The Economist

Why Managers Should Listen to Shareholders

Ask and you shall receive

Arthur balfour was a British prime minister who did not think much of his party members. “I’d rather take advice from my valet than from the Conservative party conference,” he said. Corporate executives, particularly in America, seem to take a similar attitude towards their shareholders, believing that, like children, they should be seen but definitely not heard.

Maybe managers should get their fingers out of their ears and start listening to their investors. That is the conclusion of a recent paper* by Clifford Holderness of the Carroll School of Management at Boston College.

In America and a few other countries, boards can issue more shares without shareholder approval. In some countries, shareholders must approve issuance above a certain threshold. And in yet others, investors must agree before any new stock can be created. So what happens to a company’s share price when new shares are issued? Mr Holderness performed a meta-analysis of more than 100 studies of stock reactions around the world. He found that, when shareholders approved issuance in advance, the price tended to rise by an average of 2%. But when managers issued stock without shareholder approval, the share price declined by an average of 2%.

The simplest explanation for this lies in the agent-principal conflict between executives and investors. As Mr Holderness writes, if agency conflicts did not exist, “shareholder voting on equity issuance should not matter.” However, managers may want to issue shares to fund expansion of the company, allowing them to control more assets and demand a higher salary. Investors, meanwhile, may worry about the impact of expansion on long-term returns and dislike the dilution of their control.

Another sign of agent-principal conflicts are shares that are privately placed with selected investors or used to pay for takeovers. In Australia any offering of more than 15% of the equity must be subject to shareholder approval; in America the threshold is 20%. In both countries there is a clustering of share issuance just below the limit; managers go out of their way to avoid seeking approval. In April Occidental Petroleum promised $10bn-worth of preferred shares to Berkshire Hathaway, Warren Buffett’s conglomerate, should its bid for Anadarko, a rival oil firm, succeed. Mr Buffett’s money helped it avoid asking shareholders to authorise the Anadarko deal.

This disdain for shareholder views contradicts the ethos of American capitalism. The system works, it is usually argued, because companies respond to shareholder pressure and because broad share ownership gives everyone, including workers, a stake in the American dream. One reason for the success of private equity is that investors enjoy closer scrutiny over what managers do.

But when it comes to public companies, shareholders tend to be treated like an awkward uncle at a family gathering. Their only rights are to sell their shares or to vote against the reappointment of directors. In any other field this would be extraordinary. Imagine if you appointed a letting agent to look after your house and they decided to spend lots of your money on gold taps and chandeliers. When you complain, they respond that you are only entitled to sell the house or to fire them at the end of their contract.

Managers have long grumbled that shareholders want to interfere too much. A new complaint is that socially conscious investors may insist that firms concentrate on non-financial factors, like treating workers better or cutting carbon emissions. This concern seems ill-founded. For example, research** shows that companies voted the “best to work for” produce higher subsequent long-term returns.

More generally, most meta-studies have found that companies with better environmental, social and governance records improved their financial performance. Mr Holderness’s work puts the tin lid on the argument that managers should ignore investors. When it comes to shareholders, managers should remember the words of Diogenes: “We have two ears and one tongue so that we would listen more and talk less.”

* Equity issuances and agency costs: The telling story of shareholder approval around the world”, Journal of Financial Economics

** Employee satisfaction, labour market flexibility, and stock returns around the world”, by Alex Edmans, Lucius Li and Chendi Zhang. European Corporate Governance Institute Working Paper

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