Flawed economic theories are destroying American capitalism

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With the advent of shareholder-value theory and stock-based compensation, executives have increasingly turned their attention to the expectations market, recognizing that it is where the money is. But even using earning guidance and aggressive accounting, executives can't keep expectations on the rise forever, nor can they continue to meet them as they grow forever. CEOs may well see market expectations radically outpace what can be achieved by even the best management team.

Look at Cisco Systems CEO John Chambers. Chambers spent the first decade of the twenty-first century consistently building share and increasing profits. And how did the stock price react to this real-market performance? It fell from a high over $80 per share in March 2000 to just $20 per share at the end of 2010, destroying hundreds of billions of dollars of shareholder value. Expectations for Cisco in the year 2000, when it set the record for the

highest market capitalization in history (over $550 billion), were simply unachievable, no matter how well Cisco went on to perform. Those expectations were fueled by exuberance utterly outside Cisco's control.

In the face of expectations that can run wild, CEOs have increasingly focused on what they can control: managing share price over the short run. Shareholders, on the other hand, should want CEOs to focus on the long term, on increasing share price more or less forever. So it turns out that rather than aligning the interests of shareholders and executives, stock-based compensation has reinforced the agency problem it was created to solve. What's more, it has destroyed long-term shareholder value by driving shorter and shorter horizons of decision making and contributing to shorter CEO tenure. CEOs know that expectations are likely to fall, so they have incentive to leave or retire in order to cash in stock-based compensation instruments while expectations are high.

Focusing executives on shareholder value maximization using stock-based compensation was supposed to give shareholders a better deal. Yet, it simply hasn't worked out that way. Total returns on the S&P 500 for the period from the end of the Great Depression (1933) to the end of 1976, the beginning of the shareholder-value era, were 7.5 percent (compound annual). From 1977 to the end of 2010, they were 6.5 percent-suggesting that shareholders have little to celebrate, despite having been made the clear priority.

But it isn't just about the money for shareholders, or even the dubious CEO behavior that our theories encourage. It's much bigger than that. Our theories of shareholder value maximization and stock-based compensation have the ability to destroy our economy. These theories underpin the regulatory fixes instituted after each market bubble and crash. Because the fixes begin from the wrong premise, they will be ineffectual; until we change the theories, future crashes are inevitable. New theories that recognize the important distinction between the real market and the expectations market, and that return our focus to the real market, are needed.

The difference in outcomes between a real-market focused world and an expectations market dominated world is stark and critically important for the economy. When the real market is dominant, customers are the focus and the central task of companies is to find ever better ways of serving them. Entrepreneurs (like Thomas Edison or Henry Ford) who create customer value through innovations in products, services, and business models earn the highest rewards. When the expectations market is dominant, traders are the focus and gaming markets is the task. In our current, expectations-oriented world, market makers or specialists are consistently among the most profitable businesses in America, earning supernormal returns year after year, even when the markets plummet and the rest of us lose. For instance, hedge fund managers James Simons and John Paulson each made over $2 billion in personal compensation in 2008 while markets were plummeting.

The real market produces a positive-sum game for society. Everyone can be better off as more and more value is created for customers. In contrast, the expectations market produces a gigantic zero-sum game. In trading, by definition, for every dollar won, there is a dollar lost. It therefore pits players against one another to split up finite rewards.

In the real market, there is opportunity to build for the long run rather than to exploit short-term opportunities. Because the real market is grounded in real people, real companies, real employees, real factories, etc., it shifts slowly without huge volatile swings. A great year in the real market is 4 percent economic growth, and a bad year-like 2008-is 3 percent shrinkage. But because expectations have no bounds, the expectations market swings wildly with huge volatility. While the economy shrank modestly in 2008, stock prices dropped 50 percent.

A real-market orientation creates individual and societal good, while an expectations orientation creates a downward spiral that threatens both individual well-being and the health of our economy. American capitalism is in danger and the danger stems directly from the way we have linked the real world to the expectations world, amplifying the influence of the expectations market on the real market. By tying together the real and expectations markets, we have created an environment in which many companies focus more on their stock analysts than on their customers. We have created an environment in which expectations must be met at all costs, meaning morally dubious behavior and even outright illegality is no longer off the table (see Adelphia, Tyco and Enron).

The moral authority of business diminishes with each passing year, as customers, employees, and average citizens grow increasingly appalled by bad behavior and abundant greed. At the same time, the period between market meltdowns is shrinking, and regular investors are growing ever more skittish. Meanwhile, more capital and more talent are flowing into hedge funds, which exploit and even cause volatility in individual stocks and broader indices. It is a pretty sorry picture and one that has little chance of getting better with the current theories in place.

The capital markets-and the whole of the American capitalist system-hang in the balance. The expectations game is beginning to destroy the real game, slowly from within. But it isn't too late. American capitalism can get back to the real game, back to funding and building companies to create meaningful products and services that customers care about. It can switch its attention from the zero-sum expectations market to the positive-sum real market.

American capitalism is at a critical juncture. Our leaders have embraced a persuasive but ultimately flawed theory to construct their understanding of the economy, the model of executive compensation and the role of business. This theory leads us inexorably down a path to greater volatility, less value creation and minimal authenticity. But it is by no means impossible to turn things around. In 1976, the business world embraced a new theory of the firm that transformed the game. It can do so again. It can embrace a

different conception of business. It can devise a new model for executive compensation. It can create new structures that support, rather than fight against, authenticity and meaning. It is a matter of devising a new theory of the firm, and shifting our focus and behavior toward that understanding. In doing so, we can fix the game.

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