Members’ Independent Voice

Dissecting the ‘Dumbest Idea in the World’

A review of *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public* by Lynn Stout

The CFA Institute’s mission is “To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society[1].” Those last six words should lead us to ask what useful role investment professionals fulfil in society and how we can rebuild public confidence in finance.

Lynn Stout’s recent book is as good a place to start as any. For as long as most of us can remember, shareholder wealth maximization has been the guiding principle in corporate governance and finance. In her brief (115 pages) and highly readable tour de force Stout delivers a comprehensive rejection of this principle.

Shareholder primacy has not always been received wisdom. Stout cites a 1932 dispute, conducted on the pages of the Harvard Law Review, between Adolf Berle (co-author of The Modern Corporation and Private Property) and Merrick Dodd. By 1954 Berle had conceded that Dodd’s argument that the corporation “…has a social service as well as a profit-making function[2]” had won the day. The shareholder primacy principle only made a come-back in the late 1970s, when established economic views were being revised and neoliberal ideology was on the rise.

Yet shareholder value is hardly enshrined in law. Stout, a Princeton University law professor, describes the case of the United States, where nothing in Federal or state law obliges boards to maximize shareholder wealth to the exclusion of all other goals. Even in the UK, where the law is more shareholder friendly, their interests are not placed above all others.

Nor are shareholders sole residual risk bearers. All stakeholders are subject to outcomes that depend on firm performance, and many, especially employees, make deep commitments that are not easily transferred – whereas equity positions may be reversed in a matter of seconds, or less.

But surely, investment managers as fiduciaries must favour a principle that puts shareholders’ interests first and foremost? Well, not necessarily. Of course those managing other people’s money must guard client interests over and above their own, but the ideology of shareholder value is not a logical conclusion. Ultimate clients of money managers, such as members of a pension fund, are often affected by corporate decisions in numerous ways. They are employees and live in communities; their quality of life is affected by factors such as employment rights, tax revenues and the natural environment. An exclusive focus on shareholder returns to the detriment of other concerns will likely harm such clients more than it will benefit them.

And shareholders are not a homogenous group with identical interests. There are major differences amongst shareholders. Whilst well diversified ‘universal owners’ with long-term interests have a stake in the overall health of the economy, hedge fund managers, for instance, with highly concentrated holdings, focus on immediate returns for specific positions. The latter are more strongly motivated to wield influence in their short-term financial interest – the rest of us should beware of the ‘activist’ investor.

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Stout also applies the concept of ‘team production theory’, the idea that if shareholders agree to restrict their ability to maximize their gains at everyone else’s expense, other ‘team’ members such as employees, creditors and the community at large may deepen their commitments. A narrow focus on short-term gain is counterproductive.

Moreover, Stout counters Friedman’s argument that profit maximization is the only legitimate social goal of a firm. Shareholder value is founded on the notion of homo economicus, an individual who is rational, purely self-interested and profit-maximizing. As Stout points out ‘… a purely rational and purely selfish person is a functional psychopath[3].’ The vast majority of us are not psychopaths, so why conduct policy based on an obsolete theory that assumes we are?

We also need to keep in mind how rarely shareholders actually do affect decision making. Voting rights are largely restricted to a limited range of decisions, at occasional intervals. Shareholders usually cannot even call Extraordinary General Meetings. Add the poor motivation of diversified institutions to be active owners, and we must surely doubt if shareholder sovereignty can work at all. In reality corporate managers and a handful of financiers control the levers of power, often in their own interests. During the decades of the ascendancy of shareholder value the ratio of CEO earnings to average employee earnings has soared and is now often of the order of several hundred. An apt analogy might be the Marxist concept of the ‘dictatorship of the proletariat’, which in practice led, in the words of the historian Asa Briggs, merely to the dictatorship of the dictator. Little wonder, then, that Jack Welch has called shareholder value the ‘dumbest idea in the world.’

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[1] http://www.cfainstitute.org/about/vision/Pages/index.aspx

[2] p.17

[3] p. 96