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MAY 28, 2007

IDEAS -- OUTSIDE SHOT

By Clayton M. Christensen and Scott D. Anthony

Put Investors In Their Place

Why pander to people who now hold shares, on average, less than 10 months?

Why do smart, motivated, hardworking managers find it so difficult to innovate? Here's one key culprit: the belief that management's primary obligation is to maximize shareholder value. That credo, which is shaky to begin with, distorts managers' sense of responsibility. And in fact it has been rendered obsolete by developments in the capital markets.

The notion that managers must above all appease investors drives behavior that focuses exclusively on quarterly results. Thus, many management teams hesitate to invest in promising innovations that are likely to hurt near-term financial performance. As a consequence, leaders in industries facing disruptive change—such as grocery retailing and newspapers—lose both direction and strength as they try to figure out what kind of shareholder value they should create.

How did managers develop this risky fixation? It turns out the entreaty to maximize investor value was not revealed by a deity to any of the prophets of profit. It came from economists. Calculus is a primary analytical tool of microeconomics. The essence of calculus is maximization and minimization. At some point, some now-defunct economist seems to have said: "Let us assume that managers' responsibility is to maximize shareholder value." This made the mathematics work. And through endless repetition, nearly everyone came to assume that managers are responsible for maximizing shareholder value.

Through the 1960s, this premise wasn't at odds with reality: The average shareholding period was more than five years. Managers seeking to maximize the long-term strength and growth of their companies could reward these patient shareholders. But today shares are held, on average, less than 10 months. Should managers really regard such investors, whose investment horizons are shorter than the most nearsighted of managers, as stakeholders whose value they ought to maximize?

Perhaps it is time for companies to adjust the paradigm of management responsibility: "You are investors and speculators, not shareholders, and you temporarily find yourselves holding the securities of our company. You are responsible for maximizing the returns on your investments. Our responsibility is to maximize the long-term value of this company. We will therefore act in the interest of those whose interests coincide with our long-term prospects, namely employees, customers, the communities in which our employees live, and the minority of investors who plan to hold our securities for several years."

Companies that are serious about serving patient capital might even consider changing how they are organized. Certain outfits that have demonstrated the ability to take advantage of disruptive change have a different ownership structure from most public companies in the U.S. and Europe. Tata Sons in India, for example, is a privately held conglomerate. It has expanded into luxury hotels, information-technology services, and online education and entertainment. Certain of Tata Sons' subsidiaries are publicly held, while others are private. This seems to give it the luxury of creating, under the private umbrella, new business units whose economic models are disruptive to the parents' model.

Li & Fung in Hong Kong and Cox Enterprises in the U.S. are similarly structured. Each conglomerate seems to have demonstrated the ability to invest in disruptive growth far more nimbly than businesses whose shares at the holding company level are publicly traded. Of course, private companies are capable of frittering money away; but we believe the right structure can help a company's chances of mastering innovation.

This logic suggests a socially constructive use of the vast overhang of private-equity capital searching for deals. Those firms should take more companies private. They could then repay the debt needed to buy those companies by selectively taking certain subsidiaries public again, thus creating the flexibility enjoyed by Tata, Li & Fung, and Cox.

Such restructuring could curb a shareholder value paradigm that has run amok. Well-intentioned, smart managers are systematically destroying companies by failing to take actions they know are right in the long term. Instead of slavishly serving an antiquated and increasingly irrelevant function, managers should find ways to reward investors and stakeholders who want innovation, not plunder.

Views expressed in Outside Shot are solely those of contributors.

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