II. Stockholders' objectives vs. Bondholders' objectives

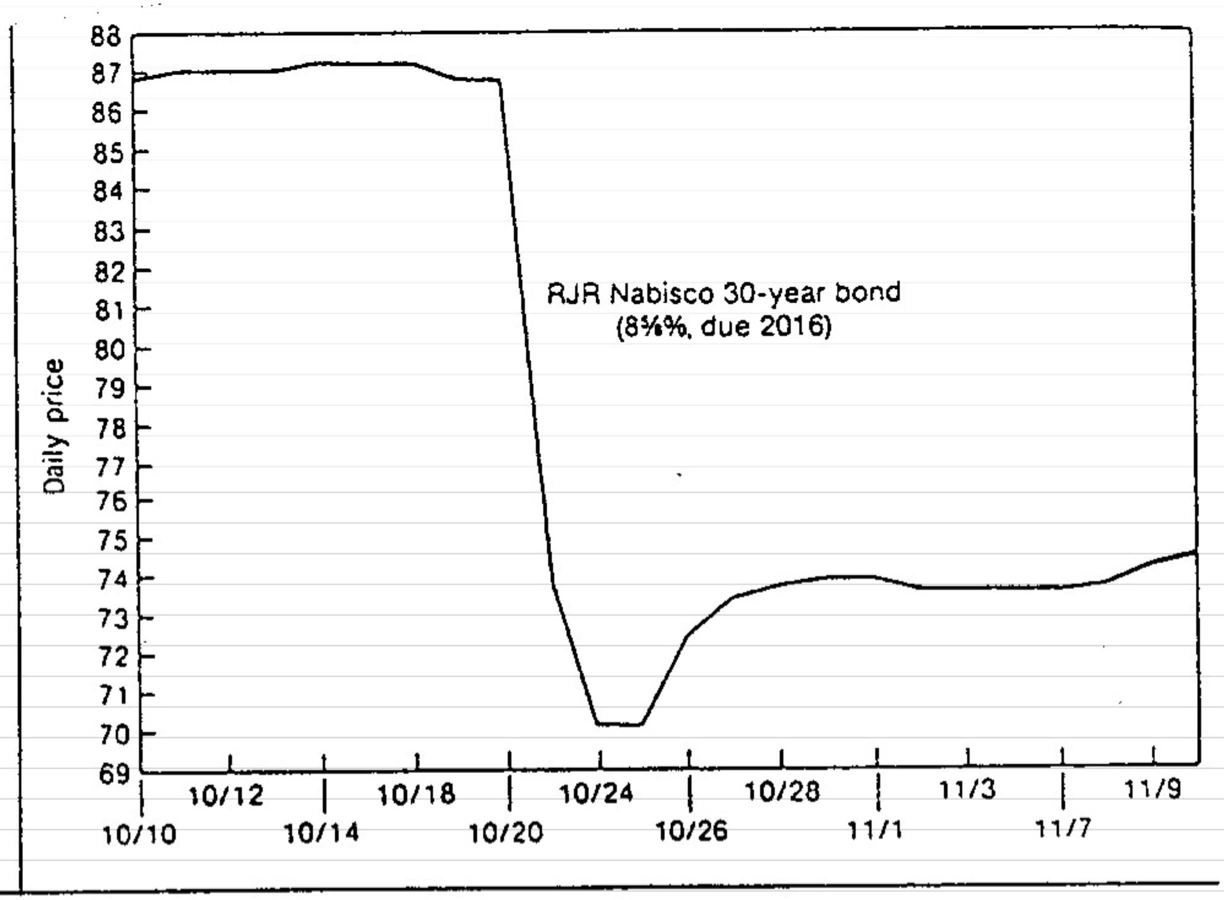
- *In theory*: there is no conflict of interests between stockholders and bondholders.
- *In practice*: Stockholder and bondholders have different objectives. Bondholders are concerned most about safety and ensuring that they get paid their claims. Stockholders are more likely to think about upside potential

Examples of the conflict..

- A dividend/buyback surge: When firms pay cash out as dividends, lenders to the firm are hurt and stockholders may be helped. This is because the firm becomes riskier without the cash.
- Risk shifting: When a firm takes riskier projects than those agreed to at the outset, lenders are hurt. Lenders base interest rates on their perceptions of how risky a firm's investments are. If stockholders then take on riskier investments, lenders will be hurt.
- Borrowing more on the same assets: If lenders do not protect themselves, a firm can borrow more money and make all existing lenders worse off.

An Extreme Example: Unprotected Lenders?

RJR Nabisco's Bonds Sink Following Announcement of the Leveraged Buyout



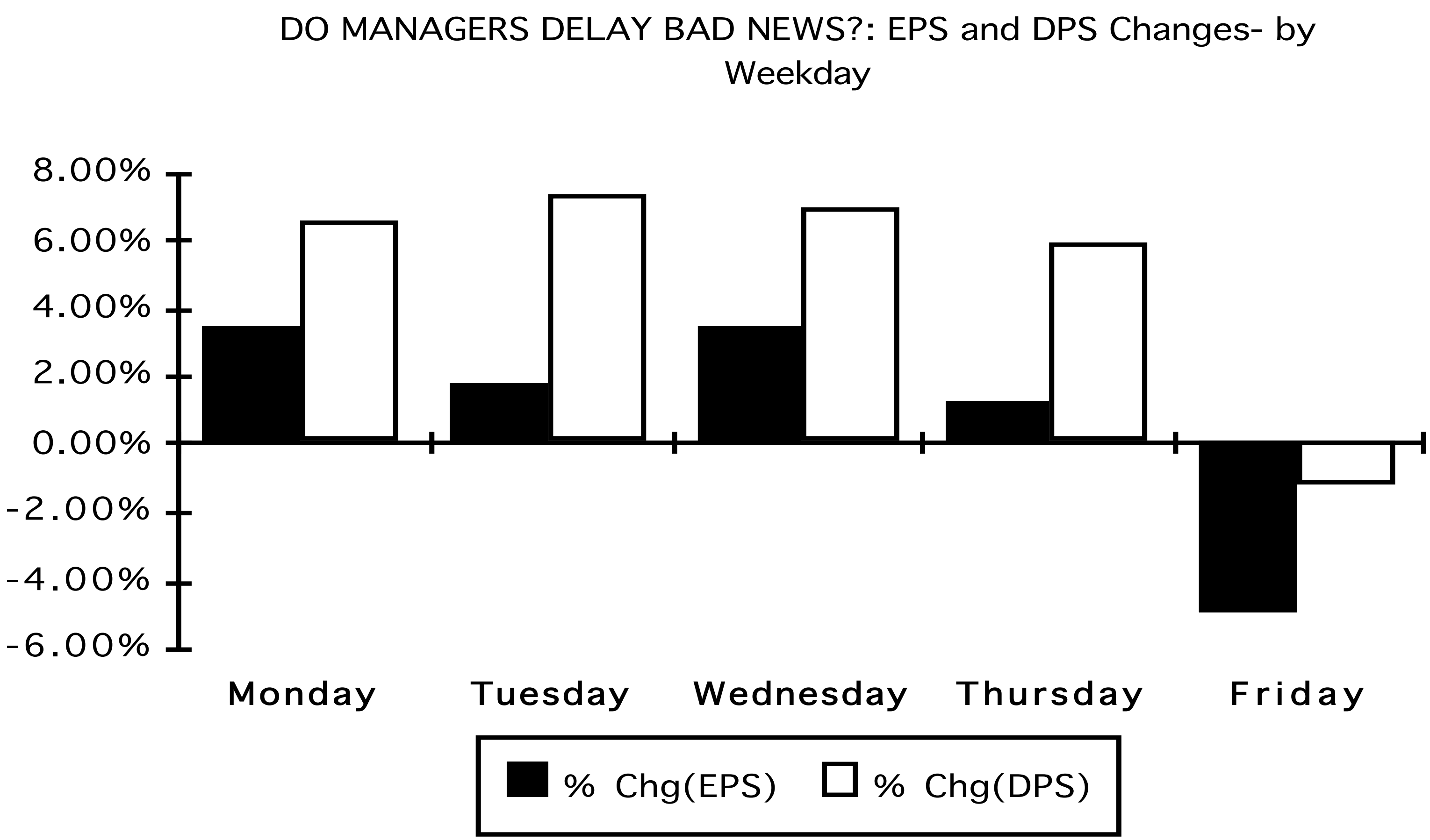
III. Firms and Financial Markets

- <u>In theory</u>: Financial markets are efficient. Managers convey information honestly and and in a timely manner to financial markets, and financial markets make reasoned judgments of the effects of this information on 'true value'. As a consequence-
  - A company that invests in good long-term projects will be rewarded.
  - Short term accounting gimmicks will not lead to increases in market value.
  - Stock price performance is a good measure of company performance.
- <u>In practice</u>: There are some holes in the 'Efficient Markets' assumption.

Managers control the release of information to the general public

- Information management (timing and spin): Information (especially negative) is sometimes suppressed or delayed by managers seeking a better time to release it. When the information is released, firms find ways to "spin" or "frame" it to put themselves in the best possible light.
- Outright fraud: In some cases, firms release intentionally misleading information about their current conditions and future prospects to financial markets.

Evidence that managers delay bad news?



Some critiques of market efficiency..

- Investor irrationality: The base argument is that investors are irrational, and prices often move for no reason at all. As a consequence, prices are much more volatile than justified by the underlying fundamentals. Earnings and dividends are much less volatile than stock prices.
- Manifestations of irrationality
  - Reaction to news: Some believe that investors overreact to news, both good and bad. Others believe that investors sometimes under react to big news stories.
  - An insider conspiracy: Financial markets are manipulated by insiders; Prices do not have any relationship to value.
  - Short termism: Investors are short-sighted, and do not consider the long-term implications of actions taken by the firm

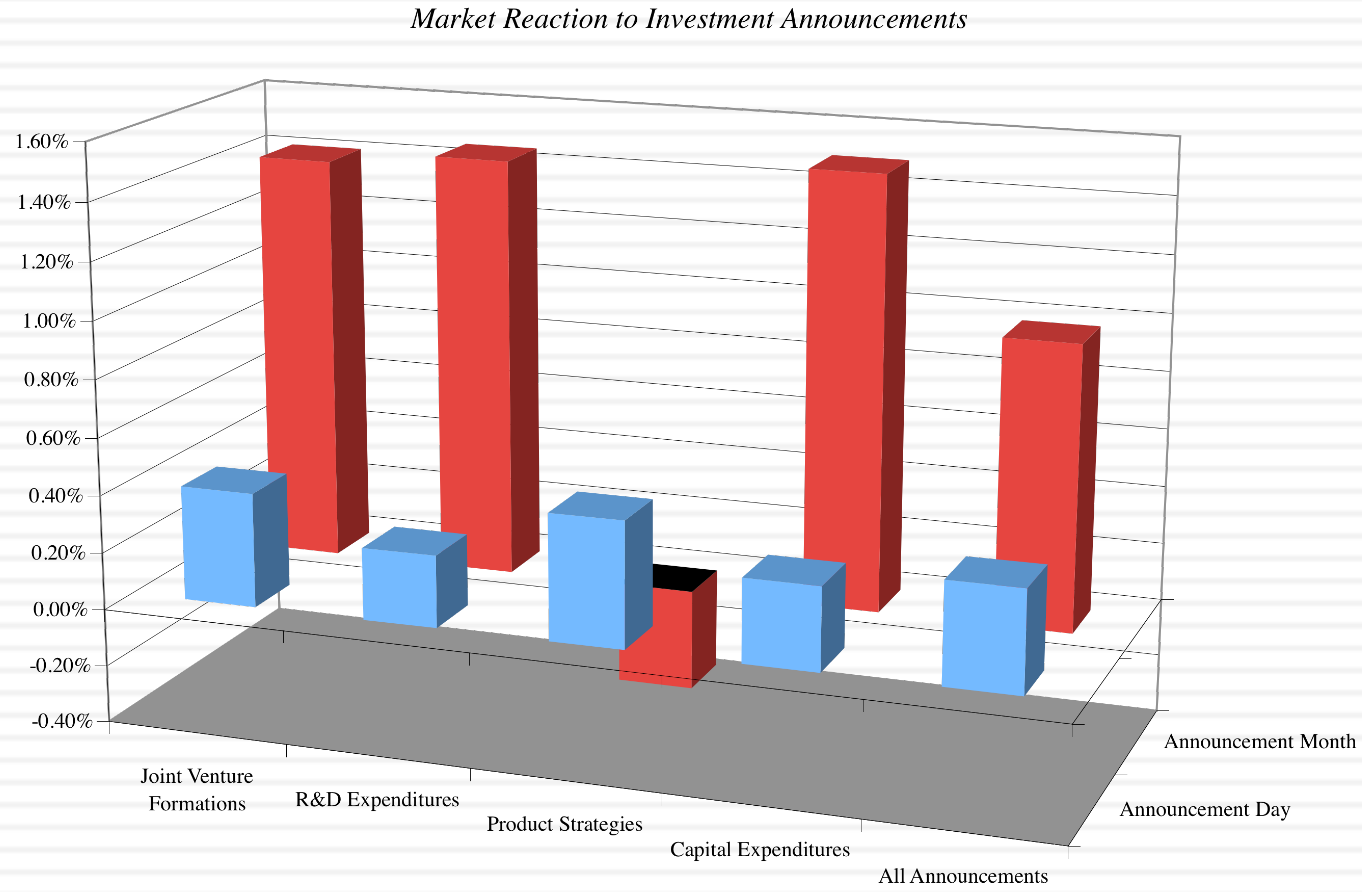
Are markets short sighted and too focused on the near term? What do you think?

- Focusing on market prices will lead companies towards short term decisions at the expense of long-term value.
  a. I agree with the statement
  b. I do not agree with this statement
- Allowing managers to make decisions without having to worry about the effect on market prices will lead to better long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement
- Neither managers nor markets are trustworthy. Regulations/laws should be written that force firms to make long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement

Are markets short term? Some counter (albeit not conclusive) evidence that they are not..

- Value of young firms: There are hundreds of start-up and small firms, with no earnings expected in the near future, that raise money on financial markets. Why would a myopic market that cares only about short term earnings attach high prices to these firms?
- Current earnings vs Future growth: If the evidence suggests anything, it is that markets do not value current earnings and cashflows enough and value future earnings and cashflows too much. After all, studies suggest that low PE stocks are under priced relative to high PE stocks
- Market reaction to investments: The market response to research and development and investment expenditures is generally positive.

If markets are so short term, why do they react to big investments (that potentially lower short term earnings) so positively?



But what about market crises?

- Markets are the problem: Many critics of markets point to market bubbles and crises as evidence that markets do not work. For instance, the market turmoil between September and December 2008 is pointed to as backing for the statement that free markets are the source of the problem and not the solution.
- The counter: There are two counter arguments that can be offered:
  - The events of the last quarter of 2008 illustrate that we are more dependent on functioning, liquid markets, with risk taking investors, than ever before in history. As we saw, no government or other entity (bank, Buffett) is big enough to step in and save the day.
  - The firms that caused the market collapse (banks, investment banks) were among the most regulated businesses in the marketplace. If anything, their failures can be traced to their attempts to take advantage of regulatory loopholes (badly designed insurance programs… capital measurements that miss risky assets, especially derivatives)

IV. Firms and Society

- In theory: All costs and benefits associated with a firm's decisions can be traced back to the firm.
- In practice: Financial decisions can create social costs and benefits.
  - A social cost or benefit is a cost or benefit that accrues to society as a whole and not to the firm making the decision.
    - Environmental costs (pollution, health costs, etc..)
    - Quality of Life' costs (traffic, housing, safety, etc.)
  - Examples of social benefits include:
    - creating employment in areas with high unemployment
    - supporting development in inner cities
    - creating access to goods in areas where such access does not exist

Social Costs and Benefits are difficult to quantify because ..

- Cannot know the unknown: They might not be known at the time of the decision. In other words, a firm may think that it is delivering a product that enhances society, at the time it delivers the product but discover afterwards that there are very large costs. (Asbestos was a wonderful product, when it was devised, light and easy to work with… It is only after decades that the health consequences came to light)
- Eyes of the beholder: They are 'person-specific', since different decision makers can look at the same social cost and weight them very differently.
- Decision paralysis: They can be paralyzing if carried to extremes.

A test of your social consciousness: Put your money where you mouth is...

- Assume that you work for Disney and that you have an opportunity to open a store in an inner-city neighborhood. The store is expected to lose about a million dollars a year, but it will create much-needed employment in the area, and may help revitalize it.
- Would you open the store?
  - Yes
  - No
- If yes, would you tell your stockholders and let them vote on the issue?
  - Yes
  - No
- If no, how would you respond to a stockholder query on why you were not living up to your social responsibilities?

So this is what can go wrong...

1. Annual meetings are too tightly scripted & controlled
2. Boards are rubber stamps for CEOs

STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

Businesses create side costs and side benefits to society that cannot be traced back to the firm.

Lend Money

BONDHOLDERS

Managers

SOCIETY

Significant Social Costs

Bondholders can get ripped off

Some costs cannot be traced to firm

Delay bad news or provide misleading information

Markets make mistakes and can overreact

Covenant and lender protections provide only partial defense against shareholder overreach.

Markets are sometimes short term & oftentimes irrational.

FINANCIAL MARKETS

Traditional corporate financial theory breaks down when ...

- Managerial self-interest: The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- Unprotected debt holders: Bondholders (Lenders) are not protected against expropriation by stockholders.
- Inefficient markets: Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- Large social side costs: Significant social costs can be created as a by-product of stock price maximization.

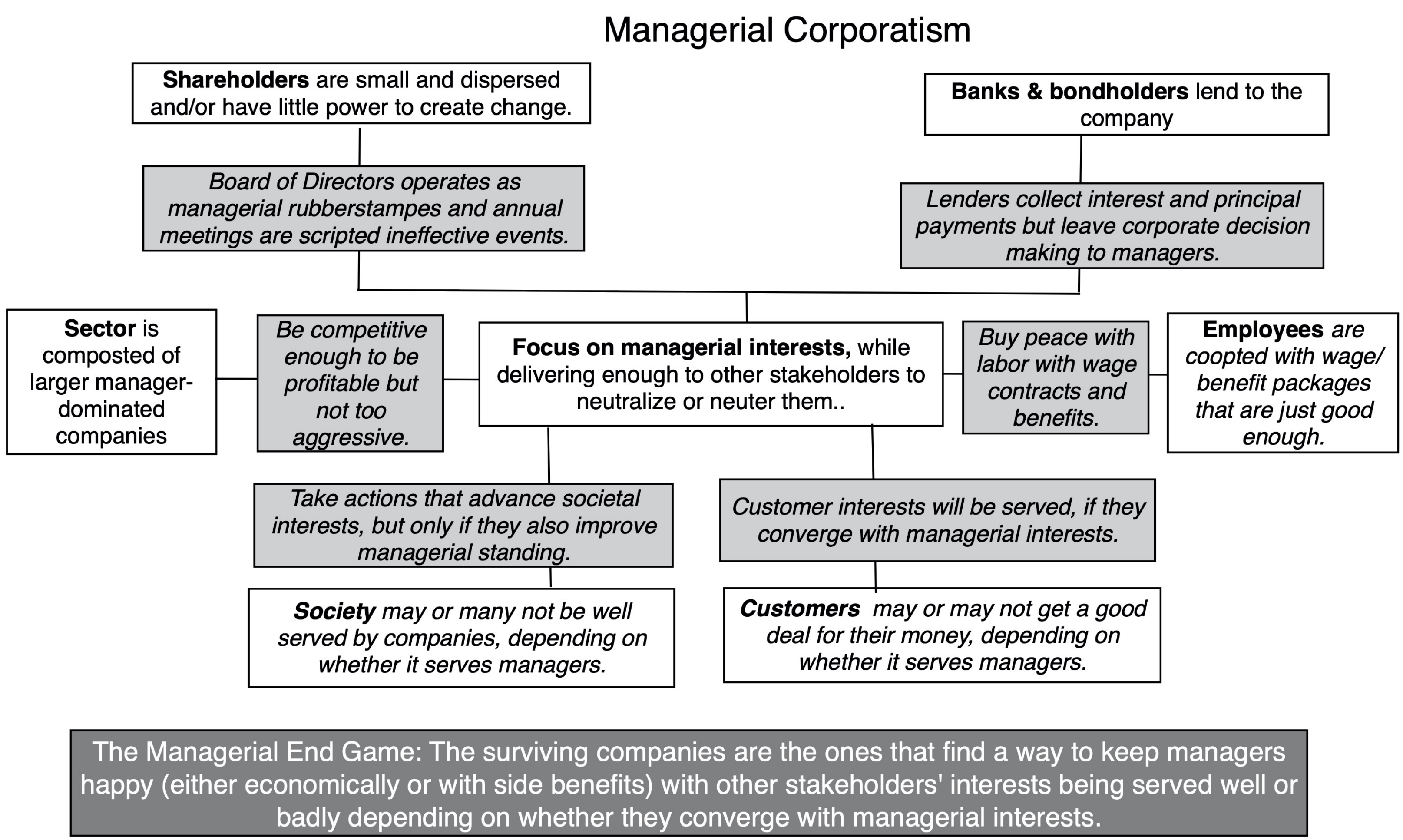
When traditional corporate financial theory breaks down, the solution is:

- A non-stockholder based governance system: To choose a different mechanism for corporate governance, i.e, assign the responsibility for monitoring managers to someone other than stockholders.
- A better objective than maximizing stock prices? To choose a different objective for the firm, either by shifting to a different metric or stakeholder group(s).
- Maximize stock prices but minimize side costs: To maximize stock price, but reduce the potential for conflict and breakdown:
  - Making managers (decision makers) and employees into stockholders
  - Protect lenders from expropriation
  - By providing information honestly and promptly to financial markets
  - Minimize social costs

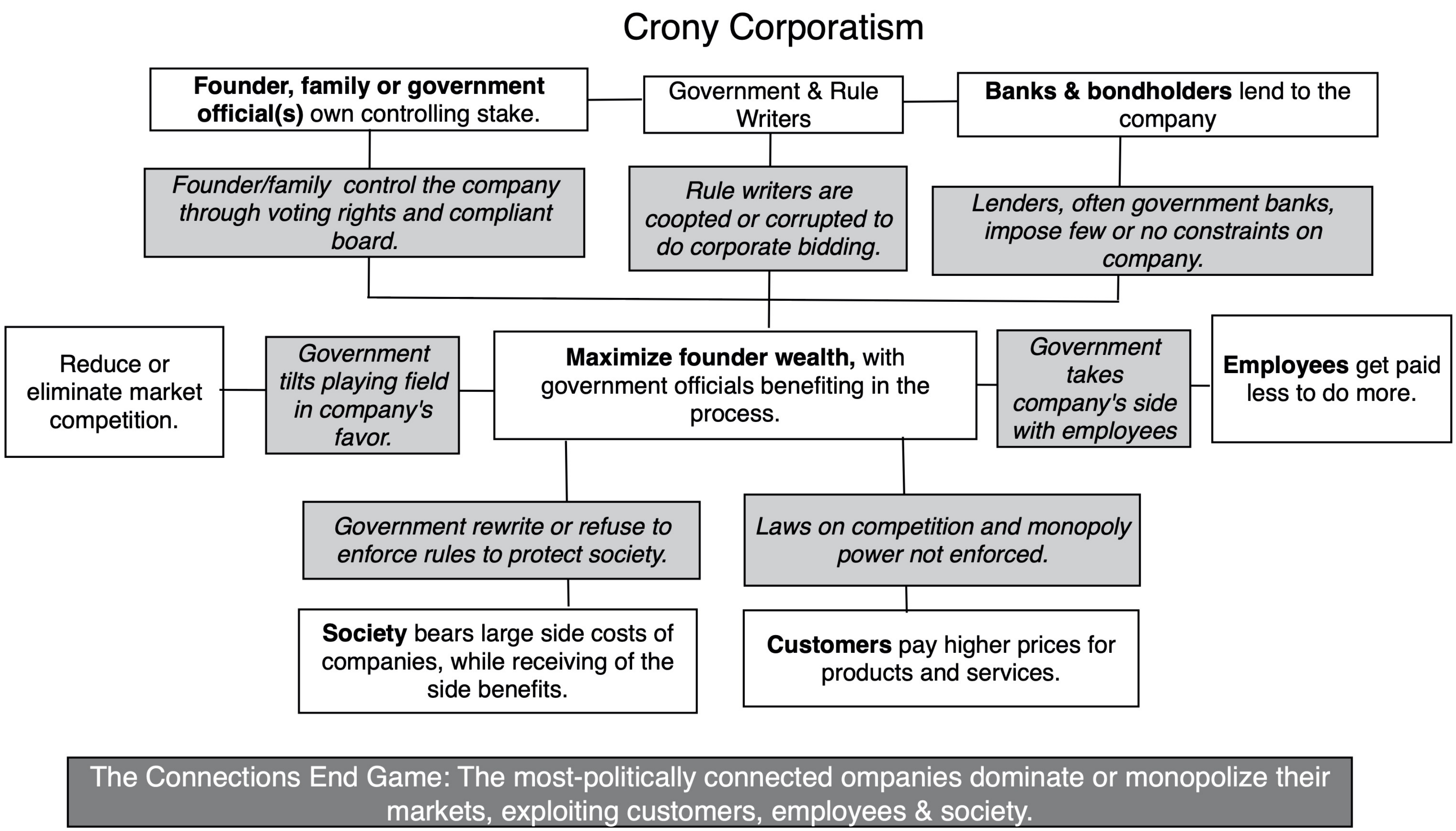
I. An Alternative Corporate Governance System

- Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus
  - Other Asian countries have modeled their system after Japan, with family companies forming the core of the new corporate families
- At their best, the most efficient firms in the group work at bringing the less efficient firms up to par. They provide a corporate welfare system that makes for a more stable corporate structure
- At their worst, the least efficient and poorly run firms in the group pull down the most efficient and best run firms down. The nature of the cross holdings makes its very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.

One End game: Managerial Corporatism



A Skewed Version: Crony Corporatism



IIa. Choose a Different Metric to Maximize

- Firms can always focus on a different objective function. Examples would include
  - maximizing earnings
  - maximizing revenues
  - maximizing firm size
  - maximizing market share
  - maximizing EVA
- The key thing to remember is that these are intermediate objective functions.
  - To the degree that they are correlated with the long-term health and value of the company, they work well.
  - To the degree that they do not, the firm can end up with a disaster

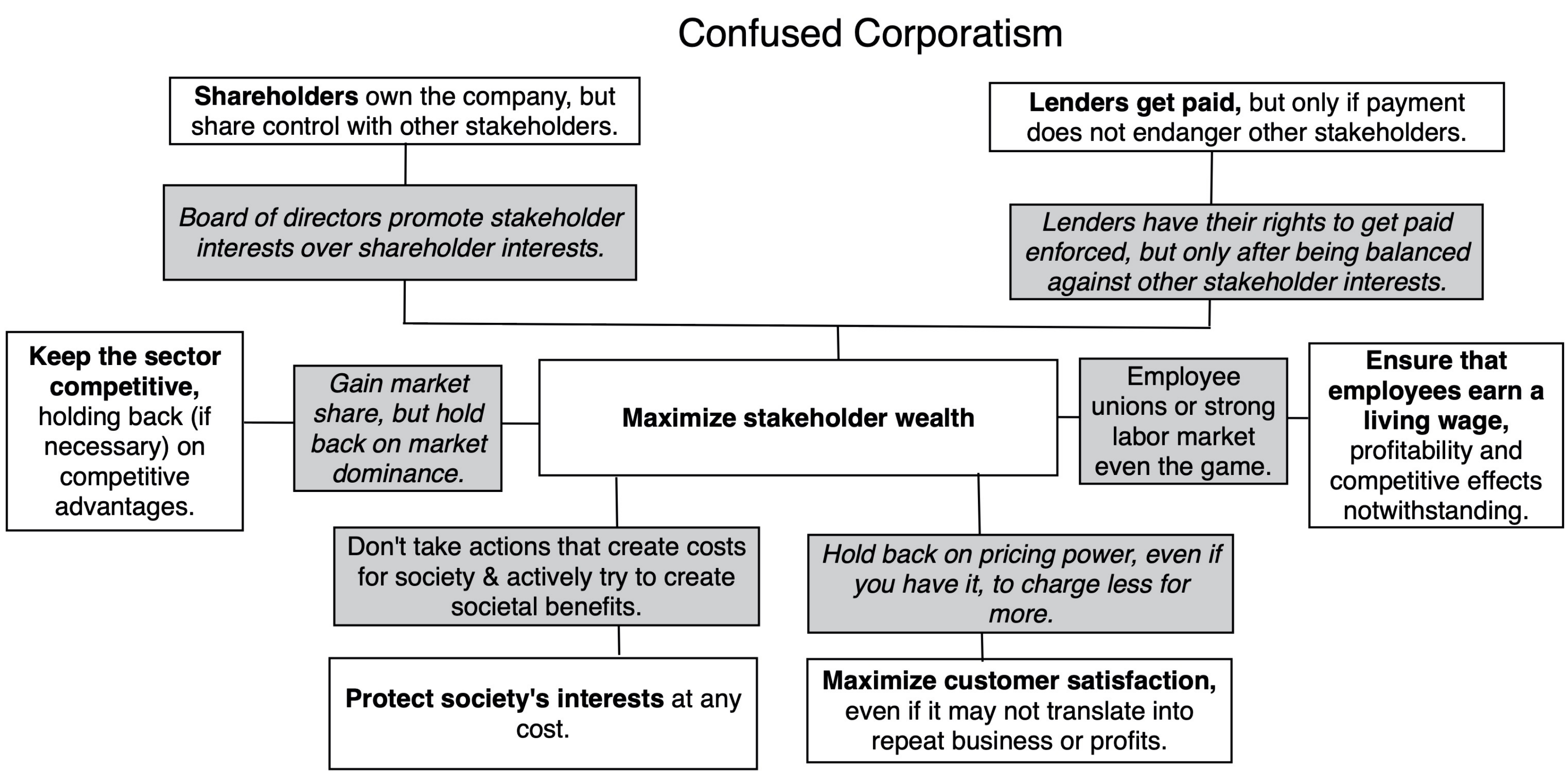
IIb. Maximize stakeholder wealth

- A fairness argument: To the extent that shareholder wealth maximization seems to, at least at first sight, put all other stakeholders in the back seat, it seems unfair.
- An Easy Fix? The logical response seems to be stakeholder wealth maximization, where the collective wealth of all stakeholders is maximized. That is the promise of stakeholder wealth maximization.
- Protective response: As corporations have found themselves losing the battle for public opinions, many CEOs and even some institutional investors seem to have bought into this idea.

The Business Roundtable's Message..

- *While each of our individual companies serves its own corporate purpose, we share a **fundamental commitment to all of our stakeholders**. We commit to:*
  - ***Delivering value to our customers**. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.*
  - ***Investing in our employees**. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.*
  - ***Dealing fairly and ethically with our suppliers.** We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.*
  - ***Supporting the communities in which we work**. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.*
  - ***Generating long-term value for shareholders**, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders*

Confused Corporatism



The Confused End Game: In the attempt to serve all stakeholders, none will be served, and there will be no accountabiity for managers, leading to companies that are less competitive and efficient.

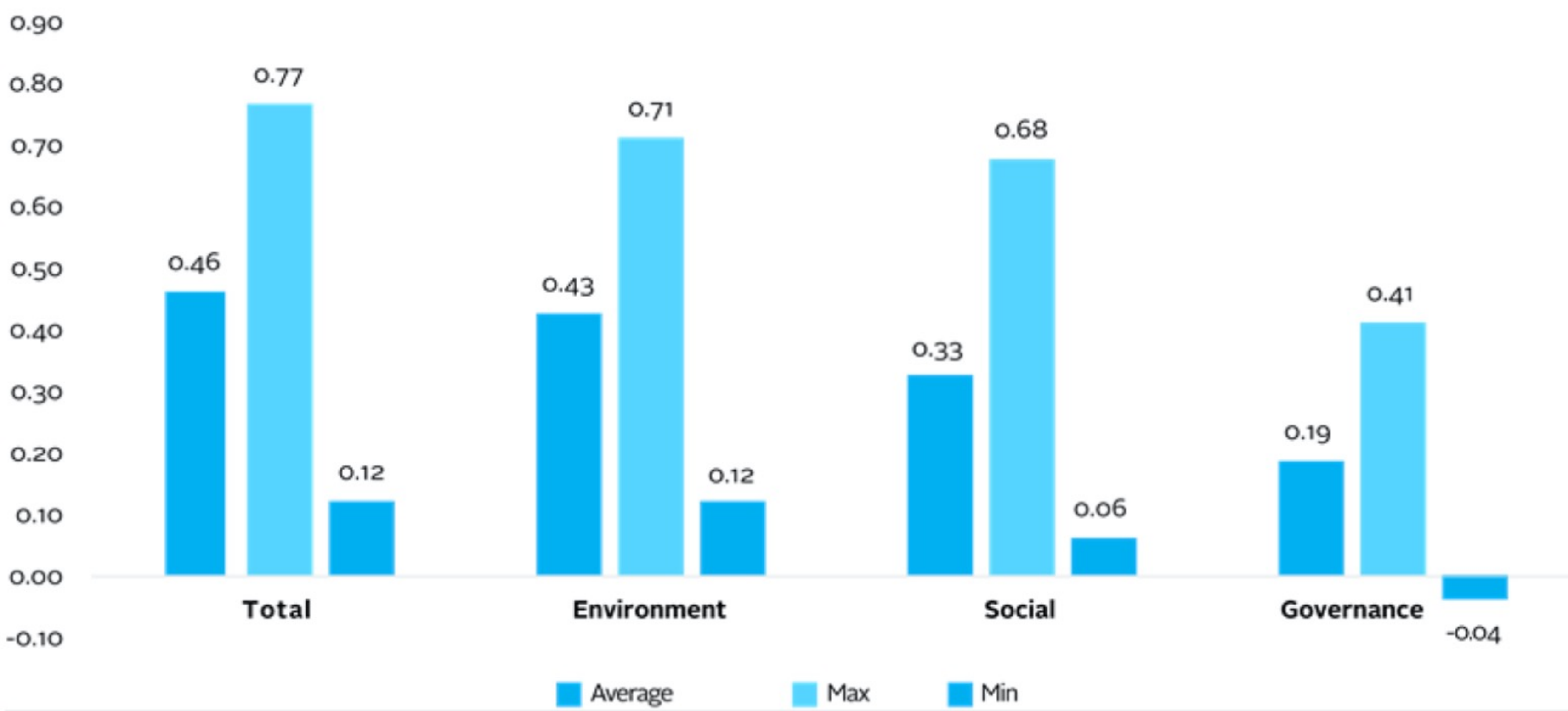
If confused corporatism sounds like a good deal, some cautionary notes..

- Government-owned companies: The managers of these companies were given a laundry list of objectives, resembling in large part the listing of stakeholder objectives, and told to deliver on them all. The end results were some of the most inefficient companies on the face of the earth, with every stakeholder group feeling ill-served in the process.
- US research universities: These entities lack a central focus, where whose interests dominate and why shifts, depending on who you talk to and when. The end result is not just economically inefficient operations, capable of running a deficit no matter how much tuition is collection, but one where every stakeholder group feels aggrieved.

The ESG Promises: Cake for all, with no calories!

- Good for companies: For companies, the promise is that being "good" will generate higher profits for the company, at least in the long term, with lower risk, and thus make them more valuable.
- Good for investors: For investors in these companies, the promise is that investing in "good" companies will generate higher returns than investing in "bad" or middling companies.
- Good for society: For society, the promise is that not only would good companies help fight problems directly related to ESG, like climate change and low wages, but also counter more general problems like income inequality and healthcare crises.

But what comprises goodness? The services disagree..



Average, minimum, and maximum correlations across providers

1. ESG and Value: Where's the beef?

- A Weak Link to Profitability: There is *a small positive link between ESG and profitability*, but one that is very sensitive to how profits are measured and over what period. Breaking down ESG into its component parts, environment (E) offered the strongest positive link to performance and social (S) the weakest, with governance (G) falling in the middle.
- A Stronger Link to Funding Costs: Studies of "sin" stocks, i.e., companies involved in businesses such as producing alcohol, tobacco, and gaming, find that these stocks are less commonly held by institutions and that they face higher costs for funding, from equity and debt). While these companies face higher costs, and have lower value, investors in these companies generate higher returns.
- And to Failure/Disaster Risk: "Bad" companies are exposed to disaster risks, where a combination of missteps by the company, luck, and a failure to build in enough protective controls (because they cost too much) can cause a disaster, either in human or financial terms.

2. ESG and Returns: Mixed findings

- Invest in bad companies: A comparison of two Vanguard Index funds, the Vice fund (invested in tobacco, gambling, and defense companies) and the FTSE Social Index fund (invested in companies screened for good corporate behavior on multiple dimensions) and note that a dollar invested in the former in August 2002 would have been worth almost 20% more by 2015 than a dollar invested in the latter.
- Invest in good companies: There are some studies that find that good companies earn higher returns, but the outperformance is more due to factor and industry tilts than to social responsiveness. Some of the strongest links between returns and ESG come from the governance portion, which, as we noted earlier, is ironic, because the essence of governance, at least as measured in most of these studies, is fealty to shareholder rights, which is at odds with the current ESG framework that pushes for a stakeholder perspective.
- ESG has no effect: Splitting the difference, there are other studies that find little or no differences in returns between good and bad companies. In fact, studies that more broadly look at factors that have driven stock returns for the last few decades find that much of the positive payoff attributed to ESG comes from its correlation with momentum and growth.

3. ESG and Society

- There are some who argue that even if ESG is bad for companies and investors, it is good for society, because companies will treat their customers and employees better, while catering to their local communities.
- There are three fundamental flaws:
  - <u>Greenwashing</u>: ESG allows companies to sound good, while not doing good, and that it will allow for posturing and public relation ploys that do little to advance public good.
  - <u>Outsourcing goodness</u>: It makes the CEOs the arbiters of goodness and badness.
  - <u>Behind the curtain</u>: Pressuring companies to invest in the good and divest themselves or avoid the bad may only push bad behavior to less observable and monitored parts of the economy.