, how can they keep managers in check? Only by selling shares or casting votes.

This helps explain why executives complain about the short-term focus of the stock market even as finance scholars find evidence that markets still look deep into the future. Using the right statistical tools, you can separate useful, rational signals from the market's noise. But if you look at what your company's stock did today—or even this month—you are likely to see hyperactive chaos. Human nature dictates that we give more attention to simple recent signals than to complex long-run trends—especially when we are paid to give attention to them, as most top executives have been over the past two decades.

Suggested Reading

Lucian A. Bebchuk, “The Case for Increasing Shareholder Power,” Harvard Law Review, January 2005

Fischer Black, “Noise,” The Journal of Finance, July 1986

Andrew G. Haldane, “Patience and Finance,” speech, September 9, 2010 (available at bankofengland.co.uk)

Andrew G. Haldane and Richard Davies, “The Short Long,” speech, May 11, 2011 (available at bankofengland.co.uk)

Lynn A. Stout, The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public (Berrett-Koehler, 2012)

Prices aren’t the only way shareholders convey information to executives. They can also just talk to them. In many instances well-informed investors—from venture capitalists with a start-up to Warren Buffett with the Washington Post Company—have offered crucial information, analysis, and advice to management. But such behavior is not really encouraged in the current market environment.

Regulation Fair Disclosure, adopted by the SEC in 2000, requires that all substantive corporate disclosures be released immediately to the public. The goal was to level the informational playing field for investors, which seems admirable enough. But some of the results have been troubling. One study, by Armando R. Gomes, Gary B. Gorton, and Leonardo Madureira, found that in the wake of Reg FD, small companies and complex companies have struggled to attract analysts’ attention and capital. By forcing all communications into the public sphere, Reg FD may have made it harder to communicate nuance and complexity.

The rule says nothing about communications from shareholders to managers, but by making managers warier of such meetings and reducing the incentives for shareholders to participate in them, it has most likely impeded that information stream as well. Communication between corporate managers and the investor community now takes place mostly during the conference calls that follow the release of quarterly earnings. The participants in these calls are a mix of actual investors and analysts from brokerages and independent research firms. In our experience, analysts ask most of the questions, and they tend toward the superficial and the short term.

Bringing back the old days in which some analysts and investors had special access to corporate information is probably a nonstarter. Then again, some investors do still have special access: Shareholders who own more than 5% of a company or hold a seat on its board are exempt from Reg FD—they are considered corporate insiders and are subject to different restrictions and disclosure requirements. It might be time to look for a middle ground in which long-term investors

who aren't technically insiders are allowed to exchange some but not all of their maneuvering room for franker interactions with management.

Short of a change in the rules, more informal communication between long-term shareholders and managers is a good idea. Such interactions bring useful market information to executives and allow them to build relationships with shareholders that can lead to less adversarial, more-effective governance. Communication between board members and shareholders is also helpful, but it seldom happens now. Many top executives seem to think that board members cannot be trusted with such interactions. Yet if directors cannot be trusted to meet with and listen to shareholders, how can they be expected to competently govern a corporation? In meetings between shareholders and board members that one of us (Lorsch) has observed, the result has been greater trust and stronger relationships that can be drawn on in future crises.

3. Discipline

Because corporate executives are "managers of other people's money," Adam Smith wrote in The Wealth of Nations, they cannot be expected to look after that money with the care that, say, partners or sole proprietors would. This has come to form the central quandary of corporate governance: How can we get managers to do their jobs well—and what exactly does doing well mean?

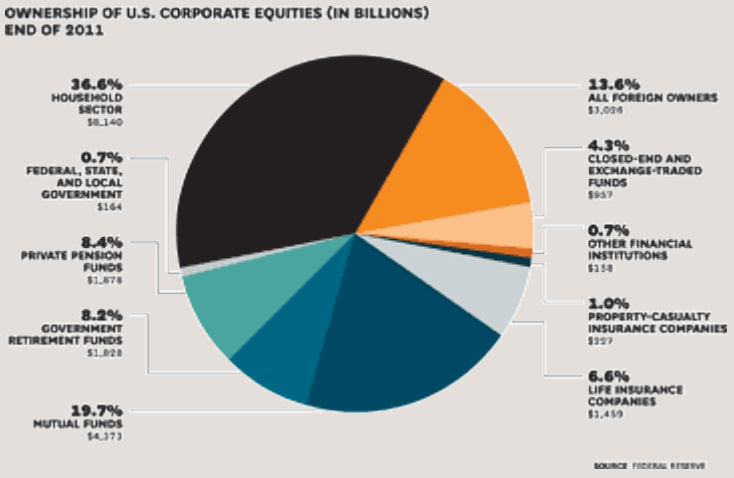
The modern understanding of this difficulty has been defined to a large extent by an academic article written in 1976 by Michael C. Jensen and William H. Meckling, who framed the issue as a conflict between what they called "principals" (shareholders) and "agents" (managers). If an agent owned the business, Jensen and Meckling argued, there was no conflict. But as the ownership percentage went down, agents inevitably faced the temptation to do things that benefited themselves rather than the principals. The main challenge of corporate governance was keeping agents from taking advantage of principals.

Why, exactly, were shareholders (as opposed to employees, customers, or citizens of the community where a company was based) the only principals worth worrying about? "Since it is logically impossible to maximize in more than one dimension," Jensen explained years later, "purposeful behavior requires a single valued objective function." If there has to be just one objective of the corporation, maximizing shareholder value seems an obvious choice. It wasn't exactly Jensen's choice: He argued that maximizing enterprise value—which counts both a company's equity and its debt—was the appropriate goal. But shareholders and debt holders often have different interests and priorities, so shareholder value became the shorthand goal that executives, investors, academics, and others latched on to.

It is difficult to overstate the power of this idea. It is elegant. It is intuitive. There's even evidence to back it up: Marianne Bertrand and Sendhil Mullainathan found that public companies with a large (more than 5% of shares outstanding) shareholder who isn't the CEO are better governed, pay their executives more rationally, and outperform companies that have no such "principal" minding the store. What's missing, though, is a clear answer to the question of what to do in the absence of such a principal. When shareholders are widely dispersed, how can they keep managers in check?

Who the Shareholders Are

Institutional investors—mutual funds, pension funds, insurance companies—have become the chief owners of the shares of U.S. corporations. The data below actually understate the institutional share by leaving out hedge funds, which don't disclose enough information for government statisticians to track them reliably, and thus fall mostly in the "household" category.



They have only two major tools at their disposal—selling shares or casting votes. Both are problematic. Selling can be said to discipline managers by driving the stock price down, but it's awfully hard for one shareholder, even a big one, to have a discernible impact. Also, among the biggest shareholders are index funds, which can't choose to sell—they must own all the stocks in a given market index. And more generally, as we've seen, stock prices are noisy and fitful in their conveyance of information.

That leaves the vote, which has its own weaknesses. The biggest is that so many investors don't hold on to their shares for long—and, obviously, short-termers aren't as good as long-termers at disciplining and guiding managers. A study by José Miguel Gaspar, Massimo Massa, and Pedro P. Matos found that companies with a large percentage of high-turnover shareholders sold themselves in mergers at a discount, overpaid for acquisitions, and generally underperformed the market. Another issue is that big institutions, which own the lion's share of stock, tend to have widely diversified portfolios. Owning shares in hundreds or even thousands of companies makes it difficult to focus on the governance and performance of any of them.

As a result, most professional money managers have come to rely heavily on intermediaries—the market leader is Institutional Shareholder Services—to tell them how to vote. It's better than nothing, which is what most individual investors do, but it's a standardized and usually superficial sort of oversight. ISS focuses on a handful of governance practices disclosed in public documents, and the evidence that these factors correlate with more-effective governance or corporate success is so far lacking.

Some investors do go beyond the check-the-box approach. The California Public Employees' Retirement System, or CalPERS, chooses certain companies from its portfolio whose performance and corporate governance practices it regards as below par. It then communicates privately and publicly with the boards and management of those companies to encourage changes in their boardrooms and strategies. Does this work? Early research showed evidence of a positive "CalPERS effect" on the stock price of targeted companies; but since then the effect has faded. Even more activist are the few hedge funds that take large positions in a single company they believe is undershooting its potential and then agitate for changes in strategic direction or the management team. These funds apparently do succeed in increasing stock prices over the medium term—although, as the legal scholar Lynn Stout points out, raising a target company's stock price is not necessarily equivalent to creating economic value.

Still, even if you believe that the threat of takeovers and hedge fund activism can have a healthy disciplinary effect on managers, the cost of these efforts is so high that they will always be rare. Most institutional investors simply lack the motivation and the time to effectively discipline or otherwise oversee management. And investors have differing time frames and priorities; they aren't all necessarily seeking the same things. Top corporate executives, meanwhile, are highly paid, highly motivated, and highly skilled full-time professionals who—except in times of great corporate distress—will find it easy to outmaneuver or outlast disgruntled investors.

Giving shareholders more things to vote on won't change this. It may even make things worse, by spurring a culture of conflict between shareholders and managers and incentivizing the latter to become ever more mercenary and self-interested. Yet the appeal of "shareholder democracy" is so great that most changes in corporate governance over the past few years have involved strengthening the shareholder franchise. In the U.S. there's "say on pay," a provision of the 2010 U.S. Dodd-Frank financial reform legislation that requires companies to put their executive pay practices to a (nonbinding) shareholder vote at least once every three years. Dodd-Frank also called for "proxy access"—allowing some big shareholders to nominate their own director candidates—although the SEC rule to this effect was struck down by the U.S. Supreme Court, and prospects for the proposal are currently unclear. Shareholder activists have pushed for, and often gotten, governance changes at individual corporations that range from requiring that directors get a majority vote of all shareholders (not just a majority of those voting) to annual voting for all directors (as opposed to staggered voting in which only a few directors are up for election each year) to the dissolution of "poison pill" arrangements meant to dissuade hostile takeovers.

Most institutional investors lack the motivation and the time to discipline or otherwise oversee management.

All this has transpired in the name of giving more power to the owners of corporations. But remember, shareholders aren't quite the same as owners. A simple illustration: If you own a car, you're liable for damages in an accident even if they exceed the value of the car. But shareholders are on the hook only for what they've invested. And although some shareholders behave much like owners, most of them are effectively renters—often ultra-short-term renters. In real estate, renters are entitled to legal protection but seldom given a formal say in how a

property is managed or whether it can be bought or sold. That seems appropriate for short-term shareholders as well.

The “say on pay” rule includes a first step in this direction: Only those who have owned shares in a company for more than two years get to vote. We advocate more-sweeping change. One possibility that has been suggested is a sliding scale on which voting power increases with length of ownership. A simpler approach would be to restrict voting in corporate elections of any kind to those who have owned their shares for at least a year.

Such changes would give more clout to the shareholders who are presumably least interested in day-to-day stock price and quarter-to-quarter earnings changes—thus tempering short-termism. And separating long-haul shareholders from the rest could enable more communication and trust between them and boards and managers. The key would be to shed the notion of shareholder democracy that animates much discussion of corporate governance and move toward granting more say to those shareholders most likely to have something to contribute.

Then there’s the question of how boards are chosen. The proxy access rule struck down by the Supreme Court was an attempt to make it easier for shareholders to nominate rival board candidates. But the rule as contemplated would probably have been invoked only when a company was already in serious difficulty. More important, if contested board elections did somehow become common, one likely impact would be to discourage competent people from serving on boards. It’s a rare businessperson who relishes a contentious election campaign. There’s also no evidence that bringing in more outside board members improves governance. Of the many studies done on the impact of board composition, most show no effect at all, and a substantial minority show a correlation between more insiders and better performance.

Approaches that encourage shareholder input but not confrontation and conflict are more likely to succeed in improving boards. For example, large shareholders could suggest board candidates—either informally or through an advisory group of shareholder representatives. This would resemble current practice in Sweden, where a committee representing the largest shareholders recommends nominees for a board.

The Way Forward

In the 1970s many big corporations in the United States had a complacency problem. Managers saw themselves as the stewards of important institutions and were resistant to change despite big shifts in the competitive landscape. In response, shareholders became impatient, and academics devised theories about how to keep self-interested managers toeing the line. The result was a revolt that goaded managers into being less risk-averse and more willing to embrace change. But shareholders have not proved successful at controlling the more aggressive breed of managers that the revolt helped spawn. How could they? Except when a company is in trouble (generally the only time that shareholders succeed in cobbling together antimanagement majorities), conflict between shareholders and managers is asymmetric warfare, with shareholders in no position to prevail.

Paying too much attention to what shareholders say they want may actually make things worse for them. There's a growing body of evidence (for example, Rosabeth Moss Kanter's "How Great Companies Think Differently," HBR November 2011) that the companies that are most successful at maximizing shareholder value over time are those that aim toward goals other than maximizing shareholder value. Employees and customers often know more about and have more of a long-term commitment to a company than shareholders do. Tradition, ethics, and professional standards often do more to constrain behavior than incentives do. The argument here isn't that managers and boards always know best. It's simply that widely dispersed short-term shareholders are unlikely to know better—and a governance system that relies on them to keep corporations on the straight and narrow is doomed to fail.

Given how many unintended and unwelcome consequences have flowed from the governance and executive pay reforms of the past few decades, we're wary of recommending big new reforms. But we do think that giving a favored role to long-term shareholders, and in the process fostering closer, more constructive relationships between shareholders, managers, and boards, should be a priority. So should finding roles for other actors in the corporate drama—boards, customers, employees, lenders, regulators, nonprofit groups—that enable those actors to take on some of the burden of providing money, information, and especially discipline. This is stakeholder capitalism—not as some sort of do-good imperative but as recognition that today's shareholders aren't quite up to making shareholder capitalism work.

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