

Life is about trade-offs. There are only twenty-four hours in a day no matter how efficiently you manage your time, and everyone runs out of money eventually. And so we all have to make choices, allocating scarce—or at least limited—resources (like time and money) among competing objectives (like career and family). It's a lot easier to make those choices when we have a clear sense of what it is we're trying to achieve and a clear line of sight between specified alternatives and how they serve that highest goal.

of success. Objective functions that violate this constraint leave managers unable to make consistent trade-offs when faced with conflicting objectives.

For instance, imagine that a company wishes to increase its current-year profits as well as its market share. It is likely that, for a while, as market share increases, so does profitability. At some point, though, further increases in market share are only possible through activities that reduce current-year profits. Charged with increasing both simultaneously—which means there is no mech-

rooted in fundamental notions of property rights. For example, the late Nobel laureate Milton Friedman basically asserted that shareholders own the corporation and managers are agents of the owners, so managers should do what the shareholders want. (It's a safe bet that shareholders want their investments to make money.)

Putting shareholder wealth first doesn't make an intractable decision easy—who's to say whether cutting R&D or cutting sales does less harm to shareholder wealth?—but it sure can

First Things First

BY MICHAEL E. RAYNOR



Why shareholder wealth shouldn't be your top priority.

Managers in corporations face similar sorts of trade-offs all the time. How do they strike a balance between cutting costs to sustain profitability and hanging on to good people so the company can grow again when conditions improve? How far beyond government mandates should a company go with its “green” initiatives when the financial benefits are unclear?

Practically speaking, then, managers need some “ultimate goal” that they are trying to attain, what economists refer to as the “objective function” of the corporation. To be useful, this objective function must also be single-valued—that is, there must be a single measure

anism for making a trade-off between the two—a manager will be unable to act rationally when forced to decide between increasing the ad budget to improve market share and holding it constant to avoid reducing profits.

So what should an organization's single-valued objective function be? A widely held view (I'm betting especially so among *TCB Review* readers) is that shareholder-wealth maximization is the only viable candidate. Every choice that corporate managers make should be made with an eye to creating as much financial wealth as possible for the providers of equity capital. This belief is often defended as a moral obligation,

help. With a moral mandate that eliminates the confusion of trying to balance an ever-expanding list of stakeholders or constituencies, managers can at least focus their analytical powers on maximizing one specific outcome.

Not so fast.

Corporations are, legally, artificial persons allowed to facilitate social action that generates wealth. Society grants this privilege because, on balance, the formation of corporations enhances social welfare. No one's rights would be violated if corporations were abolished and all commerce were henceforth conducted through proprietorships or partnerships. By accepting limited liability,

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from theory to practice

shareholders give up some of the rights that usually attend ownership of an asset. After all, how can I claim the right to direct the corporation to pursue ends of my choosing if I am not held accountable for any harm wrought in the pursuit of those aims? We must not confuse the moral foundations of capitalism (the rights of the individual and the concept of private property) with the social expedient of the limited liability corporation. A stock certificate is a particular sort of claim on corporate wealth; it is not a deed of ownership.

The rather uninspiring truth of the matter is that shareholders are nothing more than suppliers of capital. Just as workers supply intellectual and physical labor, just as customers supply revenue, just as governments supply the rule of law and a social context within which to function, investors supply a critical input without which the corporation could not exist. And just as with all other suppliers of key inputs, shareholders must be paid for their contribution in accordance with the relative scarcity of their input and the bargaining power they enjoy. Fundamentally, all suppliers are equal.

But what's a manager to do? There might not be any moral reason to put shareholders first, but for practical reasons, *something* has to come first. What?

How about this: the corporation. A manager's first objective must be the survival of the corporate entity. To be sure, the corporation must compete in free and well-functioning markets for its key inputs—including capital—which means no greenmail, no poison pills, no union busting, no subterfuge or flouting of relevant laws or customs, no golden parachutes for entrenched, self-enriching management, and so on. But the purpose of the corporation is the preservation and propagation of its own existence.

I can think of one company that, viewed from the outside at least, seems to behave in this way. Costco Wholesale Corp. is the country's fifth-largest retailer. Its revenue growth, of course, depends on creating value for customers,

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which is in large part a function of providing low prices. But not *too* low: The company is also profitable, so customers don't reap all the benefits of the company's powerful business model.

What about suppliers? For most, Costco is likely a coveted account. But low prices come at a cost, so to speak, so it's fair to assume that the company is as uncompromising with its suppliers as any dominant retailer.

Employees, too, seem to be doing pretty well. *The New York Times*, in a feature on the company, reported that the average pay is \$17 per hour, 42 percent higher than at comparable retailers, and Costco's healthcare plan is the envy of workers elsewhere. But that can't be the whole explanation for Costco's success. After all, Karl Marx was right: Capitalism works only when employees are paid less than the full value of the contributions they make. And so, if those who work at Costco are like those who work at every company I've been part of, I shouldn't be surprised to find at least a few who feel they're not being paid everything they're worth.

Neither is there much evidence to suggest that Costco is passing its surplus wealth on to managers. Jim Sinegal, as CEO of the twenty-ninth-largest

U.S. company, earned \$550,000 in salary and bonus last year, less than 10 percent of what many other CEOs of comparable companies received.

So it must be shareholders who are getting the windfall, right? Not necessarily. Although the company's stock has outperformed the S&P 500 index since 2000—strongly suggesting that it's returning more than merely its cost of capital—some feel that the returns could have been even higher still. As one Deutsche Bank equity analyst grumbled, "At Costco, it's better to be an employee or a customer than a shareholder."

So what's going on? Everyone seems to be content, but everyone seems to feel they could do better. My take on it is that Costco pays everyone involved more than the minimum required to secure their participation, but has chosen to maximize returns to no one. Striking this balance just right results in a risk-adjusted return to each relevant party (customers, suppliers, employees, managers, stockholders) that maximizes the long-term survival and growth prospects of the company itself.

I think that most managers, if pressed, would admit to thinking of the trade-offs they make in similar terms. They don't seek to "maximize" returns to anyone, even shareholders. Rather, the best managers keep all the relevant parties happy (enough) to continue playing ball so that (to mix my metaphors) the wheels just stay on the bus. This amounts to putting the corporation first.

And this is a good thing. Generalized to the entire economy, relentless competition between corporations for relevant inputs of labor, capital, and revenue amounts to a quasi-Darwinian selection process, and only those corporations that are able to generate sufficient risk-adjusted returns for all contributors will make the cut. As a consequence, when every corporation looks out for itself, the net winner is society at large. And that's important, since the only reason the body politic allows corporations to exist is because they make us all—not just shareholders—better off. 🌐