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 2008 crisis illustrates 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) was 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?

Put simply, traditional corporate financial theory breaks down when ...

- Managerial self-interest drives decision making: The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- Debt holders are unprotected: Bondholders (Lenders) are not protected against expropriation by stockholders.
- Markets are inefficient and prices don't reflect value: Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- Businesses create large side costs for society (externalities): Significant social costs can be created as a by-product of stock price maximization.

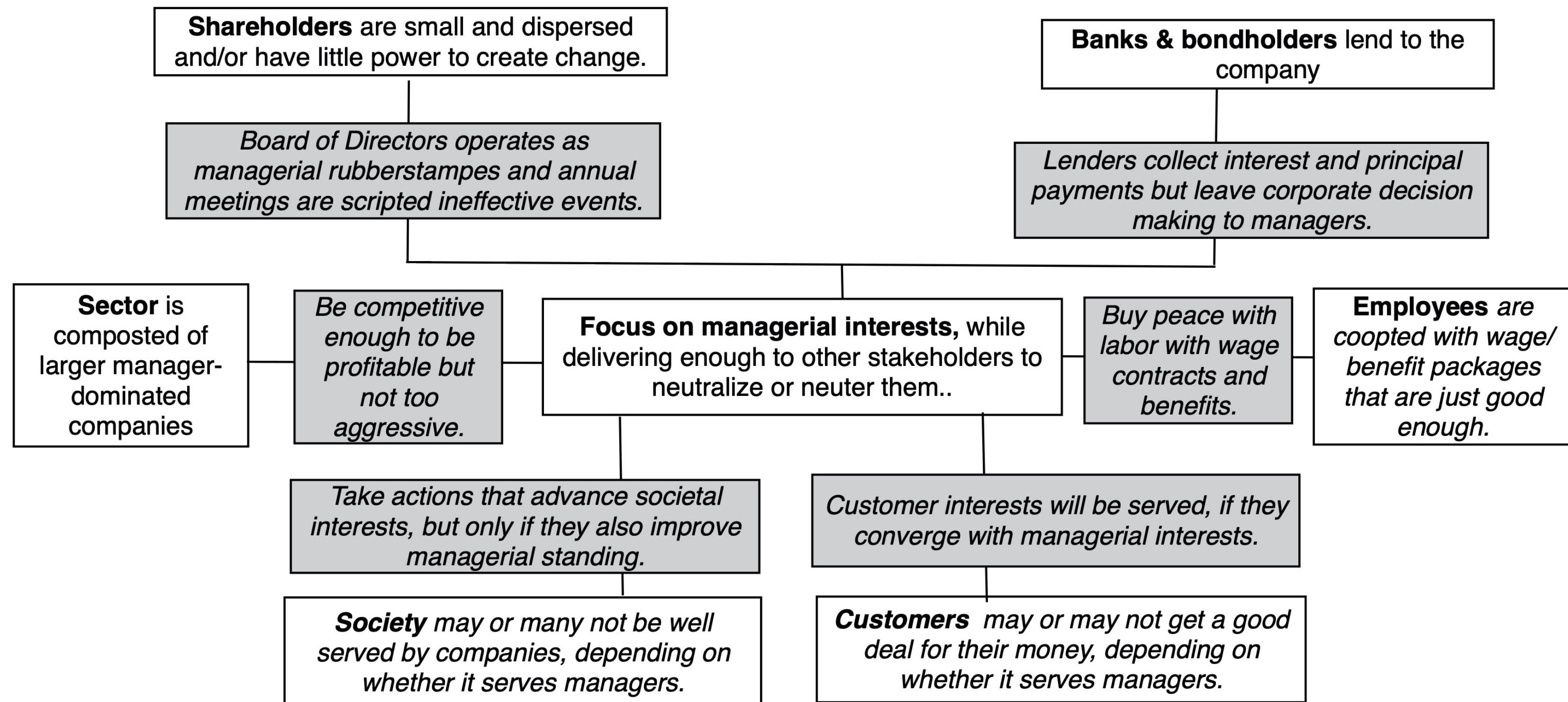
When traditional corporate financial theory breaks down, the solution is:

- 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

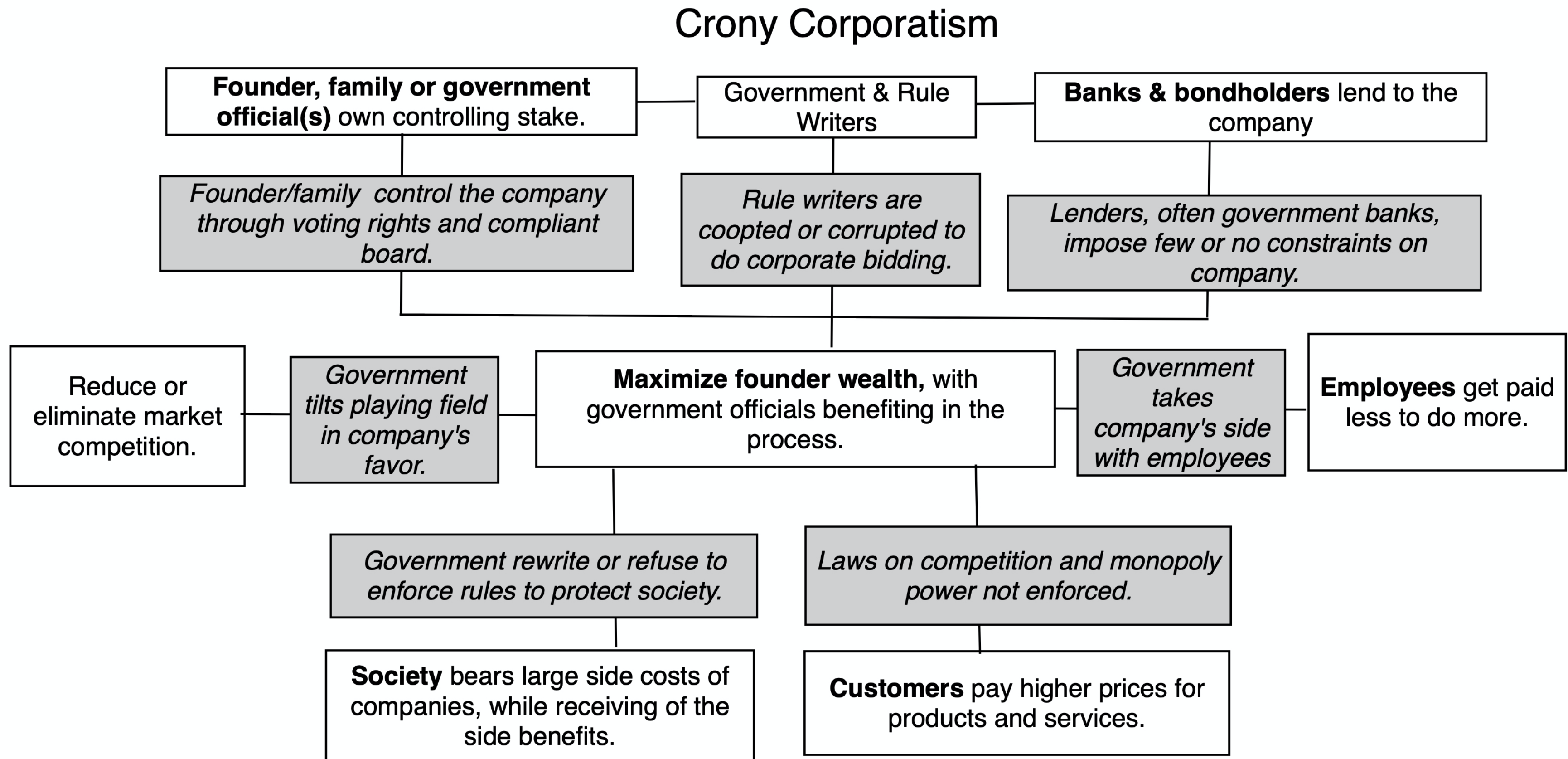
I. An Alternative Corporate Governance System

- 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

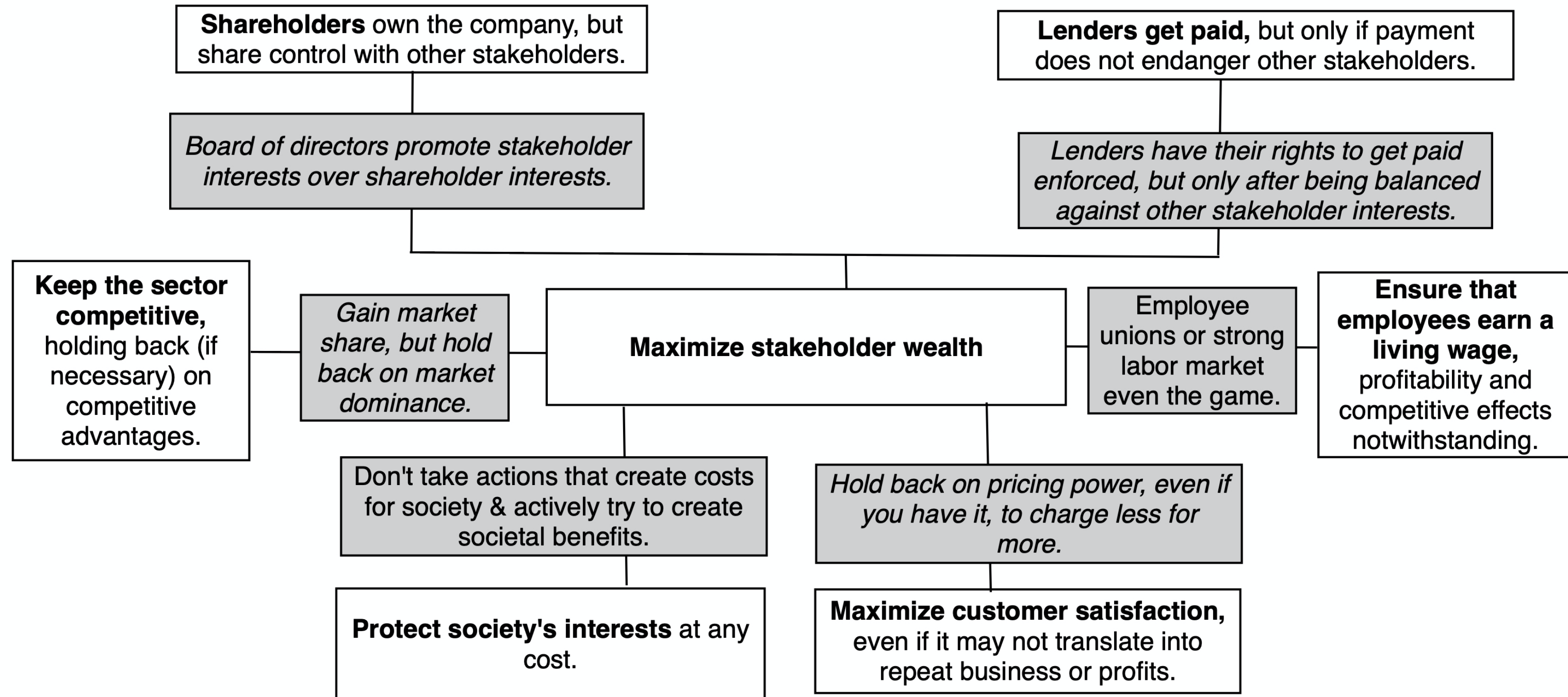
IIb. Maximize stakeholder wealth

- 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



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.

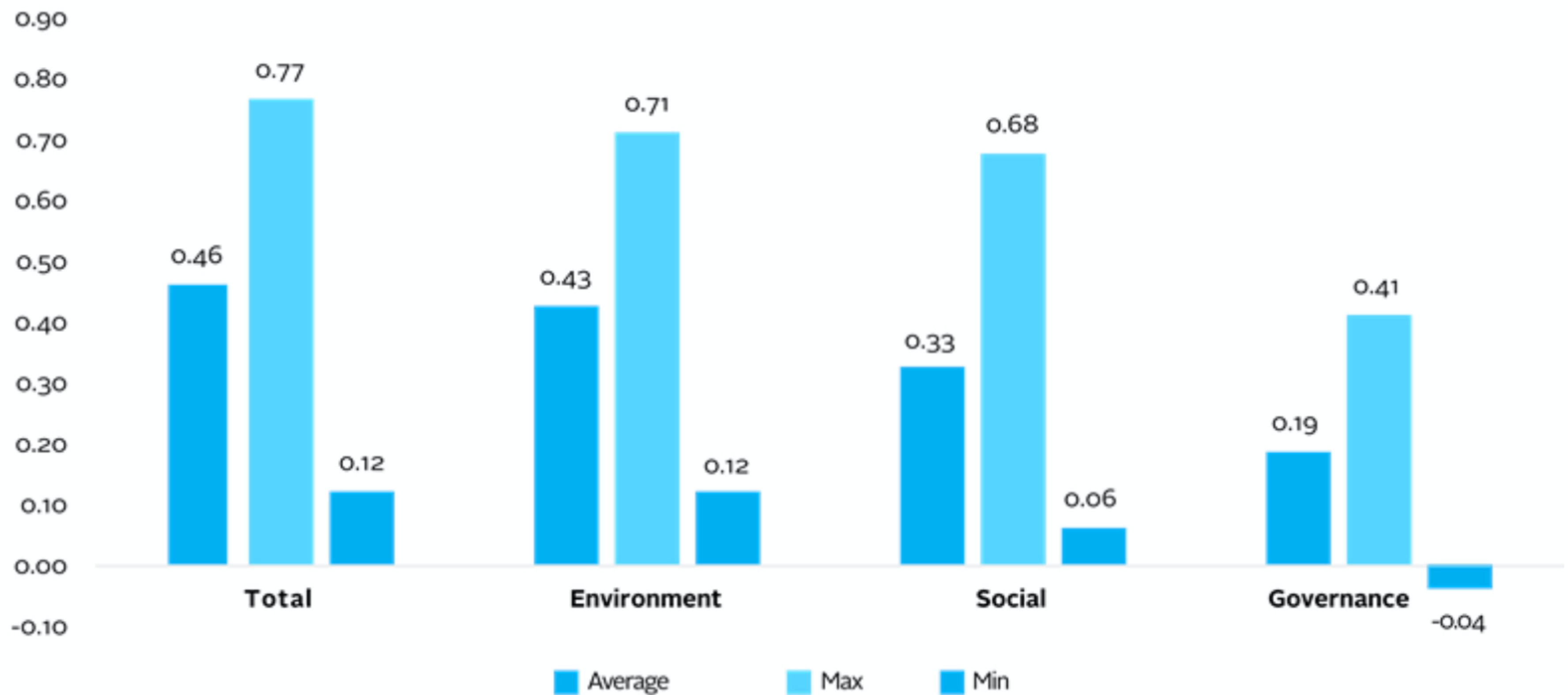
IIc. The ESG Promises: Cake for all, with no calories!

- It is measurable: Much as ESG advocates try to claim it is not about scores, it is undeniable that its growth in use has come from the scoring.
- It is good for value: 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.
- It is 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.
- It is 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.

ESG: The Contra Case

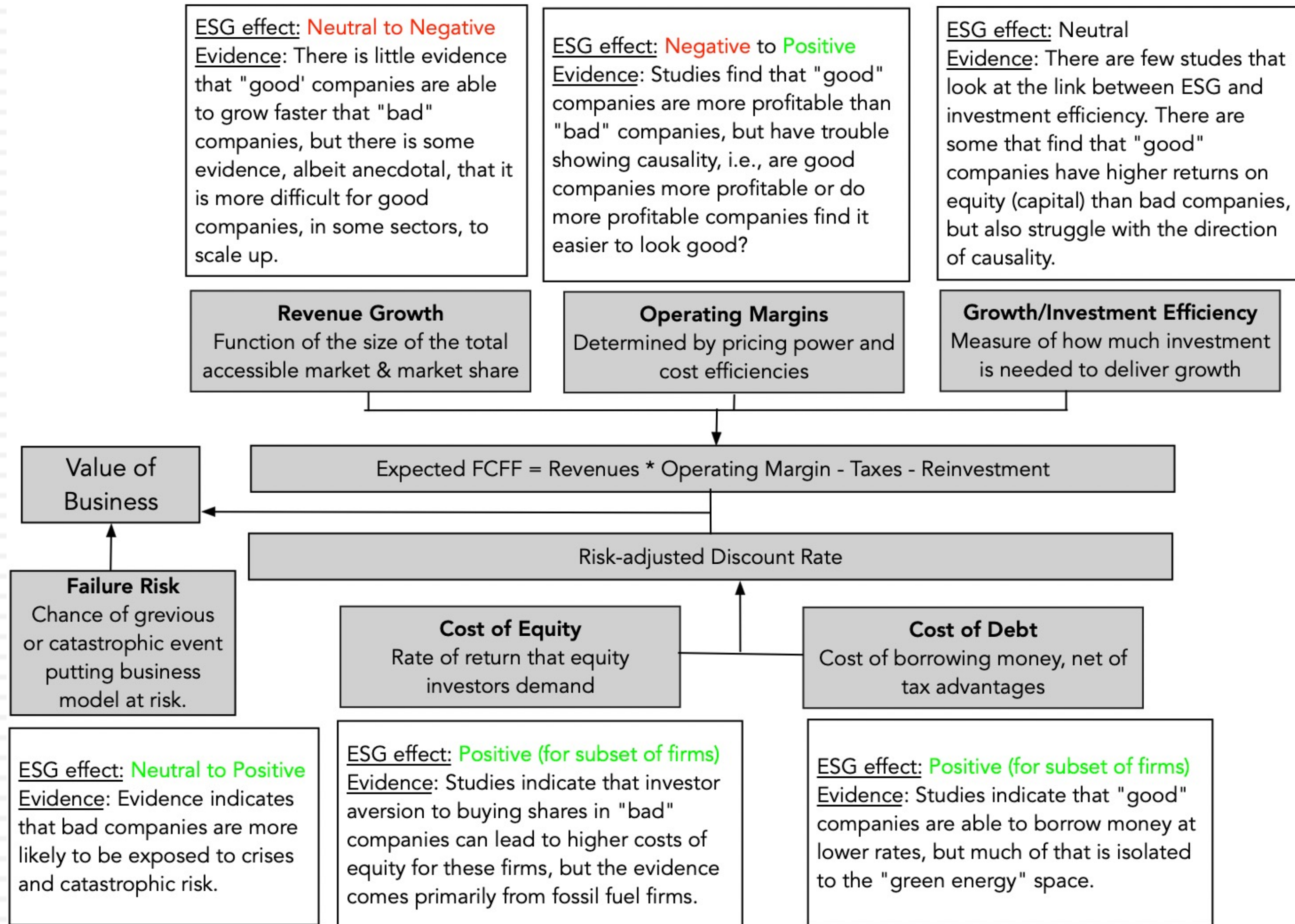
1. ESG is **<u>difficult (if not impossible) to measure</u>**, since goodness is in the eyes of the beholder and changes over time. Not surprisingly, this results in (a) significant disagreements on ESG scores for the same company across different services and (b) changes in the score for a company across time from the same service (Exxon Mobil has seen its ESG scores rise from the bottom quartile to the top one, over time().
2. **The notion that increasing ESG always increases value is absurd**. It can increase value at some companies, smaller and serving niche markets (Patagonia, REI), decrease value at others (where being good costs you with no revenue gain, which is true for the vast majority of companies that spend money on ESG) or do nothing for value.
3. The notion that **investing in high ESG companies will earn you alpha, risk-adjusted returns that exceed what you make, is the epitome of the "have your cake and eat it too" sales pitch** that has led ESG to where it is today. In reality, doing good will cost you, and you have to be okay with it.
4. The fallback that even if ESG is not good for companies or investors, it should be pursued, because it is good for society is also questionable. **You would be hard pressed to find a single dimension (that ESG supposedly cares about) where we are better off now than we were 20 years ago, when ESG was created.**

1. ESG measurement angst…



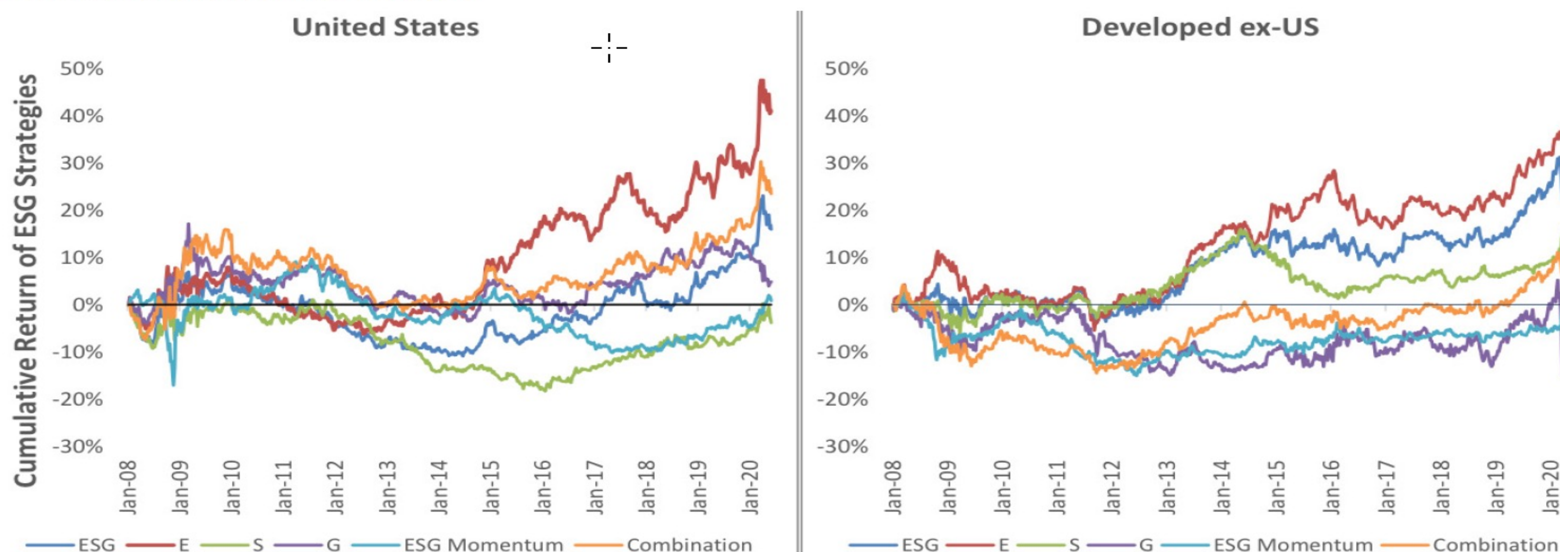
Average, minimum, and maximum correlations across providers

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



3. The ESG Pitch: Investing in "good" companies generates alpha…

Exhibit 3: Cumulative Returns of ESG Strategies



The plots show the time series of cumulative returns of the strategies, calculated from daily returns for the entire sample period. The sample period ranges from 1/01/2008 to 30/06/2020. The strategies refer to the Scientific Beta US universe and Scientific Beta Developed ex-US universe.

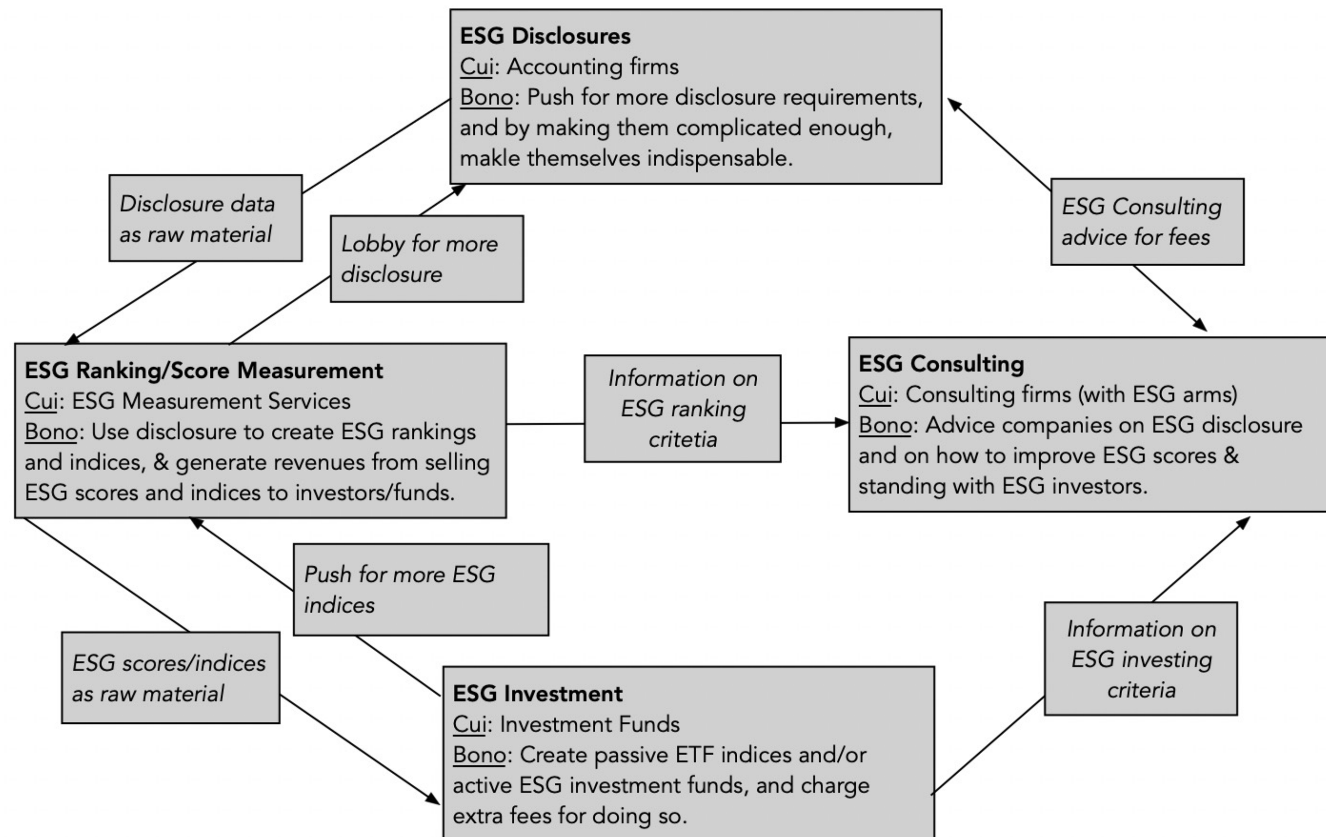
Jan 2008 - Jun 2020	ESG		E		S		G		ESG Momentum		Combination	
Geographic Universe	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US
Ann. Return	1.29%	1.63%	2.89%	2.43%	-0.23%	1.07%	0.45%	-0.85%	0.15%	-0.26%	1.92%	0.48%
t-statistic	0.85	0.90	1.71	1.59	-0.05	0.70	0.40	-0.05	0.19	-0.11	1.23	0.36
CAPM Alpha	2.57%	1.63%	3.99%	2.43%	0.54%	1.08%	1.30%	-0.52%	0.06%	-0.14%	2.84%	0.53%
t-statistic	1.55	1.05	2.28	1.68	0.35	0.79	0.84	-0.23	0.04	-0.12	1.62	0.37
7 Factor Alpha	-0.33%	1.31%	0.96%	1.95%	-1.17%	1.95%	-0.22%	-1.75%	0.00%	0.86%	0.96%	0.52%
t-statistic	-0.24	0.85	0.68	1.43	-0.84	1.43	-0.16	-0.78	0.00	0.73	0.59	0.36

Source: Honey, I shrunk the ESG alpha

4. 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 ploys 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.

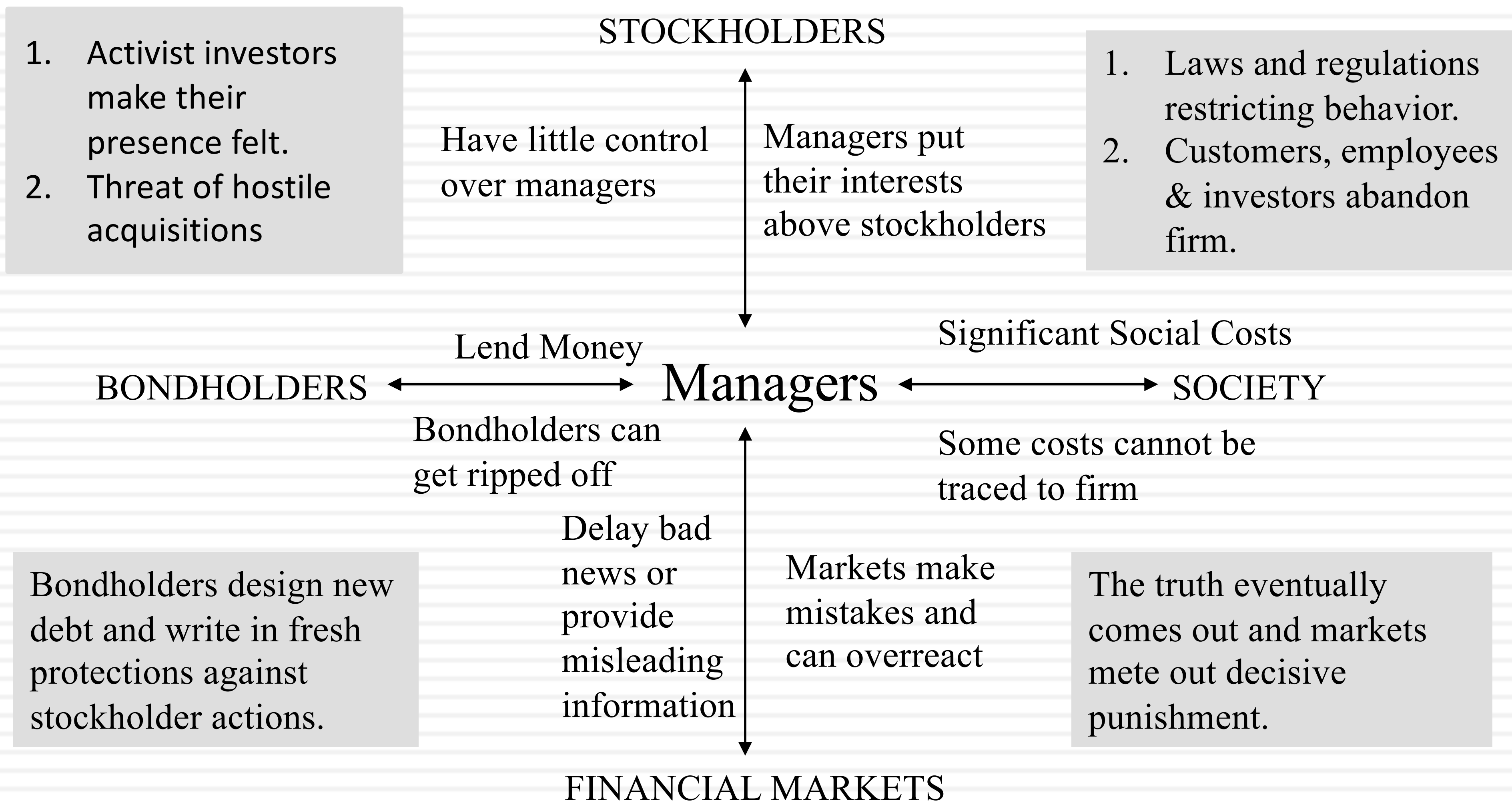
So why is ESG still being sold? Cui Bono? (Who benefits?)



III. Maximize Stock Price, subject to ..

- 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 can lead to a much more active market for corporate control.
  - stockholders taking advantage of bondholders can lead to bondholders and lenders protecting themselves better.
  - firms revealing incorrect or delayed information to markets can lead to markets becoming more "skeptical" and "punitive"
  - firms creating social costs can lead to more regulations, as well as investor and customer backlashes.

Market Discipline as Self-correction



1. The Stockholder Backlash

- 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.
- Shareholders become more receptive to activist investor campaigns: Activist investors (individuals and institutions) target companies where shareholders are unhappy with the status quo and push for change.
- Hostile acquisitions: There is nothing that focuses management minds more than the threat of a hostile acquisition. 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

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.
- 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

Board Members	*Occupation*
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

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... Iger's entry and a new age dawns?

A New CEO

A Better Board?

Board Members	*Occupation*
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, JLabs, 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

And a plan for transition..

In 2011, Iger announced his intent to step down as CEO in 2015 to allow a successor to be groomed.

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

- In 2011, the board voted to 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.
  - Shareholder votes challenging management became more common.

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

- 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.