

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:
 - Greenwashing: ESG allows companies to sound good, while not doing good, and that it will allow for posturing and public relation plays that do little to advance public good.
 - Outsourcing goodness: It makes the CEOs the arbiters of goodness and badness.
 - Behind the curtain: 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.

III. Maximize Stock Price, subject to ..

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- The strength of the stock price maximization objective function is its internal self correction mechanism. Excesses on any of the linkages lead, if unregulated, to counter actions which reduce or eliminate these excesses
- In the context of our discussion,
 - ▣ managers taking advantage of stockholders has led to a much more active market for corporate control.
 - ▣ stockholders taking advantage of bondholders has led to bondholders protecting themselves at the time of the issue.
 - ▣ firms revealing incorrect or delayed information to markets has led to markets becoming more “skeptical” and “punitive”
 - ▣ firms creating social costs has led to more regulations, as well as investor and customer backlashes.

The Stockholder Backlash

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- Activist Institutional investors have become much more active in monitoring companies that they invest in and demanding changes in the way in which business is done. They have been joined by private equity firms like KKR and Blackstone.
- Activist individuals like Carl Icahn specialize in taking large positions in companies which they feel need to change their ways (Blockbuster, Time Warner, Motorola & Apple) and push for change.
- Vocal stockholders, armed with more information and new powers: At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors

The Hostile Acquisition Threat

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- The typical target firm in a hostile takeover has
 - ▣ a return on equity almost 5% lower than its peer group
 - ▣ had a stock that has significantly under performed the peer group over the previous 2 years
 - ▣ has managers who hold little or no stock in the firm
- In other words, the best defense against a hostile takeover is to run your firm well and earn good returns for your stockholders
- Conversely, when you do not allow hostile takeovers, this is the firm that you are most likely protecting (and not a well run or well managed firm)

In response, boards are becoming more independent...

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- Boards have become smaller over time. The median size of a board of directors has decreased from 16 to 20 in the 1970s to between 9 and 11 in 1998. The smaller boards are less unwieldy and more effective than the larger boards.
- There are fewer insiders on the board. In contrast to the 6 or more insiders that many boards had in the 1970s, only two directors in most boards in 1998 were insiders.
- Directors are increasingly compensated with stock and options in the company, instead of cash. In 1973, only 4% of directors received compensation in the form of stock or options, whereas 78% did so in 1998.
- More directors are identified and selected by a nominating committee rather than being chosen by the CEO of the firm. In 1998, 75% of boards had nominating committees; the comparable statistic in 1973 was 2%.

Disney: Eisner's rise & fall from grace

- In his early years at Disney, Michael Eisner brought about long-delayed changes in the company and put it on the path to being an entertainment giant that it is today. His success allowed him to consolidate power and the boards that he created were increasingly captive ones (see the 1997 board).
- In 1996, Eisner spearheaded the push to buy ABC and the board rubberstamped his decision, as they had with other major decisions. In the years following, the company ran into problems both on its ABC acquisition and on its other operations and stockholders started to get restive, especially as the stock price halved between 1998 and 2002.
- In 2003, Roy Disney and Stanley Gold resigned from the Disney board, arguing against Eisner's autocratic style.
- In early 2004, Comcast made a hostile bid for Disney and later in the year, 43% of Disney shareholders withheld their votes for Eisner's reelection to the board of directors. Following that vote, the board of directors at Disney voted unanimously to elect George Mitchell as the Chair of the board, replacing Eisner, who vowed to stay on as CEO.

Eisner's concession: Disney's Board in 2003

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<i>Board Members</i>	<i>Occupation</i>
Reveta Bowers	Head of school for the Center for Early Education,
John Bryson	CEO and Chairman of Con Edison
Roy Disney	Head of Disney Animation
Michael Eisner	CEO of Disney
Judith Estrin	CEO of Packet Design (an internet company)
Stanley Gold	CEO of Shamrock Holdings
Robert Iger	Chief Operating Officer, Disney
Monica Lozano	Chief Operation Officer, La Opinion (Spanish newspaper)
George Mitchell	Chairman of law firm (Verner, Liipfert, et al.)
Thomas S. Murphy	Ex-CEO, Capital Cities ABC
Leo O'Donovan	Professor of Theology, Georgetown University
Sidney Poitier	Actor, Writer and Director
Robert A.M. Stern	Senior Partner of Robert A.M. Stern Architects of New York
Andrea L. Van de Kamp	Chairman of Sotheby's West Coast
Raymond L. Watson	Chairman of Irvine Company (a real estate corporation)
Gary L. Wilson	Chairman of the board, Northwest Airlines.

Changes in corporate governance at Disney

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1. Required at least two executive sessions of the board, without the CEO or other members of management present, each year.
2. Created the position of non-management presiding director, and appointed Senator George Mitchell to lead those executive sessions and assist in setting the work agenda of the board.
3. Adopted a new and more rigorous definition of director independence.
4. Required that a substantial majority of the board be comprised of directors meeting the new independence standards.
5. Provided for a reduction in committee size and the rotation of committee and chairmanship assignments among independent directors.
6. Added new provisions for management succession planning and evaluations of both management and board performance
7. Provided for enhanced continuing education and training for board members.

Eisner's exit... and a new age dawns? Disney's board in 2008

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<i>Board Members</i>	<i>Occupation</i>
John E. Pepper, Jr. (Chairman)	Retired Chairman and CEO, Procter & Gamble Co.
Susan E. Arnold	President, Global Business Units, Procter & Gamble Co.
John E. Bryson	Retired Chairman and CEO, Edison International
John S. Chen	Chairman,, CEO & President, Sybase, Inc.
Judith L. Estrin	CEO, J Labs, LLC.
Robert A. Iger	CEO, Disney
Steven P. Jobs	CEO, Apple
Fred Langhammer	Chairman, Global Affairs, The Estee Lauder Companies
Aylwin B. Lewis	President and CEO, Potbelly Sandwich Works
Monica Lozano	Publisher and CEO, La Opinion
Robert W. Matschullat	Retired Vice Chairman and CFO, The Seagram Co.
Orin C. Smith	Retired President and CEO, Starbucks Corporation

But as a CEO's tenure lengthens, does corporate governance suffer?

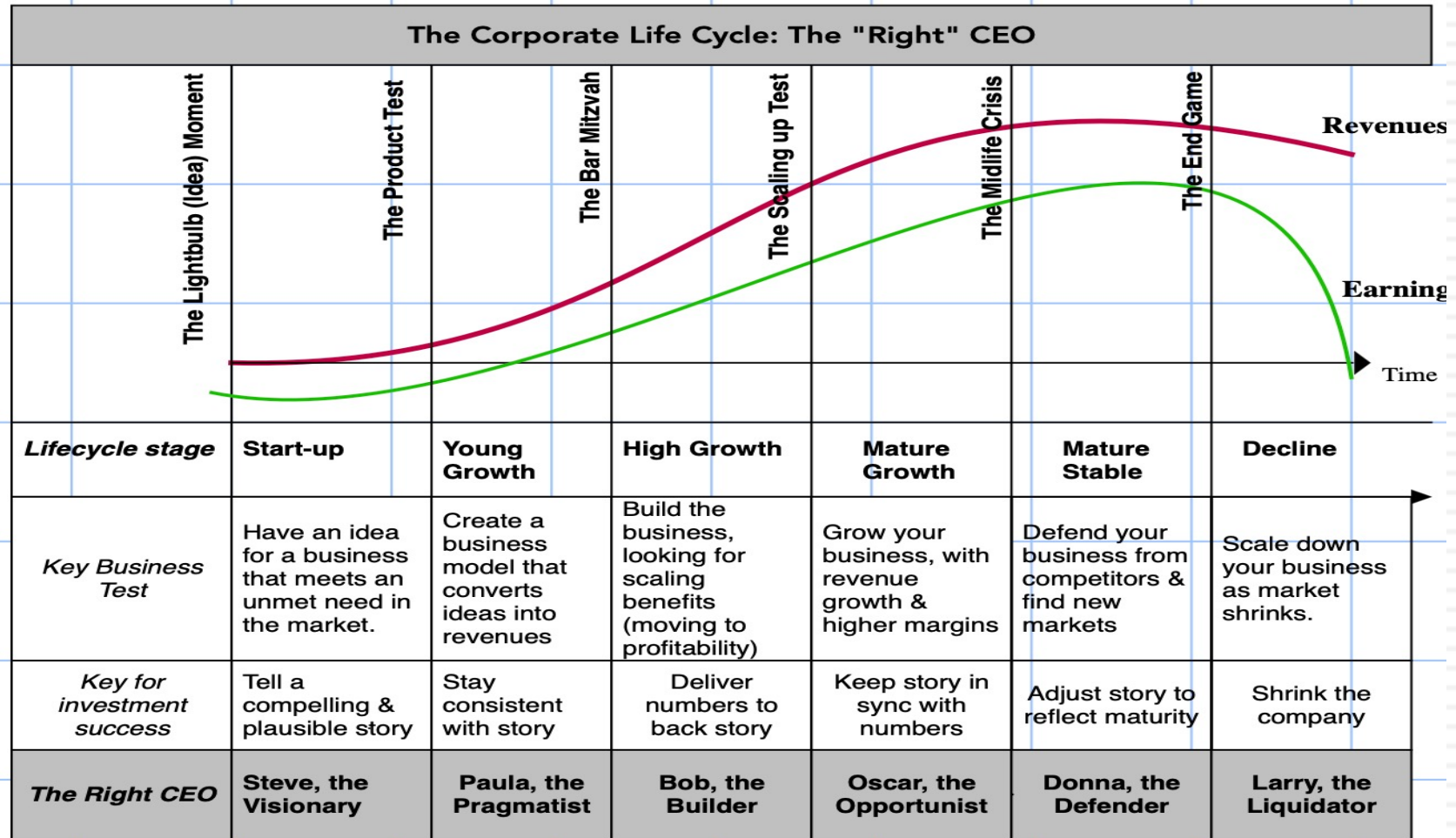
- ❑ In 2011, Iger announced his intent to step down as CEO in 2015 to allow a successor to be groomed.
- ❑ The board voted reinstate Iger as chair of the board in 2011, reversing a decision made to separate the CEO and Chair positions after the Eisner years.
- ❑ There were signs of restiveness among Disney's stockholders, especially those interested in corporate governance. Activist investors (CalSTRS) started making noise and Institutional Shareholder Services (ISS), which gauges corporate governance at companies, raised red flags about compensation and board monitoring at Disney.

Iger's non-exit, the domino effect and a resolution?

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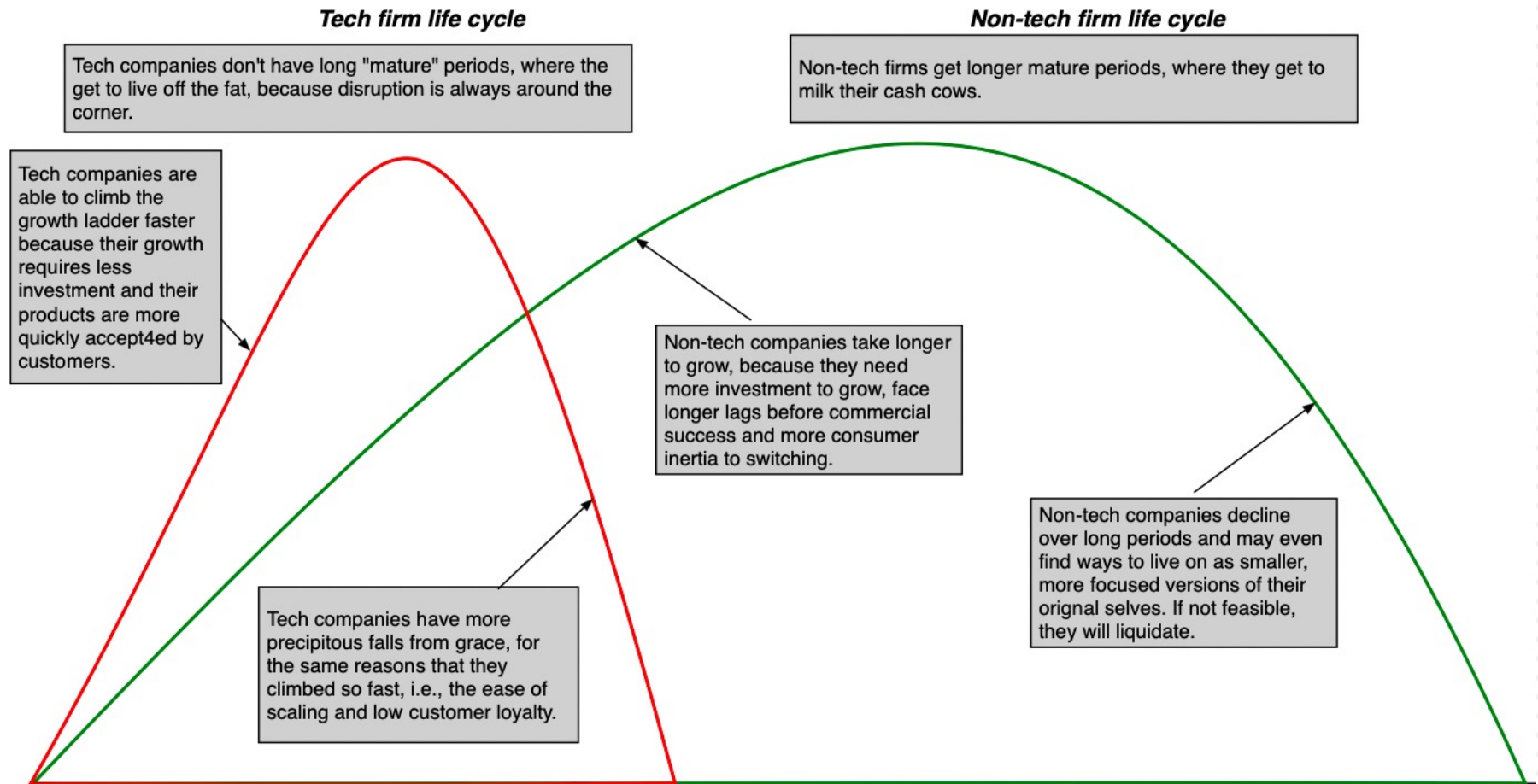
- In 2015 but Disney's board convinced Iger to stay on as CEO for an extra year, for the "the good of the company".
 - In 2016, Thomas Staggs who was considered heir apparent to Iger left Disney. Others who were considered potential CEOs also left.
 - In 2017, Disney acquired Fox and announced that Iger's term would be extended to 2019 (and perhaps beyond) because his stewardship was essential for the merger to work.
- In February 2020, Iger stepped down as CEO (but stayed on as Exec Chair until Dec 2021), and Bob Chapek, head of Disney Theme Parks, took his place. Disney's stock price dropped about 8% in the immediate aftermath.

A Life Cycle View of CEOs



The Compressed Tech Life Cycle

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The Bondholders' Defense Against Stockholder Excesses

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- More restrictive covenants on investment, financing and dividend policy have been incorporated into both private lending agreements and into bond issues, to prevent future “Nabiscos”.
- New types of bonds have been created to explicitly protect bondholders against sudden increases in leverage or other actions that increase lender risk substantially. Two examples of such bonds
 - ▣ Puttable Bonds, where the bondholder can put the bond back to the firm and get face value, if the firm takes actions that hurt bondholders
 - ▣ Ratings Sensitive Notes, where the interest rate on the notes adjusts to that appropriate for the rating of the firm
- More hybrid bonds (with an equity component, usually in the form of a conversion option or warrant) have been used. This allows bondholders to become equity investors, if they feel it is in their best interests to do so.

The Financial Market Response

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- While analysts are more likely still to issue buy rather than sell recommendations, the payoff to uncovering negative news about a firm is large enough that such news is eagerly sought and quickly revealed (at least to a limited group of investors).
- As investor access to information improves, it is becoming much more difficult for firms to control when and how information gets out to markets.
- As option trading has become more common, it has become much easier to trade on bad news. In the process, it is revealed to the rest of the market.
- When firms mislead markets, the punishment is not only quick but it is savage.

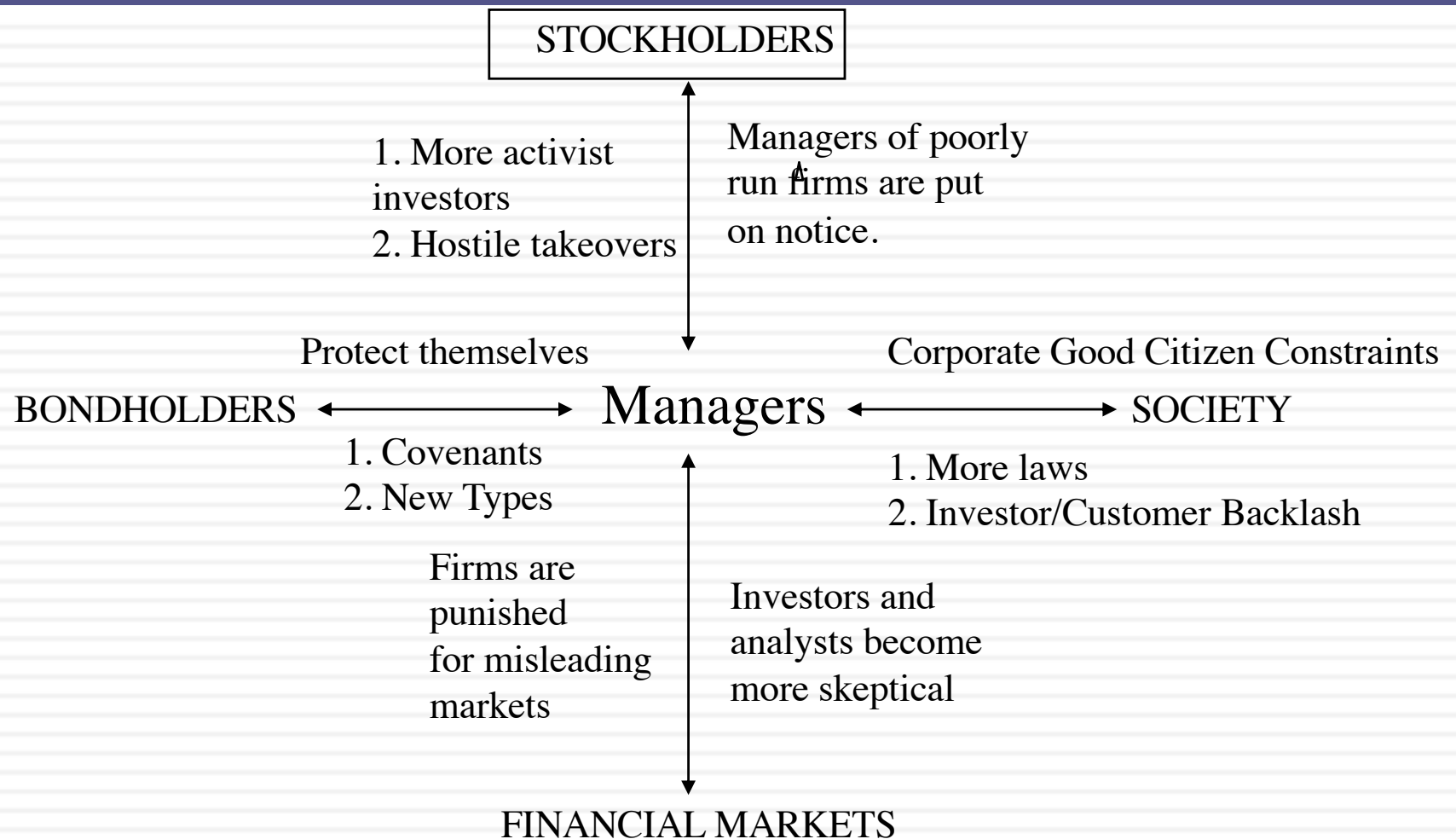
The Societal Response

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- If firms consistently flout societal norms and create large social costs, the governmental response (especially in a democracy) is for laws and regulations to be passed against such behavior.
- For firms catering to a more socially conscious clientele, the failure to meet societal norms (even if it is legal) can lead to loss of business and value.
- Finally, investors may choose not to invest in stocks of firms that they view as socially irresponsible.

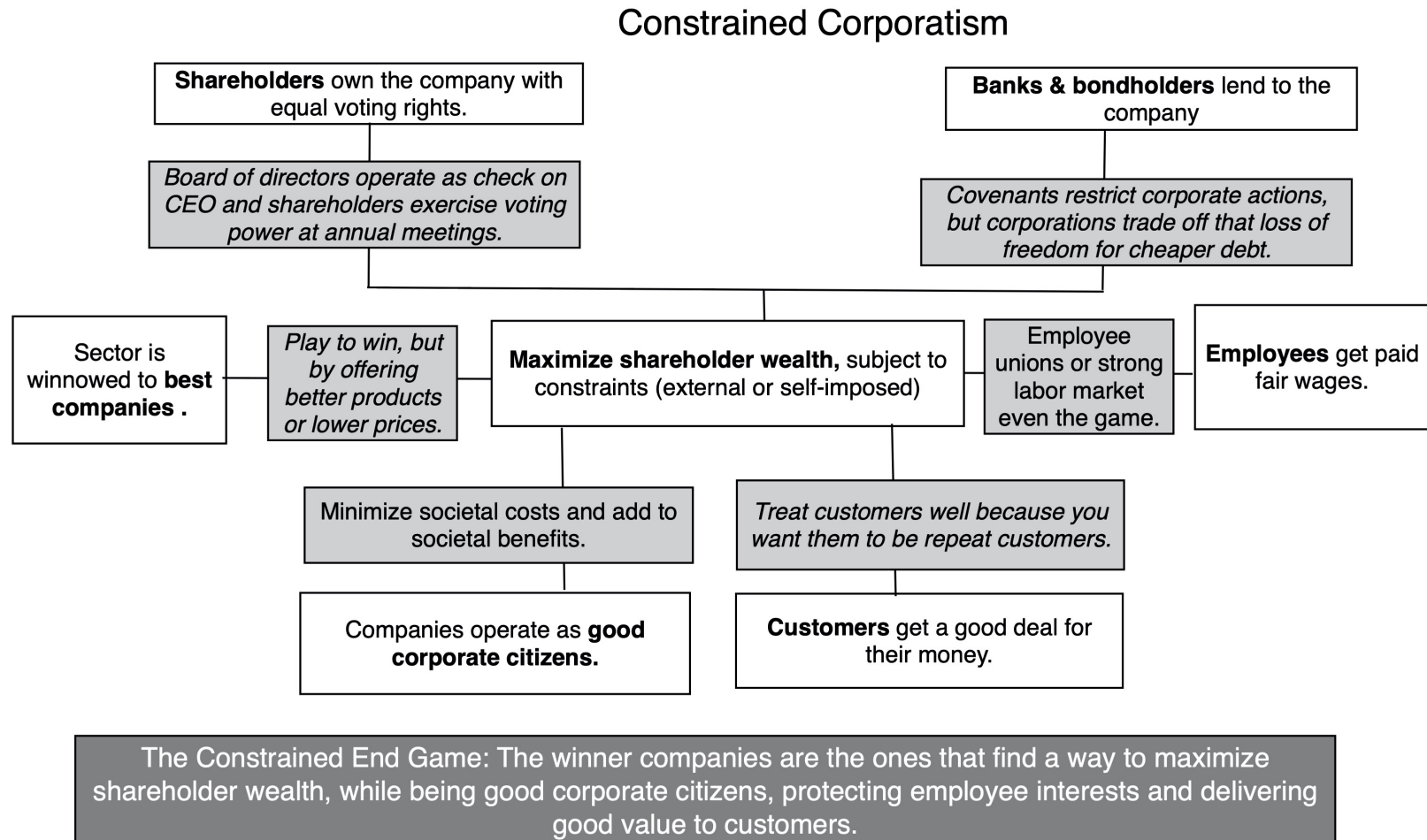
The Self-Correction?

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Constrained Corporatism

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The Modified Objective Function

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- For publicly traded firms in reasonably efficient markets, where bondholders (lenders) are protected:
 - Maximize Stock Price: This will also maximize firm value
- For publicly traded firms in inefficient markets, where bondholders are protected:
 - Maximize stockholder wealth: This will also maximize firm value, but might not maximize the stock price
- For publicly traded firms in inefficient markets, where bondholders are not fully protected
 - Maximize firm value, though stockholder wealth and stock prices may not be maximized at the same point.
- For private firms, maximize stockholder wealth (if lenders are protected) or firm value (if they are not)

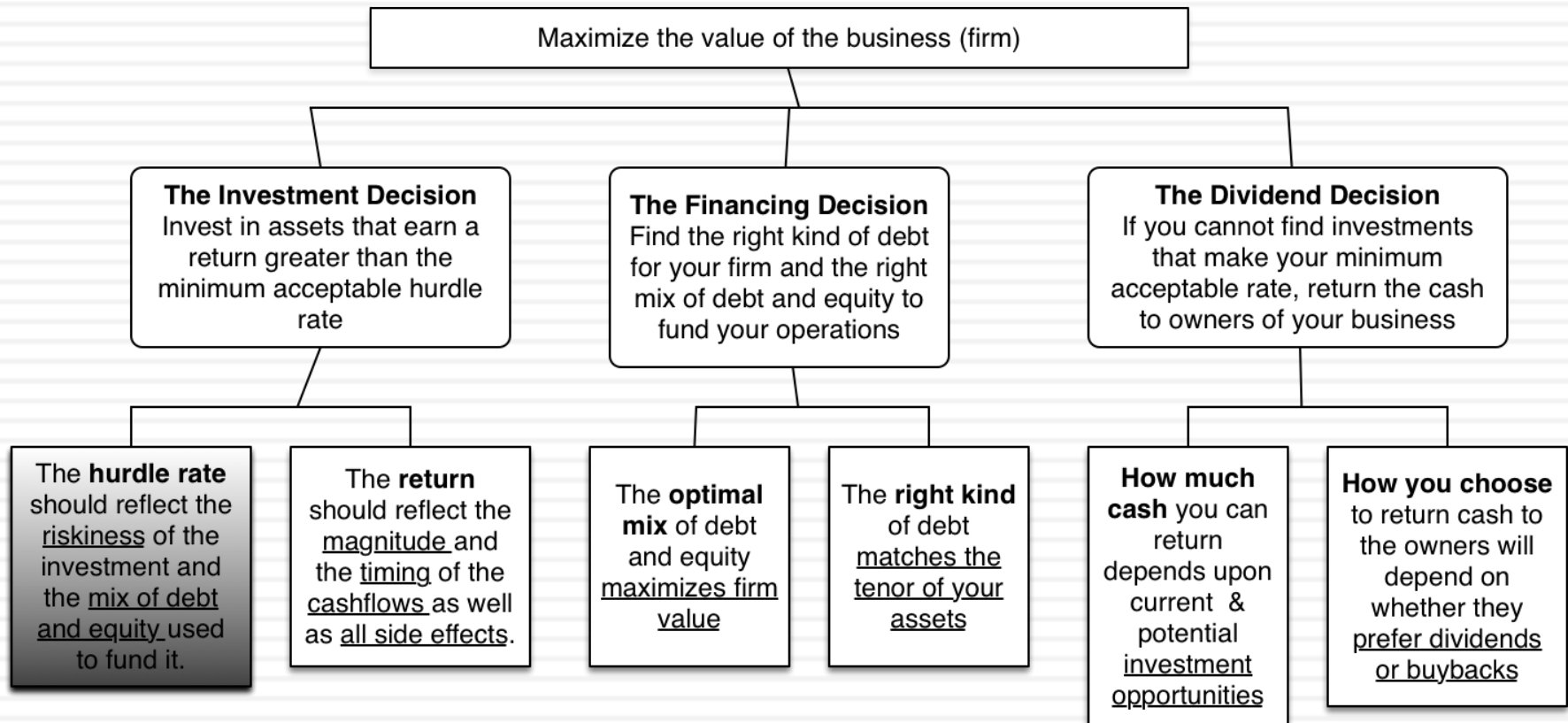


THE INVESTMENT PRINCIPLE: RISK AND RETURN MODELS

“You cannot swing upon a rope that is attached only to your own belt.”

First Principles

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The notion of a benchmark

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- Since financial resources are finite, there is a hurdle that projects have to cross before being deemed acceptable. This hurdle should be higher for riskier projects than for safer projects.
- A simple representation of the hurdle rate is as follows:
Hurdle rate = Riskless Rate + Risk Premium
- The two basic questions that every risk and return model in finance tries to answer are:
 - ▣ How do you measure risk?
 - ▣ How do you translate this risk measure into a risk premium?

What is Risk?

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- Risk, in traditional terms, is viewed as a ‘negative’ . Webster’ s dictionary, for instance, defines risk as “exposing to danger or hazard”. The Chinese symbols for risk, reproduced below, give a much better description of risk

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- The first symbol is the symbol for “danger”, while the second is the symbol for “opportunity”, making risk a mix of danger and opportunity. You cannot have one, without the other.
- Risk is therefore neither good nor bad. It is just a fact of life. The question that businesses have to address is therefore not whether to avoid risk but how best to incorporate it into their decision making.

A good risk and return model should...

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1. It should come up with a measure of risk that applies to all assets and not be asset-specific.
2. It should clearly delineate what types of risk are rewarded and what are not, and provide a rationale for the delineation.
3. It should come up with standardized risk measures, i.e., an investor presented with a risk measure for an individual asset should be able to draw conclusions about whether the asset is above-average or below-average risk.
4. It should translate the measure of risk into a rate of return that the investor should demand as compensation for bearing the risk.
5. It should work well not only at explaining past returns, but also in predicting future expected returns.

The Capital Asset Pricing Model

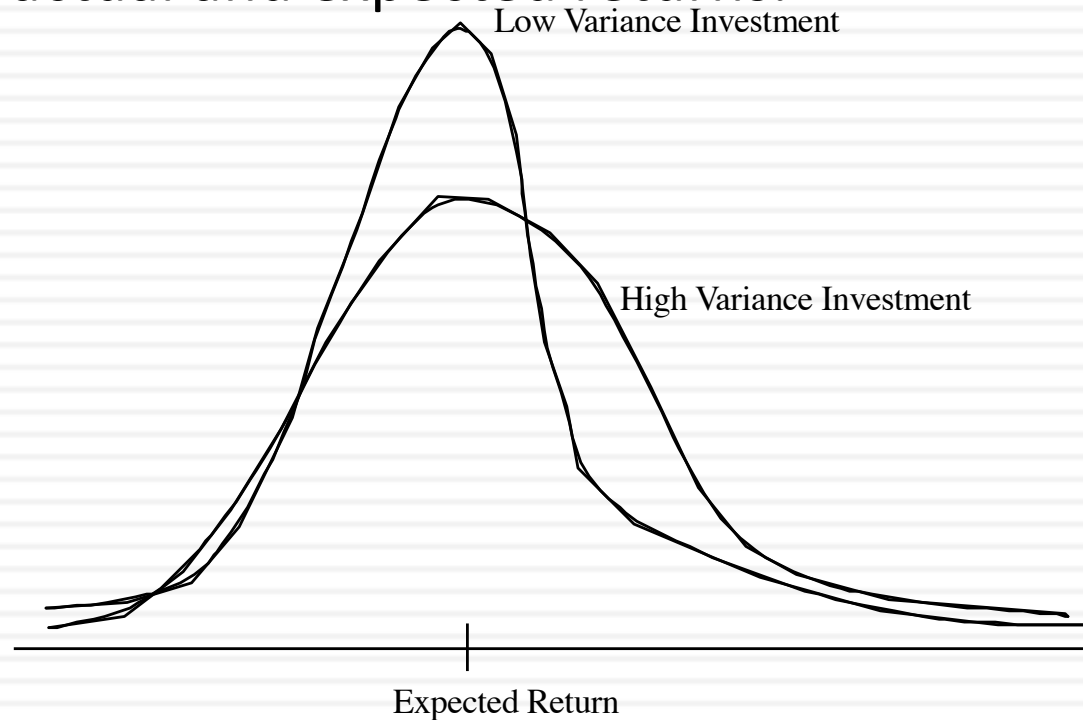
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1. Uses variance of actual returns around an expected return as a measure of risk.
2. Specifies that a portion of variance can be diversified away, and that is only the non-diversifiable portion that is rewarded.
3. Measures the non-diversifiable risk with beta, which is standardized around one.
4. Translates beta into expected return -
$$\text{Expected Return} = \text{Riskfree rate} + \text{Beta} * \text{Risk Premium}$$
5. Works as well as the next best alternative in most cases.

1. The Mean-Variance Framework

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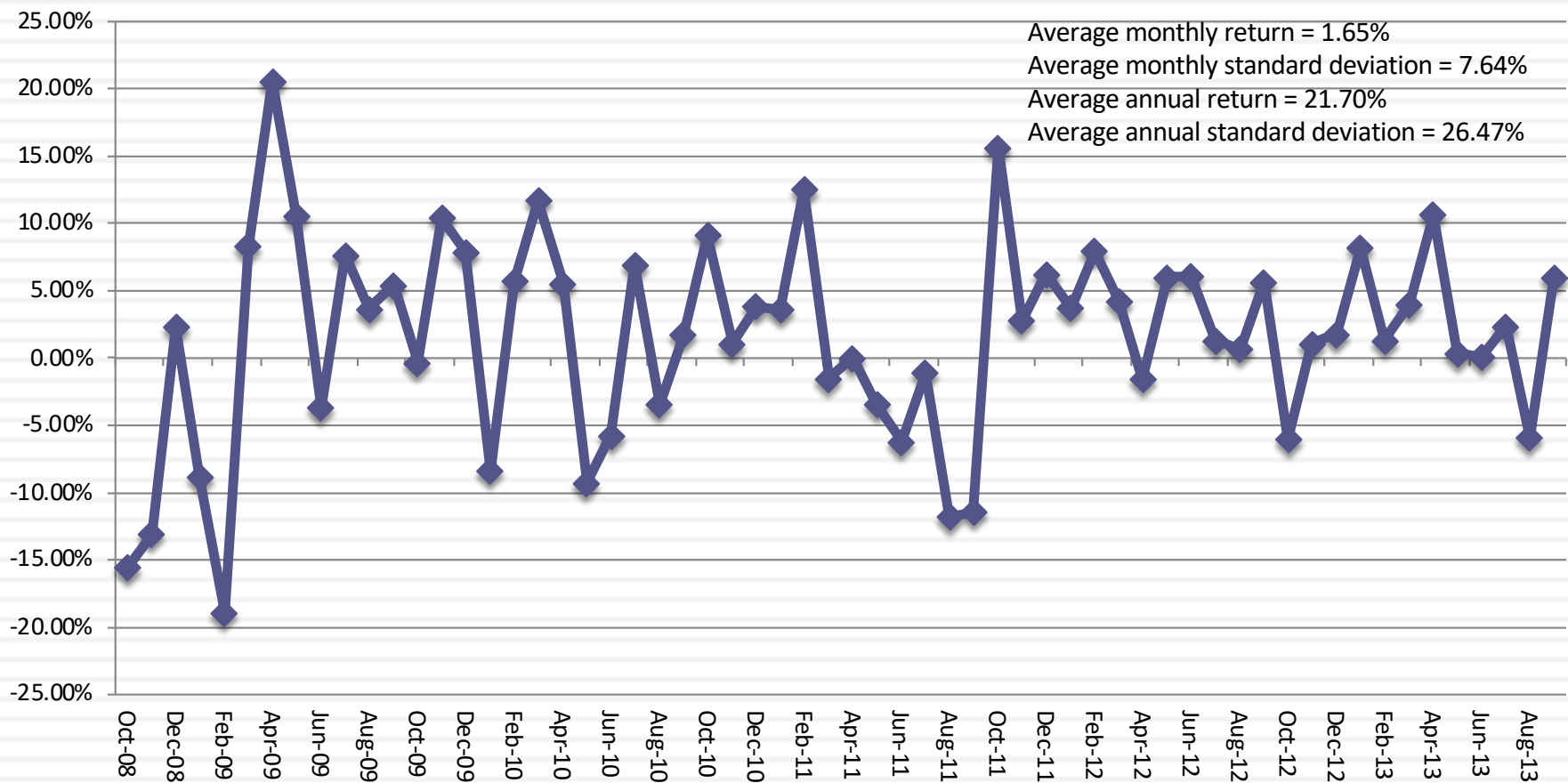
- The variance on any investment measures the disparity between actual and expected returns.



How risky is Disney? A look at the past...

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Returns on Disney - 2008-2013



Do you live in a mean-variance world?

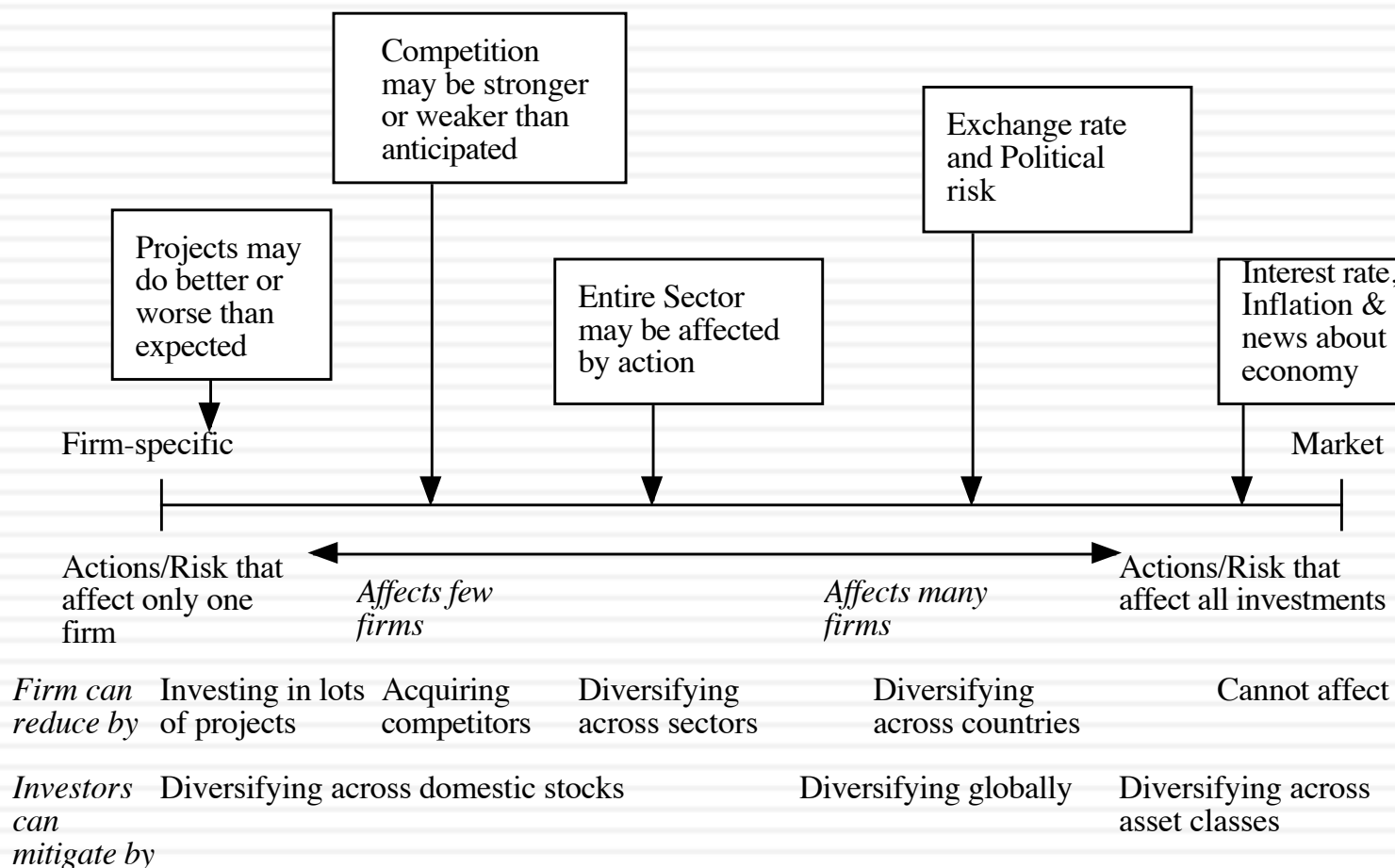
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- Assume that you had to pick between two investments. They have the same expected return of 15% and the same standard deviation of 25%; however, investment A offers a very small possibility that you could quadruple your money, while investment B's highest possible payoff is a 60% return. Would you
 - a. be indifferent between the two investments, since they have the same expected return and standard deviation?
 - b. prefer investment A, because of the possibility of a high payoff?
 - b. prefer investment B, because it is safer?
- Would your answer change if you were not told that there is a small possibility that you could lose 100% of your money on investment A but that your worst case scenario with investment B is -50%?

2. The Importance of Diversification: Risk Types

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Figure 3.5: A Break Down of Risk



Why diversification reduces/eliminates firm specific risk

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- Firm-specific risk can be reduced, if not eliminated, by increasing the number of investments in your portfolio (i.e., by being diversified). Market-wide risk cannot. This can be justified on either economic or statistical grounds.
- On economic grounds, diversifying and holding a larger portfolio eliminates firm-specific risk for two reasons-
 - a. Each investment is a much smaller percentage of the portfolio, muting the effect (positive or negative) on the overall portfolio.
 - b. Firm-specific actions can be either positive or negative. In a large portfolio, it is argued, these effects will average out to zero. (For every firm, where something bad happens, there will be some other firm, where something good happens.)

The Role of the Marginal Investor

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- The marginal investor in a firm is the investor who is most likely to be the buyer or seller on the next trade and to influence the stock price.
- Generally speaking, the marginal investor in a stock has to own a lot of stock and also trade that stock on a regular basis.
- Since trading is required, the largest investor may not be the marginal investor, especially if he or she is a founder/manager of the firm (Larry Ellison at Oracle, Mark Zuckerberg at Facebook)
- **In all risk and return models in finance, we assume that the marginal investor is well diversified.**

Application Test: Who is the marginal investor in your firm?

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- You can get information on insider and institutional holdings in your firm from:
 - ▣ <http://finance.yahoo.com/>
 - ▣ Enter your company's symbol and choose profile.
- Looking at the breakdown of stockholders in your firm, consider whether the marginal investor is
 - ▣ An institutional investor
 - ▣ An individual investor
 - ▣ An insider