The flourishing firm

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ABSTRACT
This short opinion piece describes how several features of a particular private equity model might cause firms to flourish. These features are compared to common practice at public firms and to guidelines propounded by corporate governance codes. Potential philosophical and practical shortcomings of fashionable governance approaches are considered, with particular reference to the contest between the 'enlightened shareholder' and 'stakeholder inclusive' theories of governance. The key role that the widespread structural problems of fragmented ownership and short investor time horizons might play in undermining the objectives of both of these approaches is discussed. The private equity model is presented as resolving these problems by enabling clear and unflinching long-term sharing of outcomes to be set up, in a way that it is difficult to mimic in public firms.

KEYWORDS
Corporate governance, private equity, short-termism

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1. INTRODUCTION

1.1 A decade in private equity and forty-odd man-years in the boardroom lead me to this: that the private equity model of investing and governing firms, when practised as explained here, is more likely to cause them to flourish than other models I've observed. In flourishing thus, they are more likely to please their various stakeholders.

1.2 This is not to say that private equity can't be practised in many ways, with outcomes that may delight or disgust, that private equity outperforms other investment models on average, or even that the approach described here is at all widely applied. These are interesting issues, but outside the scope of this paper. In particular, the model described bears no resemblance to the 1980s *Barbarians at the Gate* (Burrough & Helyar, 1989) style of private equity—involving high levels of debt and consequently an intense focus on short-term cash flows at the expense of any poor soul who gets in the way.

1.3 A secondary observation is that several principles of the approach described counter prevailing practice at most public firms and many private ones; and impugn the prevailing wisdom embodied in diverse codes, syllabi and manuals. I will try to locate these principles in the corpus of ethical or economic theory and suggest where consensus theories might err.

1.4 It would be Pollyannaish to believe that the private equity principles described can be applied ubiquitously. Reality often gets in the way, mostly in the form of stubborn habit. It would also be naïve to believe that these principles are rule sets that can be applied mechanically, with pure consequential logic governing every decision. A key reason it is tricky for firms to flourish is that the important problems they face are commonly addressable only by intuitive judgement. Would-be codifiers and prescribers hate this fact, as it frustrates their attempts to assess compliance unambiguously. But in a world obsessed by metrics and measurement, it is a fact to bear in mind.

1.5 The toolbox is too small when the quest for the flourishing firm is conducted primarily in structural and metrical terms. The fund manager does better if he has, as his central concern, what inspires people to act courageously, ethically and with the long game in mind. Economic rewards follow such behaviour, but must not be the driver.

1.6 This is an opinion piece, and consequently rather longer on argument than it is on evidence; a somewhat personal description of principles stumbled upon or learnt from others in the muddled way of the real world. Selecting them and learning how to apply them has been fulfilling and rewarding, both extrinsically and intrinsically, and they are shared here with the intent of distilling and refining them through critical engagement.

2. OUTLINE

Section 3 discusses the principal-agent problem and how steps taken to address it often play out in public companies. Section 4 explains how the measures undertaken in the private equity model to mitigate the principal-agent problem have an impact on culture and decision quality. Section 5 critiques the 'enlightened shareholder' and 'stakeholder inclusive' corporate governance approaches, locates the private equity model in their context, and proposes that the main determinant of their relative performance is the decision time horizon. Section 6 expands on how the private equity approach resolves short-termism while the public model entrenches it. Section 7 considers the question of whether elements of the private equity model can be ported into large or public companies. Section 8 concludes.

3. CORPORATE GOVERNANCE

3.1 The Principal-agent Challenge

> The directors of [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own … Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. (Smith, 1776)

3.1.1 Of course Adam Smith was writing in an era when joint-stock corporations were quite novel and abominably governed, and it is the case that they nonetheless ended up playing a major role in economic history. Without them the great sea voyage and railway booms would almost certainly have emerged more glacially. However, this passage captures beautifully the essence of the principal-agent problem that is the target of most corporate governance measures, though they may disagree on who precisely the principal is.

3.1.2 When one considers the labyrinthine connections that wed household ownership to the ultimate units of production surveyed by public firms, it is something of a wonder, and perhaps a testament to the power of Smith's "invisible hand", that anything resembling effective decision-making takes place in their context. Households own pension and mutual fund obligations backed by funds whose managers are often selected by trustees who do not themselves participate in the economic performance of those funds. These funds in turn own tiny stakes in hundreds of firms, so that it is wishful thinking to expect the fund managers to apply their minds rigorously to the governance of those firms. The fund managers theoretically appoint directors to look after their interests, but in practice the directors are vetted by managers and mostly have little equity in the firms in their charge. Stakes in these firms change hands at the press of a button after a morning meeting and with sickening frequency. The link between ownership and control is ephemeral. Monetary incentives devised

by directors to encourage managers to act like owners are routinely perverted by poor design, short-termism and gaming of the measures under the weight of other managerial incentives—to build empires or fly in smart jets.

3.1.3 Is it not a strange kind of optimism that expects good to prevail in such circumstances?

3.2 Measures to address Agency Problems

3.2.1 Corporate governance approaches attack the principal-agent challenge—of managers making decisions that don't suit stakeholders—(Jenson & Meckling, 1976) by enjoining directors to:

- propound *ethical codes* encouraging managers to make decisions not in their own interests;
- adopt *approval frameworks* that locate certain key decision rights above management;
- devise *reporting frameworks* to ameliorate information asymmetries between management and owners and measure the impact of managerial decisions;
- design and implement *incentive systems* that are sufficient to overwhelm managerial incentives that are at odds with stakeholder preferences; and
- subject themselves to *election procedures* designed to make "board capture" by the executive less profound.

3.3 Going through the Motions

3.3.1 These measures are not entirely ineffective. The net result, while perhaps not disastrous, is far from ideal.

3.3.2 My experience in the public company boardroom started when I was a green, naïve and eager young adviser to American public firms. Grey and paunchy friends of the CEO would slump behind mountainous board packs they evidently hadn't gotten through, while he surfed in on a rising tide of PowerPoint slides. Any question was but a children's sandcastle in the face of the ebb. Painstakingly crafted or not, it would swiftly be subsumed. When the water swept back there would be no trace of it.

3.3.3 The highly scripted presentations and agendas that dictated the flow of board meetings were hard work. As much as economists would have us coldly ignore sunk costs, we really have to fight our natures to do so. The more fastidious preparation was held as a virtue, the more the sunk cost balance would escalate, and the less receptive the executive would be to contemplating revisions of his proffered strategy. With a CEO used to standing before the board with a PowerPoint presentation behind him, honesty was hard to come by. (If in a hundred slides there is a thirty-page exegesis of some strategic proposal and a board member raises a killer objection on page three, is the CEO more likely to see the light and toss the proposal or to come up with some rationalisation to

skirt the objection and proceed with the remaining twenty-seven?) The setting begat the 'big man' CEO, tending towards the splashy show of strategic thinking, backed by the faux science of the strategy textbook that belies the true complexity of the business world; prone to boldness where reactive or piecemeal postures would do better. This all profoundly emasculated the board, so that they would only be stirred to action in the face of crisis, crisis made more likely by infatuation with grand strategy.

3.3.4 With no stake in the upside, but the threat of reputational exposure in the event of crisis, the board would resort to governance by checklist, so that the waves of PowerPoint were interspersed by sandy stretches of time spent on 'CYA' trivia. As described by Haldane (2012), because all of this information could "clog up the cognitive inbox, overload the neurological hard disk", the problem of reduced receptivity to amending strategies and tactics was amplified.

3.3.5 This flood of information and barren pedantry was punctuated by a performance management process resembling that of a slightly dull teacher critiquing the essay of a brilliant pupil in a subject somewhat outside his habitual domain. The teacher, though dimly aware of being manipulated, risked too much embarrassment and discomfort to speak his mind, so that more often than not he didn't.

3.3.6 All of this created an environment low on engagement, where governance measures barely scratched the surface of the principal-agent challenge.

4. THE PRIVATE EQUITY APPROACH: LONG-TERM SHARING OF OUTCOMES

4.1 It would be unfair to suggest that all public companies resemble this caricature in its entirety, but not unfair to suggest that few resemble the private equity construct outlined here. In this private equity world, the capital providers invest contemporaneously and alongside the fund manager and the management of the portfolio company, so that all of their fortunes are irretrievably and profoundly linked over long periods. The money is stably invested, with typical ownership periods closer to a decade than a month. The fund manager's participation is limited to a handful of firms with which he is intimately familiar. He goes to great pains to ensure that the relationship between the executive and himself is symmetrical in terms of both intensity and tenor.[1]

4.2 With the principal-agent problem thus reduced, the board becomes less about reporting and approval, and more about collaboration. The day-to-day process all

1 The reader steeped in the world of the capital asset pricing model will immediately spot the problem that the fund manager, poorly diversified, may eschew specific risk, the avoidance of which is of no benefit to the ultimate shareholder, who can diversify at the portfolio level. I'd contend that whatever costs this entails are small in relation to the benefits. Perhaps better to "[p]ut all your eggs in one basket and – WATCH THAT BASKET." (Twain, 1894)

starts with tone. Four practices help: 1. No PowerPoint—conversation is preferred to presentation. 2. Flexible agendas. 3. Skinny board packs. 4. No independent directors. Partnership is pursued, rather than a teacher-pupil or master-servant milieu. Alignment of incentives makes information asymmetries less relevant. One can reasonably and reliably expect to be engaged on any issue germane to the flourishing of the firm and its stakeholders. Egos are left at the door, enabling realism in decision-making. Difficult issues are quite entitled to dominate the agenda. Contact outside the board is frequent and welcome. In this way, the small board can become a highly engaged and constructive team where the postures of executives and non-executives are barely distinguishable, and all are bent on creating enduring value.

4.3 The board tries to project this partnership approach in its engagement with other stakeholders, ever mindful of the value of durable implicit contracts in a fickle world. A key underpin is the posture adopted to pay. Carrots and sticks—incentives by another name—are for animals of a farmyard nature, not for people. They are profoundly alien to the language of partnership. Employing them—even having the thought that you should—is no way to treat your fellow man. Instead, pay structures pursue the goal of sharing of outcomes.

4.4 What does sharing of outcomes mean?

— It means seeking to share in value created in absolute terms, not relative to anyone's subjective expectations. Nobody is to be paid relative to a budget. That way, stellar achievements in one year don't turn into unrealistic targets the next, so there is no impulse to sandbag or indulge in temporal profit-shifting exercises. The ideal of collaboration is also not undermined by starting out with an adversarial negotiation over targets.

— It means referencing a single objective measure. Value created can be estimated or even precisely calculated, obviating the need for formal evaluation and feedback mechanisms, which only serve to entrench teacher-pupil atmospheres. It may be a hard taskmaster, but the security of a long time horizon somehow makes exposure to the vicissitudes of fate easier to endure.

5. THE PRIVATE EQUITY APPROACH IN THE CONTEXT OF OTHER GOVERNANCE MODELS

5.1 This particular private equity way trips the wires of many very broadly invoked corporate governance principles. Before assessing the impact of these 'breaches' some background is required.

5.2 South Africa's King Code of Governance Principles (King, 2009) correctly contrasts the 'enlightened shareholder' approach, which is dominant in the Anglo-American world, with the 'stakeholder inclusive' approach, pointing out that while "[in] the 'enlightened shareholder' approach the legitimate interests and expectations

of stakeholders only have an instrumental value", the stakeholder inclusive approach holds something else.

5.3 The charge of instrumentalism is worth exploring. The point is not that shareholders will never value other stakeholders or do things that please them, but that they will only value and please them to the extent that shareholder value is enhanced. If you're a stakeholder theorist you don't like this—you believe that boards should willingly contemplate actions that please other stakeholders *at the expense* of long-term shareholder value. If you don't believe this, then you're an enlightened shareholder theorist—you believe that such actions diminish social welfare.

5.4 The Enlightened Shareholder Approach

5.4.1 These approaches are at the crux of an important debate. Underlying the enlightened shareholder approach is the notion that market mechanisms adequately communicate all stakeholder interests. So employees will bid up their wages if working conditions are miserable, cheated customers will ruin a company's reputation so that it can no longer sell, and so on. Jensen (2001) states this perspective succinctly:

> Two hundred years of work in economics and finance implies that in the absence of externalities and monopoly (and when all goods are priced), social welfare is maximized when each firm in an economy maximizes its total market value.

5.4.2 This is pretty accurate, but does not highlight an implicit and important time horizon qualification. If the corporate world's institutions are established in a milieu of short-termism, then Jensen's list of things that need to be absent is an item or two short. In particular, there would need to be an absence of frictions in a great many markets that, as a matter of brutal fact, are plagued by very serious ones. At the risk of over-generalising, these frictions fall hardest upon the least powerful stakeholders. For example, a retail customer who has been cheated may find fair legal redress overwhelmingly expensive and time-consuming. Management teams driven to achieve short-term results might well disregard the longer-term destruction that such cheating produces—the destruction of reputation or customer loyalty, goods that are as important to abiding shareholders as they are to the victim.

5.4.3 And as the time horizon shrinks, this list of potential abuses grows exponentially, the instrumentalism of the approach becomes more pivotal, and any sense of 'enlightenment' evaporates. Indeed, the existence of such asymmetric frictions amid myopia and the scope that they provide for abuse of power by managers in an environment of short-termism is plentifully evidenced by the non-market institutions that society has established to mitigate them. Where legal process is too expensive, we have ombuds, consumer protection initiatives, customer complaint websites, codes of professional conduct and various collectives such as labour unions.

5.4.4 The toxic combination of short-termism with equity- and profit-related pay packages that emerged from strident shareholder value mentality attained a nadir in the run-up to the global financial crisis of 2007–8. Nowhere was this more evident than in US and European banks, where annual bonuses were linked to the perceived future profitability of long-term contracts, notably mortgages. This drove all manner of malfeasance with results that are now widely recognised. Loan officers and their bosses pushed unaffordable mortgages upon borrowers, then put lipstick on the pigs before flogging them to gullible investors, pocketing eye-watering bonuses along the way.

5.4.5 Another potential problem embedded in Jensen's perspective is that it requires the definition of social welfare maximisation to be exhaustively resolvable in terms of market value. Sandel (2012) has the measure of this:

> A market economy is a valuable and effective tool for organizing productive activity.… [but the] tendency of markets and cash incentives to crowd out non-market goods can be seen in many spheres of life.…

5.4.6 To summarise, the enlightened shareholder approach may be deficient firstly because short-termism, financial incentives and market frictions combine to permit abuses of power that may be insufficiently counterbalanced by non-market institutions, and secondly because it treats people (stakeholders) instrumentally—in Kant's 'Formula for Humanity' (Kant, 1785), "as means to an end"—in a world where social welfare is not entirely communicable by market mechanisms. On the face of it at least, it confronts profound economic and ethical challenges.

5.4.7 The private equity approach, with its emphasis on co-investment by the management team alongside the fund manager, must be seen to sit squarely in this enlightened shareholder camp. However, its emphasis on long-term, highly aligned co-ownership makes it less susceptible to the problems that come with short-termism, problems that interact with a focus on value to produce a highly toxic brew. My personal experience is that private equity portfolio companies, which typically meld long-term structures with strong manager-shareholder alignment and a minimum of intervention by independent directors, are commonly fastidious about looking after other stakeholders. Managers don't take long to grasp that enduring augmentation of shareholder value can't emerge when customers, suppliers or employees are sequentially abused in the short term. Reputational consequences will catch up and erode shareholder value.

5.4.8 Another aspect of my personal experience is that when you create profound alignment and a culture of shared outcomes around a long-term objective function, inspiration begins to triumph over instrumentalism. The fastidious attention to other stakeholders, even if it germinates instrumentally, tends towards a more humane

perception of them, a greater likelihood of conceiving them as ends, not means; an implicit acknowledgement that some goods are non-market goods. There is something about the conviction that it is valuable to share outcomes that radiates beyond the firm.

5.5 The Stakeholder Inclusive Approach

5.5.1 We can now return to the King code (2009), having entertained and amplified its critique of the enlightened shareholder approach, at least in the presence of short-termism. The code says that whereas the enlightened shareholder approach is perversely instrumental in its approach to stakeholders, the stakeholder inclusive approach stands for something else. Unfortunately, it is weak in its exposition of what exactly that something else is. It doesn't give examples of situations where some stakeholder's long-term interests are at odds with those of the shareholders, and how a board should proceed in addressing the problem. It simply ends up admonishing the board to consider stakeholder interests. It does so, failing to point out that any board consists of directors who are also stakeholders, in the sense that they have personal interests in outcomes that will sometimes be at odds with those of other stakeholders. It does so:

> on the basis that this is in the best interests of the company … as a sustainable enterprise and … a responsible corporate citizen.

5.5.2 This clearly makes a stakeholder of the company itself, which is problematic, because the company is a mere legal persona, not a sentient entity with independent preferences. Try asking the company what it prefers and you must necessarily find yourself asking an employee or a director or a shareholder what they imagine the company prefers. And they can only guess, because what the company 'wants' is not accessible in the first place, and their interpretation of this consequently nebulous notion is framed by their own preferences as stakeholders. No matter how many courts in however many jurisdictions stipulate that the company is a separate persona in law, it cannot be a separate person in fact.

5.5.3 Indeed, the company, as a legal construct or institution, merely inherits the preferences of its various stakeholders, and it is precisely the role of governance to oversee the trade-offs between those preferences. Personifying the company as a 'corporate citizen' is a nice try, but insufficient to escape the predicament. In the end, trying to balance stakeholder preferences by invoking the preferences of the company is an exercise in circular reasoning, unlikely to reveal much of use. It also carries the potential for a manager or director, whose self-interest is too embarrassing to admit, rather to invoke the nebulous 'interests of the company' against a reasonable proposal from another stakeholder, a ruse I have witnessed too many times.

5.5.4 This all resonates with a general criticism of stakeholder theory, exemplified again by Jensen (2001), who writes that:

> stakeholder theory argues that managers should make decisions so as to take account of the interests of all stakeholders … Because [its] advocates refuse to specify how to make the necessary trade-offs among these competing interests they leave managers with a theory that makes it impossible for them to make purposeful decisions.

5.5.5 The King code (2009), and stakeholder inclusive models, in general, sidestep this essential trade-off question, other than to say that the evaluation should be done on a case-by-case basis, which is to say next to nothing. While they go to great lengths to set up arrayed organs of governance and to promote various practices, they don't contain the vaguest of guidelines on how the trade-off of interests should proceed.

5.5.6 Whereas it can be argued that the enlightened shareholder approach's deficiencies are substantially remediated by imposing long time horizons, the stakeholder inclusive approach, while it may conceptually be less instrumental under all circumstances, is not helped by lengthening time horizons when it comes to its key weakness—that it fails to provide guidelines for trading off stakeholder preferences. Long time horizons may even complicate the articulation of such trade-offs.

5.5.7 However, when short-termism prevails structurally, the stakeholder inclusive approach would seem to have a chance of faring better than the shareholder value approach. It may muddle along quite horribly, but that is better than the poisonous concoction created when the acute economic alignment of shareholder value theory collides with short-termism. The checklist containment of the stakeholder inclusive approach, clumsy though it may be, may apply at least a flimsy handbrake to larceny.

5.6 The Independent Director

5.6.1 Market inefficiency and ethical concerns suggest a void. Somebody, it would seem, needs to trade off stakeholder preferences. Furthermore, trading off those preferences may at times be an ethical, not a market, activity. Who should the ethical adjudicator be?

5.6.2 Under the stakeholder inclusive approach the burden falls upon the 'independent directors', where criteria for independence go about the absence of any financial alignment with a particular stakeholder or any personal relationship with management, and devote particular attention to the lack of equity ownership by the director. The idea is that such people:

— are more likely to be impartial adjudicators, resolving trade-offs between stakeholder preferences by their own ethical lights; and

— ought to form the majority of non-executive directors so that partisan (or non-independent) directors can be overruled.

5.6.3 Interestingly, although the enlightened shareholder approach, which sets shareholder wealth as the unambiguous corporate objective, might be expected to find such independent directors wholly inappropriate, its proponents are far from uniform in this regard. Hardliners opine as expected, preferring shareholding directors, but others within the broader enlightened shareholder church feel that independent directors are needed to resolve trade-offs among shareholders themselves, for example, in settings where a controlling shareholder can abuse minorities.

5.6.4 Nonetheless, for the sake of this discussion, let us proceed as if the germane question is whether, while the presence of affiliated or partisan shareholders is accepted under both approaches, the dominance by independent directors in practice improves the assessment and resolution of stakeholder trade-offs.

5.6.5 This is a difficult question to answer empirically, not least of all because the definition of 'independent' varies. However, there have been some noble attempts to do so.

— A study of Australian firms (Lawrence & Stapledon, 1999) failed to produce solid evidence supporting the proposition that independent directors add to firm value.
— Studies of the US and UK markets have produced very mixed results, with the most significant (Bhagat & Black, 2002) finding no support for the independence concept, even after controlling for a comprehensive range of potentially confounding factors.

5.6.6 Needless to say, the responses to these findings, which cast a distinctly negative light on the independent director, vary based on perspective. Some claim that the problem is that value shouldn't be an objective at all or that directors are insufficiently independent, while others claim that the problem is that they are too independent!

5.7 Weighing the Arguments

5.7.1 From a higher, if somewhat cheekier, vantage point, one would be hard-pressed to argue that the rise of stakeholder value practices, which seems to have occurred even in enlightened shareholder strongholds, has been accompanied by higher wages, fewer retrenchments, better products or happier consumers. Pikketty (2013) would surely opine that the very opposite has occurred.

5.7.2 At the very least, the question of whether the stakeholder inclusive remedy of applying plenty of independent directors is at all effective is an open one. As much as fashionable theoreticians might proclaim otherwise, it is entirely possible that the enlightened shareholder approach affords an empirically more effective answer.

5.7.3 My contention, informed by evidence that is admittedly both visceral and anecdotal, proceeds as follows:

- Both the enlightened shareholder and the stakeholder inclusive approaches are inadequate in the face of short-termism. They are, perhaps irretrievably, exposed to managerial manipulation, the former perhaps more so than the latter.
- When the problem of short-termism is resolved, the enlightened shareholder approach fares better. As the time horizon lengthens, the behavioural and ethical shortcomings of this approach attenuate, to the point where the economic and social outcomes are happier than they would be under a stakeholder inclusive approach—perhaps not optimal or ideal, but happier.
- While the independent directors of the stakeholder model are more likely to go with the flow until crisis emerges, the more engaged and active directors of the private equity model are more likely to steer away from crisis in the first place. This confers benefits upon employees, suppliers and customers, who would otherwise be traumatised by retrenchment programmes, lurching succession imbroglios, demand gyrations and inconsistent service levels.

6. HOW GOVERNANCE METHODS PLAY OUT UNDER SHORT-TERMISM

6.1 How the Private Equity Approach can resolve Short-termism

6.1.1 As mentioned, in the private equity world, both the management team and the fund manager load up on equity on day one and enter into agreements that join them at the hip until the eventual exit of one or both. Sharing of outcomes is thus *explicitly* set up envisaging timeframes approaching a decade. A fund manager-operating manager cohort entertaining the possibility of eventual exit to another private equity fund must furthermore *implicitly* envisage timeframes exceeding a decade. In the real world and for most purposes that is as good as forever.

6.1.2 The private equity architecture is competent to realise this situation because of its stability. From day one of the deal, nobody is under any illusion that the game is about anything other than the creation of long-term value. Managerial ownership is articulated at inception. There is nowhere to hide from this. The fund manager will be there to quieten the bruised egos and bank balances that straitened circumstances bring on. Having suffered alongside his management team he will have earned sufficient stature to be resolute and to be heard when he reminds them that the path to rewards has been established and there is no scope for renegotiation in the face of short-term pressures. To paraphrase Graham & Dodd (1934), at the end of the day you will be measured by the weighing machine, not the voting machine.

6.2 How Public Companies entrench Short-termism

6.2.1 Though we humans behave ourselves and are most productive when we work in relationships that are enduring and reciprocal—and this observation applies to our 'workships' as much as it does to our marriages and friendships—we have structured the modern corporate world so that short-term pressures loom large, and these pressures

preclude us from exhibiting the better angels of our nature. The ensuing failures are as much economic as they are ethical. Much potential is squandered. Where we could be creative, we are cynical. Where we could be sincere, we are political. Where we could innovate, we game the system.

6.2.2 Many factors contribute to short-termism, but at the heart of it all lies an unholy triumvirate: visibility of stock prices, frequent public reporting of earnings and an exaggerated conception of a strong and enduring link between current period earnings and stock price movements. Short-term incentives around share prices and current period performance measures escalate the already pernicious psychology these three engender.

6.2.3 To see the effects of this, contrast the dead-simple private equity architecture described above with that of public companies. Public company boards speak of long-term incentives, but usually grant them annually with reference to stock prices that at some time will invariably be suppressed. One vintage will expire worthless, while another may catch a dip and trigger an enormous bonanza. Under such conditions there is great scope for managerial pay and long-term value creation to diverge wildly and for swing-for-the-fences mentality to prevail. The temptation to manipulate earnings, to be parsimonious with the truth about corporate performance and potential with a view to boosting the share price, can be overwhelming.

6.2.4 Two famous surveys conducted in the US in 1998 found that pressure on CFOs to manipulate earnings was breathtakingly widespread and effective (Barr, 1998). In one of them, fully 78% admitted they had been asked to use accounting rules to boost results, and half of those admitted to acceding. Cash flows eventually expose such manipulation, so one must surely infer both that short-term incentives somewhere in the power structure were creating enormous pressure and that the payoffs for such manipulation were considerable.

6.2.5 At times a backlash to this boondoggle has emerged. Right now, for instance, it is very fashionable to avoid such accidents and reduce an executive's exposure to the stock price by replacing stock options with restricted stock, the pay-off from which is much less sensitive to changes in firm value. But this entails replacing a relatively cheap security with a dear one, to which the fashionable response is to impose a cluster of medium-term performance hurdles on the vesting or exercise rights (Hudson & Pichler, 2004). The lingo centres on the noble-sounding admonition, entrenched by the King code, for example, that the participation right should be 'performance-based', which, to someone who is not thinking, sounds peachy. But this simply hurls the executive into a world of metric mayhem, rife with potential for gaming, retrading and manipulation. Whether the stock goes up or down over time is secondary to whether the metrics are attained. If they are, there will be a considerable pay-off, if they aren't

there will be much less or nothing. It seems very doubtful that the remedy is any better than the disease it purports to cure.

6.3 Proliferation of Incentives in the Public Model

6.3.1 Mindful of the potential for this added complexity to have unintended consequences, incentives proliferate. In addition to the long-term incentives, there must be short-term cash incentives, based on accounting and key performance indicators (KPIs); medium-term ones to reward 'strategic objectives'; and a coterie of handsomely paid consultants, advisers and bankers reassuring the board that they are not out of their collective minds, diverting attention away from the real economics of the incentives to the accounting or tax benefits of one or another structure.

6.3.2 As soon as multiple financial performance measures enter the room, one should pause. Economic theory suggests that all but one will be sensible. The unambiguous relationship between increasing long-term economic profit and maximising long-term value creation is seriously old hat and readily borne out by simplistic formulaic manipulation, which is laid out in the Appendix. It is also quite clear that no similar claim may be made for any other financial measure.

6.3.3 The interesting question that then arises is why so many other financial measures prevail. If a single metric that is bog simple, readily demonstrable and supported by the economic theory of several hundred years will do the job, why on earth would we have any truck with RONA or EPS[2] or whatever? Even worse, why do boards pay management teams to maximise measures that cannot claim an unambiguous link to value creation, or which can easily be shown to be inconsistent with value creation? As an example of how silly this practice is, consider a firm that produces multiple products, all of which produce adequate though different RONAs. This firm can boost its RONA by selling off the lowest RONA division, even at a discount to its fair value. This would clearly destroy value, rightly calling into question whether RONA is a reasonable metric. And so it goes for any other metric you may care to offer. Proffering a spread of metrics in the hopes that their various shortcomings will cancel out is a typical, vaguely understandable, yet indefensible reaction, getting you at least part of the way to the galactic incoherence of the 'balanced scorecard'.[3]

6.3.4 How do such manifestly bizarre compensation practices gain such currency? To provide one explanation among many, I have learnt to cower in fear and loathing at the first mention of the term 'best practice'. It's invariably an excuse for defending the indefensible. An awful lot of stuff, especially in the public space, is described as

2 RONA=return on net assets. EPS=earnings per share

3 An easy way to set a nice examination question for any first year economics, management or business course would be to pick any financial measure other than residual income and have the students explain several ways in which maximising it would not be consistent with value creation.

best practice, but by my lights looks senseless. Application of it does not lead to good outcomes. If you say, "This thing is best practice, and this is what it is," you are generally not holding it up against any alternative. It's a way of escaping the onus of saying, "It is better because …"

6.3.5 What is better is to encourage management teams to consider alternatives to proclaimed best practice. An excellent example of the world gone wrong is the pervasive presumption that the balanced scorecard is state of the art. Balanced scorecards lay out a menu of desirable outcomes that, *ceteris paribus*, are for the better. Higher sales, better cash flow, greater market share, fewer accidents, better personal grooming; you name it, these are all candidate measures. But in the same way that the stakeholder inclusive theory generally fails to describe the trade-offs that stakeholder welfare improvements entail, employment of multiple metrics in the balanced scorecard world is problematic without a system of trading them off.

6.3.6 Seldom is this issue addressed head-on. Trade-offs are instead implied by arbitrary weightings. Except by bizarre coincidence these weightings will imply something that is economically, even ethically, incoherent. And, if you have a coherent trade-off in mind, you can necessarily apply that trade-off arithmetically and bring yourself back to a single measure, thereby invalidating the notion of requiring any sort of balancing or scorecard in the first place.

6.3.7 For example, I might view higher sales and lower costs as independently virtuous, but if I apply a weighting other than unity to either, I will end up with something that does not imply profit. Profit, as a measure, subsuming both, will do a much better job than an arbitrary weighting of the two. And so it goes, no matter how remote the relevant metrics are from one another. As soon as you have forced yourself to confront the required trade-off, you have made of the scorecard an unnecessary mediation, except, perhaps, for didactic purposes, as a way of explaining to the minions that profit is equal to sales less costs.

6.3.8 You can worsen matters further by combining this weirdness with another form—the practice of assessing performance in relation to the negotiated subjective expectations called budgets, rather than in relation to long-term value creation—and you have truly nonsensical analysis.

6.3.9 As part of a balanced scorecard or otherwise, another executive compensation widget frequently encountered is the KPI. These are defined and applied variously, but broadly speaking the idea is that there are certain things—things that may or may not be subsumed in the economic results that are the main reflection of performance—that deserve emphasis and some link to pay. They normally relate to individual functional performance and are typically non-financial and quite specific: "Open three branches in

London" or "Implement the new POS system by 31 March". They are often proposed by the individual concerned, so that the structure is one of "You tell me what's important for you to do this year and then I'll pay you a little something if you do it." For roles where outcomes are difficult to measure—typically low-level or functional ones—KPIs may have merit. But when it comes to senior executives, outcomes are readily measurable in market value or economic profit terms that in the long term reflect the consequences of all actions. Bringing in KPIs alongside such financial measures, as is typical, then has the followings effects: 1. Being additive in the pay equation, KPIs distort the reward for executing on the indicator to a level beyond a proportionate share of their impact on value, because that precise share is already fully contained in the financial result. 2. They imply a prioritisation schema that is unlikely to relate to the economic reality of the role. 3. They introduce a didactic tone to the conversation between the board and the executive. Instead of sharing outcomes and engaging on the art of improving them, we have created an agency problem misalignment and instilled a tone that reinforces it.

6.3.10 In these ways and diverse others, things decay into desperate confusion. In how many ways? In medicine there is a concept of nosology, the categorisation of diseases. There is no end to the nosology of incentive systems, to the novel and creative ways in which common sense is perverted in this field. But there is one thing these diseases have in common—a way in which the nosology collapses into one palpable, noxious reality. Short-termism prevails.

6.4 Proliferation of Codes and Laws

6.4.1 The proliferation of codes and laws is a natural side effect of short-termism and a natural stakeholder-oriented approach to mitigating the poor behaviour that short-termism generates. This proliferation also develops a self-perpetuating element. Accounting firms, pay consultants, professional independent directors, professional bodies and many others have an interest in seeing these codes increase in complexity over time, as this is attended by greater demand for their services. It is easy to argue for the addition of a new rule that doesn't in itself seem unreasonable, and to pan anyone who objects to it as some kind of capitalist fiend.[4]

7. IS THE PRIVATE EQUITY APPROACH TRANSPORTABLE?

7.1 A Recapitulation

7.1.1 The private equity approach described incorporates several features. Long-term sharing of outcomes is established at time zero. The sharing of outcomes posture is a world apart from the 'carrots and sticks' land of incentives. It is set up inflexibly, so that renegotiation in the face of short-term pressure is not in play. The sharing is absolute, not relative to expectations or budgets. It is set up with respect to an outcome, not a

4 For an interesting discourse on how complexity in regulation can detract, see Haldane (2012).

collection of inputs or marginal nice-to-haves. The outcome is singular—the creation of long-term value. Alignment means you can safely replace a tone that emphasises checklist governance, risk-avoidance, monitoring and curtailment, with a spirit of collaboration and engagement. Drivers of value are objects of shared concern, not tasks to which boards try to bend management.

7.1.2 It may be difficult to see the collection of these features being applied elsewhere—in firms steeped in other ways, or in large firms, or in public firms that are beset by rules that more or less make these features illegal. Must these features always come as a package? Can we usefully employ a few, or is it the case that omitting any one makes the rest insincere—statements of good intent attracting lip service and little more—or subject to gaming?

7.2 The Case of the Large Corporation

7.2.1 It is easy to see how to go about articulating long-term shared outcomes in the modestly sized firm. What about the large firm? As scale increases, do we run into difficulties?

7.2.2 There are indeed clear and entirely expected challenges that emerge for the large firm, making it necessary to go further than simply loading up executive management with equity and making hay. If you want to push the long-term shared outcomes philosophy deeper into the organisation it is not sufficient to push the equity deeper, as you very quickly run into line-of-sight problems. Any particular business unit may make but a small contribution to overall firm value, so that even spectacular performance by that unit's line manager may not result in an appreciable increase in long-term share value. An obvious solution to this is to link business unit pay to business unit performance. But with no equity to work with we are forced to resort to using the long-term increase in business unit earnings as a proxy. This turns out to be an entirely defensible approach. In the short term, earnings and the value of listed businesses diverge wildly. Over one year as little as 15% of market value movements are explained by earnings (Springborg, 2015), partly because the market's movements embed mood and sentiment, but more so because earnings are buffeted by vagaries of chance, cycle and strategy that do not represent permanent change. Yet over periods as short as five years, this disconnect all but disappears, so that the cumulative change in earnings explains 75% of changes in firm value. Define earnings in economic profit terms (as justified in Appendix 1) and the explanatory power increases further.

7.2.3 The details of how this can be implemented are extensively discussed in the value-based management literature (see, for example, Ehrbar, 1998). The long and short of it is that the line manager shares in the *increase* in economic profit, with no reference to budgets. A simple banking system ensures that short-term swings and

roundabouts cancel out so that there are no medium-term divergences between pay and value creation. This is a far simpler architecture than the typical balanced scorecard implementation, affording a very clear and direct link between decision-making and sharing of outcomes. This affords a way to drive deep into the organisation the ethical posture of shared outcomes (not carrots and sticks), in a way that is not readily susceptible to short-term gaming in the form of earnings manipulation or crafty sandbagging during budget negotiations.

7.2.4 Crucial to this equation is that the system needs to be imposed by C-level executives who are tied into the kind of equity arrangements described here as part of the private equity approach. Less rigorous formats do not engender sufficient stability of intent. The programme is knocked from its path at the first speed bump, and replaced with some run-of-the-mill incentives horror show.

7.2.5 Amid stability of intent, it is easy for managers to learn to trust such systems, and from this emerges a crucial opportunity—the opportunity to negotiate pay packages that have smaller guaranteed components and that contain the ratio between managerial and factory floor salaries.

7.2.6 There are of course limits to this—it is always hard to deal with functional roles, as opposed to line management ones, and interdivisional synergies that regularly entail opaque transfer pricing can leave one scratching one's head. But these are brutal facts of organisational design. Shared outcomes thinking, far from complicating them, provides useful perspective to the exercise of resolving the turf battles they confer.

7.3 Public Companies

7.3.1 Is it possible to bring key features of this into the public space? Can you articulate things so that the long-term is more in view? Sometimes, perhaps. The argument has been advanced that public firms that have long-term block shareholders outperform their peers. It is quite easy to imagine that their presence might bring forth much of the stability and endurance that well-structured private equity models involve; that these block holders might stay the course in exerting the discipline, clarity and order that is required to turn minds towards the enduring objective. But the evidence is murky and heavily dependent on the type of block holder that is considered.

7.3.2 More interestingly, if it is correct that stable, engaged shareholders cause returns on capital to be higher, why do they not emerge spontaneously with greater frequency than observed? I'd venture that successful block holding is most often realised when founders list their companies and then stay the course. Governance and corporate control provisions designed to protect minorities (or stock exchanges?) make it very costly for block holders to attain positions of sufficient influence when the starting point is a diversely held company, whose shareholder base might turn over several

times a year. In such a context it is difficult to conceive of concentrated, long-term thinking prevailing, especially through times of crisis, when it is most sorely needed.

7.3.3 Even if there was a mechanism by which a large mutual fund, for instance, might obtain a sufficient portion of a public firm's equity for it to exert sufficient influence on the decision time-horizon of that firm along the lines described above, that holding might be forced to an end by most unnatural processes. From time to time every listed firm enjoys a period of over-valuation. When that over-valuation occurs, would not the mutual fund be obliged to extinguish its position? Would not that block holding prove ephemeral? With that as a potential course of uncertain proximity, how committed would the mutual fund be to rolling out a programme of profound cultural change?

7.3.4 This invites enormous questions. Have our markets—with their layers of intermediation, their fragmented ownership registers, their liquidity—separated ownership and control to an inefficient degree? Has the pursuit of the mathematical reduction of volatility by diversification ignored the impact that diversification has on governance, and thence on the levels of returns themselves? Would we not be better off with greater concentration of ownership, fewer levels of intermediation, less visibility of prices, larger trading frictions, longer holding periods? I think the answer to all of the above is 'yes' and suspect that in our life times we will witness a *market driven* retreat from the listed structure as its profound costs become evident.

7.3.5 More grandly, could we not be said to have lost the plot the moment we started viewing buy and sell decisions as artefacts of statistical parameters—as in Markowitz's portfolio theory (1952)—as bags of cash flows (as in the discounted cash flow analysis). Again I say 'yes'. The value of a firm, both in terms of its value to its shareholders and its societal impact, seems clearly to depend on who owns it, and how the structural features of that ownership combine to give decision-making its time-horizon and ethical milieu.

8. CONCLUSION

8.1 Though I have clearly plumped for one model and criticised others, I am not intent on doctrinal parricide. I have argued, for example, that the stakeholder model may be fit for a world plagued by short-termism; a corner solution to a suboptimal programming model, perhaps, but a solution nonetheless. Surely too, there are examples of listed firms thriving amid the sheer unbridled conviction of a larger-than-life character with fire in his eye and stock in his pocket. Perhaps some of the problems this paper has pointed to have their roots in the notion that there is, or should at all be, a single over-arching framework for corporate governance. To be sure, some laws are needed to govern commercial affairs. The limited liability construct was a terrific enabler of commercial flourishing, and it required counterbalancing—by laws against reckless trading, for example. But the market structures, laws, codes and standards

governing the corporation have become a malicious, creeping monster, corroding virtue, promoting cynicism, throttling creative spirits and inhibiting our flourishing. We are in the grip of Isaiah Berlin's hedgehogs (Berlin, 1953)—grand theorists possessed by a dream that there is one right way, who try to replace a natural plurality of values and approaches with monolithic, enervating uniformity; who try to make a science of what is really a humanity. This they do with no eye on today's root problem of short-termism, which is where the real attention should be brought to bear. Indeed, they exacerbate it.

8.2 In general, as much as we may wish to make a scientific study of the ingredients for a flourishing firm, it seems more promising to shuttle between philosophy and practice. There are too many confounding variables, too many definitional problems to address governance questions in a robust and compelling experimental fashion. Better to start from intuitions about the values we should strive for (see Asher, 2015) and to imagine how productive we might be, how we might flourish, if we found ways to embed them in our institutions.

8.3 On that note, I would end by observing that we are first social animals. As much as the worst in us can emerge when our greed rises to respond to short-term incentives, altruistic inclinations run deep in us. I believe that we are strongly inclined towards, and happiest, embedded in long-term relationships of reciprocity and sincerity. Yet the world of the public company has mutated into an inveterately short-term affair, where such relationships find scant traction. This world brings out the worst in us. Rules and codes intent upon mitigating this bad behaviour proliferate. But they merely serve to increase our alienation from the institutions that loom so large in our lives. Undoing this unwelcome evolution of capitalism requires addressing the structures that ferry in short-termism.

8.4 When long-term ownership is in place it is safe to approach decisions from the clearer perspective of the enlightened shareholder and amid fewer strictures—to share long-term outcomes in a way that promotes the flourishing of the firm and of the people who work for it.

APPENDIX

A.1 Value created is simply the excess of a firm's fair value over the amount of capital invested in it:

$$FV - Capital$$

A.2 This can be cast as

$$PE \times E - Capital$$

A.3 Maximising the excess of fair value over capital is necessarily the same as maximising any fraction *k* of that excess:

$$k \times PE \times E - k \times Capital$$

A.4 Setting *k* equal to an estimate of the *real* cost of capital it is easy to see that maximising value is identical to maximising economic profit, at least as long as the PE used to value the firm approximates the inverse of its real cost of capital:[5]

$$k \times (1/k) \times E - k \times Capital$$

A.5 This collapses to

$$E - k \times Capital$$

A.6 This is nothing other than economic profit, or residual income. Maximising something other than this over the long-term implies maximising something other than value.

5 For example, a 6% real cost of capital would entail using a 13 PE. It is left to the reader as an exercise in economic thought to consider the reasonableness of the use of a real cost of capital. The place to start is with a translation of a company's accounts into an imaginary inflation-free currency. In the long run, the required relationship between capital costs and valuation ratios is expected. Any wide divergence between the two speaks to a failure of capital markets to clear; low PEs attended by low capital costs, for example, would suggest profound buying opportunities and supernormal profit potential.

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