

Lecture 6

Governance

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Our previous analysis is independent of the firm's goals

Introduction

- Up until now, firm objectives have not been our main concern:
 - ① Limit order markets are trading mechanisms, having little to do with the motivations of those using it.
 - ② Arbitrage opportunities, or more generally APT, are attractive to anyone serving their own interests.
 - ③ The bidding rules we derived for auctions take the underlying valuations as given by any arbitrary tastes.
 - ④ Our portfolio analysis is for small investors who cannot affect the probability distribution of financial returns.
- What are the objectives of publicly traded firms?

How firms reward their top employees

Identifying shareholder objectives

- One way of discerning the objectives of publicly traded firms is investigate the pay structure of top managers.
- The CEO manages the day-to-day activities of his firm.
- Managerial compensation comes in the form of:
 - ① Cash and bonus
 - ② Stock and option grants
 - ③ Abnormal return on stocks and options held by the manager
 - ④ Pension and retirement benefits
 - ⑤ Compensation for termination
- My work with alumnus Dr. Margiotta and Prof Gayle shows that CEO compensation is very sensitive to the firms' financial abnormal return (that is net of return on market portfolio), because of the amount of the firm's (granted but not yet vested) securities he holds.

TABLE 4—CROSS-SECTIONAL INFORMATION ON COMPONENTS OF COMPENSATION
(In thousands of US\$ (2000); standard deviations in parentheses)

Variable	Rank	Old	New restricted	New all
Salary and bonus	All	219 (114)	838 (1,066)	667 (905)
	CEO	261 (115)	1,037 (1,365)	1,127 (1,282)
	Non-CEO	179 (97)	640 (576)	552 (738)
Value of options granted	All	79 (338)	2,401 (13,225)	903 (3,753)
	CEO	111 (439)	3,402 (18,172)	1,782 (7,169)
	Non-CEO	51 (198)	1,401 (4,237)	681 (2,106)
Value of restricted stock granted	All	11 (95)	187 (1,633)	152 (936)
	CEO	8 (72)	242 (2,021)	298 (1,464)
	Non-CEO	13 (112)	133 (1,118)	115 (743)
Change in wealth from options held	All	5 (134)	785 (14,636)	281 (8,710)
	CEO	7 (167)	1,667 (17,078)	1,474 (13,567)
	Non-CEO	3 (94)	-76 (11,706)	-18 (6,939)
Change in wealth from stock held	All	-3 (439)	-40 (5,681)	125 (4,350)
	CEO	0.434 (479)	-14 (6,712)	264 (6,791)
	Non-CEO	-7 (398)	-64 (4,496)	90 (3,473)

How firms reward their lower ranked employees

Identifying shareholder objectives

- Below the very top ranks, compensation does not depend as much on the firm's abnormal returns.
- My current research with Profs Gayle and Golan suggests that, on the lower rungs, the prospect of promotion is a very important motivator, which substitutes for performance pay.
- Our results suggest that removing pay incentives at the top level might have a negative cascading effect throughout the organization.
- Are there other incentives at work?
 - 1 TARP companies, alternative energy source companies supported by the government, provide some small sample evidence on the effects of taxpayer-funded public policy experiment.
 - 2 To what extent does lower and middle level management oppose shrinking the size of the firm through dividend payouts and stock buyouts thus limit internal promotion prospects?

Concentrated ownership and firm returns

Identifying shareholder objectives

- Another way of discerning shareholder goals is to estimate abnormal returns as a function of ownership concentration by individuals.
- There is some evidence that this function has an inverted U shape.
- High levels of ownership concentration might lead to a tightly controlled board that can more easily monitor management.
- At very high levels of concentration, a large shareholder (coalition) might use the company for his own consumption purposes.
- For example did the Bankroft family, or does Rupert Murdoch, use the Dow Jones Company to peddle the WSJ editorial policies, reducing its expected dividend stream?

Investor Activism

Ownership and firm value

- Mutual funds are a potentially powerful mechanism for marshalling the resources of like minded investors to take over and control enterprises and pursuing goals that do not maximize expected wealth.
- Although the firms they control lose value, the controlling owners may accomplish other real objectives instead, such as environmental goals.
- In such cases dissenting minority shareholders suffer at the hands of the board (having failed to anticipate these changes by selling their shares first).



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Are non wealth maximizing firms takeover targets?

Identifying shareholder objectives

- Firms not maximizing their expected wealth have correspondingly lower equity values.
- They represent a profit opportunity to private investors and/or their management.
- If the board is not organized to prevent a buyout, their positions are at risk.
- Potential buyers often partially fund their purchases with the help of creditors, raising the debt/equity ratio.
- When their intentions are made public, this raises the equity value of outstanding shares, increasing the acquisition costs.
- This helps explain why limit sell orders are not stacked on the ask price.

Diluting ownership and control

Ownership and firm value

- Strong boards supported by concentrated ownership and/or voting rights can fend off takeovers if they choose.
- Three other major functions of the board are to:
 - ① set CEO compensation in the interests of those represented on the board.
 - ② assist in the promotion and succession process of executive management.
 - ③ oversee fiduciary obligations of the firm.
- When large shareholders reduce their stake in the firm, the board becomes more fragmented, and does not perform its functions as well.
- This causes the equity value of the firm to fall.
- This helps to explain why limit buy orders are not stacked at the bid price.

Investment Projects in the Firm

Debt and Equity

- The Modigliani-Miller theorem states that the asset value of the firm does not depend on the nature of its financing
- The theorem implies the debt equity ratio is essentially irrelevant in determining the value of the firm.
- Reducing the size and scope of the firm, or mitigating its growth, is easily achieved by distributing dividends.
- To raise funds for expansion requires the board to borrow or sell new equity.
- New equity dilutes ownership concentration, increases the cost monitoring management and induces different forms of governance.
- Raising corporate debt increases the odds of bankruptcy, which typically leads to a drastic reorganization of the firm's management, and its activities.
- These very different types of costs illustrate how and why strategic concerns limit the applicability of the theorem.

Alternative organizational forms

Matching the goals of owners to the type of firm

- Privately held firms do not run the risk of takeover, so are a more attractive vehicle for pursuing non wealth maximizing objectives.
- Sole proprietorships, partnerships, nonprofit organizations, and limited liability private companies are the main alternatives to working for a publicly listed firm or a government agency.
- Most business firms are not publicly listed, and most employees are not employed in a publicly listed firm.
- With the exception of limited liability private companies, there is no presumption that wealth maximization is paramount.
- For example the owner of a sole proprietorship is personally liable for his firm, and thus more likely to maximize expected utility rather than expected wealth.
- This helps to explain why only those concerns that are driven by wealth maximization tend to become incorporated.

Employer Firms, Establishments, Employment, and Annual Payroll Small Firm Size Classes, 2006

Employment size of firm	Firms	Establishments	Employment	Annual Payroll (\$1,000)
Total	6,022,127	7,601,160	119,917,165	4,792,429,911
0*	794,622	796,218	-	42,278,863
1-4	2,875,406	2,880,935	5,959,585	187,451,177
5-9	1,060,787	1,073,496	6,973,537	214,137,111
10-14	428,399	444,615	5,011,995	160,553,028
15-19	218,417	233,909	3,664,403	121,640,050
20-24	135,142	150,584	2,948,977	98,669,944
25-29	90,182	104,010	2,421,084	82,297,946
30-34	65,322	78,830	2,081,209	71,052,815
35-39	48,158	60,707	1,776,169	62,312,576
40-44	38,019	49,887	1,593,034	56,338,411
45-49	29,641	40,625	1,390,311	49,763,757
50-74	87,461	134,133	5,269,759	189,023,587
75-99	41,940	78,979	3,596,332	132,458,117
100-149	40,325	97,341	4,876,978	179,563,625
150-199	18,992	63,227	3,266,060	123,141,302
200-299	18,058	85,804	4,366,806	164,713,408
300-399	8,328	55,791	2,865,423	110,211,852
400-499	4,857	43,556	2,162,078	83,185,528
500-749	6,024	68,071	3,654,660	145,405,025
750-999	2,950	44,312	2,543,023	102,146,596
1,000-1,499	2,962	60,928	3,605,836	152,725,489
1,500-2,499	2,374	76,065	4,537,676	195,499,433
2,500-4,999	1,877	113,479	6,479,030	304,377,206
5,000-9,999	931	121,673	6,490,547	302,709,162
10,000+	953	643,985	32,382,653	1,460,773,903
<20	5,377,631	5,429,173	21,609,520	726,060,229
<50	5,784,095	5,913,816	33,820,304	1,146,495,678
<100	5,913,496	6,126,928	42,686,395	1,467,977,382
<500	6,004,056	6,472,647	60,223,740	2,128,793,097

* Employment is measured in March, thus some firms (start-ups after March, closures before March, and seasonal firms) will have zero employment and some annual payroll. Excludes farms.

Source: U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. Businesses.

Summary

- This lecture has focused on the goals of publicly listed firms.
- The more diffuse the ownership of the firm, the easier it is for the board and the firm's employees to pursue, both individually and collectively, their own objectives.
- Traders and shareholders consequently value the firm less than otherwise, but the rate of return is not affected (to a first order of approximation).
- Lower stock prices make the firm an attractive takeover target for investment and groups such as Blackstone and Berkshire Hathaway, who buy such firms, take the control of the board (or take the firm private) reorganize its management and product lines, and then resell.
- When a single shareholder (or family) owns a large enough proportion of the voting stock (like the Ford family), they can pursue their own objectives insulated against the threat of takeover.