Harvard Business Review

BLOG: The Conversation

Why CEOs Don't Owe Shareholders a Return on Market Value

11:41 AM Thursday March 11, 2010

by Roger Martin | Comments (5)

Taking responsibility for something one is incapable of doing has never been a particularly good idea. Politicians get in trouble for promising their electorates that they can fix the economy when they can't. Money managers get in trouble when they tell their clients that they will beat the market when they can't. The only thing of which we can be sure is that in due course the promise-taker will be disappointed and the promise-giver will be frustrated. And in due course, disappointment and frustration turns to anger and recrimination for both sides.

This same sad story plays out between modern CEOs and their shareholders. CEOs promise that they will increase their 'shareholder value' and dedicate themselves to that task. But shareholder value increases only when expectations of future performance increase from its current level and no CEO can keep their company marching ahead of expectations forever.

John Chambers is arguably the finest telecommunications equipment company CEO of his generation and Cisco Systems the best company in its industry — probably by a wide margin. But Chambers' company has arguably been 'destroying shareholder value' since 2001 when Cisco was trading at over three times today's price of around $25 per share. The problem: in 2001, expectations for Cisco were so overblown that no management team could even hope to keep them at that level, let alone raise them.

Trying to raise expectations indefinitely is not only impossible, it's positively damaging. CEOs saddled with high expectations feel compelled to take risky actions to try to do the impossible in order to generate still more overblown expectations. CEOs who are the beneficiary of low expectations will take shareholders to the cleaners by making boatloads of stock-based compensation by simply hanging around and waiting for expectations to float up to their natural level.

CEOs strive to increase shareholder value because they think it is the right thing to do (their moral obligation) and are reinforced in this belief by their boards that provide them incentives for doing just that. It isn't 'the right thing to do' and boards shouldn't encourage them to think it is. The fact is, despite their belief to the contrary, neither boards nor management actually owe public shareholders an attractive return on the market value of the stock they purchased.

Think about the dynamics for a minute. I decide to take my company public at $20/share. Bill buys a share of my IPO issue at $20. I do owe Bill a fair return on the $20 of equity capital that he provided me because he actually gave me $20 of capital with which to invest. If my risk-adjusted cost of equity is 10%, I need to aim to earn him a return of at least $2 (whether I retain the earnings for further investment or return it to him in dividends). Let's say that I invest Bill's $20 very cleverly in a competitive advantage that enables me to earn $4/share instead of just $2/share. Shareholders are gleeful with my clever investing and my wonderful competitive advantage: the stock shoots to $40/share.

Bill decides to cash in and sells his share to Bernie for $40/share. Did Bill ask my permission? No, he can sell his share whenever and to whomever he wishes. Did my company get any capital out of the transaction? Nope. Bill pockets the $20 profit. I still only have Bill's original $20 investment. However, the expectation, which I heartily accept as a modern company CEO, is that my company will earn a 10% return on Bernie's $40/share stock - and everybody else's for that matter.

Without reinvestment, all competitive advantages decay over time. I made a really clever investment with the IPO capital from Bill and all the other initial investors and that produced a terrific competitive advantage. But over time it will wither away. So this year I might earn $4/share but without capital infusion, it is likely that next year it will be $3.90 and the next year $3.80 and so on.

Thanks to my initial unexpectedly clever initial investment (the IPO price would have been higher had it been expectedly clever), I have heightened expectations but no associated extra capital. And this is the mismatch that so very many public companies face. And this is where so many of them blow their corporate brains out trying risky initiatives: hoping beyond hope to meet expectations.

The fallacy is that CEOs think that they have an obligation to earn an attractive return for shareholders who purchased their shares from an existing shareholder at above the price at which those shares were sold out of the corporate treasury. The only shareholder to whom the CEO owes anything is the shareholder who provided capital to the company. That shareholder deserves a return at the cost of equity on that initial investment.

Of course, that's not quite the whole story. If the stock price does rise and the company decides to issue new stock at a higher level, let's say at $40/share, then the CEO should feel the obligation to shareholders to earn return at or above the cost of equity on that higher value. And because there is only one class of shares and the company can't distinguish between one common shareholder and the next, that means earning a return on the $40/share level for all shareholders. But if the stock subsequently goes to $50/share, the company won't owe shareholders a return on that $50/share level — unless it issues yet more stock at that level.

In the long run, companies would be healthier and their shareholders better off if their CEOs only sought to earn a return on the capital provided to them by shareholders, i.e. their book capital not their market capital. Enshrining that in the mission statements of America's corporations would be a great place to start.

Roger Martin is the Dean of the Rotman School of Management at the University of Toronto in Canada and the author of The Design of Business: Why Design Thinking is the Next Competitive Advantage *(Harvard Business Press, 2009). His website is rogerlmartin.com*