Why great CEOs ignore their stock price

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In corporate America, we have, to borrow a phrase from Jack Bogle, an abundance of "management," but not enough "leadership ."

(Photo: Anonymous AP)

Corporate America, to borrow a phrase from Jack Bogle, has an abundance of "management," but not enough "leadership ." Over the past year, this problem has come to a boil -- and has shown that we are in desperate need of new types of leaders at the helms of our publicly listed companies.

We need far fewer income statement managers and far more business-builders.

Cash on hand

The cash piles in corporate America are at record highs. Corporate cash was at $1.25 trillion in the third quarter, according to S&P Dow Jones's Howard Silverblatt , eclipsing the previous record for the fifth straight quarter.

The Washington Post's Jia Lynn Yang reported that in 2013, there were 885 stock buybacks authorized. That compares to 52 in 1985. The 30 Dow Jones stocks collectively bought back $211 billion of their own stock -- more than three times what they spent on research and development (R&D) in 2012.

Rather than investing in new lines of business, buying new equipment, building new factories or warehouses, training new employees or hiring new ones, or testing package-delivery drones, companies are buying back stock and paying dividends.

Now, I'm a fan of dividends. Dividends not only pad my pocket as an outside shareholder, they actually enforce discipline on management teams -- because dividend reductions are such ominous signs, management teams will more prudently allocate capital so as to avoid such a scenario, evidence suggests.

Stock buybacks are another matter. They're good in theory, but companies more often than not buy at highs and cease at lows. (The discrepancy reminds me of a great one-liner from Aswath Damodaran: "Dividends are like getting married; buybacks are like hooking up.")

Incentives

The simple reason for Corporate America's lack of imagination is found in the incentives of our executive suites.

Stock-based compensation has exploded in the past 40 years, as part of a push to "align" inside management and outside shareholders. In 1970, CEO compensation was $850,000 on average; less than 1% of that came in the form of stock-based incentives. In 2000, those figures were $14 million and 50%, according to Roger Martin's Fixing the Game .

Aside from exploding CEO pay in general, the "alignment" has had questionable effects.

Short-term thinking

Consider a 2004 academic paper, "The Economic Implications of Corporate Financial Reporting." Professors John Graham, Campbell Harvey, and Shiva Rajgopal surveyed 401 financial executives and interviewed an additional 20 in-depth. They found that "managers candidly admit that they would take real economic actions such as delaying maintenance or advertising expenditure and would even give up positive NPV [net present value] projects to meet earnings benchmarks."

In a world where executives are measured by the stock price -- and more importantly, compensated based on the stock price -- it makes sense that a majority of them would forego building the business in order to preserve the share price. Incentives are aligned with short-term share price metrics, so stock buybacks explode, as they did last year. (Remember: buybacks have a direct impact on earnings per share.)

As the professors conclude, "such unambiguous managerial intent to burn economic value to meet financial reporting goals has not been previously documented."

An equally damning stat: Per Moneyweek, "private companies in the U.S. (which care more for longevity than next quarter's EPS figures) invest nearly twice as much relative to their total assets every year than listed companies."

Shareholder complicity

Part of the blame lies with ... us, the shareholder class.

It's entirely possible that corporate managers are aligned with outside shareholders -- outside shareholders who are obsessed with the short term.

In The Atlantic, Justin Fox wrote:

One could attach many adjectives to the giant banks that tumbled down during the financial crisis of 2007 and 2008: reckless, greedy, hubristic, stupid. Here's one that may come less readily to mind: shareholder-friendly. But that's what they were. Several studies have found that the more shareholder-oriented a bank's corporate governance and executive-pay arrangements were heading into the crisis, the more trouble the bank got into. A misplaced focus on pleasing shareholders, it seems, must be added to the roster of causes of the crash.

The average investor holding period has shrunk to less than six months, by some estimates . Colin Mayer says that short-termism is integral to corporate behavior because of "rules that give a shareholder for three days as many rights in that period as the long-term investor."

Mayer drills home the point: "It's as if we are conferring voting rights on members of the population who intend to renounce their citizenship tomorrow."

The "real market" versus the "expectations market"

Roger Martin of the University of Toronto's Rotman School of Management wrote a thought-provoking book called Fixing the Game, in which he argues that we should divorce the "real" market, in which companies make and sell products or services to consumers, and the "expectations" market, in which stocks are traded among external parties. In short, it should look a lot more like the NFL.

Martin compares it to the way football is played on the field while it's wagered on among gamblers and bookmakers. We wouldn't reward Bill Belicheck for how well the Patriots perform versus the point spread, Martin argues; so it's silly that executives are rewarded more for beating analyst earnings targets than for creating real and lasting value in their business. Two incredible examples from Martin's book: Microsoft (ticker: MSFT) met or beat earnings expectations in 41 of its first 42 quarters as a public company; its only miss was by a single penny. Under Jack Welch, General Electric (NYSE: GE) hit analyst earnings forecast to the penny in 41 out of 46 quarters .

When I interviewed Martin via phone this past summer, he told me his No. 1 recommendation to fix the boardroom problem was to "banish" stock-based compensation -- that is, to fix the incentive issue.

With a wave of the wand, that would make public company executives a whole lot more like private company executives -- focused on appeasing customers and building an institution for the long term.

This was drilled home in a recent Fortune profile of the privately held Hearst Corp. At a time when media companies are hurting badly, Hearst is thriving.

One big reason: Its management team hasn't been subjected to the pressures of Wall Street. As one analyst told Fortune, "They [Hearst] go by their own wavelength. They don't talk to Wall Street. You try, they hang up on you."

As a result, "about 90% of Hearst's revenue now comes from businesses that were not part of" the company in 1979. Some novel sources: a 20% stake in ESPN, Fitch Ratings service, and a grass-fed beef business.

There are examples of this type of leadership in public companies -- Bob Iger at Disney (NYSE: DIS) , Jim Sinegal and his successor Craig Jelineck at Costco (NASDAQ: COST) , Warren Buffett at Berkshire Hathaway (NYSE: BRK-A) . But the shining example in our public markets is Amazon.com (NASDAQ: AMZN) , where Jeff Bezos has turned Amazon from a mere online bookseller to the store where you buy everything. And along the way, it's built an incredible "side" business in Amazon Web Services. He's done this (famously) without turning much of a profit because Bezos constantly plows money into building Amazon.

It will be a great day when that sort of long-term, business-building mentality isn't such a novelty among public company executives.

What can be done?

There are potential policy solutions -- like a higher short-term capital gains tax rate or special incentives for long-term investors such as a special dividend or a 0% capital gains rate for a lengthy holding period -- which I'll leave for another discussion. But the best solution to this is also the most unlikely -- a change in behavior, in how shareholders judge their executives and, therefore, how executives manage their company.

We must look years out (not quarters). We must be patient. We must not overreact to failure -- CEOs are not flawless and will back the wrong horse from time to time.

To come full-circle to Bogle, think like an owner, not a renter. And demand that our boardrooms do the same.

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