The myth of shareholder primacy

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A surprising alliance of big business, activists and left-wing politicians have condemned the shareholder value paradigm. But did it ever really exist?

In the late 1960s, a young banker named Joel Stern was working on a project to transform corporate management. Stern's hunch was that the stock market could help managers work out how their strategies were performing. Simply, if management was effective, demand for the firm's stock would be high. A low price would imply bad management.

What sounds obvious now was revolutionary at the time. Until then, profits were the key barometer of success. But profits were a crude measure and easy to manipulate. Financial markets, Stern felt, could provide a more precise measure of the value of management because they were based on more 'objective' processes, beyond the firm's direct control. The value of shares, he believed, represented the market's exact validation of management. Because of this, financial markets could help managers determine what was working and what was not.

In doing this, Stern laid the foundation for a 'shareholder value' management that put financial markets at the core of managerial strategy.

Stern would probably never have imagined that these ideas would, 50 years later, be castigated as a fundamental threat to the future of liberal capitalism. In recent times, everyone from the Business Roundtable group of global corporations,[1] to the Financial

[1] Henderson R & Temple-West P (2019) 'Group of US corporate leaders ditches shareholder-first mantra', *Financial Times*. https://www.ft.com/content/e21a9fac-c1f5-11e9-a8e9-296ca66511c9

Times,[2] to Bernie Sanders[3] have lined up to condemn the shareholder ideology. “Fifty years of shareholder primacy,” wrote the *Financial Times*, “has fostered short-termism and created an environment of popular distrust of big business.”[4]

It is not the first time Stern’s creation has come under fire. A decade ago, Jack Welsh, former CEO of General Electric, declared shareholder value “probably the dumbest idea in the world”.[5] And, 15 years before that, British political commentator Will Hutton (among others) found paperback fame with his book The State We’re In, preaching much the same message.

To critics, the rise of shareholder value is a straightforward story;[6] one that has been told over,[7] and over,[8,9] again. Following a general crisis of postwar profitability in the late 1970s, corporate managers came under fire from disappointed shareholders complaining about declining returns. Shareholder revolts forced managers to put market capitalisation first. The rise of stock options to compensate corporate managers entrenched shareholder value by aligning the interests of managers and shareholders. Companies began sacrificing productive investments, environmental protections, and

2 Financial Times editorial board (2019) ‘Business must act on a new corporate purpose’, *Financial Times*. https://www.ft.com/content/3732eb04-c28a-11e9-a8e9-296ca66511c9

3 Schumer C & Sanders B (2019) ‘Schumer and Sanders: Limit Corporate Stock Buybacks’, *The New York Times*. https://www.nytimes.com/2019/02/03/opinion/chuck-schumer-bernie-sanders.html

4 Financial Times editorial board (2019) ‘Business must act on a new corporate purpose’, *Financial Times*. https://www.ft.com/content/3732eb04-c28a-11e9-a8e9-296ca66511c9

5 Guerrera F (2009) ‘Welch condemns share price focus’, *Financial Times*. https://www.ft.com/content/294ff1f2-0f27-11de-ba10-0000779fd2ac

6 Lazonick, William, and Mary O’Sullivan. ‘Maximizing Shareholder Value: A New Ideology for Corporate Governance’. Economy and Society 29, no. 1 (2000): 13–35. https://doi.org/10.1080/030851400360541.

7 Feher, Michel. Rated Agency: Investee Politics in a Speculative Age. Near Futures. New York: Zone Books, 2018.

8 Norton L (2018) ‘Economist Mariana Mazzucato on the Downside of Shareholder Value’, magazine article. https://www.barrons.com/articles/the-downside-of-shareholder-value-1535571901

9 Blakeley, Grace. Stolen: How to Save the World from Financialisation. New edition. London: Repeater Books, 2019.

worker security to ensure that shareholder returns were maximised. The fear of stock market verdicts on quarterly reports left them no choice.

This account fits a widespread belief that financiers and rentiers mangled the postwar golden era of capitalism.[10] More importantly, it suggests a simple solution: liberate companies from the demands of shareholders. Freed from the short-term pursuit of delivering shareholder returns, companies could then return to long-term plans, productive investments, and higher wages.

In two recent articles,[11,12] we have argued that this critique of shareholder value has always been based on a misunderstanding. Stern and the shareholder value consultants did not aim to put shareholders first; they worked to empower management. Seen in this light, the history of the shareholder value ideology appears differently. And it calls for alternative political responses.

To better understand Stern's ideas, it is important to grasp the broader context in which he was writing. In the 1960s, a group of firms called the conglomerates were pioneering many of the practices that later became associated with the shareholder revolution: aggressive mergers, divestitures, leveraged buyouts, and stock repurchasing

These firms – such as Litton Industries, Teledyne and LTV – revolutionised corporate strategy by developing new techniques to systematically raise money from

10 Pettifor A (2019) 'High finance is wrecking the economy and the planet – but it won't reform itself', *Prospect.* https://www.prospectmagazine.co.uk/magazine/high-finance-is-wrecking-the-economy-and-the-planet-but-it-wont-reform-itself-banking-wall-street-city-of-london

11 Knafo, Samuel, and Sahil Jai Dutta. 'The Myth of the Shareholder Revolution and the Financialization of the Firm'. Review of International Political Economy 0, no. 0 (7 August 2019): 1–24. https://doi.org/10.1080/09692290.2019.1649293.

12 Knafo, Samuel, and Sahil Jai Dutta. 'Patient Capital in the Age of Financialized Managerialism'. Socio-Economic Review 14, no. 4 (1 October 2016): 771–88. https://doi.org/10.1093/ser/mww027.

financial markets. They wheeled and dealed their divisions and used them to tap financial markets to finance further predatory acquisitions. Instead of relying on profits from productive operations, they chased speculative transactions on financial markets to grow.

These same tactics were later borrowed by the 1980s corporate raiders, many of which were in fact old conglomerators from the 1960s. The growing efficiency with which these raiders captured undervalued firms on the stock market and ruthlessly sold off their assets to finance further acquisitions put corporate America on alert.

With fortunes to be made and lost, no manager could ignore the stock market. They became increasingly concerned with their position on financial markets. It was in this context that corporate capitalism first spoke of the desire to ‘maximise shareholder value’. While sections of the corporate establishment were put on the defensive, the main reason for this was not that shareholders imposed their preferences on management. Instead, it was competitor managers using the shareholder discourse as a resource to expand and gain control over other firms. Capital markets became the foundation of a new form of financialised managerial power.

These changes made the approach of management consultants championing shareholder value attractive. Stern Stewart & Co (the firm founded by Stern and his business partner Bennett Stewart III) took advantage of the situation. They widely sold their ideas about financial markets as a guideline for corporate strategy to firms looking to thrive in this new environment.

As the discourse and tools of shareholder value took hold, they served three distinct purposes. First, they provided accounting templates for managerial strategies and a means to manage a firm’s standings on financial markets. The first and most famous metric for assessing just how much value was being created for shareholders was one Stern himself helped develop: economic value added (EVA).

Second, they became a powerful justification for the idea that managers should be offered share options. This was, in fact, an old idea, floated in the 1950s by management consultants such as Arch Patton of McKinsey as a means to top up relatively stagnant managerial pay. Yet it was relaunched in this new context as part of the promise to 'align the interests of managers with shareholders'. Stock options helped managerial pay skyrocket in the 1990s – a curious fact for those who believe that managers were 'disciplined' by shareholders.

Third, the notion of shareholder primacy helped to offload managerial responsibility. An amorphous and often anonymous 'shareholder pressure' became the explanation for all manner of managerial malpractice. Managers lamented the fact they had no choice but to disregard workers and other stakeholders because of shareholder power. Rhetorically, shareholders were deemed responsible for corporate problems. Yet in practice, managers more often than not enrolled shareholders into their own projects, using the newly formed alliance with shareholders to pocket huge returns for themselves.

Though shareholder demands are now depicted as the problem to be solved, the same reformist voices have in the past championed shareholders as the solution to corporate excesses. This was the basis for the hope around the 'shareholder spring' in 2012,[13] and the recent championing of activist shareholders as 'labour's last weapon'.[14]

By challenging the conventional narrative, we have emphasised how it is instead the financialisation of managerialism,[15] or the way in which corporations have leveraged

[13] Burgess K & McCrum D (2012) 'Boards wake up to a shareholder spring', *Financial Times*. https://www.ft.com/content/a284e414-95ee-11e1-a163-00144feab49a

[14] Webber D (2018) *The Rise of the Working-Class Shareholder: Labor's Last Best Weapon*, Harvard University Press

[15] Dutta S J, Knafo S, Lane R, Lovering I & Wyn-Jones S (2019) 'Neoliberalism and the Strange Non-Death of Planning', *Progress in Political Economy*. http://ppesydney.net/neoliberalism-and-the-strange-non-death-of-planning/

their operations on financial markets, that has characterised the shareholder value shift. Politically, this matters.

If shareholder demands are understood to be the major problem in corporate life, then the solution is to grant executives more space. Yet the history of shareholder value tells us that managers have been leading the way in corporate governance. They do not need shielding from shareholders or anyone else, and instead need to be made accountable for their decisions. Critiques of shareholder primacy risk muddying the responsibility of managers who have long put their own interests first. Perhaps the reason why executives are now so ready to abandon shareholder primacy is because it never really existed.

This is an amended version of an article originally published on the blog of the Political Economy Research Centre, Goldsmiths University.[16]

[16] Dutta S J and Knafo S (2019) 'The myth of shareholder primacy', blog post, Political Economy Research Centre. http://www.perc.org.uk/project_posts/the-myth-of-shareholder-primacy/