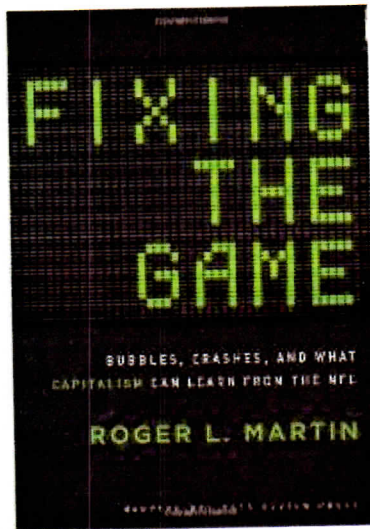


The Dumbest Idea In The World: Maximizing Shareholder Value



Forbes 2011
by Steve Denning

There is only one valid definition of a business purpose: to create a customer.

Peter Drucker, *The Practice of Management*

"Imagine an NFL coach," writes Roger Martin, Dean of the Rotman School of Management at the University of Toronto, in his important new book, *Fixing the Game*, "holding a press conference on Wednesday to announce that he predicts a win by 9 points on Sunday, and that bettors should recognize that the current spread of 6 points is too low. Or picture the team's quarterback standing up in the postgame press conference and apologizing for having only won by 3 points when the final betting spread was 9 points in his team's favor. While it's laughable to imagine coaches or quarterbacks doing so, CEOs are expected to do both of these things."

Imagine also, to extrapolate Martin's analogy, that the coach and his top assistants were hugely compensated, not on whether they won games, but rather by whether they covered the point spread. If they beat the point spread, they would receive massive bonuses. But if they missed covering the point spread a couple of times, the salary cap of the team could be cut and key players would have to be released, regardless of whether the team won or lost its games.

Suppose also that in order to manage the expectations implicit in the point spread, the coach had to spend most of his time talking with analysts and sports writers about the prospects of the coming games and "managing" the point spread, instead of actually coaching the team. It would hardly be a surprise that the most esteemed coach in this world would be a coach who met or beat the point spread in forty-six of forty-eight games—a 96 percent hit rate. Looking at these forty-eight games, one would be tempted to conclude: "Surely those scores are being 'managed'?"

Suppose moreover that the whole league was rife with scandals of coaches "managing the score", for instance, by deliberately losing games ("tanking"), players deliberately sacrificing points in order not to exceed the point spread ("point shaving"), "buying" key players on the opposing team or gaining access to their game plan. If this were the situation in the NFL, then everyone would realize that the "real game" of football had become utterly corrupted by the "expectations game" of gambling. Everyone would be calling on the NFL Commissioner to intervene and ban the coaches and players from ever being involved directly or indirectly in any form of gambling on the outcome of games, and get back to playing the game.

Which is precisely what the NFL Commissioner did in 1962 when some players were found to be involved betting small sums of money on the outcome of games. In that season, Paul Hornung, the Green Bay Packers halfback and the league's most valuable player (MVP), and Alex Karras, a star defensive tackle for the Detroit Lions, were accused of betting on NFL games, including games in which they played. Pete Rozelle, just a few years into his thirty-year tenure as league commissioner, responded swiftly. Hornung and Karras were suspended for a season. As a result, the "real game" of football in the NFL has remained quite separate from the "expectations game" of gambling. The coaches and players spend all of their time trying to win games, not gaming the games.

The real market vs the expectations market

In today's paradoxical world of maximizing shareholder value, which Jack Welch himself has called "the dumbest idea in the world", the situation is the reverse. CEOs and their top managers have massive incentives to focus most of their attentions on the expectations market, rather than the real job of running the company producing real products and services.

The "real market," Martin explains, is the world in which factories are built, products are designed and produced, real products and services are bought and sold, revenues are earned, expenses are paid, and real dollars of profit show up on the bottom line. That is the world that executives control—at least to some extent.

The expectations market is the world in which shares in companies are traded between investors—in other words, the stock market. In this market, investors assess the real market activities of a company today and, on the basis of that assessment, form expectations as to how the company is likely to perform in the future. The consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of the company.

"What would lead [a CEO]," asks Martin, "to do the hard, long-term work of substantially improving real-market performance when she can choose to work on simply raising expectations instead? Even if she has a performance bonus tied to real-market metrics, the size of that bonus now typically pales in comparison with the size of her stock-based incentives. Expectations are where the money is. And of course, improving real-market performance is the hardest and slowest way to increase expectations from the existing level."

In fact, a CEO has little choice but to pay careful attention to the expectations market, because if the stock price falls markedly, the application of accounting rules (regulation FASB 142) classify it as a "goodwill impairment". Auditors may then force the write-down of real assets based on the company's share price in the expectations market. As a result, executives must concern themselves with managing expectations if they want to avoid write-downs of their capital.

In this world, the best managers are those who meet expectations. "During the heart of the Jack Welch era," writes Martin, "GE met or beat analysts' forecasts in forty-six of forty-eight quarters between December 31, 1989, and September 30, 2001—a 96 percent hit rate. Even more impressively, in forty-one of those forty-six quarters, GE hit the analyst forecast to the exact penny—89 percent perfection. And in the remaining seven imperfect quarters, the tolerance was startlingly narrow: four times GE beat the projection by 2 cents, once it beat it by 1 cent, once it missed by 1 cent, and once by 2 cents. Looking at these twelve years of unnatural precision, Jensen asks rhetorically: 'What is the chance that could happen if earnings were not being "managed"?' " Martin replies: infinitesimal.

In such a world, it is therefore hardly surprising, says Martin, that the corporate world is plagued by continuing scandals, such as the accounting scandals in 2001-2002 with Enron, WorldCom, Tyco International, Global Crossing, and Adelphia, the options backdating scandals of 2005-2006, and the subprime meltdown of 2007-2008. The recent demise of MF Global Holdings and the related ongoing criminal investigation are further reminders that we have not put these matters behind us.

"It isn't just about the money for shareholders," writes Martin, "or even the dubious CEO behavior that our theories encourage. It's much bigger than that. Our theories of shareholder value maximization and stock-based compensation have the ability to destroy our economy and rot out the core of American capitalism. These theories underpin regulatory fixes instituted after each market bubble and crash. Because the fixes begin from the wrong premise, they will be ineffectual; until we change the theories, future crashes are inevitable."

"A pervasive emphasis on the expectations market," writes Martin, "has reduced shareholder value, created misplaced and ill-advised incentives, generated inauthenticity in our executives, and introduced parasitic market players. The moral authority of business diminishes with each passing year, as customers, employees, and average citizens grow increasingly appalled by the behavior of business and the seeming greed of its leaders. At the same time, the period between market meltdowns is shrinking. Capital markets—and the whole of the American capitalist system—hang in the balance."

How did capitalism get into this mess?

Martin says that the trouble began in 1976 when finance professor Michael Jensen and Dean William Meckling of the Simon School of Business at the University of Rochester published a seemingly innocuous paper in the *Journal of Financial Economics* entitled "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure."

The article performed the old academic trick of creating a problem and then proposing a solution to the supposed problem that the article itself had created. The article identified the principal-agent problem as being that the shareholders are the principals of the firm—i.e., they own it and benefit from its prosperity, while the executives are agents who are hired by the principals to work on their behalf.

The principal-agent problem occurs, the article argued, because agents have an inherent incentive to optimize activities and resources for themselves rather than for their principals. Ignoring Peter Drucker's foundational insight of 1973 that the *only valid purpose of a firm* is to create a customer, Jensen and Meckling argued that the singular goal of a company should be to maximize the return to shareholders.

To achieve that goal, they academics argued, the company should give executives a compelling reason to place shareholder value maximization ahead of their own nest-feathering. Unfortunately, as often happens with bad ideas that make some people a lot of money, the idea caught on and has even become the conventional wisdom.

During his tenure as CEO of GE from 1981 to 2001, Jack Welch came to be seen—rightly or wrongly—as the outstanding exemplar of the theory, as a result of his capacity to grow shareholder value at GE and magically hit his numbers exactly. When Jack Welch retired from GE, the company had gone from a market value of \$14 billion to \$484 billion at the time of his retirement, making it, according to the stock market, the most valuable and largest company in the world. In 1999 he was named "Manager of the Century" by *Fortune* magazine. Since Welch retired in 2001, however, GE's stock price has not fared so well: GE has lost around 60 percent of the market capitalization that Welch "created".

Before 1976, professional managers were in charge of performance in the real market and were paid for performance in that real market. That is, they were in charge of earning real profits for their company and they were typically paid a base salary and bonus for meeting real market performance targets.

The change had the opposite effect from what was intended

The proponents of shareholder value maximization and stock-based executive compensation hoped that their theories would focus executives on improving the real performance of their companies and thus increasing shareholder value over time. Yet, precisely the opposite occurred. In the period of shareholder capitalism since 1976, executive compensation has exploded while corporate performance has declined.

"Maximizing shareholder value" turned out to be the disease of which it purported to be the cure. Between 1960 and 1980, CEO compensation per dollar of net income earned for the 365 biggest publicly traded American companies fell by 33 percent. CEOs earned more for their shareholders for steadily less and less relative compensation. By contrast, in the decade from 1980 to 1990, CEO compensation per dollar of net earnings produced *doubled*. From 1990 to 2000 it quadrupled.

Meanwhile real performance was declining. From 1933 to 1976, real compound annual return on the S&P 500 was 7.5 percent. Since 1976, Martin writes, the total real return on the S&P 500 was 6.5 percent (compound annual). The situation is even starker if we look at the rate of return on assets, or the rate of return on invested capital, which according to a comprehensive study by Deloitte's Center For The Edge are today only one quarter of what they were in 1965.

Although Jack Welch was seen during his tenure as CEO of GE as the heroic exemplar of maximizing shareholder value, he came to be one of its strongest critics. On March 12, 2009, he gave an interview with Francesco Guerrera of the *Financial Times* and said, "On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy... your main constituencies are your

employees, your customers and your products. Managers and investors should not set share price increases as their overarching goal. ... Short-term profits should be allied with an increase in the long-term value of a company."

The shift to delighting the customer

What to do? Given the numbers of the people and the amount of money involved, rescuing capitalism from these catastrophically bad habits won't be easy. For most organizations, it will take a phase change. It means rethinking the very basis of a corporation and the way business is conducted, as well as the values of an entire society.

"We must shift the focus of companies back to the customer and away from shareholder value," says Martin. "The shift necessitates a fundamental change in our prevailing theory of the firm... The current theory holds that the singular goal of the corporation should be shareholder value maximization. Instead, companies should place customers at the center of the firm and focus on delighting them, while earning an acceptable return for shareholders."

If you take care of customers, writes Martin, shareholders will be drawn along for a very nice ride. The opposite is simply not true: if you try to take care of shareholders, customers don't benefit and, ironically, shareholders don't get very far either. In the real market, there is opportunity to build for the long run rather than to exploit short-term opportunities, so the real market has a chance to produce sustainability. The real market produces meaning and motivation for organizations. The organization can create bonds with customers, imagine great plans, and bring them to fruition.

"The expectations market," says Martin, "generates little meaning. It is all about gaining advantage over a trading partner or putting two trading partners together, then tolling them for the service. This structure breeds a kind of amorality in which information is withheld or manipulated and trading partners are treated as vehicles from which to extract money in the short run, at whatever the cost to the relationship."

By contrast, the real market contributes to a sense of authenticity for individuals. Because individuals can find meaning in their jobs. They are not playing a zero-sum game. They are doing something real and positive for society.

Examples of the shift

Martin cites three examples of firms that are, even within the legal limits of today's world, focused on the real world of customers and products more than gaming the stock market.

One is **Johnson & Johnson** [JNJ]. In 1982, when the Tylenol poisonings occurred, "J&J was in a terrible bind. Tylenol represented almost a fifth of the company's profits, and any decline in its market share would be difficult to reclaim, especially in the face of rampant fear and rumor. Yet, rather than attempt to downplay the crisis—it was after all, likely the work of an individual madman in one tiny part of the country—J&J did just the opposite. Chairman James Burke immediately ordered a halt to all Tylenol production and advertising, distributed warnings to hospitals across the country, and within a week of the first death, announced a nationwide recall of every single bottle of Tylenol on the market. J&J went on to develop tamper-proof packaging for its products; an innovation that would soon become the industry standard." Burke's actions were not the heroic act of a single individual, says Martin. The actions flowed from the company credo which is engraved in granite at the entry to company headquarters, which makes crystal clear that customers are first, then employees, and shareholders absolutely last. Martin contrasts J&J's handling of the Tylenol crisis with the handling of the *Deepwater Horizon* oil spill in 2010 by BP [BP], which he sees as driven by a short-term concern for BP's profits.

A second example is **Procter & Gamble** [PG] which "declares in its purpose statement: 'We will provide branded products and services of superior quality and value that improve the lives of the world's consumers, now and for generations to come. As a result, consumers will reward us with leadership sales, profit and value creation, allowing our people, our shareholders and the communities in which we live and work to prosper.' For P&G, consumers come first and shareholder value naturally follows. Per the statement of purpose, if P&G gets things right for consumers, shareholders will be rewarded as a result."

A third example is **Apple**. Steve Jobs seemed to delight in signaling to shareholders that they didn't matter much and that they certainly wouldn't interfere with Apple's pursuit of its original customer-focused purpose: 'to make a contribution to the world by making tools for the mind that advance humankind.' Jobs's feisty, almost combative demeanor at shareholder meetings is legendary. At the meeting in February 2010, one shareholder asked Jobs, "What keeps you up at night?" Jobs quickly responded, 'Shareholder meetings.'"

Making needed legal changes

Admonishing CEOs (and investors) to ignore the expectations market and refocus on delighting the customer isn't going to work, says Martin. It's as likely to be "as effective as admonishing frat boys to stop chasing girls." For CEOs, there are massive incentives for staying attuned to it and severe punishments for ignoring it. Investors, analysts, and hedge funds continue to reward firms that meet expectations and punish those that do not. Missing expectations, a dropping stock-price, and real-asset write-downs can together create an unstoppable downward spiral. In the current environment, to simply ignore the expectations market is to court disaster.

One of the great values of the Martin's book is that he puts his finger on the needed legal changes that can help shift the dynamic of business away from gaming the expectations market and back to doing the real job of delighting customers.

- One is the **repeal of 1995 Private Securities Litigation Reform Act**, which contains what has become known as the "safe harbor" provision. "To move ahead productively," he writes, "the safe harbor provision should simply be repealed. Executives and their companies should be legally liable for any attempt to manage expectations. Without the safe harbor provisions, there would be no earnings guidance and that would be a great thing." Making this change would immediately bring the practice of giving guidance to the stock market, and so gaming expectations, to a screeching halt. There is, says Martin, simply no societal value to earnings guidance. The market will know exactly what earnings are going to be at the end of the quarter, in just three or fewer months. Society is not better off to have an executive publicly guess at what that number is going to be. We need to turn executives from the useless, rapid task of managing expectations to the psychologically and economically rewarding business of creating value.
- A second is the **elimination of regulation FASB 142** which forces the real write-downs of real assets based on the company's share price in the expectations market. The current rule forces executives to concern themselves with managing expectations in order to avoid write-downs. Changing the rule would remove the major sanction that now exists for executives who ignore the expectations market.

- A third is to restore the focus of executives on the real market and on an authentic life by **eliminating the use of stock-based compensation as an incentive**. This doesn't mean that executives shouldn't own shares. If an executive wants to buy stock as some sort of bonding with the shareholders or for whatever other reasons, that's just fine. However, executives should be prevented from selling any stock, for any reason, while serving in that capacity—and indeed for several years after leaving their posts. Stock based compensation is a very recent phenomenon, one associated with lower shareholder returns, bubbles and crashes, and huge corporate scandals. In 1970, stock based compensation was less than 1 percent of compensation. By 2000, it was around half of compensation. For the last 35 years, stock-based compensation has been tried. It had the opposite effect of what was intended. We should learn from experience and discontinue it.

Other needed changes

Martin also argues for associated changes:

- We must **restore authenticity to the lives of our executives**. The expectations market generates inauthenticity in executives, filling their world with encouragements to suspend moral judgment. They receive incentive compensation to which the rational response is to game the system. And since they spend most of their time trading value around rather than building it, they lose perspective on how to contribute to society through their work. Customers become marks to be exploited, employees become disposable cogs, and relationships become only a means to the end of winning a zero-sum game.
- We need to address **board governance**. Boards have become complicit in gaming the expectations market, and the associated inflation of executive compensation.
- We need to **regulate expectations market players, most notably hedge funds**. Net, hedge funds create no value for society. They have huge incentives to promote volatility in the expectations market, which is dangerous for us but lucrative for them. So, we need to rein in the power of hedge funds to damage real markets.

What's next?

In a book that offers so much, one is tempted to ask for more. Perhaps in subsequent writings, Martin will expand and carry his thinking forward. In future writings, he might document more of the economically disastrous practices that enable firms to meet their quarterly targets, such as looting the firm's pension fund or cutting back on worker benefits or outsourcing production to a foreign country in ways that further destroy the firm's ability to innovate and compete.

He might also spell out the specific management changes that are necessary to delight the customer. The command-and-control management of hierarchical bureaucracy is inherently unable to delight anyone—it was never intended to. To delight customers, a radically different kind of management needs to be in place, with a different role for the managers, a different way of coordinating work, a different set of values and a different way of communicating. This is not rocket science. It's called radical management.

He might also show how the shift from maximizing shareholder value to delighting the customer involves a major power shift within the organization. Instead of the company being dominated by salesmen who can pump up the numbers and the accountants who can come up with cuts needed to make the quarterly targets, those who add genuine value to the customer have to re-occupy their rightful place.

He might also build on the theme that the shift from maximizing shareholder value to delighting the customer doesn't involve sacrifices for the shareholders, the organizations or the economy. That's because delighting the customer is not just profitable: it's hugely profitable.

Bottom-line: capitalism is at risk

American capitalism hangs in the balance, writes Martin. His book gives a clear explanation as to why this is so and what should be done to save it. A large number of rent-collectors and financial middlemen making vast amounts of money are keeping the current system in place. The fact that what they are doing is destroying the economy will not sway their thinking. As Upton Sinclair noted, "It is difficult to get a man to understand something, when his salary depends upon his not understanding it."

Is change possible? Martin believes so, quoting Vince Lombardi: "We would accomplish many more things if we did not think of them as impossible." Other "impossible" changes have been accomplished.

"Not long ago, it seemed fanciful that public smoking would be restricted and tobacco companies would sponsor public service ads that discourage smoking," wrote Deepak Chopra and David Simon in 2004. "But this shift in awareness occurred when a critical mass of people decided they would no longer tolerate a behavior that harmed many while benefited a few."

For instance, the Aspen Institute's Corporate Values Strategy Group has been working on promoting long-term orientation in business decision making and investing. In 2009, twenty-eight leaders representing business, investment, government, academia, and labor (including Warren Buffett, CEO of Berkshire Hathaway, Lou Gerstner, former CEO of IBM and Jim Wolfensohn, former president of the World Bank) joined with the Institute to endorse a bold call to end the focus on value-destroying short-termism in our financial markets and create public policies that reward long-term value creation for investors and the public good.

Ultimately, the change will happen, not just because it's right, but because it makes more money. Once investors realize what is going on, the economics will drive the change forward. The recognition that maximizing shareholder value is the dumbest idea in the world is an obvious but still a radical idea.

Like all obvious, radical ideas, in the first instance it will be rejected. Then it will be ridiculed. Finally it will be self-evident and no one will be able to remember why anyone ever thought otherwise.⁹

Buy the Martin's book. Read it. Implement it. The very future of our society "hangs in the balance".

Roger L. Martin: Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL. Harvard Business Review Press 2011.