Bower, J & Paine L, 2017

MAY–JUNE 2017 ISSUE

MANAGING FOR THE LONG TERM

IN THIS PACKAGE WE EXAMINE HOW A FOCUS ON MAXIMIZING SHAREHOLDER VALUE CAN THREATEN COMPANIES' HEALTH AND FINANCIAL PERFORMANCE.

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THE DATA: WHERE LONG-TERMISM PAYS OFF

The Error at the Heart of Corporate Leadership

by Joseph L. Bower and Lynn S. Paine

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The Board View: Directors Must Balance All Interests

by Sarah Cliffe

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NOAH WILLMAN

The 29th U.S. secretary of commerce and chair emerita of the National Association of Corporate Directors, Barbara Hackman Franklin has served on the boards of 14 public and four private companies. She has been cited by the American Management Association as one of the 50 most influential corporate directors in America. She is the president and CEO of Barbara Franklin Enterprises, a consulting firm that advises American companies doing business in international markets.

HBR: Do you agree that an excessive focus on shareholders has become a problem?

FRANKLIN: The short answer is yes. But let me first tell you how I think about corporate governance. I have always viewed it as a tripartite system of checks and balances. Shareholders own shares and elect the board of directors. The board of directors sets policies and hires and fires the CEO. The CEO and management run the company. The power balance among those three parties ebbs and flows over time, but there's always some balance. When I first joined boards of large public companies, three decades ago, CEOs were dominant. Then boards began to assert themselves, and the balance shifted toward them, particularly after Sarbanes-Oxley was passed, in 2002. The balance has shifted again in the past five or six years, toward shareholders.

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But there's an added complication, which is activist shareholders, and their increased presence seems to me different from the normal ebb and flow among the three parties. Different and more worrying. This has been a new thing over the past few years. So I agree that the power should now shift back from shareholders and more toward boards and management.

What impact do you see?

The hedge fund activists have affected how other investors behave. I see an increase in pressure from the investment community generally for quarterly earnings, for pushing up the stock price. There's some impact perhaps on strategy development and how resources are being allocated. The idea that we should "think like an activist" pops up from time to time in boardroom conversations.

> Hedge fund activists have affected how other investors behave.

When Joseph Bower and Lynn Paine sent their article around for comments, one person said that corporate centricity wouldn't be possible unless boards made some substantive changes in how they do their job. Does that sound right to you? If so, what changes?

One thing I like about that article: It defines some of the things that boards should have been doing all along. And some boards are doing them, but maybe not enough. (It's hard to do them if you're experiencing unrelenting pressure for short-term performance.) For example, boards need to have strategy discussions with management and the CEO all year long. It can't be a "once and done" event—strategy needs to be discussed at literally every meeting.

If strategy is on the docket every time, then you can discuss all aspects of it—short-term versus long-term decisions, of course, and whether any decisions need to be revisited. Resource allocation is a part of that. Risk management is a part of that. And underlying the ability to tackle those questions is how the culture in the boardroom works. Is there respect for all voices? Is the CEO willing to listen, interact, and respond? Is there just one agenda: the future well-being of the corporation and its stakeholders, always with an eye to how that will create value for shareholders?

> Too much focus on any single measure harms the long-term purposes of a company.

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A focus on the short term has led some boards to neglect core responsibilities, such as succession planning. That, too, needs to happen continuously. Board members need to be sure there's a viable bench of CEO candidates, and that means knowing them really well. That way, when you need to make a decision about the next leader, you can match the right candidate to the strategic direction.

Another piece that gets neglected—but is hugely important to this discussion—is good communication. The board and the company need to give shareholders and other stakeholders accurate, timely information. Some shareholders get unnerved when they don't know enough about what's really going on or about the thought process that led to a collective decision. A lot of times when things come unglued, it's the result of poor communication.

Compensation is another big part of the board's job. How should the thinking on that change, if at all?

People talk a lot about "pay for performance." But what does that mean? I think boards need to develop a balanced scorecard for assessing performance, which will then help to determine compensation. If you have a performance scorecard that covers an array of issues, both long term and short term, it's another hedge against short-termism.

Regardless of whether there's a shift away from shareholder centricity, I think boards are going to have to step up because of changes in the business environment that are happening now, as often occurs when we have a new administration and a new Congress.

Bower and Paine believe that extreme shareholder centricity turns boards and executives into order takers rather than fiduciaries and that boards and CEOs must keep the health of the organization—rather than wealth maximization—front and center.

Yes, I agree with that. I have always believed that my fiduciary responsibility was to the corporation, and that includes its stakeholders. The article calls them constituencies, but we're talking about the same thing. You have to include stakeholders as well as shareholders.

There are interesting variations among state-level statutes. In the first place, most state corporation statutes do not require directors to put shareholders first. Rather, it is the body of case law accumulated over several decades that has caused the focus on maximizing shareholder value. And it's worth noting that there are now 28 states whose statutes allow directors to consider the interests of "other constituencies." I believe this is a good thing.

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What do you hear CEOs saying about how they balance pressures from various constituencies?

I think there is concern about balancing longer term and short term. Some of us have signed on to these pronouncements claiming that there's too much emphasis on short-termism, whether it's a focus on stock price or on TSR. Too much focus on any single measure is really detrimental to the long-term purposes of a company. Finding the right balance is on all our minds—CEOs as well as board members.

But it's the global business environment that is keeping us up at night.

You've spent a lot of time in boardrooms—is there anything big that you wish Bower and Paine had addressed?

For me, what's missing is a discussion of the appropriate power balance between management and the board. That's easy to define on paper but really difficult in practice. A topic for another day. Maybe once we get the problem of activist investors sorted out, the authors can tackle that.

Sarah Cliffe is an executive editor at the *Harvard Business Review*.

The Data: Where Long-Termism Pays Off

by Dominic Barton, James Manyika, and Sarah Keohane Williamson

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Does short-termism destroy value? The question is increasingly debated by leaders in business, government, and academia. But little hard evidence has been presented on either side of the issue, in part because the phenomenon involves many complex factors and is hard to measure.

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Seeking to quantify the effects of short-termism at the company level and to assess its cumulative impact on the nation's economy, we tracked data on 615 nonfinancial U.S. companies from 2001 to 2014 (representing 60% to 65% of total U.S. market cap). We used several standard metrics as proxies for long-term behavior, including the ratio of capital expenditures to