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Lift the curse of shareholder value

By Edward Hadas
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"Shareholder value maximisation" belongs in the trash heap of economic history. The fact that it is still popular needs some explanation.

What's wrong with the idea that companies should be run exclusively to maximise the short-term gains of equity investors? Pretty much everything, as work by academics such as Hugh Willmott, Jeroen Veldman, Lynn Stout, Paddy Ireland and John Kay shows.

First, shareholders don't deserve special treatment. They are just one contributor to corporate success – and this contribution becomes less important over time.

Second, the idea that they own companies is an oversimplification. Boards are actually supposed to promote the firm's overall good over the long haul.

Third, they are poorly placed to steer the company's future. Most are legally barred from acquiring the inside information needed for informed decisions.

Fourth, this single-minded focus produces awful results. Not just scandals and collapses like Enron or Lehman Brothers, but smaller disgraces like factories closed at a moment's notice, or R&D programmes shuttered so buybacks and dividends can be maintained.

Some high priests of shareholder value, like former General Electric boss Jack Welch, have recanted. And the ethos never took hold as firmly in, say, Germany, as it did in Anglo-Saxon boardrooms. But the idea has remained remarkably resilient. Why?

There's an easy, cynical answer. Exorbitantly paid investors and executives do not see enough of the real world to care much about how their pursuit of shareholder value could affect it. Pay awards tied to shareholder returns serve as an incentive not to think critically.

But the idea could not have got so far and stayed powerful for so long if it didn't seem plausible to many people.

One mistake is to assume economic actors always act to "maximise" something – for companies, profits. In fact, life is much more complicated. John Kay is onto something when he says that companies actually have to optimise, or try to get the most of many different goods.

However, I think the fundamental issue is even deeper: an excessively financial, numerical view of economic purpose. This is what I call the "ultimate money illusion": treating money as worthy of veneration.

Of course, money, finance and profits are all crucial tools in the modern economy. Companies work in the cash economy and investors will always measure their returns. However, companies, especially large ones, are not simple profit-machines. They are multifaceted human endeavours, like the family, church, school, army or nation.

The corporate goal is to be good at all of the many things that companies do. The list is long. They should offer quality and value to customers, a good deal to suppliers and workers, care for the environment, loyalty to many different communities, fair returns for investors, respect for the past and a commitment to the future. They should be honourable and imaginative, reliable and humane.

Some of these things can be priced more or less accurately in monetary terms, but for most of them it is foolish to try. An estimated dollar value of virtue or loyalty will inevitably add more confusion than insight. And the reliance on any simply monetary definition of corporate success, no matter how complex the maths behind it, will often degrade behaviour.

For example, a purely financial calculation might conclude that cash payments to shareholders offer a higher "risk-adjusted return" than wage increases or investments in new technology. For an apostle of shareholder value, the argument ends there. But high payouts to shareholders put the company on a path that is likely to stimulate popular hostility and unlikely to lead to long-term success.

It is possible to come up with a different answer by tweaking the calculations. Just put a higher value on profits a few decades hence or raise the expected return on new investments. But the use of numbers just confuses the analysis. It is better to move beyond the dollar values and pay more careful attention to some necessarily non-countable factors: the enduring responsibility to workers, the nation and the future.

Corporate communities can be a powerful force for promoting the common good. After all, companies are more flexible than monolithic governments and more professional and powerful than scattered individuals. However, if managers and boards focus too much on getting the numbers right, particularly for the next few quarters, the potential will be squandered.

Shareholder value is a particularly pernicious version of the ultimate money illusion. But it is far from the only one. As long as everything economic is discussed primarily in monetary terms, there can be little respect for some of the finest attributes of the modern economic arrangement, including the flexible, effective and reasonably just modern corporation.

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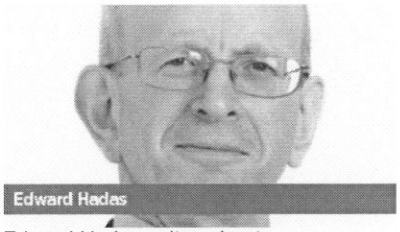

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Edward Hadas writes about macroeconomics, markets and metals for Reuters Breakingviews. Before becoming a journalist, he worked for 20 years as an equity analyst in Europe and the US. His book, "Human Good, Economic Evils: A Moral Approach to the Dismal Science" is published by ISI Books in Wilmington, Delaware. He has also written a course-book about political philosophy for the Maryvale Institute in Birmingham. Edward has degrees from Columbia University, Wadham College, Oxford and the State University of New York at Binghamton. He has a website, edwardhadas.com.
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