BusinessWeek

WHAT'S YOUR STORY IDEA? March 17, 2009, 6:17PM EST

Shareholder Value: Time for a Longer View?

Experts—among them Jack Welch—are expressing reservations about the long-popular practice of managing for the short term. Are they getting through?

By David Bogoslaw

A wholesale reassessment of values is occurring in the business community, fueled by the financial crisis and widespread anger at both Wall Street and the billions taxpayers have been forced to contribute in bailouts. One part of this review is the notion of shareholder value, and the principles by which companies are managed. For years, many investors and companies calculated the reward of ownership on brief periods, often no longer than three months. The value of an enterprise was frequently seen solely through its stock price.

Jack Welch, the former boss of General Electric (GE), brought this discussion to the fore in a newspaper interview published Mar. 12. Welch (who is also a *BusinessWeek* columnist) called maximizing shareholder value "a dumb idea" when used as a business strategy. Instead, he argued, this value is merely an outcome of sound practices geared toward long-term growth. During Welch's two-decade-tenure as GE's chairman and CEO, the conglomerate's consistent meeting or beating of quarterly earnings targets helped to drive Corporate America's focus on short-term profits and the stock price. "[Y]ou would never tell your employees, 'Shareholder value is our strategy,'" Welch said in an online Q&A. "That's not a strategy that helps you know what to do when you come to work every day."

WHAT "SHORT-TERMISM" HAS BROUGHT US

Even before Welch reiterated this point, there had long been awareness of the problem of public companies focused on short-term profitability to the detriment of sustainable growth over time. A paper by John Graham and Campbell Harvey of Duke University and Shiva Rajgopal of the University of Washington, published in December 2005 in the *Journal of Accounting and Economics*, found that 78% of more than 400 executives interviewed admitted that they had sought to smooth earnings between quarters at the expense of long-term value.

In June 2007, the Aspen Institute published a list of principles aimed at shifting the focus for companies and institutional investors from short term to long term when measuring value creation. The principles were developed in cooperation with the Business Roundtable Institute for Corporate Ethics, investor groups such as the California Public Employees' Retirement System (CalPERS), and the Center for Audit Quality. They advocated industry best practices to develop forward-looking strategic metrics and suggested companies improve the way they communicate their business strategies to investors to avoid offering—or responding to—quarterly profit estimates. Companies such as Google (GOOG) do not provide revenue or earnings guidance, while others such as GE, Coca-Cola (KO), and McDonald's (MCD) no longer target quarterly per-share income for investors. The principles also proposed ways to improve performance-based executive compensation plans.

"Now is a very good time to think about what the focus on short-termism has brought us, and what it's brought us is killing the goose that lays the golden eggs … the kind of market that produces sustainable growth," says Nell

Minow, editor and co-founder of the Corporate Library, an independent research firm that analyzes corporate governance issues.

INCENTIVES HAVE PLAYED A BIG PART

Compensation specialists and other corporate goverance experts agree that the financial crisis and economic downturn have aligned to spur a shift away from the short-term focus toward longer-term and more substantive measures of corporate growth. The irony, however, is that what may be driving greater receptivity for such a shift on Wall Street are practical considerations: the lack of visibility about future earnings makes short-term projections virtually impossible, while many companies still have confidence in their long-term ability to increase profits, according to Pearl Meyer, a New York-based compensation expert.

There has begun to be a turn in companies providing quarterly earnings estimates, says Judy Samuelson, executive director of the Aspen Institute's Business and Society Program, which led the efforts that resulted in the Aspen principles. General Electric's 2008 decision to swear them off "is certainly a bellwether," Samuelson says. More important, rather than just throwing out quarterly guidance, GE replaced it with metrics along the lines of what the Aspen principles suggest, "providing a more robust set of indicators that in fact are better information about the future of the business," she says.

A key reason for the short-term focus on quarterly results by many top executives is the incentive structure, specifically the overuse of stock options, according to corporate governance experts. The public outrage over the use of taxpayer dollars to fund executive bonuses in the financial industry—with American International Gropup (AIG) the current poster child—has added more impetus to reform executive compensation.

"The secret is to have a board that forces management to focus on the longer term, and to have a management compensation structure that focuses on long-term holdings," says Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. A better compensation vehicle for executives is restricted stock with a creative vesting structure that seriously restricts resale of the stock until after an executive leaves the company, he says. "The idea is you want to lock him into long-term value."

PREVENTING RIDES INTO THE SUNSET

Eliminate options, which can be exercised only when the stock is above a given price, and you remove the temptation among CEOs to manipulate quarterly results so they can exercise the options, sell the stock, and leave the company, says Elson. He believes U.S. companies are moving away from an options culture. Awarding executives restricted stock is generally seen as more conducive to creating long-term value for shareholders in a company.

Vineeta Anand, chief research analyst at the AFL-CIO's investment arm, says a meaningful portion of executive compensation should be paid in the form of equity, and 75% of it should be held for at least two years past an executive's retirement. If a large portion of an executive's compensation is tied up in long-term awards, "they can't run a company into the ground … and ride off into the sunset and cash in all their chips," Anand says.

The AFL-CIO has filed shareholder proposals pushing for hold-past-retirement provisions in executive compensation contracts at a handful of companies that received TARP money, including Citigroup (C), JPMorgan Chase (JPM), and Bank of New York Mellon (BK). It also co-filed a proposal at AIG along with the American Federation of State, County, and Municipal Employees.

Even if a majority of shareholders pass such proposals, companies can still refuse to adopt them. If that happens, activist shareholders have to target individual directors and threaten to embarrass them by withholding votes for their re-election to the board, says Anand.

ARE COMPANIES GETTING THE MESSAGE?

There are signs in the current proxy season that companies are relying less on total shareholder returns or quarterly earnings per share as part of how they determine executive bonuses, says Alexander Cwirko-Godycki, a spokesman for Equilar, a Redwood Shores (Calif.)-based information services firm specializing in executive compensation. While so far only about 10% of the companies in the Russell 3000 index have filed proxy statements for fiscal year 2008, Cwirko-Godycki says Equilar has noticed an early trend away from basing annual incentives on growth in revenue or net income and giving more weight to cash flow, working capital, and internally directed company goals such as customer service or efficiency of certain business processes.

"This is a byproduct of the disclosure rules put in place by the [Securities and Exchange Commisssion] at the end of 2006," says Cwirko-Godycki. "They're giving a true breakdown of what a bonus formula is. It's a lot easier to tell when these changes are taking place and how the weighting of the company emphasis and company goals might be changing."

Banning accelerated vesting of stock options and other equity awards when executives leave a company would also substantially change the thinking on compensation, believes Anand at the AFL-CIO. Having to wait another few years until their awards were fully vested and available to them, she says, would discourage executives from making decisions geared only for short-term performance gains.

FINDING ETHICS IN A DOWNTURN

The growing prevalence of clawbacks, which allow companies to take back executive bonuses when a company is forced to restate past years' earnings, is another sign that companies are moving toward closer alignment of executive compensation with long-term company goals. In 2006, only 18% of the 100 largest U.S. companies by revenue had clawback policies, but that increased to 64% by 2008, says Cwirko-Godycki. "The question remains, 'Do they have enough teeth to actually be effective?'" he says. "The number of cases where they've actually been used is relatively small."

One of the main goals of the Aspen principles was to persuade executives to take the lead in shifting the corporate focus toward long-term value creation, says Jim Allen, director of capital markets policy at the CFA Institute's Centre for Financial Market Integrity in Charlottesville, Va. He sees a need for more emphasis on business ethics among company leaders.

"In a downturn, people find ethics," says Allen. "They're more willing to accept an ethical position than they are when they're in a bull market and everything's going well."

Bogoslaw is a reporter for BusinessWeek's Investing channel.