Cidel
Cidel Asset Management Inc.

Cidel Research: From Shareholder to Stakeholder Value

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At Cidel, we are constantly devoting time and effort to analyzing the various markets and changing conditions in order to stay ahead of potential changes and understand their diverse impacts. By doing so, we believe we stand better able to position our portfolios and stay ahead of the curve to ultimately deliver results for our clients. Whether it be saving for retirement, leaving a legacy to future generations, or purchasing the picturesque cottage on the lake, Cidel aims to assist you in meeting your financial objectives. This research-based discussion focuses on shareholder and stakeholder theories and their impact for investors.

Since the end of WWII, there have been two theories that have defined the purpose of a corporation - stakeholder theory and shareholder value theory. At the time of our initial research in February 2020, there were strong indications that developed markets were on a precipice of a 3rd phase, or rather, returning to a model previously embraced. Fast forward to today and the evidence seems to have grown exponentially.

Stakeholder theory defines a manager's duty towards balancing the shareholders' financial interests against the interest of other stakeholders such as employees, customers and the local community, even if it reduces shareholder returns. Alternatively, shareholder value theory originally proposed that a manager's primary duty was to maximize shareholder's wealth by increasing dividends through profitability. Important to note is that the original shareholder theory definition did not mention maximizing share prices, which seems to be the most common interpretation of the theory today. This shift from maximizing shareholder wealth through dividends to shareholder returns through maximizing stock prices has progressed over decades, beginning in the mid-1970s.

From the end of WWII through to the beginning of the 1970s, corporations in the Western developed world broadly operated according to stakeholder theory. CEOs saw their main objective as overseeing the welfare of their employees and customers. As long as the firm made a decent profit every year and raised the dividend, this was considered good enough. There was a widespread belief that corporate & country and company & worker prosperity were closely linked. This is corroborated by the strong proportional wage growth workers saw through the mid-1970s with cumulative income growth since the end of WWII for the bottom 90% of earners at 150%, and the top 1% of earners at 25%. Further, aggregate wage compensation in the economy equalled approximately 50% of Gross Domestic Income consistently from 1940-1975. From 1975 to today, these figures have moved in the opposite direction.

In 1976, "finance professors William Meckling and Michael Jensen offered a quantitative economic rationale for maximizing shareholder value along with generous stock-based compensation to executives who followed the theory"[1]. The paper soon became the academic proof board of directors relied on to grant ever-increasing executive compensation packages with the aim of aligning incentives with shareholders. From this, the shift towards maximizing shareholder returns through maximizing stock prices ascended.

In the 1980s, the Reagan Administration passed sweeping deregulation measures which essentially kick started all merger and acquisition activity, prior legislation lifted the restrictions on Life Insurers and Pension funds from owning stocks, and capital markets witnessed a boom in innovation coinciding with the proliferation of computing technology leading to the creation of junk/high yield bonds, corporate raiders and buyouts funds, and the rising influence of wall street analysts. The previous corporate philosophy of retain and reinvest shifted to downsize and distribute.

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In 1981, the Business Roundtable, a non-profit comprised of CEOs of major U.S. companies, put out a statement defining the purpose of a corporation as having a "responsibility to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs and build the economy". By 1997, they had changed their tune to say that the "principal objective of a business enterprise is to generate economic returns to its owners", by which time the shareholder value theory was fully entrenched in corporate America. In fact, it became dangerous for executives to acknowledge anything other than maximizing shareholder returns for fear of losing their job.

Through the 2000s, these trends only compounded, leading to dramatic changes in the overall distribution of wealth in society. For example, from 1979 to 2017 the bottom 80% of workers saw their real earnings grow 22% cumulatively (0.5% per year), while the top 1% saw 157% growth and even further, the top 0.1% saw 343% growth. The ratio of CEO-to-worker compensation increased from 20x in 1965 to 296x in 2013. Aggregate wage compensation in the economy steadily declined from 50% to 43% of Gross Domestic Income.

Prior to the outbreak of the COVID-19 pandemic, there was strong momentum on the part of companies adopting a more stakeholder-inclusive mentality with many investors increasingly pushing for action, recognizing the risks of not adopting. Key issues such as gender and race pay equity, living wages, carbon intensity and climate change risks, sustainability of products and costs of externalities, share buybacks, executive compensation, and data privacy are among a list of key ESG and stakeholder topics being put to management teams. According to Morningstar, investors moved a record $20.6bn of capital into ESG-focused funds in 2019, nearly 4 times the previously annual record in 2018[3].

With all of this history, what does the world look like today? If 1976 symbolized the year the U.S. economy shifted from operating according to the stakeholder theory to the shareholder theory, will 2020 characterize the pivot back towards some version of the stakeholder model? Bridgewater Associates' founder Ray Dalio, who has prospered under the shareholder value theory, sees the system as broken. "The world has gone mad and the system is broken… The system of making capitalism work well for most people is broken"[2].

The catalysts for change have been building for years, as seen in growing inequality and climate change, to name a few. Are we at an inflection point? There is a growing call for action; Governments may increasingly prioritize social well-being; Companies will need to focus on all stakeholders; Investors will need to recognize and reward companies embracing all stakeholders and better understand corporate investment decisions that build business resiliency. In an era of increasing transparency and political and social disruption, there will be increasing impetus for companies to meet the call to become partners in supporting a more inclusive and sustainable environment. Linking various stakeholders' considerations and corporate strategy has never been more important.

While we do not know how or when this may ultimately take effect, being able to recognize such trends and incorporate this information into our valuation and analytical process puts Cidel in a strong position to position our portfolios in an effective way that remains aligned with our proven investment philosophy.

[1] Forbes

[2] LinkedIn

[3] Morningstar

BSR (2016). The Future of Stakeholder Engagement: Transformative engagement for inclusive business

Marsh & McLennan (2016). Resilience Amid Disorder: Steering a path through social and political unrest

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