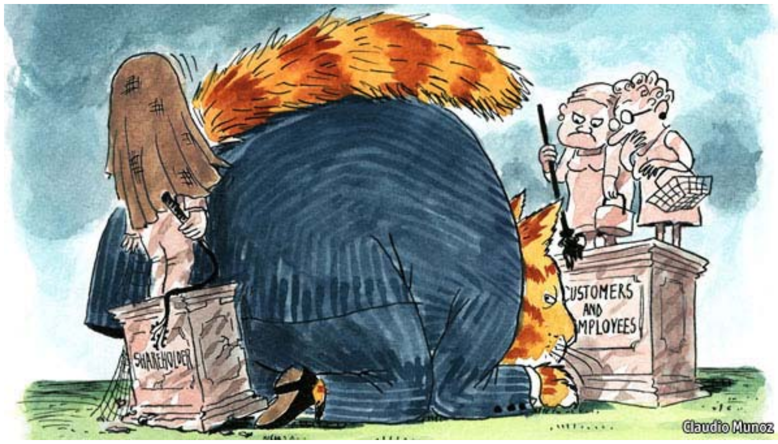
A new idolatry

Apr 22nd 2010
From The Economist print edition

The economic crisis has revived the old debate about whether firms should focus most on their shareholders, their customers or their workers



THE era of "Jack Welch capitalism" may be drawing to a close, predicted Richard Lambert, the head of the Confederation of British Industry (CBI), in a speech last month. When "Neutron Jack" (so nicknamed for his readiness to fire employees) ran GE, he was regarded as the incarnation of the idea that a firm's sole aim should be maximising returns to its shareholders. This idea has dominated American business for the past 25 years, and was spreading rapidly around the world until the financial crisis hit, calling its wisdom into question. Even Mr Welch has expressed doubts: "On the face of it, shareholder value is the dumbest idea in the world," he said last year.

In an article in a recent issue of the *Harvard Business Review*, Roger Martin, dean of the University of Toronto's Rotman School of Management, charts the rise of what he calls the "tragically flawed premise" that firms should focus on maximising shareholder value, and argues that "it is time we abandoned it." The obsession with shareholder value began in 1976, he says, when Michael Jensen and William Meckling, two economists, published an article, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", which argued that the owners of companies were getting short shift from professional managers. The most cited academic article about business to this day, it inspired a seemingly irresistible movement to get managers to focus on value for shareholders. Converts to the creed had little time for other "stakeholders": customers, employees, suppliers, society at large and so forth. American and British value-maximisers reserved particular disdain for the "stakeholder capitalism" practised in continental Europe.

Now, Mr Martin argues, shareholder value should give way to "customer-driven capitalism" in which firms "should instead aim to maximise customer satisfaction." This idea is winning some converts. Paul Polman, who last year became boss of Unilever, a consumer-goods giant, recently said to the *Financial Times*, "I do not work for the shareholder, to be honest; I work for the consumer, the customer…I'm not driven and I don't drive this business model by driving shareholder value."

Nor is it just customers who are expected to benefit from a backlash against the cult of shareholder value. Mr Lambert reports that a recent survey of the CBI's members found that most expected that a "more collaborative approach would emerge with various different groups of stakeholders", including suppliers and the institutions that educate workers. And a forthcoming book by Vineet Nayar, the chief executive of HCL Technologies, a fast-growing Indian business-process outsourcing firm, takes a quite different position to Mr Martin, as is evident from its title: "Employees First, Customers Second".

Has the shareholder-value model really failed, however? The financial meltdown has certainly undermined two of the big ideas inspired by Messrs Jensen and Meckling: that senior managers' pay should be closely linked to their firm's share price, and that private equity, backed by mountains of debt, would do a better job of getting managers to maximise value than the public equity markets. The bubbles during the past decade in both stockmarkets and, later, the market for corporate debt highlighted serious flaws with both of these ideas, or at least with the way they were implemented.

A firm's share price on any given day, needless to say, can be a very poor guide to long-term shareholder value. Yet bosses typically had their pay linked to short-term movements in share prices, which encouraged them to take measures to push the share price up quickly, rather than to maximise shareholder value in the long run (by when they would probably have departed). Similarly, private-equity firms took on too much debt during the credit bubble, when it was available on absurdly generous terms, and are now having to make value-destroying cuts at many of the companies in their portfolios as a result.

In some ways the current travails of Goldman Sachs (see article) epitomise the problem. The investment bank embraced the maximisation of shareholder value when it went public in 1999. Although it insists that it does not live quarter to quarter, senior figures from its previous incarnation as a partnership, when it naturally championed the long-term interests of its employees (the partners), argue that it would have been much more wary in those days of any deals that made a quick buck at the risk of alienating customers. But, as Mr Lambert points out, "It wasn't just the banks which had a rush of blood to the head. For a few years, a fair number of other companies seemed to put almost as much effort into managing their balance-sheets as into wooing their customers." In his view, "If you concentrate on maximising value to shareholders over the short term, you put at risk the relationships that will determine your longer-term success."

Yet this need not mean that the veneration of shareholder value is wrong, and should be replaced by worship at the altar of some other business deity. Most of those preaching reverence for other stakeholders concede that the two are usually not mutually exclusive, and indeed, often mutually reinforcing. Mr Martin, for example, admits that "increased shareholder value is one of the by-products of a focus on customer satisfaction." Likewise, in India's technology industry, where retaining talented staff is arguably managers' hardest task, Mr Nayar's devotion to employees, which he says has helped increase revenues and profits, may be the best way to maximise long-term shareholder value.

In other words, the problem is not the emphasis on shareholder value, but the use of short-term increases in a firm's share price as a proxy for it. Ironically, shareholders themselves have helped spread this confusion. Along with activist hedge funds, many institutional investors have idolised short-term profits and share-price increases rather than engaging recalcitrant managers in discussions about corporate governance or executive pay.

Giving shareholders more power to influence management (especially in America) and encouraging them to use it should prompt them and the managers they employ to take a longer view. In America, Congress is considering several measures to bolster shareholders at managers' expense. In Britain, the Financial Reporting Council has proposed a "stewardship code" to invigorate institutional investors. "This is a phoney war between shareholder capitalism and stakeholder capitalism, as we haven't really tried shareholder capitalism," says Anne Simpson, who oversees corporate-governance activism for CalPERS, America's biggest public pension fund. "Rather than give up on shareholder value, let's have a real go at setting up shareholder capitalism."