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CAN WE REDUCE SOME OF THE BOOMS AND BUSTS IN COMPANIES?

Corporate crashes are not new. Two of the biggest in history took place within months of each other almost three centuries ago - in Britain and France in 1720: the South Sea Bubble and the Mississippi Scheme. There are now concerns about the financial viability of the current system of "shareholder value".

This article is in three parts. The first examines some of the mechanisms of "boom" and "bust" cycles that have characterised western economies for centuries. The second part looks at two of the best known classical "booms' and "busts": the South Sea Bubble and the Mississippi Scheme. There is nothing new under the sun. The article ends with concerns about the current concept of "shareholder value" – and there are three speculations on what will be the next trend. It remains to be seen whether we can do better this time.

The Cycle of Booms and Busts

History does not necessarily repeat itself – it is simply that people forget. Suddenly a small financial operation becomes a major venture and people are anxious to buy into it. More and more people are drawn into this venture - and then suddenly the bubble bursts. The trick is to be in early, sell early, make the profits and go. Of course, it is not always clear just when it is appropriate to pull out. For example, in the South Sea Bubble, Sir Isaac Newton, saw the bubble coming, sold his stake early and made 7,000 pounds. But then the bubble kept on inflating; he thought that the bubble could just keep on inflating and so he bought back in – and then eventually lost 20,000 pounds. He is reputed to have said: "I can calculate the motions of heavenly bodies, but not the madness of people".

Some bubbles have bizarre causes. An early notorious bubble was the tulip craze in the Netherlands in the 1630s. The Netherlands was becoming a super power, there was plenty of money around for some people, and so the money had to be spent on something. Suddenly it became fashionable to own tulips. The craze peaked between 1634 and 1638. But while it lasted, the participants were fixated on the need to buy or sell tulips.

There is no set formula governing a boom and bust cycle. Some of the inflating is done by manipulation, if not downright illegal means (such as falsely optimistic company reports in the mass media). There can also be people acting on "inside information" and so they know when they should get out. Greed is also an important factor. There is also the role of wishful thinking and having a positive mental attitude – even though the reality is not necessarily as positive as could be thought. There is also the fact that some people do not want to admit that they have made an error and so persist in the hope that all will be well in the end. Some of these points can be illustrated in the South Sea Bubble and the Mississippi Scheme.

South Sea Bubble and Mississippi Scheme

The South Sea scandal was derived from a company that was supposed to do overseas trade (but had only a few ships), it was chaired by the King, had half of the MPs in the House of Commons as investors, and in which the Chancellor of the Exchequer invested a small fortune and had the wisdom to sell out once he got inside information on the company's problems. Some people made great fortunes from the scandal but most people lost a great deal.

The South Sea Company was formed in 1711. Its purpose was to supply 4,800 slaves each year for 30 years to the Spanish plantations in Central and South America. Britain had imposed the right to supply slaves to Spanish America on Spain in a 1713 peace treaty. The company bought the contract from the British Government for almost 10 million pounds (which was a large proportion of the British national war debt). This was a huge sum of money but the company hoped that more lucrative trading rights with Spanish America could be obtained once the British had established a presence in that wealthy market. It was also assumed that the slave trade was going to be very profitable.

This was an era of great optimism and a sense of progress. People had a passion for business and followed commercial developments through a rapidly expanding new medium: newspapers. The company knew the value of publicity. Suddenly it became very fashionable to own shares in the company. Owning shares in a company was then quite a new idea and people had little experience of what to look for (or to avoid). Word got around that share-owning was the smart thing to do.

As the price of the shares increased, so the directors issued more shares to keep up with demand. Shareholders were permitted to buy shares on the payment of some of their cost in the expectation that they could pay the rest of the amount by selling off some of the shares when their price had increased still more. Other Europeans heard about this boom and so they too bought some shares, thereby driving up the price still more.

Other companies were also created. There was an explosion of share offerings for companies claiming to be involved in manufacturing, farming, real estate, imports and exports. The classic share offering was for "For carrying on an undertaking of great advantage, but nobody to know what it is". Some people were foolish enough to invest in that – and never got their money back.

By June 1720, the directors of the South Sea Company were getting worried about all the speculation in shares in the various companies. They encouraged the politicians (many of whom were their own shareholders) to adopt the so-called "Bubble Act" requiring all companies issuing shares to have a royal charter. This additional government regulation improved shareholder confidence in the South Sea Company's shares and so the price continued to rise.

By September 1720 the directors realized that the share price bore no relationship at all to the value of the company itself and so they began to sell their own shares. When this became public knowledge, it sparked a wave of panic selling. The company collapsed and many investors lost all their money.

A parliamentary investigation in 1721 uncovered widespread corruption among the directors, company officials and their political friends. Unfortunately some of the key players had already fled the country with the incriminating records.

Meanwhile, across the English Channel there was a similar corporate scandal in France. John Law was born in Scotland in 1671. His father was a goldsmith and banker, and Law grew up with a skill in mathematics and a taste for gambling. He killed someone in duel and had to flee Britain for the continent. He eventually based himself in France. In 1717 he acquired a controlling interest in the derelict Mississippi Company (and renamed it Compagnie d'Occident). The company had a monopoly of trade with the French territory of Louisiana in what is now the United States. To finance the company he issued shares. Shareholders assumed that the company would become very profitable with the economic development of that territory.

Law issued publicity material over-stating the territory's extensive wealth. Suddenly people wanted to buy more shares in his company. As in Britain, there was a mood of optimism and people expected the company to do well. The company was responsible for the largest influx of settlers into Louisiana up to that time and so it seemed that money could be made from that colony. In 1719 Law obtained approval from the French Government to expand his trade monopoly into other French colonies. In 1720 the company took over the banking for the government.

The bubble burst in October 1720. As in Britain, some of the shareholders realized that the price of the shares exceeded the value of the company and so sold their own shares. This triggered panic selling. The company collapsed. Law fled France in December 1720 and he died in poverty in Venice in 1729.

The two corporate crashes had many similar points. First, a sensible business venture (a trading company with a few assets) was taken to excess, especially because of unrealistic expectations of what it could do. Second, there was a herd instinct: people were buying shares not because they knew about the business but simply because others were doing so and they did not want to miss out. Third, there were warning voices about the risks of speculation but they were ignored. People were blinded to commonsense by the promise of wealth. Fourth, some of the money was recovered but generally the main ringleaders in both crashes escaped punishment (not least the lynchings that the newspapers were calling for).

The corporate crashes had three long-term impacts. First, they have provided the benchmarks against which later crashes have been compared. It seems that humans have still not learnt much from history.

Second, both crashes stifled economic development for almost half a century. There was a mood of conservatism and scepticism, with less interest in economic matters. The reluctance about owning shares meant that British and French inventors had difficulty financing their contributions to the Industrial Revolution. Had the South Sea Bubble not occurred, then Britain's - and the world's – Industrial Revolution could have begun a few decades earlier.

Finally, Thomas Guy was one trader who did very well out of the South Sea Bubble. He had a troubled conscience and so left his money to fund what is one of Britain's best hospitals: Guy's Hospital in London.

The Concept of Shareholder Value

Almost three centuries later, the stock exchange is even more important in the economic life of a developed country than it was at the time of the above case studies. Much of the current debate over the role of the stock market is based on shareholder value. This article argues that the concept of shareholder value has worn well - but now it is wearing out. Its main strength was the discipline it brought to company managers to do better. When the shareholder value movement began about two decades ago, many companies were being run by managers as their own properties and for their own benefit. The American economist John Kenneth Galbraith in the 1960s had warned that in the modern industrial state companies were by managed principally for the benefit of their managers and not the shareholders or workers, let alone the wider community.

The shareholder value movement forced managers to perform better by providing what seemed to be an objective assessment for measuring how well the company was performing. Companies that were under-performing became takeover targets.

Some of this transformation had been foreshadowed by American business writer Peter Drucker. His 1975 book The Pension Fund Revolution predicted that the rise of private pension funds in the United States would transform the nature of corporate control. Power in the modern industrial state was dispersed in favour of management. He foreshadowed that the rise of the giant pension funds would concentrate power in the hands of people who would insist that businesses be run in the interests of the shareholders.

As is often the case in economics, a good idea was taken beyond the limits of its usefulness. First, shareholder value encouraged short-term thinking. The focus was on driving up the share price and obtaining a good dividend as quickly as possible. This could be done by down-sizing, reducing business units, and reducing expenditure on infrastructure, research and development, and training. This worked in the short-term but could not be sustained over the long-term. You cannot downsize your way to greatness.

Second, salary packages were linked to share price and so CEOs had an incentive to inflate the share price (especially if they were also receiving share options). Thus, once again the attention was focussed on the short-term.

Third, this gave rise to the greed that was criticized by Alan Greenspan, Chairman of the Federal Reserve on July 16 2002: "An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed. Too many corporate executives sought ways to "harvest" some of these stock market gains". In retaliation, there have been fresh sets of government regulations on companies.

Meanwhile some downsized staff have been re-engaged at lower costs (no holiday pay or superannuation costs) as outside contractors. This has improved a company's bottom line but also aggravated the wealth differences within society. In 1982, the wealth of the 30 richest US individuals and families ranged from US$500 million up to US$8.6 billion. By 1999 the range was US$7 billion to US$85 billion, a tenfold increase. In 1980, the ten highest paid US executives had an average annual pay package of US$3.4 million but by 2001 that had increased to an average of US$ 155 million - while the typical American household in the middle quintile barely stayed ahead of inflation.

Fourth, all of this in turn has added to public disenchantment with the business community. Recent US opinion polls give businesspeople an even lower public standing than politicians. There are also fears about the future of their individual retirement accounts as the Wall Street bubble bursts. Meanwhile, the disenchantment and cynicism may also be seen inside business, such as the popularity of the Dilbert cartoons. Many offices seem to have at least one pinned up. If the corporations are not going to be loyal to the staff, why should the staff be loyal to the corporations?

What comes next? The economics pendulum never completely retraces its arc. There will not be a return to the comfortable days of the 1950s and 1960s and Galbraith's "modern industrial state". Corporations are now operating on the global level and so, unlike the 1950s, a lazy, bloated corporation will be eventually undercut by the emerging competition from China or India.

Here are three trends to watch for. First, there will be greater attention to "stakeholder capitalism". Shareholder value is very much an Anglo-American concept. It did not catch on with the same speed in continental Europe. The dominant idea there has been "stakeholder" capitalism: a recognition that a business has to operate within a larger context than just shareholders. For example, in German companies, representatives of workers participate at the top management and so a company cannot operate solely for the benefit of one lot of stakeholders (shareholders) over the others (workers, suppliers, community). Reinhard Mohn of the Bertelsmann publishing group (one of the world's largest media groups), explained in 1996: "Just as ordinary citizens no longer allow themselves to be led unquestioningly by their political leaders, and insist on their democratic rights to participate in decisions, the attitude of the employee towards his company has also changed. The worker no longer sees himself as a mere instrument for fulfilling the needs of the entrepreneur. He expects self-fulfilment in his work, as much as in other aspects of his life". British writer Will Hutton, commenting on the US corporate crisis, said on July 2 2002 that the crisis was not just due to one or two bad apples: it was a systemic weakness. He called on the Europeans to continue to develop a distinctive European model of enterprise that takes a more rounded view of what produces organizational success and sees itself with responsibilities to the wider community.

Second, there will be renewed attention to corporate governance. While directors are accountable to shareholders, they owe their duty to the company. They are obliged to have regard to the interests to shareholders but that obligation is not confined to the current body of shareholders. Directors have to act in the best interests of the company. Sir John Browne of BP (now Lord Browne) said in his 2000 BBC Reith Lecture that few companies are short-term; they want to do business again and again over the decades. Thus, the role of directors is to ensure the long-term viability of their companies. Mervyn King SC a former judge in South Africa and now one of the world's leading experts on corporate governance spoke in Australia in July 2002. He was not an advocate of shareholder value. Instead, he provided a set of questions for directors to ask themselves when making decisions at boards. One of them was: "Is the decision in the best interests of the company?" He urged directors to use long-term criteria rather than short-term ones.

The third trend is "sustainability". This is, in company terms, different from much of the recent emphasis in the shareholder value concept, with its concern for short-term results. "Sustainability" was first used in the United Nations environment debate over how economic development should take place. Sustainability is defined as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs". The term is now being applied not only to what corporations do to the environment but how they see themselves. An example of this new interest is the development of the "triple bottom line" accounting, with the assessment being made of how a corporation reports not only its financial results but also its impact on the environment and society. These are early days yet and the metrics have yet to be finalized. But the increasing attention to this subject suggests that this is trend that has caught the imagination of some of the corporate world.

To conclude, the shareholder value concept has had a good run for about two decades. Now it is necessary to look out for the new trends. But it remains to be seen if we can have any better luck at stopping the booms and busts on the stock exchange. People are now wiser about “dot.com”/ “dot.bomb” bubbles. We may not get repeat of the craze from the late 1990s. But watch out for a bubble in genetic engineering company shares next time.

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