ESG INVESTING

Shareholder Value Is Undervalued

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The idea that corporate management should focus on maximizing shareholder value is under attack, often in hyperbolic terms, with this idea blamed for great and varied harm (e.g., underinvestment, inefficiency, inequality and the failure of people to appreciate the film *Ishtar*). Recently, James Montier of the esteemed, including by me, money manager Grantham, Mayo, Van Otterloo & Co., voicing the views of many, wrote a piece calling it "The World's Dumbest Idea.'[1] In addition, attacks have appeared in *The New York Times* and in *The Wall Street Journal*. A simple web search shows this to be a concept with many prominent learned detractors and few public defenders.[2]

Luckily for markets and the economy, this is not the world's dumbest idea — not close. It's imperfect, as all things are, but it's not even a little bit "dumb."

Alas, many who think they are attacking "maximize shareholder value" have misidentified their target. Instead they oppose some practices and ideas that often get mistakenly jumbled together. There are debates to be had about all of these disputes, but few touch on the core issue of maximizing shareholder value. Some attacks are by authors genuinely concerned about, and looking to improve, markets; while others are thinly veiled anticapitalist screeds. Either way, they are pointing their fire in the wrong direction.

Basically, if capital markets price things well (with few ex ante errors, or put differently, the market is close to "efficient") then maximizing shareholder value is a very good idea. Believing that markets make common and giant predictable errors is the only legitimate beef one can have with maximizing shareholder value, and it's absolutely fair to debate this tenet.

But instead of confining the debate to this central point, or even realizing that this is the central point, critics attack shareholder value for many ancillary reasons. For instance, they laugh off the concept as vacuous, the absence of a strategy. They attack share-based and particularly options-based compensation. They attack markets and managers for being too "short-term.'[3] They attack the titular idea as inducing the "expectations game," something they hold in great contempt. Finally, they attack — and at least this salvo is on the core concept — the idea that the firm should be run for its owners, instead of for a diffuse and sometimes amorphous set of stakeholders. Some critics have valid and important points about these things. However, as I will explain, with little exception, they are not actually criticizing the shareholder value idea at all.

What Is "Maximizing Shareholder Value"?

First, let's step back and examine what the idea of "maximizing shareholder value" is and why it's intimately tied up in how "efficiently" the market prices shares.[4] Put simply, it's the idea that management's efforts should go into maximizing today's stock price. Gee, that does sound very short-term doesn't it? I mean, it has the word "today's" in it and that's pretty darn short-term! Maybe the critics are onto something?

Well, it really isn't and they really aren't. Why? Because today's stock price is itself the market's forecast of what the firm is worth considering the rest of eternity (only the first few millennia really matter). The market values Apple higher than Commodore International not on a current whim, but because the expected future cash flows to Apple's owners (shareholders) are ridiculously higher than those to Commodore International's (OK, I may have gilded the lily by choosing a foil that went bankrupt a long time ago, but I'm a bitter former Amiga owner).

When management takes action today, in principle and mostly (yes, just mostly, I'll get to that) in fact, the price today moves based on the market's collective assessment of that action's effect on the long-term value of the company. It only looks short-term to those who don't understand this, don't want to understand this, or keep hearing about this "Martin Gale" fellow and dismiss him as some British or Canadian crank. Of course, this is all only if the market is working reasonably "efficiently."

So How "Efficient" Is the Market?

Alas, markets aren't perfect. Few things are perfect. Markets get things wrong every day (certainly clear after the fact, which is often mistaken for the point, but sometimes clear even before the fact) and sometimes do so rather spectacularly. For instance, I am more than willing to call the technology episode of 1999-2000 a "bubble," and shared the trenches with GMO and others in doing so real-time. Now, going the other way, I also think the term "bubble" is grossly overused these days. That is, there is a bubble in saying "bubble." In other words, I think bubbles do occur, just rarely.

In particular, as one type of imperfection, the market may be too "short-term." Earlier I discussed how today's stock price is not actually a "short-term" measure but our best guess of long-term value. But that doesn't make it a perfect guess, and, at the risk of overusing this term, one way it may be imperfect is for price to move too much based on "short-term" not "long-term" events. I have written elsewhere that truth probably lies somewhere in between those who assert markets are wildly inefficient and those who assert they are nearly perfectly efficient. Thankfully, "imperfect" markets can be pretty darn useful. Anyway, if the problem one has with the concept of maximizing shareholder value is that markets are too short-term, then it seems exhorting, cajoling and educating us all to be more long-term in setting prices would be a better solution than attacking the goal of maximizing shareholder value. Indeed, some take this tack, pointing out where they think management is focusing too much on the short-term, and recommending reforms, particularly accounting reforms, that they feel will better deliver shareholder value, as opposed to bizarrely scuttling the concept because, perhaps, we can do better. Frankly, if critics are not urging that we work on better delivering true shareholder value, then I'm not really sure what their solutions are, so I'm a little scared!

Stepping back, one must admit that the market's long-term record, warts and all, is superb. If markets priced things as poorly as the critics assert, directly or by implication, we'd expect to see societies that adopted them floundering, while societies that adopted the opposite — and please pause and consider for a moment what the opposite really is — flourish. More mundanely, if the critics were right in their stridency, we'd expect to see an abundance of consistently successful active stock pickers regularly beating the market by taking the money of rubes who bought into short-term stories spun by venal management (though the truism that the average can't beat the average would still hold). Rather, over the long term, we see few such outrageously successful active managers with the total number a lot closer to that expected from random chance (though probably exceeding it by a bit).

Considering all the evidence, we must conclude that markets are imperfect. But actually we knew that going in, as nothing is perfect. More specifically, the market makes ex ante errors and very rarely it makes large predictable ones. But overall, it has proven a highly effective way of setting prices and close enough to "efficient" that few have consistently beaten markets. Furthermore, other means of setting prices, or worse, allocating resources without prices, have been utter tragic failures compared to the market's success.

Focusing on the Stock Price Is Not a Strategy: Yes, but Duh…

One common refrain among critics is the true statement "maximize shareholder value is not a strategy but the result of a strategy." Indeed they are correct, one does not enhance shareholder value by meditating on the stock price, stalking it or covering the walls with pictures of it all connected by push-pins and string. One maximizes it by creating value, the most you can. The practical details of this vary tremendously from company to company, but usually entail having some combination of great products, perhaps a mission that is truly beneficial to the world, satisfied customers or clients, and a team of employees that is motivated to deliver. Those who think they've made a trenchant telling critique by pointing out that "maximize shareholder value is not a strategy" are not wrong, but they must tell us what and who exactly they are criticizing. Who thinks it's a strategy unto itself and not the result of a good strategy? Maximizing shareholder value is an objective. Of course you still need a strategy to get there!

Options-Based Compensation

The critics' most common target is probably management compensation that is tied to share price, and particularly options-based compensation. Tying management compensation to share price might be, on net, a bad idea; particularly when the plan is one-sided options-based (I'm not arguing this point here, or conceding it, just admitting it's possible).[5] Options-based compensation may indeed often, though for no necessary reason, be used by those waving the shareholder-value banner, but the critics fall here for the post hoc fallacy.

There are legitimate causes for concern with stock-based compensation. First, if, as discussed above, the market has any tendency to be too "short-term," admittedly so will the price of shares or options given to management. But, again, the accusations of "too short-term" are hurled with way too much confidence.[6]

Second, the "one sided" part of options-based compensation may matter as it gives management an incentive to maximize the value of its options which, a bit ironically given this is exactly what we're arguing about, is not the same as the value of the common shares.[7] How can they be at odds? Well, options on shares are a somewhat different beast than shares themselves and this difference carries over to when they're used as compensation. You can increase option value by, all-else-equal, raising volatility and that's not necessarily in the shareholders' best interest. Now, in the presence of debt, shares are also an option on the value of the company but options of a lesser gamma (sorry for the brief geekdom) and don't have nearly the same bias. In fact, while perhaps they have a point in isolation (perhaps!), much of the criticism of maximizing shareholder value has been more about one-sided options-based compensation[8] than the more basic notion of management maximizing share price. Those raising this argument should be clear they are criticizing a specific practice — options-based compensation — and not the idea of maximizing shareholder value.

The "Expectations Game" Is Just How Markets Work

Some rail against management playing the "expectations game" where, to move the stock price, new information must come out that exceeds, or falls short of, that already inherent in the current stock price.[9] The critics blame this "game," which they hold to be very harmful, on the idea of maximizing shareholder value. But the critics are again confused. Their gripe is not with the idea of "maximizing shareholder value" but with the very idea and function of a market price itself. Indeed, it's precisely this characteristic — that of only responding to new information, or to use the critics' vernacular, winning or losing the "expectations game" — that is the defining characteristic of a highly efficient market that already incorporates existing information. Critics must decide from which direction they wish to attack. Either markets are so bad (short-term!) at setting prices that "maximizing shareholder value" is a disaster, or so good that we're all reduced to playing the "expectations game." At the very least it would be nice if they didn't hurl both criticisms in the same printed volley.

You're All Winners

Some argue that maximizing shareholder value is a bad idea because corporate managers have responsibilities to a far broader set of stakeholders than just those who own the company. First, let's be clear, of course having happy satisfied stakeholders is important. If the stock price is indeed the long-term value of the company, then things like treating customers well, compensating employees fairly, etc., are likely vital parts of maximizing the stock price. So the much-maligned effort to maximize price can, and most likely does, entail consideration of both the very long-term future and how stakeholders are doing.

It's possible that corporate managers currently don't do those things as well as they could. Remember, I concede that on average, or at times, markets might indeed be "too short-term" but think the prescription is addressing this directly — not making up brand new amorphous mission statements. In addition, nothing about maximizing shareholder value means that management has a pass to do illegal or unethical things, or that society cannot impose a cost on companies for creating externalities. It only means that within these bounds, and subject to these costs, it makes sense for management to maximize stock price. Indeed it may even make sense, and often does, for a firm to voluntarily try to do even better than society insists upon. But again, if that's the right thing for maximizing long-term value then it's a very odd world where this action is wildly unrewarded in the current stock price. If the market is indeed that inefficient, and prices fail to reflect things like deeply unsatisfied customers, employees about to leave for better treatment elsewhere, elected officials working to outlaw the company's business practices etc., then it's unfortunately true that maximizing shareholder value won't give very satisfactory results. But again we are back to the assertion that we have a very serious problem with markets setting prices. Also, simply finding this concept lacking does not automatically lead to a better alternative (and having management, separately, firm‐by‐firm, decide what's best for all stakeholders, in a highly political process, is not the likely answer).

The Key Point

The key point of this essay is not that the critics are wrong in their specifics. They certainly raise some fair points for debate and should be praised for doing so. But these are not the key points regarding maximizing shareholder value. Rather these critiques address ancillary related points.

The key point is the near equivalence of the idea that management should "maximize shareholder value" and the belief that markets price things reasonably accurately, not perfectly, most of the time. Belief or scorn for "maximize shareholder value" is essentially belief or scorn for the idea that market prices are anywhere near "efficient," even if this is often expressed in confused roundabout ways.[10]

Again, one certainly does not need to believe markets are perfectly efficient. There is lots of room between perfection and scorn as the "worst idea ever." I, for one, certainly don't believe markets are perfect! In fact, not even the most ardent efficient marketers believe in perfection, although this straw man has been used to attack them over and over. To believe in maximizing shareholder value we do not need to believe much beyond observing that markets are tough to beat, are better than all the alternatives we've observed (like committees setting prices!), and that the financial landscape is littered with the wreckage of those whose scorn for the market's judgment was too extreme.

Those who say maximizing shareholder value is something like "the worst idea ever" are essentially saying markets are wildly inefficient — disastrously and obviously so — at setting prices. Now, one is free to believe this extreme hypothesis. One can believe that markets are horrifically bad no matter how much I, and the legion of evidence, may disagree. One is free to cite the handful of exceptions that actually prove the rule here (exceptional managers and exceptional times for markets) and believe market prices consistently have no toehold on reality. But one must acknowledge that the trendy denunciation of "maximize shareholder value" is exactly this self-same extreme radical denunciation of markets themselves. If you believe maximize shareholder value is the "worst idea ever" you aren't simply cynical about how well markets function. No, you go much further. You directly claim they are utter disasters and that you have a better way. Good luck with that. Of course, you could temper your view, perhaps rephrase as "maximizing shareholder value is a pretty good though imperfect idea and here are a few suggestions for improvement," but those articles are way less exciting...

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[1] He cribs this title from Jack Welch on the same topic, a person whom I disagree with rarely and, if absolutely necessary, with great trepidation. Though in this case I don't think I'm disagreeing with Jack head-on as I believe he was mostly reminding us that truly maximizing shareholder value means thinking long-term, a point actually very close to mine.

[2] One exception being an excellent recent piece by Holman Jenkins, also of The Wall Street Journal, with surprisingly little overlap to this essay, perhaps showing how many different ways there are to defend this idea!

[3] This is fair if seen as part of the debate about market efficiency, the only debate we should be having, but turns to unfair if "perfection" is the standard as this is an impossible straw man. Moreover, the accusation of being "short-term" is totally misguided when the attackers simply do not realize how "long-term" today's price can and should be in a well-functioning market.

[4] These ideas were developed by people like Jensen, Meckling and Friedman, names that are often invoked by the critics as if they were one rider short of the equine harbingers of the Apocalypse.

[5] If you want management to maximize shareholder value, logically you should reward the team based on the difference between the current stock price and what the stock price would be without their efforts (stealing a concept from baseball quants, shareholder value above replacement management). While that is unobservable, the current stock price is probably a useful input in assessing that, as is the performance of the stock relative to an industry benchmark. But a board of directors has access to a lot of nonpublic information about management skill that is also relevant. Also, measuring contribution is only one part of the compensation decision, the other major part is what the management team is worth on the open market and what it would cost to replace them. So, even in a world where market prices were very accurate, pure stock-based compensation is probably not a great idea, but neither is ignoring the stock price in setting compensation.

[6] See the earlier discussion of market efficiency. Also, as an aside, management compensation of this sort typically comes with lock ups, short-term trading restrictions, sometimes clawbacks and often prices averaged over intervals. Moreover, the grants are revisited annually. So even if raw stock prices have short-term noise, management compensation is based on at least a somewhat longer-term version. And critics who think such compensation is still too short-term can argue for longer option and vesting terms and longer lock ups, rather than for throwing out the whole shareholder-value concept.

[7] In addition, accounting rules may make options, and how the "strike" price of options is adjusted for corporate actions, cause some actions (e.g., buybacks) to be favored over others (e.g., dividends). If this is the case, and they think it is important, critics would do better to focus on the accounting rules and the specific terms of the options awards than the basic idea of maximizing shareholder value.

[8] To take the opposite side for the moment, proponents of one-sided options based compensation point out that undiversified managers have natural incentives to fear downsides more than diversified shareholders do, and options might offset this to align interests better. A risky new business initiative might have positive risk-adjusted present value for shareholders, but management may avoid it because failure could cost them their jobs and reputations, while success would bring only a small increase to their incomes.

[9] To the extent the "expectations game" is an attempt to manipulate expectations before-the-fact, then some reforms may be helpful. But, again, this would be for the purpose of better maximizing shareholder value, not for discarding the concept.

[10] Of course, one might believe some markets are more efficient than others. For instance, if you believe private and venture markets are less efficient than public markets, then attempting to maximize what the firm could be sold for now will yield a worse result in these markets than when this principle is applied elsewhere. This is, in fact, a subset of my point, that your belief in maximizing shareholder value must be consistent with your belief in the efficiency/accuracy of market prices.