

INVESTING & WEALTH



CFA SINGAPORE INSIGHTS

By Julie Hammond

Shareholder value vs shareholder welfare

Firms, asset managers should look beyond the bottom line and pursue policies that matter to their investors

IN whose interest should companies be run? For a long time, the prevailing view held that firms should put their shareholders first by maximising profits and thus shareholder value.

But Luigi Zingales of the University of Chicago Booth School of Business believes firms and asset managers should expand their profit maximisation objective and pursue policies that reflect what their investors want. And that isn't always simply about the bottom line.

"I think 'What should companies maximise?' is the most important question we face in modern capitalist economies today," Prof Zingales explained at the 2019 CFA Institute Seminar for Global Investors, "because the way companies are run is at the very core of our capitalist system".

Indeed, the Business Roundtable recently revised how it defines the purpose of the corporation and its member CEOs committed to leading their companies for the benefit of all stakeholders, not just their shareholders.

Whether this shift is motivated by public relations considerations or signals a true change in business practices remains to be seen.

The debate

The debate over shareholder value crystallised nearly 100 years ago when two competing perspectives about the objective function of the corporation emerged.

The Shareholder Primacy view held that firms should work to maximise profits and shareholder wealth. By contrast, according to the Stakeholders Perspectives view, firms should integrate the interests of customers, employees, suppliers, creditors, and communities, among other stakeholders, in addition to shareholders.

"The debate thus far," Prof Zingales said, "has clearly been won by the Shareholder Primacy side, from both economic and legal perspectives." After all, shareholders should have decision rights since they are the "residual claimants" of the corporation, according to Prof Zingales. They are paid only after all other claims are settled and thus bear the residual risk.

The Friedman rule

Milton Friedman was a key proponent of Shareholder Primacy and authored the seminal essay, *The Social Responsibility of Business Is to Increase Its Profits*, that introduced what Prof Zingales now calls the "Friedman rule".

Mr Friedman stated that corporations should "conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom."

"The Friedman rule does not ignore workers or customer needs or desires," Prof Zingales said. A

company can adopt policies that serve a larger social purpose, appeal to millennials, attract talent, create a happy workforce, etc, and still be totally in accord with the Friedman rule. If Walmart decides to stop selling assault-style rifles and ammunition because selling such products discourages people from shopping at Walmart, that's still a profit-maximising decision.

The Friedman rule allows for other strategic objectives. Some companies — Patagonia, for example — assume the form of a "Benefit Corporation", adopting pro-social policies that appeal to particular customers.

A key but often overlooked assumption of the Friedman rule is that shareholders care only about returns. Prof Zingales finds this especially intriguing when problems with broad social or ethical impact come into play. In *Companies Should Maximise Shareholder Welfare, Not Market Value*, Prof Zingales and Oliver Hart contend that shareholders don't just think about money: "They have ethical and social concerns," they wrote. "In principle, these could be part of the 'ethical custom' Friedman refers to."

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Prof Luigi Zingales of the University of Chicago Booth School of Business

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As a result, Prof Zingales recommends that companies seek to maximise shareholder utility or welfare, in addition to making money.

"Many people say, 'I'm willing to sacrifice a little bit of my return in order to do the right thing,'" he said. "Do I want to lose money? No.' But most people have a little bit of social utility in their utility function." How shareholders vote is one good way to determine their preferences, he noted.

Why can't investors just vote with their feet?

Of course, shareholders can always unload their shares if they disagree with how a corporation conducts itself, right? Maybe not. As Prof Zingales pointed out, if you are in an index fund — and passive mutual funds and exchange-traded funds (ETFs) now account for more than US\$4 trillion in assets — divesting isn't so easy.

And even when it is, doing so might actually reward the behaviour you're seeking to punish. "Divestiture can lead to the opposite outcome of what people want," he said. "It's convenient, it doesn't

ruffle feathers too much, but it's counterproductive."

Divestiture raises the cost of capital for the company from which you're divesting, he explained. But it also raises the expected return for the shareholders who don't divest.

Why now?

The debate has arisen now for a variety of reasons, according to Prof Zingales, with growing interest in sustainability and environmental, social, and governance (ESG) issues among asset owners, a particularly critical one. Indeed, CalPERS CEO Chris Ailman defines ESG issues as "long-term operational business risks".

"Today, ESG is a standard matter of conversation for serious investors," Prof Zingales said. "Certainly this is the case in Europe, but it is also coming to the US."

Today, investors are not ignoring the problem, according to Prof Zingales, but making a choice in a vague, subtle way. "We are choosing to give a zero weight to all the social preferences," he said. "If we only maximise shareholder value, as a result, we impose a zero weight in every utility function, which I think is hard to imagine is optimal."

This was not historically the case, Prof Zingales explained. Businesses were local or controlled by families that incorporated their social preferences into how they ran their businesses. "The combination of globalisation, portfolio diversification, and capital market pressures has forced investors to put zero weight [for social preferences] in our utility functions," he said.

Measuring and aggregating investor preferences

"In the last 50 years, investors' social objectives have been largely ignored, but today there is a growing demand among investors to address them," Prof Zingales said.

"This raises new challenges, particularly for [investment professionals], because we need to measure these objectives. If I have some social objectives, I don't want to give out my money for fluff. I don't want to give out my money for general principle. I want to give it out for results. We need good measurements, good ways to aggregate preferences, and good auditing. That's a job [for investment professionals]."

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