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More builders and fewer traders: a growth strategy for the American economy

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INTRODUCTION

When the head of the world's largest investment fund publicly questions the conduct of America's leading corporations, we can be pretty sure that there's a problem.

That's what BlackRock Chairman Laurence Fink did last year in a letter to the Fortune 500 CEOs criticizing the short-term orientation that dominates today's corporate behavior. "It concerns us," he declared, that "in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many have cut capital expenditures and even increased debt to boost dividends and increase share buybacks." And he concluded, "When done for the wrong reasons and at the expense of capital investment, [returning cash to shareholders] can jeopardize a company's ability to generate sustainable long-term returns."[1]

This is bad for the economy in two ways. As the growth of the U.S. workforce slows dramatically, economic growth will depend increasingly on improved productivity, most of which comes from raising capital investment per worker. Failing to make productivity-enhancing capital investments will doom our economy to a new normal of slow growth.

Many business leaders say that they are reluctant to make long-term investments without reasonable expectations of growing demand for their products. That brings us to the second way in which corporate short-termism is bad for the economy. Most consumer demand comes from wages. If employers refuse to share gains with their employees, growth in demand is bound to be anemic.

1 Laurence Fink, "letter to corporate leaders," BlackRock, March 21 2014.

Although he clearly cares about his country, Fink is also acting as the steward of $4.8 trillion in investments. In an article published by McKinsey earlier this year, he warns that although the return of cash to shareholders is juicing equity markets right now, investors "will pay for it later when the ability to generate revenue in the long term dries up because of the lack of investment in the future."

This strategy represents more than individual greed or the pervasive influence of bad ideas. Because current incentives are so perverse, Fink argues, "It is hard for even the most dedicated CEO to buck this trend." The constant pressure to produce quarterly results forces executives to go along—or risk losing their jobs. That pressure comes from investors who are, in Fink's words, "renters, not owners, who are going to trade your stock as soon as they can pocket a quick gain."[2]

It is all too easy to dismiss Fink's worries as anecdotally-driven alarmism. But rigorous research has generated compelling evidence that he is right. Two Bank of England economists, Andrew Haldane and Richard Davies, have constructed empirical tests of short-termism. Their conclusion: the phenomenon is real, it is economically significant, and it is rising.[3] In a remarkable speech, Haldane traces the historical relation between patience and prosperity and finds evidence of rising impatience in the U.K. and U.S. economies. Volatility has increased; investors are demanding immediate returns; and they are discounting future returns more than in the past. There appears to be what Haldane calls "Gresham's law in finance": as short-term behavior increases, patient behavior can become less advantageous over an extended period of time, inducing even those who believe in patience to act myopically.[4]

As numerous public officials have noted, short-term thinking has spread well beyond corporations and financial markets to our society and public life.[5] Private sector leaders agree. As McKinsey's Dominic Barton puts it, "Myopia pervades Western institutions in every sector."[6] Programs that encourage current consumption are squeezing out long-term public investments. Whatever we may do for our children in our family lives, when it comes to our public life, we are unwilling to endure modest sacrifices even when we know that they could help bring about a brighter future for our posterity. Collective myopia is the societal disease of our time. The impatient quest for quick gain overwhelms our better motives. And in the long run, we will all be worse off.

We have to do something about this, and the place to begin is with the financial sector. As Barton bluntly puts it, "To break free of the tyranny of short-termism, we must start with those who provide

2 Laurence Fink, "Our gambling culture," *McKinsey*, April 2015.

3 Andrew G. Haldane and Richard Davies, "The Short Long," presented at the 29th Société Universitaire Européene de Recherches Financières Colloquium, Brussels, May 2011.

4 Andrew Haldane, "Patience and finance," speech delivered at the Oxford China Business Forum, Beijing, September 9 2010.

5 For example, see Sheila C. Bair, "Short-termism and the risk of another financial crisis," *Washington Post*, July 8 2011.

6 Dominic Barton, "Capitalism for the Long Term," *Harvard Business Review*, March 2011.

capital."[7] We need more patient builders and fewer impatient traders, more Warren Buffetts and fewer Carl Icahns. To get them, we cannot rely on cultural change or the collective conversion of CEOs and hedge fund leaders on the road to Damascus. Instead, we must change the laws and rules that shape corporate and investor behavior.

There's nothing wrong with paying investors handsome returns, and a vibrant stock market is something we should wish for. But when the very few can move stock prices in the short term and reap handsome rewards, and when this cycle becomes standard operating procedure, crowding out investments that boost productivity and wage increases that boost consumption, the macroeconomic consequences are debilitating.

THE FALTERING AMERICAN ECONOMY

Everyone knows that something is wrong with the American economy. It has been a full decade since the annual growth rate reached 3 percent, and it has not exceeded 2.5 percent since the end of the 2007-2009 Great Recession. Meanwhile, individuals at the very top of the income scale have appropriated almost all the gains from growth, leaving stagnant or declining wages for everyone else. These trends have sapped the great American middle class of its dynamism and its optimism.

The overall problem can be summed up in five big economic trends:

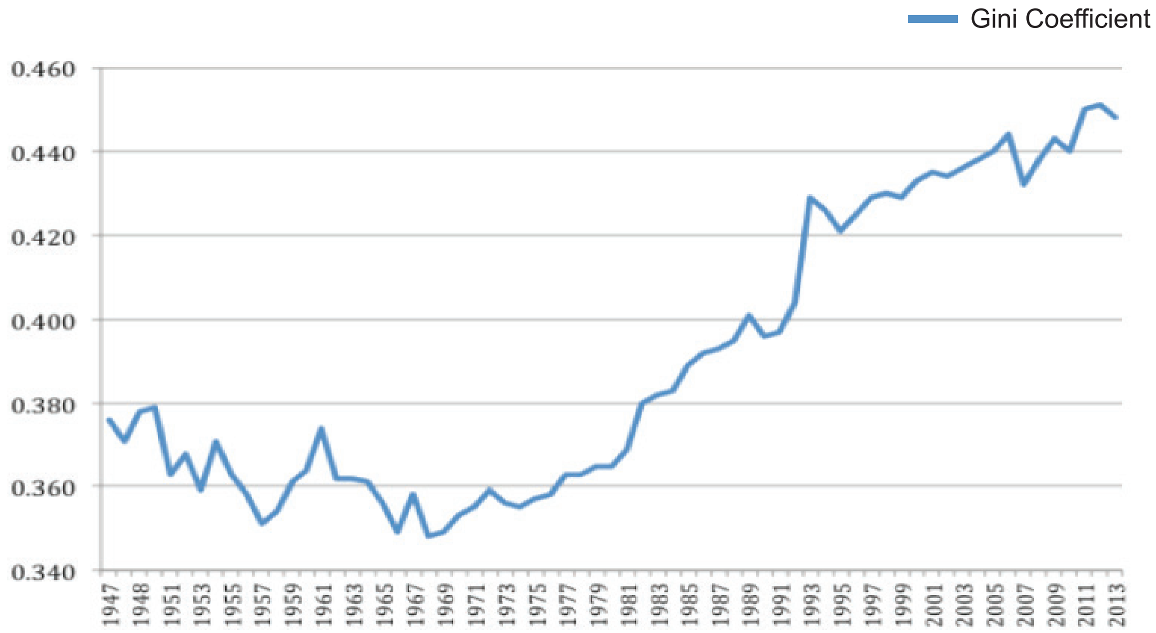
- Rising inequality
- A shrinking middle class
- An increasing wedge between productivity and compensation
- Less business investment
- Excessive financialization of the U.S. economy

Income inequality has increased steadily since the 1970s, accelerating rapidly in the 1980s. This increase in inequality coincides with deregulation of financial services in the 1980s and 1990s and an increase in U.S. non-financial firms pursuing financial investment strategies.[8]

7 Dominic Barton, "Capitalism for the Long Term."

8 For a description of this era see Krippner, Greta R., *Capitalizing on Crisis*. Harvard University Press, 2011.

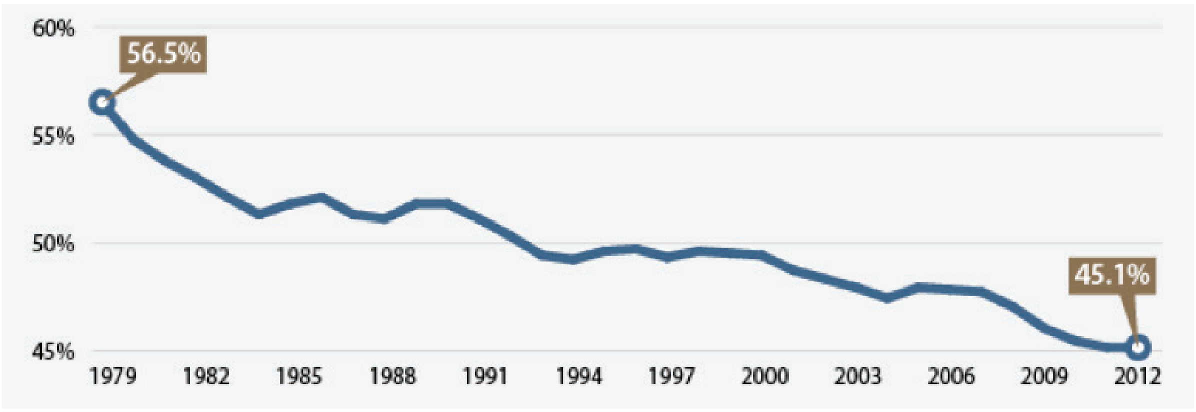
FIGURE 1:
GINI COEFFICIENT AS AN INDICATOR OF
INCOME DISTRIBUTION AMONG ALL U.S. FAMILIES, 1947-2013



Source: U.S. Census Bureau, *Historical Income, Families*

With rising inequality has come a shrinking middle class. In 1979 more than half of all working age households in America earned a middle class income, but by 2012 that share had dropped to 45 percent.

FIGURE 2:
PERCENT OF HOUSEHOLDS AGES 25-64
EARNING WITHIN 50% OF THE MEDIAN INCOME



Source: Center for Economic Policy Research

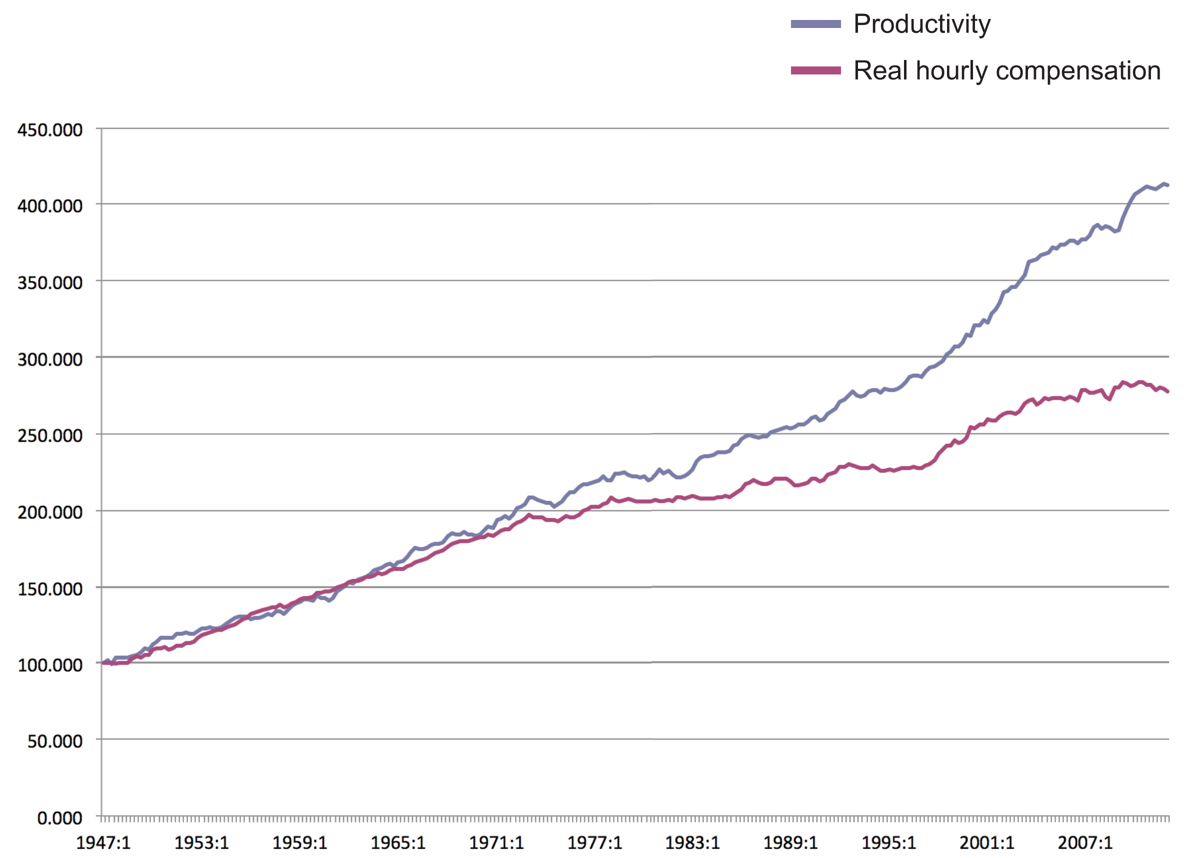
The first fifteen years of the 21st century have been especially hard for the broad middle class. The economist Rob Shapiro analyzed new data from the Census Bureau that enabled him to look at incomes by age cohort and "the distinct life cycle in income progress that most Americans experience as they age."[9] During the Reagan administration and the Clinton administration, people in their prime earning years racked up solid income gains of the sort that Americans in their prime have come to expect. But during the George W. Bush and Obama administrations, annual income growth among workers in their prime decreases significantly.

Correlated with the shrinking middle class is a weakening relationship between productivity and real wages in the United States. As Figure 3 below indicates, these two measures closely tracked each other in the sixties and in the seventies. But by the last decade of the 20th century and the first decade of the 21st century, wage growth no longer kept pace with productivity growth.[10]

9 Robert J. Shapiro, "Income growth and decline under recent U.S. presidents and the new challenge to restore broad economic prosperity," Brookings, March 2015, page 3.

10 Bureau of Labor Statistics, "Labor Productivity and Costs," accessed June 17, 2015. http://www.bls.gov/lpc. We are aware of the technical disputes about the comparability of these two time-series. But other indicators—such as labor's declining share of the GDP—suggest that the story Figure 3 tells is essentially correct.

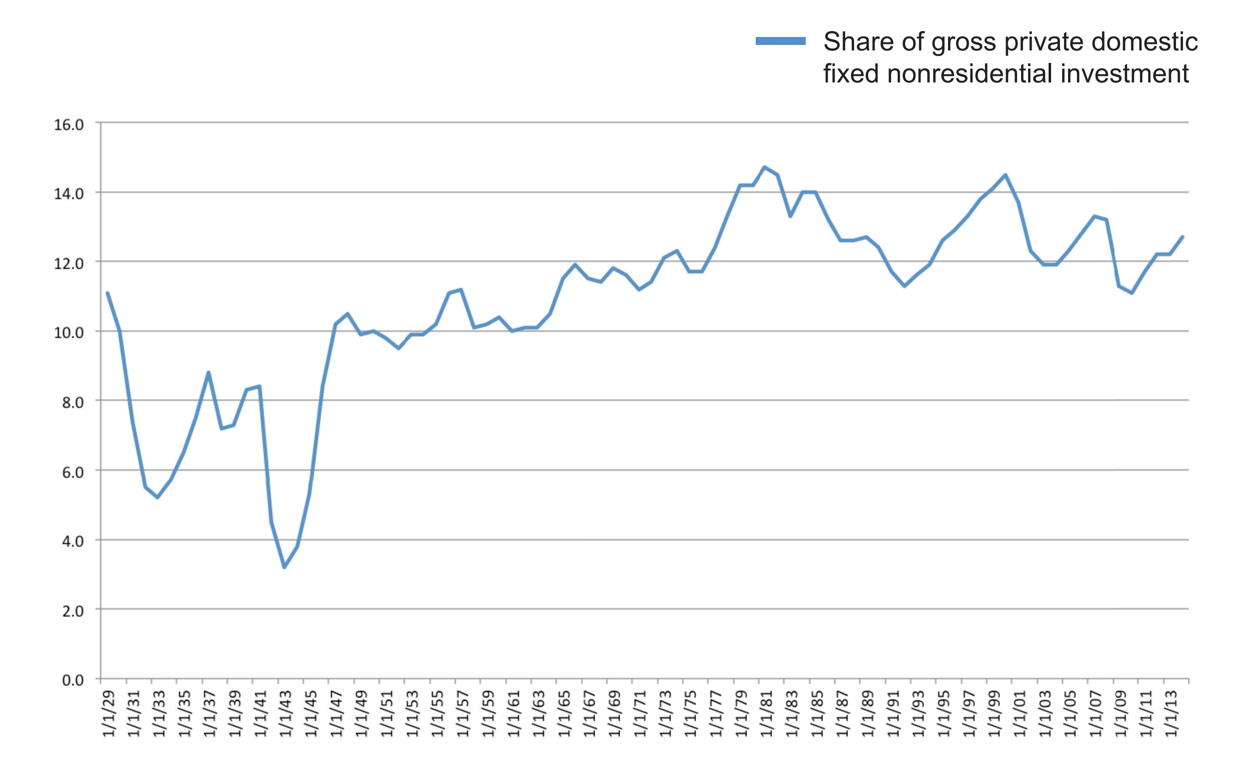
FIGURE 3: PRODUCTIVITY AND REAL HOURLY COMPENSATION, 1947-2012



Source: Bureau of Labor Statistics

Alongside these disturbing trends are lower levels of capital investment. As Figure 4 below indicates, nonresidential fixed investment has declined from nearly 15 percent of GDP in the late 1970s to only 12.7 percent today.

FIGURE 4:
FIXED CAPITAL INVESTMENT AS % OF GDP IN THE US

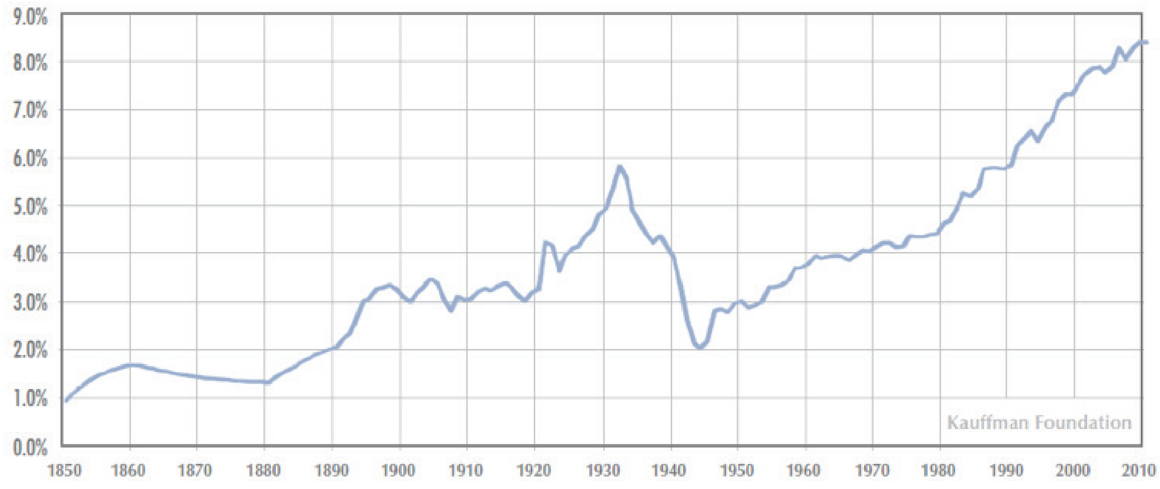


Source: US. Bureau of Economic Analysis. Data available at: http://research.stlouisfed.org/fred2

All of these trends coincide in time with what has come to be known as the “financialization” of the economy. As Figure 5 shows, the past three decades have witnessed an enormous growth in the financial sector as a percentage of U.S. GDP. As the authors of this study state: “The U.S. financial sector’s rise to relative economic importance is historically unprecedented.”[11] This represents a shift from producing goods and services to a shift toward the creation of ever more obscure financial instruments.

11 Paul Kedrosky and Dane Stangler, “Financialization and its entrepreneurial consequences.” *Ewing Marion Kauffman Foundation Research Paper* (2011), page 3.

FIGURE 5:
FINANCIAL SECTOR AS PERCENTAGE OF U.S. GDP: 1850-2009



Source: Kedrosky and Stangler, "Financialization and its entrepreneurial consequences (2011)

THE MICRO PROBLEM

There are many explanations for slow growth and stagnant incomes in the twenty first century American economy. High on the list are globalization and the role the information technology revolution is playing in the disappearance of manufacturing jobs and, more recently routine service sector jobs as well. Other oft-cited explanations include trade agreements and the waning power of labor unions.

Without passing judgment on these proposals, we emphasize an alternative explanation for our economic ills. Our thesis is simple: over the years, a set of incentives has evolved that favors short-term gains over long-term growth, returns to corporate executives and stockholders at the expense of investment in workers and in innovation. They are:

- The proliferation of stock buybacks and dividends
- The increase in non-cash compensation for senior managers
- The fixation on quarterly earnings
- The rise of activist investors

These incentives are so powerful that once they became pervasive in the private sector, they began to have broad effects. No one set out to create this myopic system, which arose piecemeal over a period of decades. But taken together, these perverse new micro-incentives have created a macroeconomic problem.

The proliferation of stock buybacks and dividends

Over the past three decades, the share of resources corporations use to repurchase their own shares has soared. For example, take the 248 companies continuously listed in the S&P 500 since 1981. That year, stock buybacks by these firms consumed a mere 2 percent of net income. Between 1984 and 1993, such purchases averaged 25 percent of net income; from 1994 to 2003, 37 percent; from 2004 to 2013, 47 percent.[12]

Repurchases represent only one way that corporations can direct their resources to shareholders. The other major vehicle—better known to average investors—is dividends, regular and special. Taken together, these payments have grown so much that they now consume nearly all the income earned by major corporations.

Consider recent experience. For the 454 companies listed continuously in the S&P 500 between 2004 and 2013, University of Massachusetts economist William Lazonick found stock buybacks consumed 51 percent of net income and 35 percent of dividends. Excluding the recession years 2001 and 2008, buybacks and dividends taken together have averaged 85 percent of net earnings for all corporations since 1998. The problem is that these kinds of heavy rewards to investors leave only 14 percent for internal investments and compensation increases for their workers.

Between 2004 and 2013, some of the best-known American corporations returned more than 100 percent of their net income to their shareholders in the form of buybacks and dividends. These firms included IBM, Microsoft, Cisco, Intel, Hewlett-Packard, Pfizer, Pepsico, and Procter & Gamble. IBM spent 92 percent of its net income just on buybacks, Cisco 103 percent, and Hewlett Packard 148 percent.[13]

One might imagine that these trends could not go any further, but they are doing just that. Companies spent more than $903 billion on dividends ($350B) and buybacks ($553B) in 2014, almost 95 percent of net income. And they are on track to spend more than $1 trillion—$400 billion in dividends, $604 billion in buybacks—in 2015.[14] In fact, April 2015 was the biggest month ever

12 William Lazonick, “Stock buybacks: From retain-and-reinvest to downsize-and-distribute,” Brookings 2015, page 8.

13 Ibid., page 9.

14 Eric Platt and Michael Mackenzie, “US investors eye record $1tn in payout as groups rein in capex,” *Financial Times*, April 13 2015, p. 1.

for announcements of new buybacks—$141 billion. If that pace continues, share repurchases will shatter the record set in 2007, right before the financial collapse.[15]

The United States has a massive economy. Even so, the numbers we have just cited are overwhelming. According to data compiled by Mustafa Erdem Sakinc of the Academic-Industry Research Network, public U.S. corporations have spent $6.9 trillion in stock buybacks over the past decade.[16] During this period, we calculate, GDP has totaled about $147 trillion, so buybacks alone account for almost 5 percent of the nation's total output (4.7 percent, to be precise) during this period.

The increase in non-cash compensation

In the 1970s, an academic critique of the stock market by professors Michael Jensen of Harvard and William Meckling of the University of Rochester argued that the U.S. economy had a "principal-agent" problem and that the best way to align manager's interests with stockholder's interests was to give managers stock options in lieu of salary.[17] Following publication of another paper by Michael Jensen, this time with Kevin Murphy, which argued that corporate executives needed to act more like entrepreneurs instead of bureaucrats, the stock in lieu of salary idea took off.[18] In 1993 a change in the tax code capped corporate deductibility of executive compensation at $1,000,000 unless amounts over that ceiling qualified as "performance-based," thus adding to the momentum for non-salary compensation.[19]

The results of this change in executive pay have been stunning. Fifty years ago, median CEO compensation was about $1 million (in 2011 dollars), almost all of which came in the form of salaries and bonuses. By 2011, median compensation had increased to nearly $9 million, 70 percent of which consisted in stock awards and options.

When we look at the country's largest corporations, the picture is even more dramatic. According to recently released figures, total compensation for the 200 CEOs of public firms with a market capitalization of at least $1 billion averaged $22.6 million in 2014. Of this total, we calculate that

15 Research cited and discussed in Gretchen Morgenson, "Stock Buybacks That Hurt Shareholders," *New York Times*, June 5 2015, B1.

16 Research cited in Nick Hanauer, "Stock Buybacks Are Killing the American Economy," *The Atlantic*, February 8 2015.

17 Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Volume 3, No. 4, October 1976.

18 Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's not how much you pay, but how," *Harvard Business Review*, May/June 1990.

19 Donald Tomaskovic-Devey, Ken-Hou Lin, Nathan Meyers, "Did Financialization Reduce Economic Growth?" p.27. Available at: http://ssrn.com/abstract=2571897. Nancy L. Rose and Catherine Wolfram, "Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation," Journal of Labor Economics, Vol. 20, No. 2, 2002. Leila Emami Davis, "The financialization of the nonfinancial corporation in the post-1970 U.S. economy" (2014). Doctoral Dissertations 2014-current.

$16.2 million—72 percent—came in the form of stock awards and buybacks.[20] The explosion of non-cash compensation has made it easier for corporate boards to raise overall compensation to undreamt-of heights without imposing a direct hit on their bottom line.

The fixation on quarterly earnings

The third trend in this incentive mix has been the growing importance of quarterly earnings reports. There is strong evidence that meeting quarterly earnings expectations motivates stock buybacks and that this behavior shapes other corporate decisions. A rigorous study by three University of Illinois scholars, Heitor Almeida, Vyacheslav Fos and Mathias Kronlund, found that repurchases were much more likely to occur for firms that narrowly would have missed their earnings forecasts in the absence of these transactions. They also found that repurchases driven by the desire to manage earnings per share caused firms acting in this manner to decrease investment, employment, and R&D.[21]

The tyranny of the quarterly report is such that corporate executives freely admit they would sacrifice the long-term wellbeing of their firms to meet short-term targets. A survey of CEOs and CFOs found that to avoid missing their own quarterly earnings estimates, 80 percent were willing to forgo R&D spending and 55 percent to delay promising long-term projects.[22] The authors conclude, "Managers candidly admit that they would take real economic actions such as delaying maintenance or advertising expenditure and would even give up positive NPV projects to meet earnings benchmarks."[23]A similar study from the authors in 2013 found that over 80 percent of CFO's cite each of the following as motivations to misrepresent earnings: incentives to influence stock price, outside pressure to hit earnings benchmarks, internal pressure to hit earnings benchmarks and to boost executive compensation.[24] A McKinsey survey found 63 percent of corporate executives reporting that pressure to deliver financial results in two years or less had intensified in the past five years.[25]

In keeping with their short time horizons for investment, today's CEOs enjoy remarkably short job tenure. A 2010 study by the Wall Street Journal found that CEOs in S&P 500 firms served on average only 6.6 years—significantly less than in earlier periods.[26] That same study found a strong

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20 "C.E.O Pay: The Rankings," *New York Times*, May 17 2015, pp. B6-7.

21 Heitor Almedia, Vyacheslav Fos, and Mathias Kronlund, "The Real Effects of Share Repurchases," Forthcoming, *Journal of Financial Economics* (JFE). Available at SSRN: http://ssrn.com/abstract=2276156.

22 John R. Graham, Cam Harvey and Shiva Rajgopal, 2005, The Economic Implications of Corporate Financial Reporting, *Journal of Accounting and Economics* 40, 3-73.

23 Ibid., page 37.

24 Ilia Dichev, John R. Graham, Cam Harvey, and Shiva Rajgopal, 2013, Earnings Quality: Evidence from the Field, *Journal of Accounting and Economics* 56, 1-33.

25 Jonathan Bailey and Jonathan Godsall, "Short-termism: Insights from business leaders," CPP Investmen Board and McKinsey & Company, December 26 2013.

26 Joann S. Lublin, "CEO Tenure, Stock Gains Often Go Hand-in-Hand", *Wall Street Journal*, July 6, 2010, p. B5.

relationship between CEO tenure and stock price. Of those who served more than fifteen years, twelve led firms whose stock price outperformed the S&P index over their terms.[27]

Activist investors

Once known as "corporate raiders," activist investors seek to change management behavior. The economic rationale for activism is that it will keep inefficient or incompetent management on its toes, and there is no doubt that this does happen.

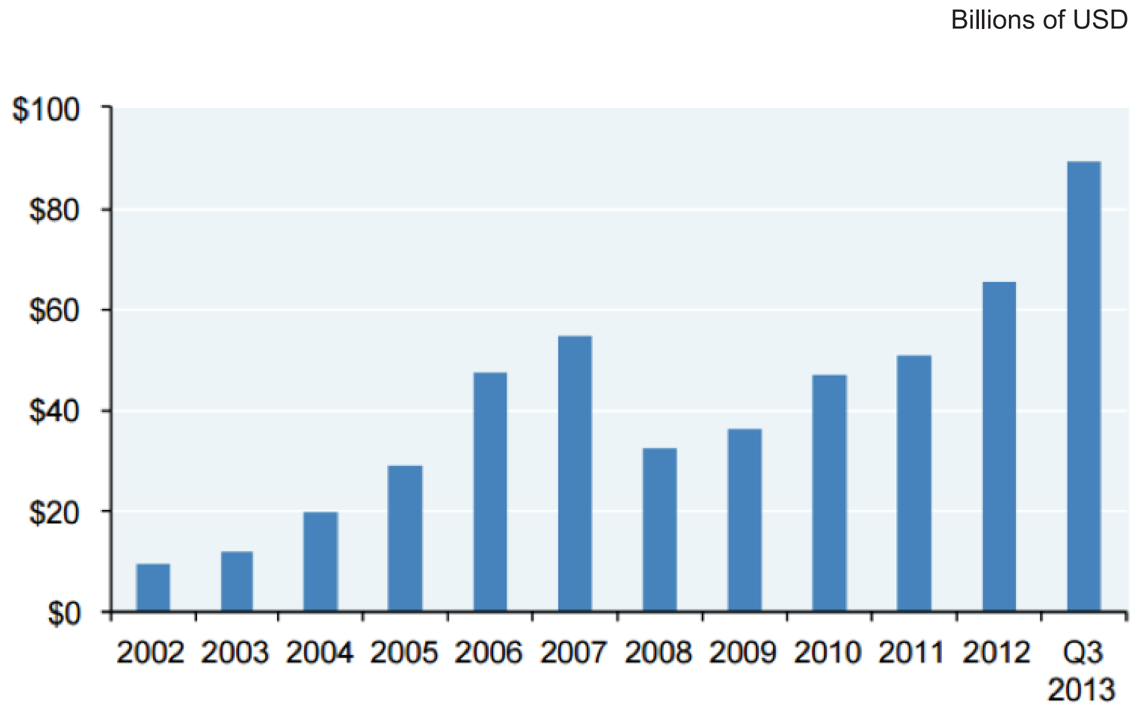
Much of today's activism occurs through hedge funds, which have proliferated since the start of the 21st century. In 2000 there were 4800 hedge funds listed worldwide; by 2012 that number had more than doubled to 10,100.[28] And over the past decade or so the assets of funds regarded as activist have grown to about $100 billion.[29]

27 Ibid.

28 The City UK, "Growth in the number of hedge funds worldwide from 2000 to 2012," last modified 2015, http://www.statista.com/statistics/273844/growth-of-the-number-of-hedge-funds-worldwide/.

29 "Eye on the Market," J.P. Morgan, Feb. 18, 2014.

FIGURE 6: THE RISE OF ACTIVIST HEDGE FUNDS



Source: Hedge Fund Research, Inc.
Note: This chart excludes activist activity by pension funds, multi-strategy hedge funds and other shareholder groups. In the 20 years from 1994-2013, activist events rose from barely above zero to nearly 200 per year in 2013. See footnote 28 for more information.

The effect of activist investing on the health of companies and, by extension, the larger economy, has been a topic of heated debate in academic circles. The leading proponent of the proposition that activist investors are good for the economy is Harvard Law School professor Lucian A. Bebchuk, who along with Duke's Alon Brav and Columbia's Wei Jiang examined 2000 activist events, concluding that there were no downsides to investor activism and that activist events yielded positive returns at both three years and at five years out.[30]

The case against activism has been made by Martin Lipton at the law firm Wachtell, Lipton, which specializes in defending companies against investor activism. In an article, "The Bebchuk Syllogism," Lipton argues that the way Bebchuk uses the Tobin Q (a standard measure of market value to book value) affects his findings. Bebchuk uses an average, which can be skewed by extreme events. As Lipton points out, if the median is used instead, the Q value is actually *lower* in the first four years

30 Lucian A. Bebchuk, Alon Brav, and Weim Jiang, "The Long-Term Effects of Hedge Fund Activism," Columbia Law Review, Vol. 115, No. 5, June 2015, pages 1085-1156.

following the attack. Put simply, activist pressure produces large right-tail gains but leaves the typical firm worse off. In a similar vein, New York University Law School's John C. Coffee Jr. notes that firms stalked by activist investors often face outcomes that may either be "a feast or a famine"—prospects that should concern boards of directors responsible for a single firm rather than a portfolio of bets.[31]

The wariness many feel about activist investors comes from the fact that the incentive structure for activist investors intensifies the impact of short-term incentives on corporate managers. Activist investors pressure managers to provide immediate returns on their investment in the form of buybacks and special dividends. Some managers have come to believe that maximizing shareholder value means boosting short-term returns. Many others have concluded that they cannot resist pressures to do so, even if they do not believe that it is the right thing to do. All too often, the fear is that the management decisions demanded by the activists are for the purpose of stock price manipulation, not long-term growth. With the rise of hedge funds, activist investing has fallen prey to the casino mentality that causes enormous stock buybacks, outsized executive compensation and fealty to quarterly earnings reports at the expense of investments in longer-term growth.

CONSEQUENCES OF THE MICRO-ECONOMIC INCENTIVE SYSTEM: THE RISE OF "SHORT-TERMISM"

As pay packages for senior managers has tilted toward non-cash compensation, managers' incentives have shifted. At the theoretical level, 2014 Nobel Prize-winner Jean Tirole and coauthor Roland Benabou have demonstrated that performance-based pay tends to shift managers' attention away from hard-to-quantify activities such as long-term risk management toward more easily quantifiable short-term tasks and targets. For example, deferring long-term commitments can raise earnings here and now. Higher reported earnings boost share prices, which enhances the value of stock options.[32] Lazonick notes that the vesting of stock awards "is often dependent on the company hitting quarterly earnings per share (EPS) targets, for which well-timed manipulative boosts from stock buybacks can be very helpful."[33]

Simple arithmetic tells us without buybacks, exercising options increases the number of shares outstanding, diluting the value of previously issued shares and reducing reported earnings per share. More than a decade ago, scholars from the University of Chicago and the University of Michigan found that corporate executives use repurchases to offset actual and potential dilution, which generally accepted accounting practices require firms to report. They also found that such buybacks do not create any value for shareholder. As one of the study's authors, M. H. Franco Wong, said,

31 John C. Coffee Jr., "Hedge Fund Activism: New Myths and Old Realities," *New York Law Journal*, May 15 2014.

32 Roland Bénabou and Jean Tirole, "Bonus Culture: Competitive Pay, Screening, and Multitasking," National Bureau of Economic Research Working Paper 18936, April 2013.

33 Lazonick, "Stock buybacks," p. 8.

"Repurchasing your own stock for this purpose is like taking money from your left pocket and moving it to your right pocket."[34]

For the corporate balance-sheet, Wong's point is incontestable. But for individual managers whose compensation depends on meeting earnings targets, the effect is to take money from the firm's coffers and transfer it to their own—and of course to shareholders, who benefit from higher stock prices. A recent survey by the *Economist* puts it this way: "pay plans can corrupt managers' motives. By buying existing shares they can offset the effect of new ones created for their personal stock-option plans. Cash leaves the firm for their pockets without being booked as a cost or reducing earnings per share." Even worse, *The Economist* points out, because interest paid on debt is tax-deductible while interest earned on cash is taxable, firms can cut their tax bills by increasing net debt to finance buybacks (and dividends). In the process, firms undertake additional risks, which can come back to bite them during economic downturns.[35]

Relatedly, Alex Edmans of the London Business School and three colleagues have discovered that CEOs strategically time favorable corporate news releases to coincide with the months in which their stock awards vest. This generates a temporary run-up in stock prices, and, they say, CEOs take advantage of these effects "by cashing out shortly after the news releases."[36]

We can debate the relative weight of these explanations for the surge in stock buybacks. There is less room for debate about their effects. As James Montier has pointed out, during the entire post-war period, retained earnings have financed almost all business investment, while stocks, bonds, and lines of credit have played a minor role. All other things equal, if a steadily rising share of internally generated resources goes to shareholders, the pool of funds available for investments shrinks.[37]

Not surprisingly, so has corporate investment. While cash distributed to shareholders as a share of cash flow has surged to a record high during the past decade, the share devoted to capital investment has fallen to a record low.[38] Among other consequences, this decline has left companies with the oldest plant and equipment stock in six decades. The average age of their fixed assets is now 22 years, the highest since 1956.[39]

34 Daniel A. Bens, M.H. Franco Wong, and Douglas J. Skinner, "What Drives Companies to Repurchase Their Stock?" University of Chicago Graduate School of Business, *Capital Ideas*, Volume 5, No. 2, Fall 2003.

35 "The repurchase revolution," *The Economist*, September 13 2014.

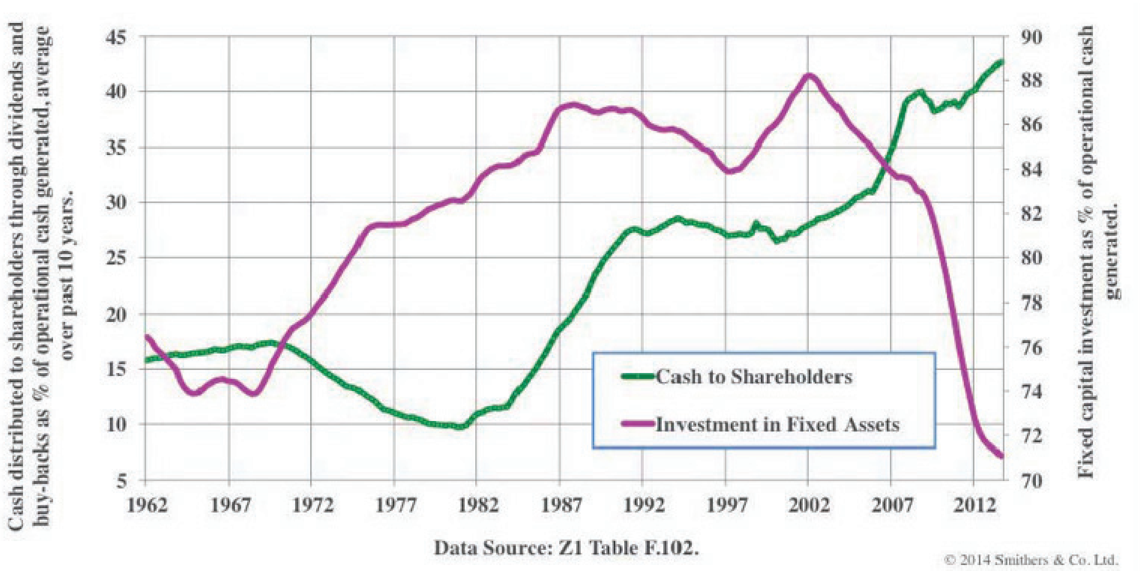
36 Alex Edmans, Luis Goncalves-Pinto, Yanbo Wang, and Moqi Xu, "Strategic News Releases in Equity Vesting Months," European Corporate Governance Institute Finance Working Paper 440/2014, September 2014.

37 James Montier, "The World's Dumbest Idea," GMO White Paper, December 2014.

38 Andrews Smithers, "Remuneration—It's Broke, So Fix It," *Executive Compensation Briefing*, March 2014.

39 Lu Wang and Callie Bost, "S&P 500 Companies Spend Almost All Profits on Buybacks," *BloombergBusiness*, October 6 2014.

FIGURE 7:
US COMPANIES PAY OUT RECORD HIGH AMOUNTS TO SHAREHOLDERS AND INVEST RECORD LOW AMOUNTS IN FIXED ASSETS



Source: Andrews Smithers, "Remuneration—it's Broke, So Fix It," *Executive Compensation Briefing*, March 2014.

Some kinds of firms—such as financial institutions and consumer retailers—can do well without significant investment in R&D. But about half the world's largest firms do depend on R&D. Among these firms, there is a direct and strong relationship between the level of R&D and long-term growth rates. When the surge and buybacks comes at the expense of R&D, it reduces growth.[40]

The same pool of internal funds serves as the source for wage and benefit increases. Although the cause and effect relation is hard to prove, the surge in stock buybacks has coincided notably in time and extent with the decline in the share of GDP that goes to labor. It has also coincided with the much-discussed "breakaway" of the top 1 percent from the rest of the population.

The buyback explosion is also driving a wedge between real and reported economic performance. During the past two years, the average growth rate of sales for the S&P 500 was 2.6 percent, but earnings per share rose more than twice as fast—6.1 percent—in part because so many companies have used buybacks to reduce their total shares outstanding. Companies with the largest buyback programs have outperformed the broader market by 20 percent since 2008. As Barclay's Jonathan Glionna puts it, "There are a couple of reasons why companies do buybacks. One is that . . . it makes stocks go up."[41]

40 For a summary of the evidence, see Matthew A. Winkler, "Big Ideas, Big Spending, Big Payoff," *BloombergView*, May 19 2015.

41 Dan Strumpf, "Companies' Stock Buybacks Help Buoy the Market," *Wall Street Journal*, September 15, 2014.

A Bloomberg analysis suggests that the unprecedented level of buybacks has put an artificial safety-net under the bull market that has now completed its sixth year without a substantial correction. Gary Black, chief investment officer at Calamos Asset Management, confirms this assessment. “It does act as a floor,” he comments, adding that the repurchase spree is an “accelerant” that is “giving juice to this market.”

At some point the game must end, of course. As Chris Bouffard, chief investment officer at Mutual Fund Store, observes, “You can only go so far with financial engineering before you actually have to have a business with real growth.” With buybacks and dividends consuming nearly all profits, the ceiling must be in sight—that is, unless corporations accelerate their acquisition of debt at low interest rates to finance yet more short-term return to shareholders.[42]

The most profound systemic effect of the buyback boom has been to turn the role of equity markets upside down. These markets are supposed to serve as vital sources of capital for corporations. But from the mid-1980s onward, Montier notes, the value of repurchased shares has exceeded the value of new shares issued. “Far from providing capital to the corporate sector,” he says, “shareholders have been extracting it.”[43] Lazonick calculates that between 2005 and 2014, the net withdrawal has averaged $399 billion per year.[44]

In addition to turning the role of the equity markets upside down, financialization depresses entrepreneurship. Paul Kedrosky and Dane Stangler of the Kauffman Foundation find that as financialization increases, startups per capita decrease, in part because the growth in the financial sector has distorted the allocation of talent. They estimate that if the sector were to shrink as a share of GDP back to the levels of the 1980s, new business formation would increase by two to three percentage points.[45]

We have substantial circumstantial evidence to show that these trends have had negative consequences at the macro level: “the influence of finance sector size on economic growth turns negative when financial services become too large a share of an economy and that high levels of financial activity crowd out investment and R&D in the non-finance sector.”[46] But to strengthen the causal link we need to show that these corporate behaviors have more negative than positive consequences at the micro level as well. This poses methodological challenges, in part because standard variables are exceedingly noisy, making it hard to determine what current data sets are actually measuring.

42 Wang and Bost, “S&P 500 Companies Spend Almost All Profits on Buybacks.”

43 Montier, “The World’s Dumbest Idea.”

44 Lazonick, “Stock buybacks,” p. 3.

45 Ibid., page 14.

46 S. G. Cecchetti and E. Kharroubi, “Reassessing the Impact of Finance on Growth,” No. 381, Bank for International Settlements, 2012, p. 8. See also Joshua Aizenman, Brian Pinto and Vladyslav Sushko, “Financial Sector Ups and Downs and the Real Sector in the Open Economy: Up by the Stairs: Down by the Parachute,” *Emerging Markets Review*, Volume 16, pages 1-30; and Donald Tomaskovic-Devey, Ken-Hou Lin, and Nathan Meyers, “Did Financialization Reduce Economic Growth?” Available at SSRN: http://ssrn.com/abstract=2571897.

This problem has led scholars to construct new measures that characterize a longer-term orientation. For instance, Robert Eccles, Ioannis Ioannou, and George Serafeim looked at a matched sample of 180 companies. Using a variety of indices they constructed a measure that captured "high sustainability practices" and "low sustainability" practices. When they looked at these companies over an eighteen-year period, the high sustainability practices "significantly outperform their counterparts over the long-term, both in terms of stock market as well as accounting performance."[47]

In a novel approach, Jillian Popadak of Duke University transformed millions of reviews from career intelligence websites into a set of measures that capture dimensions of corporate culture. She finds that firms with increased attention to shareholder governance show "statistically significant decreases in customer-orientation, integrity and collaboration." In the long term, the shareholder focus leads to "significant decreases in both tangible assets and customer satisfaction along with increase in goodwill impairment…"[48] Shareholders face a tradeoff, she concludes, between "enhancing activities that produce easy-to-observe performance metrics and [those that strengthen] difficult-to-measure intangible assets."[49] The former look good in the short term; the latter help firms survive in bad times as well as keep their balance when new opportunities emerge.

In another approach to quantifying the hard-to-measure intangibles, Alex Edmans assesses the link between employee satisfaction and firm performance of companies. By using future stock returns as the dependent variable, and controlling for risk, firm characteristics, industry performance, and outliers, Edmans establishes a causal relationship between employee satisfaction and firm performance in the United States. He finds that the "100 Best Companies to Work for in America" generated 2.3 percent to 3.8 percent higher stock return per year than peer companies over the 26-year period from 1984 to 2011.[50] These results indicate that investing in the workforce rather than chasing short-term gains can improve companies' performance over the long term. But because the stock market is unable to fully value employee satisfaction, these results also suggest the importance of shielding managers from short-term stock price pressures to encourage long-term economic growth.

Alex Edmans, Lucius Li, and Chendi Shang build on this research, using lists from the "Best Companies to work for" in 14 countries to show that employee satisfaction is associated with "positive abnormal returns in countries with high labor market flexibility such as the U.S. and the U.K. but not in countries with low labor market flexibility such as Germany."[51] In lightly regulated labor

47 Robert G. Eccles, Ioannis Ioannou, and George Serafeim, The Impact of Corporate Sustainability on Organizational Processes and Performance (November 23, 2011) accessed at: http://ssrn.com/abstract=1964011.

48 Jillian A. Popadak, "A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value" October 25, 2013, page 26. Available at SSRN: http://ssrn.com/abstract=2345384.

49 Ibid., page 38.

50 Alex Edmans, "The Link Between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility," *Academy of Management Perspectives*, Volume 26, Number 4, November 2012, pages 1-19. November 2012. Available at SSRN: http://ssrn.com/abstract=2054066.

51 Alex Edmans, Lucius Li, and Chendi Zhang, "Employee Satisfaction, Labor Market Flexibility and Stock Returns Around the World," *European Corporate Governance Institute,* Finance Working Paper No. 433, June 2014.

markets such as the U.S., treating workers as stakeholders rather than as costs improves corporate performance, providing empirical evidence for the proposition that employee satisfaction serves as a valuable tool for recruitment, retention, and motivation. But the pressure to show short-term results pushes managers in the opposite direction.

WHAT CAN BE DONE? SOME POSSIBLE POLICY RESPONSES.

Whether examined at the level of the economy as a whole or at the level of the individual firm, the past few decades of American capitalism are not delivering what they should be delivering, measured against the goal of inclusive economic growth.

The proliferation of share repurchases, we argue, has had numerous bad effects—on investments, wages for average workers, and the willingness of firms to adopt a long-term perspective. The surge in non-cash compensation for CEOs has intensified these problems. In the name of better aligning managers' incentives with the interests of their companies, it has created perverse incentives to manage earnings and to report results that diverge from actual corporate performance. It diminishes incentives to seek productive investments and to make the kinds of commitments—to research and development, for example—that will show up in the bottom line five or ten years hence, not in the next quarter's earnings.

There is a compelling case, we conclude, for reining in both share repurchases and the use of stock awards and options to compensate managers. To this end, we propose the following steps:

- Repeal SEC Rule 10-B-18 and the 25 percent exemption
- Improve disclosure practices
- Strengthen sustainability standards in 10-K reporting
- Toughen executive compensation rules
- Reform the taxation of executive compensation

Repeal SEC rule 10-B-18 and the 25 percent exemption

Prior to 1982, SEC rules did not provide companies buying back their own stock with a "safe harbor" protection against insider trading violations, and many companies limited their open-market buying out of fear of SEC prosecution. The rule change that allowed for the eventual surge in share repurchases began in 1982 after the SEC adopted a new rule—10b-18 of the Securities Exchange Act—that enabled corporate managers to purchase large quantities of their companies' stock without fearing that the SEC would accuse them of stock-price manipulation.[52] This change guaranteed that companies would not be charged if their buybacks on any single day were no more than 25 percent of average daily trading volume over the previous four weeks. Nor would there be a presumption of manipulation if open-market purchases exceeded this level.

William Lazonick, who has conducted pioneering studies of this shift, recommends that this rule be dramatically curtailed or reversed outright. If ordinary Americans are not allowed to engage in insider trading based on non-public information, why should company managers be allowed to do so?

Defenders of the post-1982 regulatory regime contend that this change promotes the most efficient use of capital. There is little evidence that this is the case, and much that it is not. As David Kostin, Goldman Sachs' chief U.S. equity strategist observes, "Managements (sic) are often poor market timers. In 2007, companies allocated more than one-third of their cash use to buybacks ($637 billion) just before the S&P 500 plunged by 40 percent during the following year. Conversely, at the bottom of the market in 2009, firms devoted just 13 percent of their annual cash spending to repurchases ($146 billion)."[53] Although in principle, buybacks could be a sensible business strategy when a firm's shares lag behind its underlying worth, in practice corporate managers seldom get the timing right, in part because the incentives spurring buybacks are not well aligned with the firm's long-term growth.

Warren Buffett famously remarked that "Buying dollar bills for $1.10 is not good business for those who stick around."[54] But that is the point: many of those who engage in this practice have no intention of sticking around. They plan to take the money and run. And sadly for our economy, they get away with it.

Improve disclosure practices

Corporate executives are not required to offer quarterly earnings estimates, and a McKinsey study has found that not doing so has no negative effects on the stock price of firms that don't.[55] On the other hand, we know that publicly announcing such estimates encourages short-term behavior that weakens potentially profitable long-term investments in R&D and new ventures. Building on leading investor Robert Pozen's analysis, we recommend that firms stop issuing quarterly estimates and instead focus on meaningful long-term metrics.[56]

52 Richard L. Hudson, "SEC Eases Way For Repurchase Of Firms' Stock," The Wall Street Journal, November 10 1982.

53 Quoted in Andrew Ross Sorkin, "Mergers Might Not Signal Optimism," *New York Times*, June 9 2015, B1.

54 William Lazonick, "Profits Without Prosperity," *Harvard Business Review*, September 2014.

55 Peggy Hsieh, Timothy Koller, and S. R. Rajan, "The Misguided Practice of Earnings Guidance," *McKinsey on Finance*, Spring 2006.

56 Robert C. Pozen, "Curbing Short-Termism in Corporate America: Focus on Executive Compensation," Brookings 2014. For a specification of long-term measures, see Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term, *Harvard Business Review*, January/February 2014, pp. 44-51.

Stronger language on inclusion of sustainability standards in 10-K reporting

One of the most important and long-lasting results of the Great Depression was passage of legislation in 1933 and 1934 that created the architecture for regulating the securities market. Central to the theory of those acts is the concept that transparency is a critical component of a healthy market. The results of the legislation were disclosure requirements intended to protect the public and investors. Over the years these requirements were standardized into generally accepted accounting standards and supported and enforced by the Securities and Exchange Commission.

But as Robert Eccles and Jean Rogers of the Sustainable Accounting Standards Board (SASB) point out, as important as the development of standard financial accounting was, "the world is now a very different place—facing megatrends such as population growth, food scarcity, climate change and resource constraints. Today, financial accounting along cannot capture the complete picture of a company's value."[57]

In this day and age, a complete picture of a company's value and future can only be taken if sustainability information is evaluated side by side with financial information. Eccles and Rogers argue that for sustainability information to be meaningful it must be based on the notion of "materiality"; in other words the standard must be relevant to the success of business in a given sector. Thus, as they point out, in the pharmaceutical industry companies face material risks from a growing market in counterfeit drugs; in the software and IT services industry companies face material risk from cybercrime; the property insurance industry faces material risks from climate change. For an investor to truly understand a business, reporting must include information of a non-financial nature.

Of course, financial metrics are easy to understand and easy to produce which is why they still constitute the bulk of corporate disclosures. But SASB is working to create metrics such as "energy intensity" that can eventually be used as a standard part of 10-K reporting. The SEC already requires that companies disclose "all material information" in their 10-K forms. Stronger rules on the inclusion of non-financial data will help to shift the focus towards longer-term growth.

Toughen executive compensation rules

Another SEC rule change (this one in 1991) allowed top executives to exercise their stock options as soon as they received them, sell the acquired stock immediately—and retain the gains. This change should also be reversed, and a minimum holding period should be imposed.

In addition, to the extent that stock awards are used as part of total compensation, they should be based not on the short-term performance of the firm's stock but rather on the long-term performance

57 Robert Eccles and Jean Rogers, "The SEC and Capital Markets in the 21st Century: Evolving Accounting Infrastructure for Today's World," Brookings, September 2014, p. 2.

of the actual business. Robert Pozen has suggested granting these awards in the form of restricted shares that vest only if long-term performance goals are met—and then requiring executives to hold the vested shares for a period of years, or even until retirement.[58] We endorse these proposals.

Reform the taxation of capital gains

Some tax experts have proposed eliminating the distinction between ordinary income and capital gains, and that may well be a sensible proposal. Without going all the way down that road, however, we could restructure the treatment of capital gains to encourage longer time horizons on the part of managers and activist investors. For example, BlackRock's chairman Laurence Fink has proposed lengthening to three years the holding period needed to qualify for capital gains treatment while taxing trading gains at an even higher rate than ordinary income for investments held less than six months. To encourage truly patient capital, the capital gains rate could be stepped down to zero over a period of (say) 10 years.[59]

Of course, we need to examine this proposal in the broader context of tax reform. But one thing is clear: our current tax code is doing little to deter short-termism, and the interaction between the code and executive compensation packages may actually be exacerbating it. We can do better.

Taken together, these reforms will go some way toward shifting managerial incentives away from short-term gains toward long-term growth. And by freeing funds for investments in employees as well as plant, equipment, and R&D, a virtuous circle becomes possible: a more satisfied and productive workforce will boost growth, which in turn will permit CEOs and boards to raise wages while offering good returns on shareholder investment. For the first time in the 21st century, we could be growing together—not apart.

CONCLUSION

A traditional function of the public corporation has been to use information and experience to invest the bulk of their earnings better than their shareholders are able to do. But if, under the theory of maximizing shareholder value that has come to dominate corporate America, publicly-held corporations now return more to shareholders than they receive from them, one may wonder why these corporations continue to exist in their current form.

These doubts intensify when we compare the performance publicly-held firms with that of non-public firms. A recent study by three leading business professors finds that "compared to private firms, public firms invest substantially less and are less responsive to changes in investment opportunities, especially in industries in which stock prices are most sensitive to earnings news." These findings

58 Pozen, "Curbing Short-Termism," p. 17.

59 Fink, "Our gambling culture."

are consistent, the authors conclude, with the proposition that "short-termist pressures distort their investment decisions."[60]

Another study demonstrates that publicly-held status allows CEOs to extract more value from their firms than if they headed comparable private firms. The authors state that "After controlling for firm and CEO characteristics, we find robust evidence of a substantial pay premium in public firms." Moreover, "This public pay premium persists after accounting for differences in equity risk, dividend policy, and CEO turnover between public and private firms."[61]

When we compare family-owned businesses to those whose ownership is widely dispersed, the differences are even more pronounced. A study by three business advisors found that although family-owned firms don't do as well during boom times, they outshine their peers when the economy slumps. Summed across full business cycles, family-owned firms outperformed the others in every country studied. Among the reasons: family firms emphasize organic growth rather than flashy acquisitions, they are better at retaining talented workers, and—surprisingly—they are more successful at generating overseas sales. Overall, say the authors, "Executives of family businesses often invest with a 10- or 20- year horizon," and they "tend to manage their downside more than their upside, in contrast with most CEOs, who try to make their mark through outperformance."[62]

These businesses are more than vestigial relics of a vanishing past: the number of publicly-listed corporations in the U.S. stock market has dropped by more than half since the peak in 1997.[63] One-third of US businesses with revenues of $1 billion or more are now family-owned. In France and Germany, that figure rises to 40 percent, and it exceeds 50 percent in India and Southeast Asia. If these firms outperform publicly-held businesses while incurring fewer risks, it calls into question our basic assumptions about the rationale for the public entities at the center of our economy.[64]

We are not calling for the abolition of the public corporation. Our point is rather that our economy would work better if public corporations behaved more like private firms—if they made long-term investments, retained their workers, grew organically, and offered reasonable but not excessive compensation to their top managers, based on long-term performance rather than quarterly earnings. To make this happen, we must restructure the incentives that shape the decisions of CEOs and board of directors. By reining in stock buybacks and reducing short-term equity gains from compensation packages, we have argued, we can move significantly down this road. And we should.

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60 John Asker, Joan Farre-Mensa, and Alexander Ljungqvist, "Corporate Investment and Stock Market Listing: A Puzzle?" *Review of Financial Studies*, October 27, 2014.

61 Huasheng Gao, Michael Lemmon, and Kai Li, "A Comparison of CEO Pay in Public and Private US Firms," unpublished working paper, 2010. Available here: http://www.ccfr.org.cn/cicf2011/papers/20110108205214.pdf.

62 Nicolas Kachaner, George Stalk, and Alain Bloch, "What You Can Learn from Family Business," *Harvard Business Review*, November 2012. A McKinsey study conducted at the same time reached the same conclusion. See "The Five Attributes of Enduring Family Businesses," *McKinsey Quarterly Report*, 2009.

63 Gerald F. Davis, "After the Corporation," *Politics & Society* Volume 41, Number 2, page 291.

64 Adrian Wooldrige, "To have and to hold," *The Economist,* Special Report on Family Companies*,* April 18 2015.

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