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Modern Portfolio Theory and Shareholder Primacy

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A COMMENTARY ON Gordon G. Sollars and Sorin A. Tuluca (2018), "Fiduciary Duty, Risk, and Shareholder Desert," ***Bus Ethics Q*** 28(2): 203–218, https://doi.org/10.1017/beq.2017.47

ABSTRACT

Shareholders assume risk by investing. Sollars and Tuluca (2018) argue that while this does not justify a managerial policy of shareholder wealth maximization, it does justify compensating shareholders at the often-calculated cost of equity—the cost that investors require given the level of risk they assume. Here, I show that this can be unfair if the cost of equity is unfair. I then show how shareholder wealth maximization as a managerial imperative is better justified on other grounds.

IN NORMATIVE BUSINESS ethics, one question concerns how much of a corporation's rents are *owed* to its shareholders. According to one popular camp, the answer is: all of it. After all, the corporation is owned by the shareholders, say the so-called shareholder primacy theorists. As the residual claimants, anything not paid out in expenses or to lenders belongs to the shareholders to either take or allow for reinvestment. They go even further. The corporation is primarily *for* the shareholders, they will say, so managers should manage the company primarily with the shareholders' interest in mind. The corporation ought to be in the business of maximizing shareholder value.

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Though it once dominated business ethics, many people now disagree with this approach. So-called stakeholder theorists reply that the corporation has many different stakeholders apart from investors (e.g., employees, customers, community members), and it's acceptable (if not obligatory) for the managers to consider their interests. This isn't to say that shareholders deserve *nothing* on stakeholder theory, or that their interests shouldn't be considered. Given this, one issue for stakeholder theorists is to determine how managers should adjudicate the claims of different stakeholders, including shareholders.

Sollars and Tuluca (2018) provides a welcome contribution to this issue. They suggest that we can look to the already popular Modern Portfolio Theory from finance to judge what is owed to shareholders. When investors invest in a security, they assume a degree of systemic risk. Accordingly, they demand a premium on the investment commensurate with the level of risk incurred (Sharpe 1964). This is the general idea behind the cost of capital. Corporations need money to do business, and both creditors and investors finance the corporation for a price. If a corporation is to engage in some project, then the value of that project is a measure of the expected value of the future cash flows of the project discounted back at the cost of capital. For equity investors, managers will use the Capital Asset Pricing Model (CAPM) or other pricing models to determine the cost of equity, or how much return equity investors in particular require given the riskiness of the investment.

Sollars and Tuluca suggest that it's the cost of equity that is in fact what shareholders *deserve* from the company. That there are metrics (if not a whole science) for measuring it shows that it's not as challenging as we might have thought for managers to approximate what they should allot for shareholders. This allows Sollars and Tuluca to endorse the idea that investors deserve compensation for adding economic value at a certain risk without being led to the conclusion that shareholders are entitled to all of the corporation's rents.

In this Commentary, I want to put pressure on Sollars and Tuluca in two ways. First, I will show that there is an important difference between what investors *demand* in modern portfolio theory and what they *deserve*. While the former may be a good guide to the latter in good conditions, they may come apart. Second, I will argue that Sollars and Tuluca have not provided a successful argument against

shareholder primacy. While they successfully argue against one rationale for shareholder value maximization, they do not address the stronger motivation for it.

Demanded, But Deserved?

Sollars and Tuluca (2018: 209) say that ". . . management may properly use CAPM to measure deserved returns for all shareholders." And, again, CAPM purports to measure the cost of equity, or the price that is demanded by investors given the cyclicality of the company and the riskiness of stocks generally. But just because the cost of equity is what is *demanded* by investors does not mean that it is what investors *deserve*. What we must recognize is that the CAPM is a method of pricing – it's the price of equity financing – but pricing is not necessarily just or fair. If we could guarantee that the price of equity was fair, then it would be appropriate to conclude that the price demanded by investors was the price that they deserved. However, price is not a function of fairness; it's a function of supply and demand.

Consider payday loans. Individuals too small-time or too much of a credit risk for larger institutions need capital, and lending companies will lend to them; however, they do so at interest rates far above what is necessary to compensate for default risk, often trapping these individuals in debt. This usury is a kind of price gouging (raising the cost of capital for those that need it most) and extortion (abusing the fact that their demand for capital is inelastic). Business ethicists disagree over whether price gouging is morally wrong, but most of us judge that there is something unfair about this practice. These companies demand a price for their capital, but it's not a fair price. So, it's not deserved.

This rift also occurs in the context of investing. During a company's IPO or additional share issuances, the cost of equity is determined directly by what investors will pay for the stock. Now, suppose that, due to increased volatility as a result of wanton speculation, equity markets are temporarily low. If a company were to issue shares in this market, we might think that they could not get a fair price for those shares. The low price for the shares would be a reflection of reckless investor behavior or artificially inflated expectations, not of the intrinsic value of the shares. Investors on aggregate

have not been investing in ways that add economic value. So, their expected return implied by that price may not be deserved.

However, these are not quite the cases that concern Sollars and Tuluca. They are concerned with how managers can arrive at a fair value for the cost of equity for those shareholders they already have. How much do their investors deserve? This is trickier, because in some sense the price has already been paid; investors are already invested. What managers decide to give to investors is up to them, so this may appear to avoid the possible unfairness of the market. But this is misleading. Sollars and Tuluca suggest that the CAPM can be used by managers to determine what their investors deserve, but the CAPM measures what investors *would* demand for their investment if they were not already invested, and this is again a function of investor expectations. If expectations are inappropriately high due to reckless behavior, then the return investors demand will be more than they deserve. Investors are assuming risk in ways that do not add economic value (at least in proportion to the risk assumed), and so they do not deserve the compensated imputed by the CAPM.[2]

Arguing Against Shareholder Primacy

If we assume that stakeholder theory is right, then Sollars and Tuluca show how managers might fairly compensate investors in good conditions. However, Sollars and Tuluca (2018: 203) take themselves to also be undercutting a common argument for shareholder primacy. They say,

> A common moral argument is that shareholders have a special status when considering the duties of corporate management because shareholders' claims are the most at risk…[T]his usually includes the idea that management should adopt the goal of maximizing shareholder wealth.

The idea is that the risk borne by shareholders makes shareholders vulnerable to the decisions of management, and this generates a duty for managers. It's this fiduciary duty that shareholder primacy

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[2] There are other issues with using the CAPM to determine investor desert. Although Sollars and Tuluca discuss the assumption that investors are diversified, they omit the fact that the CAPM determines the cost of equity for the marginal investor, the theoretical investor capable of determining the stock price. Many investors in a stock, however, are not significant enough to affect the stock price. So, the CAPM will not measure what these investors deserve. At best, it approximates what they deserve in aggregate.

theorists supposedly take to justify the managerial imperative of maximizing shareholder wealth. However, Sollars and Tuluca argue that this duty can be satisfied by following the CAPM, and it does not require managers to adopt the aim of maximizing shareholder wealth.[3]

I am skeptical that this is as common an argument as they claim. Although they point to several authors arguing that managers have a fiduciary duty to shareholders, several of these authors think either that the duty does not stem from shareholder vulnerability or that it does not entail a managerial imperative of shareholder wealth maximization. Marcoux (2003), for example, argues that it's problematic enough for stakeholder theory if managers have a fiduciary duty to shareholders alone.

Putting aside the popularity of this argument, it's simply not among the more compelling arguments for shareholder primacy. Much more plausible is the idea from agency theory that shareholders hire managers to run the corporation in their interest (Jensen and Meckling 1976). Shareholders are owners of the corporation, goes this line of thought, even if they relinquish legal control over the corporation's assets. This generates a duty for managers that is not grounded in the fact that shareholders have undertaken risk, so it need not be commensurate with the level of risk assumed. Instead, the duty will be to run the company in their interest, and they are likely interested in maximizing value.

Sollars and Tuluca (2018: 214n4) address this concern of ownership in a footnote, and they don't think that it generates any stronger fiduciary duty. Even if it did entail running the business in the interest of investors, they claim that this can be done without adopting any particular aim. They compare the managers of a corporation to the trustees of a trust and argue that prudent trustees are under no obligation to maximize the value of the trust. This is hardly surprising, because that is not the point of trusts. However, the shareholder primacy theorists will think that what corporations are *for* is maximizing shareholder value. That is what shareholders are interested in and why they invested to begin with.

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[3] It's telling that Sollars and Tuluca (2018: 214n3) take their argument to only apply to publicly traded companies. In the context of private firms, investor risk may justify something like shareholder primacy. Velamuri and Venkataraman (2005) argue that the entrepreneur behind a privately held firm bears not just the risk, but the structural uncertainty of the firm.

I do not mean to argue that shareholder primacy is correct (I'm inclined to think that it is not). However, a promising motivation for it survives Sollars and Tuluca's discussion. Managers are taken to be the agents of shareholders, so acting in the interests of other stakeholders requires justification. The CAPM, then, does not delimit what shareholders fully deserve; rather, it provides managers with the minimum value a project must generate to be worth pursuing.

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