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A Theory on Corporate Greed

By JEFF MADRICK

TO many, the recent corporate scandals are a direct consequence of widespread greed. Managers and their lawyers, investment bankers and accountants simply lied to investors for their own avaricious gain.

But the root of the problem was not just human nature. It also resulted from a widely accepted economic theory about how to create incentives to govern a business.

Most of us have heard the argument. The overriding objective of a company's management should be to maximize shareholder value — that is, keep the stock price rising.

For Lynn Sharp Paine, a professor of business ethics at Harvard Business School, the single-minded attention to such priorities was at the heart of the recent problems. Concentrating on financial goals alone often led managers to abuse or neglect other areas, like product quality or research. In a new book, "Value Shift" ([McGraw-Hill](#), 2002), she writes, "In almost 20 years as a business academic, I have rarely heard anyone question this conception of performance, so deeply imbedded is it in conventional thinking."

But the principal flaw of the prevailing theory may actually be a financial one. The modern theory typically depends on the idealized efficient-markets theory, which asserts that at any given moment the stock price is not only the best measure we have of the future value of a company, but usually an accurate one. The stock price will thus send the right signals to reward appropriate managerial behavior.

It says something about the intramural vitality of the Harvard Business School that the most influential proponent of this view is Ms. Paine's colleague, Michael C. Jensen, now an emeritus professor. His second-year M.B.A. course was one of the most popular at the school.

Mr. Jensen's academic roots were in efficient-markets theory. The price of a stock, the theory goes, quickly incorporates everything publicly known about a company. As Robert J. Shiller put it in his book "Irrational Exuberance" (Princeton University Press, 2000), "Prices may appear too high or too low at times, but, according to efficient-markets theory, this appearance must be an illusion."

This may sound preposterous to some, but at least a modest version of the theory is supported by solid academic research. For example, if stock prices were obviously mispriced, it would be easy for trained professionals to beat the market. But the research shows that few can. Arguably, stock prices at least sometimes reflect a company's true value.

Mr. Jensen incorporated the idea into what seemed at the time a compelling theory of how to manage a company better. Granting generous stock options to managers, for example, would align their personal goals with those of shareholders. They would act at last like entrepreneurs, not stodgy bureaucrats.

But what if stock prices soared in a speculative boom? To take just one example, companies might make high-technology investments, even if they made no sense, just to appease wide-eyed investors and inflate the stock price. This pretty well describes the late 1990's, of course.

In fact, Mr. Shiller, a Yale economist, goes so far as to argue that stock prices rarely reflect the future accurately. His research, for example, shows that stock prices throughout the 20th century were far more volatile than the future dividends of the corporations they were supposed to track so closely. If stock prices have little relationship with a realistic estimate of a company's value most of the time, it would be devastating to advocates of equity compensation.

Still, in the booming 1990's, some efficient-markets theorists maintained that overspeculation was rare and short-lived, if indeed it existed at all, no matter how high stock prices went.

Mr. Jensen, however, began to see something he had not fully thought about. "What we learned from the 1990's," he said in an interview, "is that when a company's stock is overvalued it sets in motion a set of organizational pressures that can destroy rather than create shareholder value." Honest managers were so swept up by the need to produce rising profits just to keep their jobs, and their small fortunes, that they stepped over the line. "Overvalued stocks are like managerial heroin," he said.

A turnabout for Mr. Jensen? After the market crash, he wrote a defense of his theory in the fall 2001 issue of The Journal of Applied Corporate Finance. He clearly acknowledged that stocks can be mispriced. He said managers should resist the siren call of Wall Street in such periods.

In an interview with John Cassidy of The New Yorker last fall, he also said he was now opposed to standard stock options partly because they induced managers to lie. But Mr. Jensen remained dismissive of views that corporations owe anything to other constituencies, like employees, and of "score carding," which balances a range of measures of performance. He believes that managers can serve only one broad objective, and as a result he continues to have plenty of on-campus critics, including Ms. Paine and older-guard professors like Jay Lorsch.

In trying to reform Wall Street and protect investors, these are highly important issues. We now know stock prices cannot be relied on to keep companies honest. To the contrary, they often reward dishonesty.

We also know that making managers into shareholders, though useful, is far from a panacea for corporate ills. At least some effective government regulations are also needed. And an overhaul of corporate governance is also in order.

Have we learned our lessons? I have some doubts. Let's not forget how few academics warned us of either the market bubble that misled so many managers or the market crash that caused so many to lose so much — until it was too late. They thought none of this could possibly happen. Mr. Jensen may be adjusting, but I am not sure many others are following.