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CORPORATE TIME HORIZONS

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

NOVEMBER 8 AND 14, 1989

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CORPORATE TIME HORIZONS

WEDNESDAY, NOVEMBER 8, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Upton; and Senator Roth.

Also present: Joseph J. Minarik, executive director; and Chad Stone and John Mizroch, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will now come to order. Today is the first of two hearings on Corporate Time Horizons in which we examine whether corporate executives have the right incentives to make the kinds of long-term investment decisions that are necessary for encouraging economic growth, boosting productivity, and making the U.S. economy as competitive as possible.

Our focus today is on the structure of corporate management and on the impact of mergers and leveraged buyouts on economic performance. Our witnesses today are two distinguished economists who have studied corporate management structure and the economics of takeovers. Michael Jensen from the Harvard Business School is author of an article titled "Eclipse of the Public Corporation." F.M. Scherer from the John F. Kennedy School of Government is author of a book titled "Mergers, Sell-offs, and Economic Efficiency."

Gentlemen, we are very pleased to have both of you with us today. We look forward to your testimony and an opportunity to exchange views with you. Your prepared statements, of course, will be entered in the record in full and we ask that you begin with your testimony.

Mr. Jensen, we'll begin with you and follow with Mr. Scherer immediately thereafter and then we will turn to questions.

I want to express a word of appreciation to Senator Roth who will be here very shortly, because this hearing and the other that follows it are based on his suggestions. I am very appreciative of that because I think they're excellent suggestions.

Mr. Jensen, you may proceed sir.

STATEMENT OF MICHAEL C. JENSEN, EDSEL BRYANT FORD PROFESSOR OF BUSINESS ADMINISTRATION, HARVARD BUSINESS SCHOOL

Mr. JENSEN. Thank you, Mr. Chairman. I am pleased to be here today to discuss the issues regarding problems of corporate America and the opportunities for resolving them.

There are many signs of difficulties with American corporations as they have matured and have grown more bureaucratic and noncompetitive in international markets. It has been popular for a number of years now to blame this inefficiency on the short-term horizons of American managers. Not surprisingly, American managers and their supporters are reluctant to accept this responsibility and look to the financial markets as a scapegoat.

Often the theory is that pension funds, arbitragers and other speculators with holding horizons ranging from minutes to months and sometimes years, penalize these managers for their highly valuable long-term decisions. Not only does this evidence a pathetic ignorance of capital theory, indeed the very notion that stock prices and capital values are a claim on all future cash-flows now as well as 5 minutes or 5 years from now, but it significantly misrepresents what is going on in the markets.

I believe there is widespread waste and inefficiency in corporate America, but it is misleading to argue that it has anything to do with short-term oriented decisions. Incidentally I ask managers if they will tell me about short-term decisions they have made under pressure from the capital market—not a single one has ever owned up to one. It's always somebody else making those short-term decisions. But for every such decision that's offered I can find similar waste caused by decisions made on the basis of horizons that are far too long or simple bureaucratic waste that has nothing to do with horizons at all. It simply doesn't pay in a world of 7 percent interest rates to invest a million dollars now for a million and ten dollars 10 years from now. It would require expected returns of $700,000 to make it comparable to a savings bond rate.

The oil industry is a prime example of an industry that in the late 1970's and early 1980's wasted tens and maybe even hundreds of billions of dollars by making investments in exploration and development at a time when we had excess oil reserves. These decisions evidenced lack of concern for the fact that the payoffs would not come until very far in the future and at any reasonable interest rate. They didn't make sense. They didn't at the time and they don't now.

I would like the committee to glance at figures 1–3 in my prepared statement, where the data on total R&D expenditures in the United States as measured by the Business Week R&D scoreboard is portrayed with total merger and acquisition activity. The figures show a number of interesting things. First you will see that the level of R&D expenditures has increased in every single year since 1975, rising from roughly $12 billion to close to $60 billion in 1988. At the same time, M&A activity, represented by the jagged line at the top of the graph, rose from around $11 billion to close to $250 billion. It is very difficult to see any effect of M&A activity on aggregate R&D expenditures.

If you look at the next figure you'll see total R&D expenditures per employee plotted. It started out at a little less than $1,000 per employee and rose to a little less than $5,000 per employee. Again, rising uniformly throughout the period at a time when M&A activity again was rising from $11 billion to $250 billion.

The last figure, figure 3, shows R&D measured as a fraction of sales—which adjusts for inflation and adjusts for the scale of these firms—rose in virtually every year except one. In the period 1975 to 1988, total R&D activity rose as a fraction of sales from 1.8 percent to 3.5 percent in 1986, and then declined to 3.4 percent in the following 2 years.

So, although it is very popular to talk about both the financial markets effect on R&D and in particular the effect of M&A activity on R&D, those accusations don't pass even the most aggregate simple minded confrontation with the data.

Commissioner Grundfest of the SEC uses what I think is a very graphic example to bring the point home even more. He compares the stock market evaluation of the Merck Co., a pharmaceutical firm with a very high R&D budget, with General Motors. Merck spends approximately 11 to 12 percent of its sales on R&D, or about $15,000 per employee. Merck has sales of about $5.9 billion. General Motors has sales of $110 billion. General Motors does relatively little research and development as measured relative to its size. And, as I said, Merck has very high R&D expenditures for its size.

Those who argue that the markets are penalizing R&D might be surprised to find out that as of the beginning of 1989 the total market capitalization, the total market value of Merck & Co., is in fact $400 million larger than the total market value of General Motors. If the markets are truly penalizing firms for engaging in risky long lived R&D activity it certainly ought to show up in examples like this. There have been substantial studies of R&D and M&A and financial market activity and most of them, with one or two exceptions, show no negative effects of M&A on R&D activity.

Let's ask the question, where does the blame for this inefficiency in corporate America lie? There are only, I think, four places to look. There are four major sources of control in the public corporation. Three of them are private and one of them is public or political. The private sources are basically, one, the internal control processes of the corporations led by the board of directors. I think any fair minded assessment of the evidence over the last 40 years indicates that that model has failed.

Two, the product markets are another major source of potential control of inefficiency in corporate America. For a great deal of the past history in a rapidly growing economy, the dominant control technology—the product market—simply didn't play a very important role. In fact, one of the reasons for hearings like this is that the product markets through competition from our international competitors are playing a much more important role.

The last source of potential control in the private sector is the capital markets. And for 35 or 40 years capital markets were essentially disabled as a source of effective control. It all came about because of the elimination of what I call active investors in the late 1930's and early 1940's—elimination by a set of laws meant to cure other problems. But these laws had the indirect effect of leaving

managers unmonitored. They did this by eliminating from the scene individuals or institutions that held large quantities of equity and/or debt and were actively involved in the strategic direction of the company.

The losses became very large—approximating 50 percent or more of many corporations in the mid-1970's following the massive conglomeration and diversification merger movements of the mid-1960's and early 1970's. One of Professor Scherer's studies correctly documents that there were very large inefficiencies generated by those activities.

There is massive innovation going on in the capital markets to get around these constraints. LBO's and MBO's are just the most recent examples, in addition to the vast increase in Wall Street merchant banking activities. But even Warren Buffett and the family funds, the Pritzkers, Bronfmans, and Rockefellers are a different style or manifestation of this same phenomenon.

As a result, there is an outcry on the part of American corporate managers who are demanding protection from the workings of these control processes. They want international competition restricted through import controls, quotas, and tariffs. And they certainly want themselves protected from the control activities in the capital markets. We see that most vividly now at the State level with some 40-plus States restricting voting rights through control shareholder acts and various kinds of poison pill provisions.

Fourth, we come to the political and public arena. The Government has the responsibility through its role in setting the rules of the game for establishing an environment in which all of this activity takes place. And as I hinted, there were some mistakes made, I think, in the 1930's and there are currently mistakes being made at the State level that are substantially handicapping our corporations.

But it goes beyond that. It goes to unwise tax policies that have increased unnecessarily the cost of capital for American corporations. Unwise tax policies, in particular, include the double taxation of dividends which effectively erect barriers against the payout of capital that cannot be effectively used in many of our mature, slow growing, or even declining industries. Such double taxation imposes severe penalties for managers that do pay out capital to shareholders.

We've been fortunate that the antitrust laws have been benignly neglected over recent years. There's some movement to bring back active enforcement. I think we have to recognize that much of what economists hold near and dear to their hearts in this area is wrong. Traditionally, economists have believed that the only appropriate behavior among firms in a market economy is competition and never cooperation. I think that's wrong. It's not that there isn't a role for antitrust activity. It is to maintain the rights of entry of new competition.

Improving the bankruptcy code to reduce the cost of reorganizing companies that find themselves insolvent would go a long way to increasing the efficiency of our corporate sector and making it possible for American managers to make use of the control effects of the debt and the efficiency enhancing characteristics of debt that

so many of our competitors in Japan and Germany and other places have learned to use a long time ago.

Last, I think the disclosure regulations such as the section 13-D rules, the Hart, Scott, Rodino rules, as well as the myriad disclosure and proxy regulations by the SEC, deserve very close and careful scrutiny and a massive reorganization. We have substituted bureaucratic control for a free and open market in information. The result has been to further handicap and essentially leave the institutional holders of 40 percent of American equity with virtually no power to affect the future direction of the companies in which they own stock.

I will stop here. I will be happy to talk about any of these issues as well as the issues in the article titled "Eclipse of the Public Corporation" with you.

Thank you.

[The prepared statement of Mr. Jensen, together with the article entitled "Eclipse of the Public Corporation," follows:]

PREPARED STATEMENT OF MICHAEL C. JENSEN

CORPORATE TIME HORIZONS

Introduction

The corporate sector of the U. S. economy has been experiencing major change, and this rapid change continues as we head into the 1990s. Over the past two decades the corporate control market has generated considerable controversy, first with the merger and acquisition movement of the 1960s, then with the hostile tender offers of the 1970s and the leveraged buyouts and leveraged restructurings of the 1980s. The controversy has been renewed with the $25 billion KKR leveraged buyout of RJR-Nabisco followed by the $13.1 billion acquisition of Kraft by Phillip Morris (the largest completed corporate control transaction prior to 1988 was the Chevron purchase of Gulf oil in 1985 for $13.2 billion). These transactions are the most visible aspect of a much larger phenomenon that is not yet well understood.

In spite of the controversy that surrounds them, and the fact that they are not all efficient, these control transactions are the manifestation of powerful underlying economic forces that, on the whole, are productive for the economy. Thorough understanding is made difficult by the fact that change, as always, is threatening, and in this case the threats disturb many powerful interests. One popular hypothesis offered for the current activity is that Wall Street is engineering transactions to buy and sell fine old firms out of pure greed. The notion is that these transactions reduce productivity, but generate high fees for investment bankers and lawyers. The facts do not support this hypothesis even though mergers and acquisition professionals prefer more transactions to less and sometimes encourage deals (such as diversification programs) that are unproductive.

There has been much study of corporate control activity, and although the results are not uniform, the evidence indicates control transactions generate value for shareholders and that this value tends to come from real increases in productivity, not wealth transfers from other parties such as creditors, labor, government, customers or suppliers.[1] Those transactions that tend to be

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1 For the argument that takeover gains to shareholders come from wealth redistribution from other parties see Shleifer and Summers (1988). No evidence has yet been produced that supports this argument. Jensen and Ruback (1983) and Jarrell, Brickley, and Netter (1988) survey the evidence on the effects of control related transactions.

unproductive are the empire building and diversification mergers and acquisitions carried out by corporations flush with cash and unused borrowing power that they refuse to pay out to shareholders. Ravenscraft and Scherer (1987) and Porter (1987) document the unproductivity of these mergers, many of which were consummated in the diversification wave of the late 1960s and early 1970s.

I analyze the role of free cash flow in M&A activity and the causes and consequences of takeover activity in the U. S. in Jensen (1986, 1988). In addition I have provided the Committee with copies of my recent *Harvard Business Review* article "Eclipse of the Public Corporation" in which I (1) show how corporate control activity is part of a broader set of phenomena that is a reaction to forces that have handicapped active investors in the past 50 years and how these handicaps have contributed to the inefficiency of U.S. corporations, (2) provide a perspective on how LBOs, restructurings and increased leverage in the corporate sector are a part of the institutional innovation that are correcting these deficiencies by providing new ways for active investors to play their critical role in motivating increased productivity and competitiveness, and (3) discuss reasons why high debt ratios and insolvency are less costly now than in the past.

I shall not repeat that analysis here, but will be pleased to discuss it and its implications with the Committee if you desire. In this opening statement I want to discuss two main topics, the effects of M&A activities on R&D, and inadequacies in the way corporate CEOs are paid.

The Effect of M&A Activity on R&D Expenditures

Despite the rhetoric in the popular press and in the business community and widespread beliefs to the contrary, there is very little evidence that M&A activities have any deleterious effect on R&D expenditures. I shall not review all the evidence here but instead refer you to the excellent review and analysis of the issues by SEC Commissioner Grundfest, "M&A and R&D: Is Corporate Restructuring Stifling Research and Development" presented to the National Research Council.[2] Although the issues can become very complicated, and although there has now been considerable detailed research on the effects of restructuring on R&D, the popular accusations and the call to arms for congressional action to stop this activity cannot even pass a simple aggregate data test.

Lichtenberg and Siegel (1987, 1989) analyze Census data on 18,000 plants and 33,000 auxiliary establishments in the U.S. manufacturing sector in the period 1972-81 and find that changes in ownership significantly increase productivity and reductions in administrative overhead.

2 Grundfest (1989)

Table 1 presents summary data on R&D taken from the Business Week annual R&D Scorecard in the period 1975-88 along with the total value of M&A transactions. Figures 1-3 provide plots of the various measures of R&D vs the total value of M&A transactions. It is extremely difficult to see any relation between increases in M&A and reductions in R&D. Indeed, total R&D spending has increased every year during this period, from $12.3 billion in 1975 to almost $60 billion in 1988, rising from $1,000 per employee to over $5,000 in 1988. As a percent of sales R&D increased consistently from 1975 to 1986, almost doubling from 1.8% to 3.5% and then declining to 3.4% of sales in 1987 and 1988. At the same time M&A activity increased from $12 billion in 1975 to almost $250 billion in 1988.

In addition, there are other obvious facts indicating that the stock market does not ignore successful R&D programs, even huge ones, in arriving at the values of corporations. As Commissioner Grundfest so aptly puts it:

> ...is this highly negative view of the stock market's response to R&D supported by the evidence? To pose the issue most starkly, let me begin by asking you a question: Which company does the stock market value more highly, Merck, a research intensive pharmaceutical firm whose 1988 sales of $5.9 billion, or General Motors, the automotive giant whose 1988 sales of $110 billion are nineteen times as large as Merck's sales?. ... as of December 31, 1988, the stock market valued Merck's stock at $26.4 billion about $400 million more than General Motors stock,...
>
> But how can that be? After all, Merck is one of the most R&D intensive companies in one of the most R&D intensive industries in the world. In 1988 Merck spent $699 million on R&D: that's 11.3% of its sales, 34.9% of its profits, and $15,962 per employee. These expenditures are for R&D projects that are wildly expensive, more likely to fail than to succeed, and certain not to yield revenues in the United States for about eight to ten years from inception. Yet Merck's stock trades at a price-earnings ratio of 23, more than triple the multiple of seven accorded GM's shares by the market.
>
> If the critics are right, and if the stock market is simply too impatient or myopic to wait for the payoff from R&D, then Merck's shares should be trading at an aggregate value far below General Motor's. But Merck's shares aren't trading below General Motors, and that fact takes at least some of the wind out of the sails of market critics. Grundfest (1989, references omitted.)

TABLE 1 Summary data on R&D expenditures and M&A transactions in the period 1975-88.

YEAR	R&D Expenses* ($ billions)	R&D % change from previous year*	R&D % of sales	R&D Expenses/employee ($ thousands)	Total Value of M&A Transactions
75	$12.3	6.5%	1.8%	0.99	$11.8
76	$13.7	11.6%	1.9%	1.15	$20.0
77	$16.0	16.4%	1.9%	1.24	$21.9
78	$18.6	16.4%	1.9%	1.37	$34.2
79	$22.1	18.9%	1.9%	1.55	$43.5
80	$25.7	16.4%	2.0%	1.83	$44.3
81	$29.6	15.1%	2.0%	2.16	$82.6
82	$33.0	11.5%	2.4%	2.56	$53.8
83	$36.3	9.8%	2.6%	2.98	$73.1
84	$41.3	14.0%	2.9%	3.45	$122.2
85	$45.5	10.0%	3.1%	3.76	$179.8
86	$50.0	10.0%	3.5%	4.20	$173.1
87	$53.5	7.0%	3.4%	4.47	$163.7
88	$59.4	11.0%	3.4%	5.04	$246.9

* Restated to adjust for changes in sample from year to year.

Source: Business Week R&D Scorecard, various issues and W. T. Grimm for M&A data.

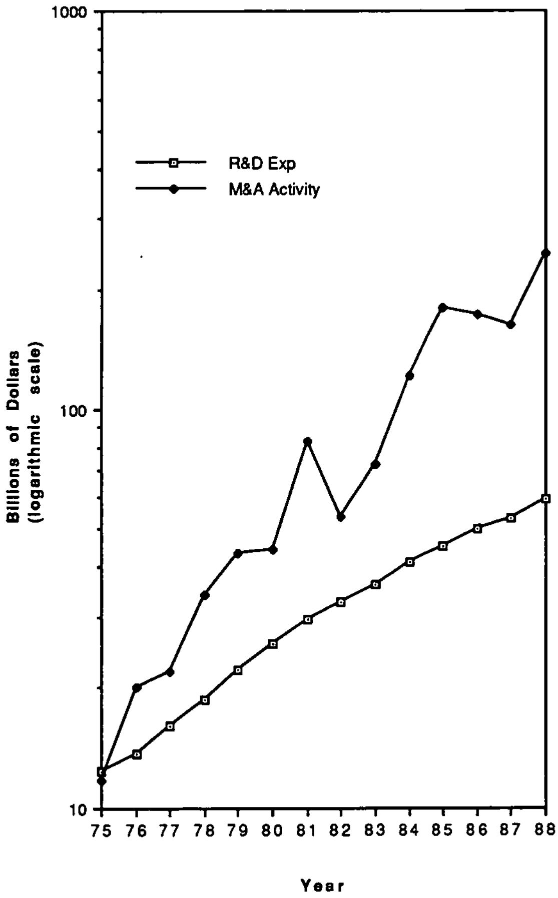

Fig. 1

Total R&D expenditures as measured by Business Week R&D Scoreboard and total dollar value of M&A activity in the period 1975-88.

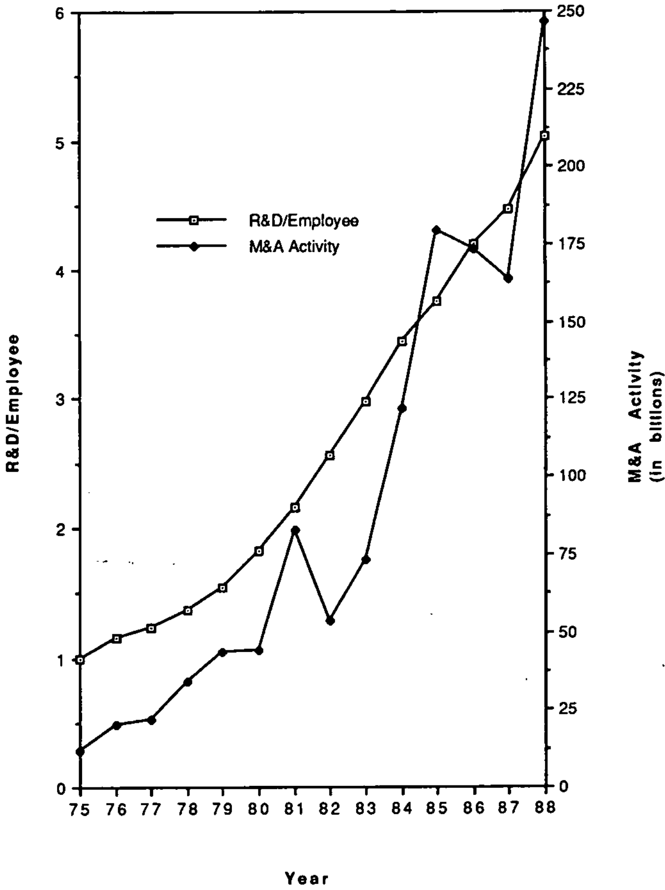

Fig. 2
Total M&A activity and R&D expenditures per employee in the period 1975-88

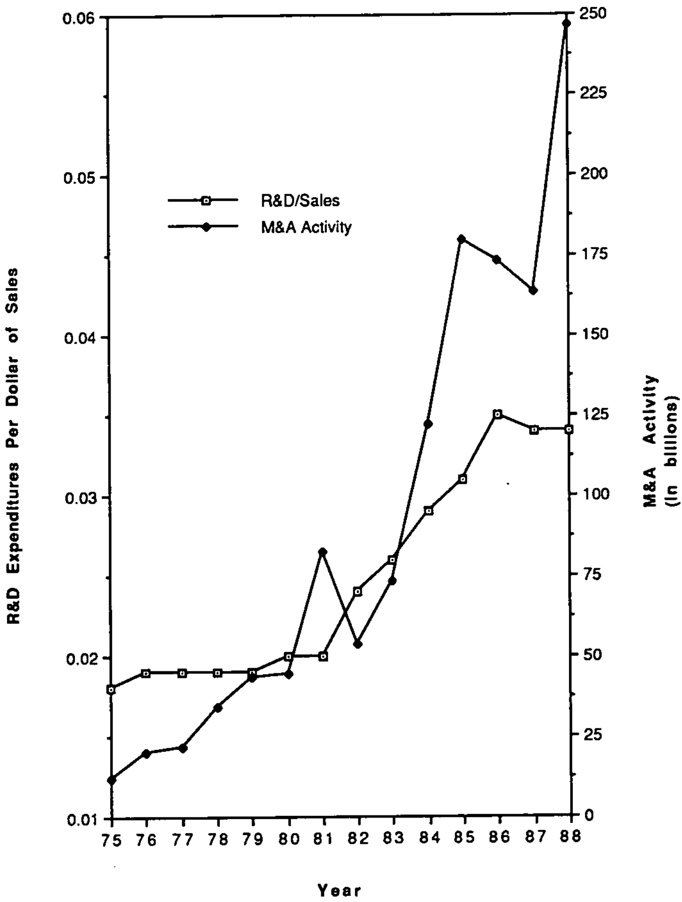

Fig. 3
R&D Expenditures per dollar of sales vs. total M&A activity in the period 1975-88.

Inadequacies with Executive Compensation[3]

My research on executive compensation with Kevin Murphy at the University of Rochester Simon School of Business over the last four years indicates that corporate CEOs are paid in ways that are independent of the performance of their organizations. This exacerbates the conflicts between shareholders and managers and, in the absence of effective monitoring by active investors, leads to vast inefficiencies in corporate decision making. Many believe these inefficiencies emanate from the tendency of corporate managers to have short time horizons relative to our competitors in the international market place. But, as I have argued elsewhere[4], they are often associated with horizons that are too long. In these situations, for example, the oil industry in the early 1970s, managers are wasting resources on projects that have negative net present values and therefore are using horizons that are too long given the current cost of capital.

The problem is exactly the opposite to that commonly asserted in media and business circles: American corporate inefficiency arises because managers are *not* motivated to maximize the market value of their firms. The problems lie not with the fact that the stock market is having too much of an impact on managers, but rather because the market is having too little effect on managerial decisions. The double taxation of dividends at the corporate level significantly exacerbates this problem by imposing tax penalties that trap equity in large mature firms that have no profitable uses for it. The result is waste, inefficiency and lagging productivity.

CEO pay is insensitive to performance

The conflict of interest between shareholders of a publicly owned corporation and the corporation's chief executive officer (CEO) is a classic example of a principal-agent problem. If shareholders had complete information regarding the CEO's activities and the firm's investment opportunities, they could design a contract specifying and enforcing the managerial action to be taken in each situation. Managerial actions and investment opportunities are not, however, perfectly observable by shareholders; indeed, shareholders don't often know what actions the CEO *can* take or which of these actions will increase shareholder wealth. In these situations, compensation policy can give the manager incentives to select and implement actions that increase shareholder wealth.

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3 The material in this section comes from Jensen and Murphy (forthcoming 1990) unless noted otherwise.
4 Jensen (1986, 1988)

Shareholders want CEOs to take particular actions—*e.g.*, deciding which issue to work on, which project to pursue, and which to drop—whenever the expected return on the action exceeds the expected costs. But the CEO compares only his *private* gain and cost from pursuing a particular activity. Compensation policy that ties the CEO's welfare to shareholder wealth helps align the private and social costs and benefits of alternative actions and thus provides incentives for CEOs to take appropriate actions.

There are many mechanisms through which compensation policy can provide value-increasing incentives, including performance-based bonuses and salary revisions, stock options, and performance-based dismissal decisions. The purpose of our research is to estimate the magnitude of the incentives provided by each of these mechanisms. The pay-performance sensitivity is estimated by following all 2,213 CEOs listed in the Executive Compensation Surveys published in *Forbes* from 1974-1986. These surveys include executives serving in 1,295 corporations, for a total of 10,400 CEO-years of data. We match these compensation data to fiscal-year corporate performance data obtained from the Compustat and CRSP data files. After eliminating observations with missing data, the final sample contains 7,750 yearly observations on compensation and includes 1,688 executives from 1,049 corporations. All monetary variables are adjusted for inflation (using the consumer price index for the closing month of the fiscal year) and represent thousands of 1986-constant dollars.

Table 2 summarizes the results of our estimates. Our estimates imply that each $1,000 change in shareholder wealth corresponds to an average increase in this year's and next year's salary and bonus of about two cents. We also estimate the CEO-wealth consequences associated with salary revisions, outstanding stock options, and performance-related dismissals; our upper-bound estimate of the total change in the CEO's wealth from these sources that are under direct control of the board of directors is about 75¢ per $1,000 change in shareholder wealth.

Stock ownership is another way an executive's wealth varies with the value of the firm. CEOs in our sample hold a median of about .25% of their firms' common stock, including exercisable stock options and shares held by family members or connected trusts. Thus, the value of the stock owned by the median CEO changes by $2.50 whenever the value of the firm changes by $1,000. Therefore, our final all-inclusive estimate of the pay-performance sensitivity—including compensation, dismissal, and stockholdings—is about $3.25 per $1,000 change in shareholder wealth.

TABLE 2

ESTIMATED PAY-PERFORMANCE SENSITIVITY.
Total Effects (Over Two Years) on CEO Compensation-Related Wealth Corresponding to Each $1,000 Change in Shareholder Wealth for CEOs from 1974-1986, by Firm Size[a]
Source Jensen and Murphy (1990)

	Predicted CEO-Wealth Change per $1,000 Change in Shareholder Wealth		
	All Firms	Large Firms	Small Firms
	(1)	(2)	(3)
1. Change in This Year's and Next Year's Salary & Bonus	2.2¢	2.0¢	4.1¢
2. Total Compensation + Present Value of the change in Salary & Bonus	30¢	25¢	75¢
3. Change in the Value of Stock Options	15¢	15¢	15¢
4. Change in Direct Pay-Related Wealth (row 2 + row 3)	45¢	40¢	90¢
5. Change in wealth due to dismissal from poor performance	30¢	5¢	225¢
6. Change in Total Pay-Related Wealth (row 4 + row 5)	75¢	45¢	315¢
7. Change in Wealth Related to Stock Ownership for CEO with Median Stockholdings[b]	$2.50	$1.40	$4.90
8. Change in All Pay- and Stock-Related Wealth[a]	$3.25	$1.85	$8.05

[a] Estimates rounded to the nearest nickel (except for row 1). Large firms have market value in a given year above the *Forbes* sample median for that year, while small firms have market value below the median.
[b] Stock ownership includes options that can be exercised within 60 days.

CEOs in large firms tend to own less stock and have less compensation-based incentives than CEOs in smaller firms. In particular, our all-inclusive estimate of the pay-performance sensitivity for CEOs in firms in the top half of our sample (ranked by market value) is $1.85 per $1,000, compared to $8.05 per $1,000 for CEOs in firms in the bottom half of our sample.

The empirical relation between the pay of top-level executives and firm performance, while positive and statistically significant, is small for an occupation where incentive pay is expected to play an important role. In addition, our estimates suggest that dismissals are not an important source of managerial incentives since the increases in dismissal probability due to poor performance and the penalties associated with dismissal are both small. Executive inside-stock ownership can provide incentives, but these holdings are not generally controlled by the corporate board, and the majority of top executives have small personal stockholdings.

The small relation between CEO pay and measures of market or accounting performance seems inconsistent with the fact that CEOs receive a large share of their total compensation in the

form of explicit incentive bonuses. The Conference Board (1984) reports that over 90% of all large manufacturing firms had bonus plans in 1983, and 87% of firms with bonus plans paid bonuses for 1983 performance. The median bonus award for CEOs in the Conference Board's survey is 50% of base salary; over 20% of the surveyed firms report CEO bonuses exceeding 70% of salary.[5]

It is possible that CEO bonuses are strongly tied to an unexamined and/or unobservable measure of performance. If bonuses depend on performance measures observable only to the board of directors and are highly variable, they could provide significant incentives. One way to detect the existence of such "phantom" performance measures is to examine the magnitude of year-to-year fluctuations in CEO compensation. Large swings in CEO pay from year to year are consistent with the existence of an overlooked but important performance measure; small annual changes in CEO pay suggest that CEO pay is essentially unrelated to all relevant performance measures. To test for the existence of such unobserved but important pay-performance sensitivity, we compare the variability of CEO pay to that of a sample of randomly selected workers.

The data indicate that year-to-year fluctuations in CEO income are not much different than income fluctuations for conventional labor groups. Column (2) in table 3 presents the frequency distribution of inflation-adjusted annual percentage changes in CEO salary plus bonus for all CEOs listed in the *Forbes* surveys from 1974 to 1986. A third of the sample observations correspond to inflation-adjusted pay changes between zero and ten percent, and three-fourths of the observations reflect pay changes between -10% and +25%. Raises in salaries and bonus exceeding 50% account for only 4.4% of the sample, and pay cuts of more than 25% account for

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5 Separate salary and bonus data are not available for the *Forbes* sample, but we matched our *Forbes* data to separate salary and bonus data published in *Business Week* from 1974-1983 and find that bonuses account for 50% of base salary for the *Business Week* sample. In addition, bonuses also account for about 50% of base salary in the 73 manufacturing-firm sample. Therefore, the Conference Board bonus data appear to be representative of the population of large firms.

TABLE 3

COMPARISON OF PAY VARIABILITY OF CEOS AND RANDOMLY SELECTED WORKERS
Frequency Distribution of Annual Percentage Changes in Real CEO Salary and Bonus and Total Pay for CEOs Listed in *Forbes* Compensation Surveys, 1974-1986, and Changes in Real Wages for Workers in the 1975-1980 Michigan Panel Survey of Income Dynamics (PSID)
Source Jensen and Murphy (1990)

Inflation Adjusted Annual Percentages	CEOs in Forbes Surveys 1974-1986		Workers in Michigan PSID Sample 1975-1980[b]
	Salary + Bonus	Total Pay[a]	
(1)	(2)	(3)	(4)
More than +50%	4.4%	6.3%	4.6%
+25% to +50%	9.4%	10.5%	6.8%
+10% to +25%	21.1%	21.3%	14.0%
0% to +10%	32.3%	29.1%	34.0%
-10% to 0%	21.9%	18.9%	28.6%
-25% to -10%	7.7%	8.9%	7.8%
Less than -25%	3.2%	5.0%	4.2%
Sample Size	8,027	8,027	10,247
Standard Deviation	30.5	49.3	41.7

[a] Total compensation typically includes salary, bonus, value of restricted stock, savings and thrift plans, and other benefits but does *not* include the value of stock options granted or the gains from exercising stock options.
[b] The wage change distributions for the Michigan Panel Study of Income Dynamics (PSID) were made available to us by Ken McLaughlin and include 10,247 male workers ages 18 to 59 reporting wages earned in consecutive periods.

only 3.2% of the sample. Column (3) in table 3 summarizes the frequency distribution of the inflation-adjusted total pay (excluding stock options). Changes in CEO compensation exceeding ±25% account for only 21.8% of the sample observations.

Column (4) of table 3 presents the frequency distribution of annual inflation-adjusted percentage wage changes for managerial and nonmanagerial workers in the Michigan Panel Study of Income Dynamics (PSID). This subset of the PSID sample covers the years 1975 to 1980 and includes 10,247 annual wage changes for male workers ages 18-59. The wage-change distributions for the random sample in column (4) are remarkably similar to the wage-change distribution for CEOs in columns (2) and (3). The standard deviation of percentage wage changes for the PSID sample is 41.7, compared to 30.5 and 49.3 for CEO salary plus bonus and CEO total compensation, respectively. There are a few minor differences which are interesting. CEOs are less likely to receive real pay cuts than workers selected at random; CEOs receive cuts in both salary plus bonus and total pay 32.8% of the time while the workers in the PSID sample received pay cuts 40.6% of the time. CEOs are more likely to receive raises exceeding 10% than random workers, 34.8% and 38% for salary plus bonus and total pay, respectively, for CEOs compared to 25.4% for all workers.

Corporate management is an occupation where *a priori* we would expect incentive compensation to be especially important. It is therefore surprising that the distribution of wage

changes for CEOs is so similar to the distribution for randomly selected workers. It appears that annual executive bonuses are not highly variable. These data seem inconsistent with economic theories of compensation—in spite of the fact that bonuses nominally amount to 50% of salary there seem to be too few major year-to-year percentage changes in CEO compensation to provide the incentives that are likely to make a substantial difference in executive behavior.

The wave of management buyouts and the improved productivity they generate are consistent with the hypothesis that CEOs and the incentives they face are important to firm performance. There is strong evidence that the 110% average net-of-market increase in value associated with these buyouts is caused by new top-management incentives (Kaplan, 1989 and Jensen, 1989). The experience with MBOs is inconsistent with the hypothesis that managerial incentives are unimportant because in these transactions the same top managers manage the same assets after the company goes private. Data from takeovers, which are associated with high management turnover and produce average increases in firm value of 50% are also consistent with the hypothesis that top-level managers can have a large effect on firm performance.

Our results are consistent with the hypothesis that political forces operating on the contracting process between shareholders and corporate managers implicitly regulate executive compensation by constraining the type of contracts that can be written. Managerial labor contracts are not, in fact, a private matter between employers and employees. Strong political forces operate in both the private sector (board meetings, annual stockholder meetings, internal corporate processes) and the public sector that affect executive pay. Managerial contracts are not private because by law the details of the pay package are public information open to public scrutiny and criticism. Moreover, authority over compensation decisions rests not with shareholder-employers but rather with compensation committees composed of outside members of the boards of directors who are elected by, but are not perfect agents for, shareholders. Fueled by the public disclosure of executive pay required by the SEC, parties such as employees, labor unions, consumer groups, Congress, and the media create forces in the political milieu that constrain the type of contracts written between management and shareholders.

The strong antagonism toward large pay changes is illustrated by the recent conflict leading to the defeat of Congressional pay increases. One Gallup poll ("Pay Raise Opponents Force Showdown" [1989]) indicates that 82% of voters opposed the 50% increase in Congressional and other governmental salaries (from $89,500 to $135,000) even though this increase would have left these salaries lower in real terms than their 1969 level. It is extremely important to remedy this problem by finding a way to substantially increase congressional and other governmental salaries if we are to continue to attract the highly qualified people that are necessary for the efficient running of the government.

The benefits of the public disclosure of top management compensation are obvious since this disclosure can help provide a safeguard against "looting" by management (in collusion with "captive" boards of directors). The costs of disclosure are less well appreciated. Public

information on "what the boss makes" affects contracts with other employees and provides emotional justification for increased union demands in labor negotiations. Media criticism and ridicule and the threat of potential legislation motivated by high payoffs to managers reduce the effectiveness of executives and boards in managing the company. The media is filled with sensational stories about executive compensation each spring at the height of the proxy season. Board members are subject to lawsuits if top-management pay is "too high" relative to pay observed in similar firms (but never if it is "too low"). Since the subjective "reasonableness" of a compensation package is strongly influenced by the political process, it is natural that well-intentioned but risk-averse board members will resist innovative incentive contracts.

These political forces, operating in both the political sector and within organizations, appear to be important but are difficult to document because they operate in informal and indirect ways. Public disapproval of high rewards seems to have truncated the upper tail of the earnings distribution of corporate executives. Equilibrium in the managerial labor market then prohibits large penalties for poor performance and as a result the dependence of pay on performance is decreased.

The Implicit Regulation Hypothesis: Evidence from the 1930s

It is difficult to document the influence of the political process on compensation since the constraints are implicit rather than explicit and the public disclosure of top-management compensation has existed for a half century. One possible way to test this implicit regulation hypothesis is to compare our pay-performance results for 1974-1986 to the pay-performance relation when regulatory pressures were less evident. We construct a longitudinal sample of executives from the 1930s using data collected by the Work Projects Administration (WPA) in a 1940 project sponsored by the Securities and Exchange Commission.[6] The WPA data, covering fiscal years 1934 through 1938, include salary and bonus paid to the highest-paid executive in 748 large U.S. corporations in a wide range of manufacturing and nonmanufacturing industries. Three-hundred ninety-four of the WPA sample firms are listed on the NYSE; market value data for these firms are available on the CRSP Monthly Stock Returns Tape.

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6 United States Work Projects Administration, *Survey of American Listed Corporations*, sponsored by Securities and Exchange Commission, Vol. 1 (January 1940) - Vol. 7 (February 1941).

TABLE 4

CEO COMPENSATION IN 1934-38 VS. 1974-86

Sample Compensation Statistics for CEOs in the Top Quartile of NYSE Corporations Ranked by Market Value[a]

(t-statistics in parentheses)

Source Jensen and Murphy (1990)

Variable (in 1986 Dollars)	1934-1938	1974-1986	test statistic for difference
CEO Salary & Bonus			
Mean	$813,000	$645,000	t = 9.1
Median	$639,000	$607,000	
Mean Market Value of Firm	$1.6 billion	$3.4 billion	t = -6.1
Mean CEO Salary & Bonus as % of Firm Market Value	.110%	.034%	t = 29.6
Change in CEO Salary & Bonus			
Mean	$31,900	$27,800	t = 0.4
Median	$200	$21,600	
Avg Standard Deviation[b]	$205,000	$127,000	t = 2.7

[a] For the 1934-1938 data, CEOs are defined as the highest-paid executive. Sample sizes are 456 and 3,988 CEO-years for the 1934-1938 and the 1974-1986 samples, respectively.

[b] The standard deviation for Δ(Salary+Bonus) was calculated for each firm with at least three years of data; the t-statistic tests the equality of the average standard deviations in the two samples.

Comparing corporate data from the 1934-1938 WPA sample to corresponding data from the 1974-1986 *Forbes* sample is difficult because of reporting differences and because of major secular changes in the number of corporations and the size distribution of corporations over the past five decades. The "CEO" designation was rarely used in the 1930s, and therefore for comparison purposes we define CEOs as the highest-paid executive. In addition, the WPA data do not reveal the name of the highest-paid executive and therefore some salary and bonus changes reflect management changes rather than pay revisions for a given manager. For comparison purposes, the 1974-1986 pay-change data utilized in tables 8 and 9 were constructed ignoring management changes. Finally, in order to compare similar firms in the two time periods, we restrict our analysis to firms that are in the top quartile of firms listed on the NYSE (ranked by market value). WPA compensation data are available for 60% of the top quartile NYSE firms from 1934-1938 (averaging 114 firms per year), and *Forbes* compensation data are available for 90% of the top-quartile NYSE firms from 1974-1986 (averaging 335 firms per year).

Table 4 presents sample compensation statistics for CEOs in the top quartile of NYSE corporations ranked by market value from 1934-1938, and compares these results to similarly constructed data from 1974-1986. Measured in 1986-constant dollars, CEOs in the largest quartile firms earned an average of $813,000 in the 1930s, significantly more than the average pay of $645,000 earned by CEOs in the NYSE top quartile from 1974 to 1986. Over this same time period, median pay fell from $639,000 to $607,000. The current popular belief that CEO pay in

TABLE 5

CEO PAY-PERFORMANCE SENSITIVITY IN 1934-38 VS. 1974-86.
Regressions of Change in CEO Salary + Bonus on Change in Shareholder Wealth for CEOs in the Top Quartile of NYSE Corporations Ranked by Market Value[a]
(t-statistics in parentheses)

Source Jensen and Murphy (1990)

Independent Variable	Regression Coefficients: Dependent Variable is Δ(Salary and Bonus) (in $1000s of 1986-Constant Dollars)	
	1934-1938	1974-1986
Intercept	6.3	22.3
Δ(Shareholder Wealth) (1000s of 1986-Dollars)	.000114 (5.6)	.000012 (7.0)
Δ(Shareholder Wealth) in Year t-1	.000061 (2.8)	.000007 (4.4)
R^2	.0702	.0144
Estimated pay/performance sensitivity, "b"	.000175	.000019
Estimated Pennies per $1,000	17.5¢/per $1,000	1.9¢/per $1,000

[a] For the 1934-1938 data, CEOs are defined as the highest paid executive. Sample sizes are 427 and 3,826 CEO-years for the 1934-1938 and the 1974-1986 samples, respectively.

the largest corporations has increased dramatically over the past several decades is therefore not supported by these sample averages. Over this same time period, there has been a doubling (after inflation) of the average market value of a top-quartile firm—from $1.6 billion in the 1930s to $3.4 billion from 1974-1986. Coupled with the decline in salaries, this means the ratio of CEO pay to total firm value has fallen significantly in fifty years—from .11% in the early period to .03% in the later period. The mean annual change in compensation in the earlier period was $31,900 as compared to $28,000 in the 1974-86 period. More importantly, the variability of annual changes in CEO pay fell considerably over this period; the average standard deviation of the annual pay changes was $127,000 in the 1970s and 1980s, significantly lower than the $205,000 average in the 1930s.

The pronounced decline in the raw variability of salary changes evident in table 4 suggests the possibility of a decreased sensitivity in the pay-performance relation. Table 5 reports estimated coefficients from regressions of change in CEO salary and bonus on this year's and last year's change in shareholder wealth. The 1930s regression indicates that each $1,000 increase in shareholder wealth corresponds to an 11.4¢ increase in this year's pay and a 6.1¢ increase in next years pay—thus the total effect of a $1,000 increase in shareholder wealth is 17.5¢. In contrast, the regression using the 1974-1986 data implies only a 1.9¢ pay change for each $1,000 change in shareholder wealth. Thus, the pay-performance relation for CEOs in the top quartile of NYSE

TABLE 6

TIME TRENDS IN CEO INSIDE STOCK OWNERSHIP
Median CEO Stock Ownership for Two Samples of Firms[a]
Source Jensen and Murphy (1990)

Year	Median Value of Stock Owned (1986 Dollars)	Median Percentage of Firm Owned
A. SAMPLE 1:		
120 Largest Firms Ranked by Market Value		
1938	$2,250,000	.30%
1974	$2,061,000	.05%
1984	$1,801,000	.03%
B. SAMPLE 2:		
73 Manufacturing Firms		
1969-1973	$3,531,000	.21%
1974-1978	$1,397,000	.14%
1979-1983	$1,178,000	.11%
15-Year Sample	$1,697,000	.16%

[a] Stock ownership obtained from proxy statements includes not only shares held directly but also shares held by family members or related trusts.

firms has fallen by a factor of ten over the past fifty years. These results, although not conclusive, are consistent with the implicit regulation hypothesis because political constraints and pressures, disclosure requirements, and the overall regulation of Corporate America, have increased substantially over the same period.

The incentives generated by CEO stock ownership have also declined substantially over the past fifty years. Table 6 shows time trends in the stock ownership of CEOs for two different samples of firms. The first sample consists of all CEOs in the 120 largest firms (ranked by stock market value) in 1938, 1974, and 1984; we collected stock ownership data for these CEOs from proxy statements. Panel A of table 10 shows that CEO percent ownership (including shares held by family members and trusts) in the largest 120 firms fell from a median of .30% in 1938 to .05% in 1974, and fell further to .03% in 1984 (*average* percent ownership fell from 1.7% in 1938 to 1.5% and 1.0% in 1974 and 1984, respectively). In addition, the median dollar value of shares held (in 1986-constant dollars) fell from $2,250,000 in 1938 to $2,070,000 in 1974 and to $1,811,000 in 1986. The decline in the value of shares held between 1974 and 1984 is especially significant since 1974 was a "bust" year in the stock market, while 1984 was a "boom" year. The value-weighted portfolio of all NYSE stocks increased by 113.4% (after inflation) over this interval, so if the median executive had maintained his stock holdings and if these had increased by the same percentage as that of the market portfolio, the value of his holdings would have increased from $2,061,000 in 1974 to $4,400,000 in 1984 instead of falling to $1,801,000.

Panel B of table 6, based on the 73 manufacturing-firm sample, shows the median value of stock owned by CEOs and their percentage ownership for the full fifteen-year sample and for five-

year intervals. From 1969-1973, the median CEO in the 73 sample firms held $3,531,000 in common stock (1986-dollars) which accounted for .21% of the shares outstanding. By 1979-1983, the median ownership had fallen 67% to $1,178,000, accounting for only .11% of the shares outstanding. Over the same time period, the *average* stock ownership, which is strongly influenced by a few CEOs with extraordinarily large holdings, fell from $14,100,000 to $8,500,000.

The political pressures associated with high pay-performance contracts do not appear to extend to gains from stock ownership. We therefore expect increases in political pressure to correspond to decreases in pay-performance sensitivity and *increases* in incentives associated with stock ownership. The dramatic decline in CEO stock ownership over the past fifty years is contrary to the implicit regulation hypothesis and suggests a significant downward trend in managerial incentives which is not explained by existing theories.

Other Evidence Consistent with the Implicit Regulation Hypothesis

Anecdotal evidence on the implicit regulation of executive compensation is abundant and consistent. One way to assess the effects of the political process on compensation contracts is to analyze changes in the contracts that occur when private firms go public or when public firms go private. A comprehensive empirical investigation is impossible since most closely held firms are obsessively secretive about their compensation practices. Insights into the differences in the pay practices of public and private firms can be obtained, however, by analyzing the recent public offerings of several investment banking houses.

Phibro-Salomon, formed by the 1981 merger of closely-held Salomon Brothers and the publicly-held Phibro Corp, generated considerable attention in the annual compensation surveys. In its first year as a public firm, roughly 20 top officials received over $1 million each, and one analyst reported "the only thing that embarrasses them is that they have to report the numbers" (*Wall Street Journal (WSJ)*, 3/21/86). In contrast, only 15 CEOs in all other publicly-held firms had salaries and bonuses exceeding $1 million in 1981 (*Forbes*, 6/7/82)[7]

Bear Stearns went public in October 1985, and CEO Alan Greenberg's $2.9 million salary and bonus was the nation's fourth highest. The compensation of the firm's managing directors was initially set at $150,000 with a bonus tied to earnings. Because earnings performance was high in 1986, the bonus pool swelled to $80 million, or an average of $842,000 for each of the firm's 95 managing directors. Six months after going public, Bear Stearns announced that the bonus pool was reduced from 40% to 25% of the company's adjusted pretax earnings in excess of

7 1981 was a big year for cashing in stock options, and 115 CEOs had *total* compensation of a million or more.

$200 million because it had "yielded an embarrassment of riches for top executives" (*WSJ* 3/21/86).

Investment banking units in publicly owned corporations have a difficult time attracting and retaining key traders. In 1986 Citicorp announced it was considering radical changes in its compensation policies "in a move to stem the wave of defections from its investment banking unit." The maximum bonuses paid to Citicorp traders at the time amounted to three to four times base salary compared to more than ten times base salaries at private Wall Street firms (*WSJ* 11/19/86).

Pressures from the media to reduce generous pay can also serve as a measure of the influence of the political process on managerial contracts. Recent headlines include: "Reform Executive Pay or Congress Will" (*WSJ* 4/24/84), "Big Executive Bonuses Now Come With a Catch: Lots of Criticism" (*WSJ* 11/19/86), "Congress Thinks It Knows Best About Executive Compensation" (*WSJ* 5/15/85), "Trading Firm's Generous Pay Stirs Questions" (*WSJ* 7/30/84), "Those Million-Dollar Salaries: Some Hefty Pay Hikes Open a Controversy About Executive Compensation" (*Time* 5/7/84), "Chrysler's Bonus Plan for Iacocca Irks UAW" (*WSJ* 4/26/84), and "The Madness of Executive Compensation" (*Fortune* 7/82). *Business Week* (5/87) reports that "General Motors Corp has decided to end its often-criticized bonus plan. The plan came under attack this year when GM set aside $169 million for executive bonuses while deciding to omit profit-sharing payments to 500,000 workers."

Direct government intervention in executive compensation is infrequent but does occur. One example is Thomas Spiegel, CEO of Columbia Savings and Loan Association in California, whose 1985 total compensation of $9,032,000 was the nation's third highest. In April 1986, the Federal Home Loan Bank Board demanded that Columbia's board of directors take "immediate steps" to recover all but Spiegel's $960,000 base salary. As justification, the Bank Board cited several earlier cases where executives were asked to return their bonuses (*National Thrift News* 8/11/86).

It seems plausible that the implicit regulation of executive compensation is more pronounced in industries that are already heavily regulated in other dimensions. The Columbia Savings case above is a good example—the Federal Home Loan Bank Board explicitly requires that compensation be "reasonable" and has the authority to demand changes in compensation practices. Smith and Watts (1986) and Murphy (1987) show that both the level of compensation and the relation between pay and performance are lower in regulated firms than in non-regulated firms. This empirical regularity is consistent with the hypothesis that compensation practices are constrained by the political sector and that these constraints become more pronounced in highly regulated firms.

Organized labor is another potentially important third party affecting compensation policies. In 1984, for example, UAW leaders used accusations of excessive executive bonuses to rally support for higher compensation to UAW members in its contract negotiations" (*WSJ* 3/6/84).

Murphy (1987) reports that executives in heavily unionized industries receive lower levels of total compensation, and a smaller share of their compensation in the form of stock options, than executives in less unionized industries, ceteris paribus. This result is also consistent with the implicit regulation hypothesis.

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Eclipse of the Public Corporation

by Michael C. Jensen

The publicly held corporation, the main engine of economic progress in the United States for a century, has outlived its usefulness in many sectors of the economy and is being eclipsed.

New organizations are emerging in its place – organizations that are corporate in form but have no public shareholders and are not listed or traded on organized exchanges. These organizations use public and private debt, rather than public equity, as their major source of capital. Their primary owners are not households but large institutions and entrepreneurs that designate agents to manage and monitor on their behalf and bind those agents with large equity interests and contracts governing the use and distribution of cash.

Takeovers, corporate breakups, divisional spinoffs, leveraged buyouts, and going-private transactions are the most visible manifestations of a massive organizational change in the economy. These transactions have inspired criticism, even outrage, among many business leaders and government officials, who have called for regulatory and legislative restrictions. The backlash is understandable. Change is threatening; in this case, the threat is aimed at the senior executives of many of our largest companies.

Despite the protests, this organizational innovation should be encouraged. By resolving the central weakness of the public corporation – the conflict between owners and managers over the control and use of corporate resources – these new organizations are making remarkable gains in operating efficiency, employee productivity, and shareholder

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New organizations resolve the central weakness of the public corporation: the struggle between owners and managers.

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The Privatization of Equity

The last share of publicly traded common stock owned by an individual will be sold in the year 2003, if current trends persist. This forecast may be fanciful (short-term trends never persist), but the basic direction is clear. By the turn of the century, the primacy of public stock ownership in the United States may have all but disappeared.

Households have been liquidating their direct holdings and indirect positions (through channels like mutual funds) at an unprecedented rate. Over the last five years, they have been net sellers of more than $500 billion of common stock, 38% of their holdings at the beginning of 1984.

Why have stock prices risen sharply despite this massive sell-off? Because there has been one huge buyer–corporations themselves. LBOs, MBOs, share repurchases, leveraged mergers and acquisitions, and takeovers have been contracting the supply of publicly held equity. In 1988, 5% of the market value of public equity (more than $130 billion) disappeared through these kinds of transactions, even after adding back all of the new issues brought to market during the year.

Of course, the risks and returns from the underlying corporate assets have not disappeared. To some extent they now reside in quasi-equity debt instruments like high-yield bonds, whose total market value exceeds $200 billion. But many of the risks and returns still exist as equity; they just take the form of large positions of privately held equity. The "privatization of equity" is now a central feature of corporate ownership in the United States.

Historically, public stock markets dominated by individual investors developed to a greater extent in the United States than in any other country. Broad public ownership offered managers a reasonably priced source of more or less permanent equity capital that could buffer the company against adversity in a way debt could not. Share ownership allowed individual investors to participate in equity returns and get the benefits of liquidity (because they could sell their shares) and diversification (because they could hold a small number of shares from many corporations).

The virtues of broad public ownership are not what they used to be, for managers or investors. One important factor is the emergence of an active market for corporate control. A capital structure consisting mostly of equity still offers managers protection against the risks of economic downturn. But it also carries substantial risks of inviting a hostile takeover or other threats to management control.

The role of the public market has also changed because investors themselves have changed. For decades, stock ownership has been migrating from direct holdings by millions of individuals to indirect beneficial ownership through large pools of capital–in particular, the huge corporate and governmental pension funds whose total value exceeded $1.5 trillion in 1988. These institutional funds, which now comprise more than 40% of total stock ownership, used to behave like large public investors. They kept diversified by retaining many different investment managers, each of whom traded an array of highly liquid public securities. But their investment philosophy has been evolving in recent years to include participation in a select number of

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value. Over the long term, they will enhance U.S. economic performance relative to our most formidable international competitor, Japan, whose companies are moving in the opposite direction. The governance and financial structures of Japan's public companies increasingly resemble U.S. companies of the mid-1960s and early 1970s–an era of gross corporate waste and mismanagement that triggered the organizational transformation now under way in the United States.

Consider these developments in the 1980s:

□ The capital markets are in transition. The total market value of equity in publicly held companies has tripled over the past decade–from $1 trillion in 1979 to more than $3 trillion in 1989. But newly acquired capital comes increasingly from private placements, which have expanded more than ten times since 1980, to a rate of $200 billion in 1988. Private placements of debt and equity now account for more than 40% of annual corporate financings. Meanwhile, in every year since 1983, at least 5% of the outstanding value of corporate equity has disappeared through stock repurchases, takeovers, and going-private transactions. Finally, households are sharply reducing their stock holdings.[1] (See the insert, "The Privatization of Equity.")

□ The most widespread going-private transaction, the leveraged buyout, is becoming larger and more frequent. In 1988, the total value of the 214 public-company and divisional buyouts exceeded $77 billion–nearly one-third of the value of all mergers and acquisitions. The total value of the 75 buyouts in 1979 was only $1.3 billion (in constant 1988 dollars), while the 175 buyouts completed in 1983

private illiquid investments and private pools of equity capital. This new investment philosophy makes broad public markets less essential for institutions.

Large pools of capital such as pension funds and endowments don't really need the liquidity the public market offers. Liquidity serves two basic purposes. It allows investors to meet unexpected cash needs and to trade their stocks. Unlike individuals, the large funds can project their cash needs well into the future based on predictable factors such as employee demographics, life expectancies, and health trends. So they can take a long-term view of investment returns and keep their holdings in illiquid assets.

Fund managers are also realizing that trading is a tough discipline in which they hold little comparative advantage. Trading is a zero-sum game played in a fairly efficient market against equally talented rivals. Worse still, large funds face diseconomies of scale when executing trades. The larger a fund, the more difficult it is to trade quickly, based on transient information advantages. The very act of trading moves markets.

Still, these managers remain charged with generating returns in excess of passive benchmarks. Enter the market for private assets such as real estate, venture capital, and, more recently, the market for corporate control and restructurings. Instead of trading a large number of small, liquid positions, the funds can buy and own smaller numbers of large, illiquid positions in a form where they (or, more likely, their agents) participate more actively with management in the control of the assets.

This alternative can be a positive-sum game; real changes in corporate policies can be a route to enhanced value. The very large funds also have a competitive advantage here. The larger their positions, the more actively they can participate in the ownership and management of the underlying assets. In the extreme, as with LBO funds, these changes can be dramatic. The LBO fund itself becomes the managing owner in partnership with company managers. In short, large institutional funds can behave more like owners and less like traders.

The same basic changes are at work in a wide variety of corporate recapitalizations where outside (or related) parties acquire large, relatively nontraded equity positions. Large pools of capital can participate in these private equity positions yet remain diversified by virtue of their own enormous size. Smaller funds and households cannot.

In the short run, this new investment philosophy has been, in the aggregate, a great success. Without the sobering influence of an economic contraction, the returns from these private investments have been very attractive. In the long run, the institutions' new philosophy is ushering in a system of equity ownership dominated by "private positions" that resembles ownership systems in Germany and Japan. Individual investors in this system will increasingly be free riders on the coattails of a small number of very large private investors rather than the central feature of the financial markets.

–JAY O. LIGHT

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had a total value of $16.6 billion. This process is just getting started; the $77 billion of LBOs in 1988 represented only 2.5% of outstanding public-company equity. (See the table, "Rise of the LBO.")

☐ Entire industries are being reshaped. Just five years ago, the leading U.S. truck and automobile tire manufacturers were independent and diversified public companies. Today each is a vastly different enterprise. Uniroyal went private in 1985 and later merged its tire-making operations with those of B.F. Goodrich to form a new private company called Uniroyal Goodrich. In late 1986, Goodyear borrowed $2.6 billion and repurchased nearly half its outstanding shares to fend off a hostile tender offer by Sir James Goldsmith. It retained its core tire and rubber business while moving to divest an array of unrelated operations, including its Celeron oil and gas subsidiary, California-to-Texas oil pipeline, aerospace operation, and Arizona resort hotel. In 1987, GenCorp issued $1.75 billion of debt to repurchase more than half its outstanding shares. It divested several operations, including its General Tire subsidiary, to pay down the debt and focus on aerospace and defense. Last year, Firestone was sold to Bridgestone, Japan's largest tiremaker, for $2.6 billion, a transaction that created shareholder gains of $1.6 billion.

Developments as striking as the restructuring of our financial markets and major industries reflect underlying economic forces more fundamental and powerful than financial manipulation, management greed, reckless speculation, and the other colorful epithets used by defenders of the corporate status quo. The forces behind the decline of the public corpora-

Developments at Goodyear also illustrate how debt can force managers to adopt value-creating policies they would otherwise resist. Soon after his company warded off Sir James Goldsmith's tender offer, Goodyear chairman Robert Mercer offered his version of the raiders' creed: "Give me your undervalued assets, your plants, your expenditures for technology, research and development, the hopes and aspirations of your people, your stake with your customers, your pension funds, and I will enhance myself and the dealmakers."[8]

What Mr. Mercer failed to note is that Goodyear's forced restructuring dramatically increased the company's value to shareholders by compelling him to disgorge cash and shed unproductive assets. Two years after this bitter complaint, Tom Barrett, who succeeded Mercer as Goodyear's CEO, was asked whether the company's restructuring had hurt the quality of its tires or the efficiency of its plants. "No," he replied. "We've been able to invest and continue to invest and do the things we've needed to do to be competitive."[9]

Robert Mercer's harsh words are characteristic of the business establishment's response to the eclipse of the public corporation. What explains such vehement opposition to a trend that clearly benefits shareholders and the economy? One important factor, as my Harvard Business School colleague Amar Bhide suggests, is that Wall Street now competes directly with senior management as a steward of shareholder wealth. With its vast increases in data, talent, and technology, Wall Street can allocate capital among competing businesses and monitor and discipline management more effectively than the CEO and headquarters staff of the typical diversified company. KKR's New York offices and Irwin Jacobs' Minneapolis base are direct substitutes for corporate headquarters in Akron or Peoria. CEOs worry that they and their staffs will lose lucrative jobs in favor of competing organizations. Many are right to worry; the performance of active investors versus the public corporation leaves little doubt as to which is superior.

Active investors are creating new models of general management, the most widespread of which I call the LBO Association. A typical LBO Association consists of three main constituencies: an LBO partnership that sponsors going-private transactions and counsels and monitors management in an ongoing cooperative relationship; company managers who hold substantial equity stakes in an LBO division and stay on after the buyout; and institutional investors (insurance companies, pension funds, and money management firms) that fund the limited partnerships that purchase equity and lend money (along with banks) to finance the transactions.

Much like a traditional conglomerate, LBO Associations have many divisions or business units, companies they have taken private at different points in time. KKR, for example, controls a diverse collection of 19 businesses including all or part of Beatrice, Duracell, Motel 6, Owens-Illinois, RJR Nabisco, and Safeway. But LBO Associations differ from publicly held conglomerates in at least four important respects. (See the illustration, "Public Company vs. LBO Association.")

Debt is a substitute for dividends. It forces managers to disgorge cash rather than waste it.

Management incentives are built around a strong relationship between pay and performance. Compensation systems in LBO Associations usually have higher upper bounds than do public companies (or no upper bounds at all), tie bonuses much more closely to cash flow and debt retirement than to accounting earnings, and otherwise closely link management pay to divisional performance. Unfortunately, because these companies are private, little data are available on salaries and bonuses.

Public data are available on stock ownership, however, and equity holdings are a vital part of the reward system in LBO Associations. The University of Chicago's Steven Kaplan studied all public-company buyouts from 1979 through 1985 with a purchase price of at least $50 million.[10] Business-unit chiefs hold a median equity position of 6.4% in their unit. Even without considering bonus and incentive plans, a $1,000 increase in shareholder value triggers a $64 increase in the personal wealth of business-unit chiefs. The median public-company CEO holds only .25% of the company's equity. Counting *all* sources of compensation – including salary, bonus, deferred compensation, stock options, and dismissal penalties – the personal wealth of the median public-company CEO increases by only $3.25 for a $1,000 increase in shareholder value.[11]

Thus the salary of the typical LBO business-unit manager is almost 20 times more sensitive to performance than that of the typical public-company manager. This comparison understates the true differences in compensation. The personal wealth of managing partners in an LBO partnership (in effect, the CEOs of the LBO Associations) is tied almost exclusively to the performance of the companies they

[illegible]

Active investors are creating a new model of general management. These investors include LBO partnerships such as Kohlberg Kravis Roberts and Clayton & Dubilier; entrepreneurs such as Carl Icahn, Ronald Perelman, Laurence Tisch, Robert Bass, William Simon, Irwin Jacobs, and Warren Buffett; the merchant banking arms of Wall Street houses such as Morgan Stanley, Lazard Freres, and Merrill Lynch; and family funds such as those controlled by the Pritzkers and the Bronfmans. Their model is built around highly leveraged financial structures, pay-for-performance compensation systems, substantial equity ownership by managers and directors, and contracts with owners and creditors that limit both cross-subsidization among business units and the waste of free cash flow. Consistent with modern finance theory, these organizations are not managed to maximize earnings per share but rather to maximize value, with a strong emphasis on cash flow.

[illegible]

In effect, LBO partnerships and the merchant banks are rediscovering the role played by active investors prior to 1940, when Wall Street banks such as J.P. Morgan & Company were directly involved in the strategy and governance of the public companies they helped create. At the height of his prominence, Morgan and his small set of partners served on the boards of U.S. Steel, International Harvester, First National Bank of New York, and a host of railroads, and were a powerful management force in these and other companies.

Morgan's model of investor activism disappeared largely as a result of populist laws and regulations approved in the wake of the Great Depression. These laws and regulations—including the Glass-Steagall Banking Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934, the Chandler Bankruptcy Revision Act of 1938, and the Investment Company Act of 1940—may have once had their place. But they also created an intricate web of restrictions on company "insiders" (corporate officers, directors, or investors with more than a 10% ownership interest), restrictions on bank involvement in

[illegible]

Year	*Public Company Buyouts* Number	*Public Company Buyouts* Average Value (In millions of 1988 dollars)	*Divisional Buyouts* Number	*Divisional Buyouts* Average Value (In millions of 1988 dollars)	Total Value of Buyouts (In billions of 1988 dollars)
1979	16	$ 64.9	59	$ 5.4	$ 1.4
1980	13	106.0	47	34.5	3.0
1981	17	179.1	83	21.0	4.8
1982	31	112.2	115	40.7	8.2
1983	36	235.8	139	58.2	16.6
1984	57	473.6	122	104.0	39.7
1985	76	349.4	132	110.1	41.0
1986	76	303.3	144	180.7	49.0
1987	47	488.7	90	144.2	36.0
1988	125	487.4	89	181.3	77.0

Source: George P. Baker, "Management Compensation and Divisional Leveraged Buyouts," unpublished dissertation, Harvard Business School, 1986. Updates from W.T. Grimm, *Mergerstat Review* 1988. Transactions with no public data are valued at the average price of public transactions.

corporate reorganizations, court precedents, and business practices that raised the cost of being an active investor. Their long-term effect has been to insulate management from effective monitoring and to set the stage for the eclipse of the public corporation.

Indeed, the high cost of being an active investor has left financial institutions and money management firms, which control more than 40% of all corporate equity in the United States, almost completely uninvolved in the major decisions and long-term strategies of the companies their clients own. They are almost never represented on corporate boards. They use the proxy mechanism rarely and usually ineffectively, notwithstanding recent efforts by the Council of Institutional Investors and other shareholder activists to gain a larger voice in corporate affairs.

All told, institutional investors are remarkably powerless; they have few options to express dissatisfaction with management other than to sell their shares and vote with their feet. Corporate managers criticize institutional sell-offs as examples of portfolio churning and short-term investor horizons. One guesses these same managers much prefer churning to a system in which large investors on the boards of their companies have direct power to monitor and correct mistakes. Managers really want passive investors who can't sell their shares.

The absence of effective monitoring led to such large inefficiencies that the new generation of active investors arose to recapture the lost value. These investors overcome the costs of the outmoded legal constraints by purchasing entire companies – and using debt and high equity ownership to force effective self-monitoring.

A central weakness and source of waste in the public corporation is the conflict between shareholders and managers over the payout of free cash flow – that is, cash flow in excess of that required to fund all investment projects with positive net present values when discounted at the relevant cost of capital. For a company to operate efficiently and maximize value, free cash flow must be distributed to shareholders rather than retained. But this happens infrequently; senior management has few incentives to distribute the funds, and there exist few mechanisms to compel distribution.

A vivid example is the senior management of Ford Motor Company, which sits on nearly $15 billion in cash and marketable securities in an industry with excess capacity. Ford's management has been deliberating about acquiring financial service companies, aerospace companies, or making some other multibillion-dollar diversification move – rather than deliberating about effectively distributing Ford's excess cash to its owners so they can decide how to reinvest it.

Ford is not alone. Corporate managers generally don't disgorge cash unless they are forced to do so. In 1988, the 1,000 largest public companies (by sales) generated total funds of $1.6 trillion. Yet they distributed only $108 billion as dividends and another $51 billion through share repurchases.[3]

Managers have incentives to retain cash in part because cash reserves increase their autonomy vis-à-vis the capital markets. Large cash balances (and independence from the capital markets) can serve a competitive purpose, but they often lead to waste and inefficiency. Consider a hypothetical world in which companies distribute excess cash to shareholders and then must convince the capital markets to supply funds as sound economic projects arise. Shareholders are at a great advantage in this world, where management's plans are subject to enhanced monitoring by the capital markets. Wall Street's analytical, due diligence, and pricing disciplines give shareholders more power to quash wasteful projects.

> **Institutional investors are powerless. Their only option is to vote with their feet.**

Managers also resist distributing cash to shareholders because retaining cash increases the size of the companies they run – and managers have many incentives to expand company size beyond that which maximizes shareholder wealth. Compensation is one of the most important incentives. Many studies document that increases in executive pay are strongly related to increases in corporate size rather than value.[4]

The tendency of companies to reward middle managers through promotions rather than annual performance bonuses also creates a cultural bias toward growth. Organizations must grow in order to generate new positions to feed their promotion-based reward systems.

Finally, corporate growth enhances the social prominence, public prestige, and political power of senior executives. Rare is the CEO who wants to be remembered as presiding over an enterprise that makes fewer products in fewer plants in fewer countries than when he or she took office – even when such a course increases productivity and adds hundreds of millions of dollars of shareholder value. The perquisites of the executive suite can be substantial, and they usually increase with company size.

equity to the transaction. Prebuyout shareholders earn average market-adjusted premiums of 38%, while the total return to capital (debt plus equity) for buyout investors is 42%. This return to buyout investors is measured on the total purchase price of the LBO, not the buyout equity. Because equity returns are almost a pure risk premium, and therefore independent of the amount invested, they are very high. The median nominal return on buyout equity is 785%, or 135% per year.

☐ Value gains do not come at the expense of other financial constituencies. Some critics argue that buyout investors, especially managers, earn excessive returns by using inside information to exploit public shareholders. Managers do face severe conflicts of interest in these transactions; they cannot simultaneously act as buyer and agent for the seller. But equity-owning managers who are not part of postbuyout management teams systematically sell their shares into LBOs. This would be foolish if the buyout were significantly underpriced in light of inside information, assuming that these nonparticipating insiders have the same inside information as the continuing management team. Moreover, LBO auctions are becoming common; underpriced buyout proposals (including those initiated by management) quickly generate competing bids.

No doubt some bondholders have lost value through going-private transactions. By my estimate, RJR Nabisco's prebuyout bondholders lost almost $300 million through the downgrading of their claims on the newly leveraged company. This is a small sum in comparison to the $12 billion in total gains the transaction produced. As yet, there is no evidence that bondholders lose on average from LBOs. Evidence on LBOs completed through 1986 does show that holders of convertible bonds and preferred stock gain a statistically significant amount and that straight bondholders suffer no significant gains or losses.[14]

New data may document losses for bondholders in recent transactions. But the expropriation of wealth from bondholders should not be a continuing problem. The financial community is perfecting many techniques, including poison puts and repurchase provisions, to protect bondholders in the event of substantial restructurings. In fact, versions of these loss-prevention techniques have been available for some time. In the past, bondholders such as Metropolitan Life, which sued RJR Nabisco over the declining value of the company's bonds, chose not to pay the premium for protection.

☐ LBOs increase operating efficiency without massive layoffs or big cuts in research and development. Kaplan finds that average operating earnings increase by 42% from the year prior to the buyout to the third year after the buyout. Cash flows increase by 96% over this same period. Other studies document significant improvements in profit margins, sales per employee, working capital, inventories, and receivables.[15] Those who doubt these findings might take a moment to scan the business press, which has chronicled the impressive postbuyout performance of companies such as Levi Strauss, A.O. Scott, Safeway, and Weirton Steel.

Importantly, employment does not fall systematically after buyouts, although it does not grow as quickly as in comparable companies. Median employment for all companies in the Kaplan study, including those engaged in substantial divestitures, increased by nearly 1%. Companies without significant divestitures increased employment by 5%.

Moreover, the great concern about the effect of buyouts on R&D and capital investment is unwarranted. The low-growth companies that make the best candidates for LBOs don't invest heavily in R&D to begin with. Of the 76 companies in the Kaplan study, only 7 spent more than 1% of sales on R&D before the buyout. Another recent study shows

LBO performance: dramatic gains in profit margins, cash flow, sales per employee, and working capital.

that R&D as a fraction of sales grows at the same rate in LBOs as in comparable public companies.[16] According to Kaplan's study, capital expenditures are 20% lower in LBOs than in comparable non-LBO companies. Because these cuts are taking place in low-growth or declining industries and are accompanied by a doubling of market-adjusted value, they appear to be coming from reductions in low-return projects rather than productive investments.

☐ Taxpayers do not subsidize going-private transactions. Much has been made of the charge that large increases in debt virtually eliminate the tax obligations of an LBO. This argument overlooks five sources of additional tax revenues generated by buyouts: capital gains taxes paid by prebuyout shareholders; capital gains taxes paid on postbuyout asset sales; tax payments on the large increases in operating earnings generated by efficiency gains; tax payments by creditors who receive interest payments on the LBO debt; and taxes generated by more efficient use of the company's total capital.

Overall, the U.S. Treasury collects an estimated 230% more revenues in the year after a buyout than

tion differ from industry to industry. But its decline is real, enduring, and highly productive. It is not merely a function of the tax deductibility of interest. Nor does it reflect a transitory LBO phase through which companies pass before investment bankers and managers cash out by taking them public again. Nor, finally, is it premised on a systematic fleecing of shareholders and bondholders by managers and other insiders with superior information about the true value of corporate assets.

The current trends do not imply that the public corporation has no future. The conventional twentieth-century model of corporate governance–dispersed public ownership, professional managers without substantial equity holdings, a board of directors dominated by management-appointed outsiders–remains a viable option in some areas of the economy, particularly for growth companies whose profitable investment opportunities exceed the cash they generate internally. Such companies can be found in industries like computers and electronics, biotechnology, pharmaceuticals, and financial services. Companies choosing among a surplus of profitable projects are unlikely to invest systematically in unprofitable ones, especially when they must regularly turn to the capital markets to raise investment funds.

> The public corporation will decline in industries such as aerospace, banking, and food processing.

The public corporation is not suitable in industries where long-term growth is slow, where internally generated funds outstrip the opportunities to invest them profitably, or where downsizing is the most productive long-term strategy. In the tire industry, the shift to radials, which last three times longer than bias-ply tires, meant that manufacturers needed less capacity to meet world demand. Overcapacity inevitably forced a restructuring. The tenfold increase in oil prices from 1973 to 1981, which triggered worldwide conservation measures, forced oil producers into a similar retrenchment.[2]

Industries under similar pressure today include steel, chemicals, brewing, tobacco, television and radio broadcasting, wood and paper products. In these and other cash-rich, low-growth or declining sectors, the pressures on management to waste cash flow through organizational slack or investments in unsound projects is often irresistible. It is in precisely these sectors that the publicly held corporation has declined most rapidly. Barring regulatory interference, the public corporation is also likely to decline in industries such as aerospace, automobiles and auto parts, banking, electric power generation, food processing, industrial and farm implements, and transportation equipment.

The public corporation is a social invention of vast historical importance. Its genius is rooted in its capacity to spread financial risk over the diversified portfolios of millions of individuals and institutions and to allow investors to customize risk to their unique circumstances and predilections. By diversifying risks that would otherwise be borne by owner-entrepreneurs and by facilitating the creation of a liquid market for exchanging risk, the public corporation lowered the cost of capital. These tradable claims on corporate ownership (common stock) also allowed risk to be borne by investors best able to bear it, without requiring them to manage the corporations they owned.

From the beginning, though, these risk-bearing benefits came at a cost. Tradable ownership claims create fundamental conflicts of interest between those who bear risk (the shareholders) and those who manage risk (the executives). The genius of the new organizations is that they eliminate much of the loss created by conflicts between owners and managers, without eliminating the vital functions of risk diversification and liquidity once performed exclusively by the public equity markets.

In theory, these new organizations should not be necessary. Three major forces are said to control management in the public corporation: the product markets, internal control systems led by the board of directors, and the capital markets. But product markets often have not played a disciplining role. For most of the last 60 years, a large and vibrant domestic market created for U.S. companies economies of scale and significant cost advantages over foreign rivals. Recent reversals at the hands of the Japanese and others have not been severe enough to sap most companies of their financial independence. The idea that outside directors with little or no equity stake in the company could effectively monitor and discipline the managers who selected them has proven hollow at best. In practice, only the capital markets have played much of a control function–and for a long time they were hampered by legal constraints.

Indeed, the fact that takeover and LBO premiums average 50% above market price illustrates how much value public-company managers can destroy before they face a serious threat of disturbance. Takeovers and buyouts both create new value and unlock value destroyed by management through

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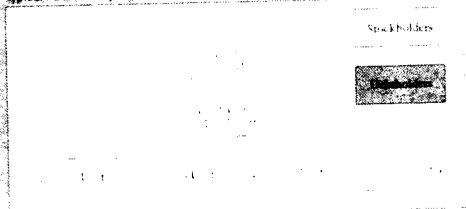
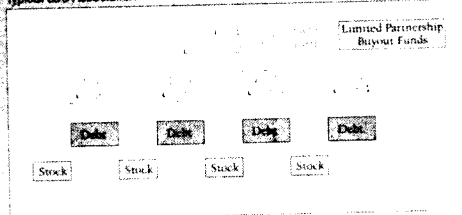
control. The general partners in an LBO Association typically receive (through overrides and direct equity holdings) 20% or more of the gains in the value of the divisions they help manage. This implies a pay-for-performance sensitivity of $200 for every $1,000 in added shareholder value. It's not hard to understand why an executive who receives $200 for every $1,000 increase in shareholder value will unlock more value than an executive who receives $3.25.

LBO Associations are more decentralized than publicly held conglomerates. The LBO Association substitutes compensation incentives and ownership for direct monitoring by headquarters. The headquarters of KKR, the world's largest LBO partnership, has only 16 professionals and 44 additional employees. In contrast, the Atlanta headquarters of RJR Nabisco employed 470 people when KKR took it private last year in a $25 billion transaction. At the time of the Goldsmith tender offer for Goodyear, the company's Akron headquarters had more than 5,000 people on its salaried payroll.

Public Company vs. LBO Association





It is physically impossible for KKR and other LBO partnerships to become intimately involved in the day-to-day decisions of their operating units. They rely instead on stock ownership, incentive pay that rewards cash flow, and other compensation techniques to motivate managers to maximize value without bureaucratic oversight. My survey of 7 LBO partnerships found an average headquarters staff of 13 professionals and 19 nonprofessionals that oversees almost 24 business units with total annual sales of more than $11 billion. (See the table "LBO Partnerships Keep Staff Lean.")

LBO Associations rely heavily on leverage. The average debt ratio (long-term debt as a percentage of debt plus equity) for public companies prior to a buyout is about 20%. The Kaplan study shows the average debt ratio for an LBO is 85% on completion of the buyout.

Intensive use of debt dramatically shrinks the amount of equity in a company. This allows the LBO general partners and divisional managers to control a large fraction of the total ownership without requiring huge investments they would be unable to make or large grants of free equity. For example, in a company with $1 billion in assets and a debt ratio of 20%, management would have to raise $80 million to buy 10% of the equity. If that same company had a debt ratio of 90%, management would have to raise only $10 million to control a 10% stake. By concentrating equity holdings among managers and LBO partners, debt intensifies the ownership incentives that are so important to efficiency.

High debt also allows LBO Associations and other private organizations to tap the benefits of risk diversification once provided only by the public equity market. Intensive use of debt means much of it must be in the form of public, high-yield, noninvestment-grade securities, better known as junk bonds. This debt, which was pioneered by Drexel Burnham Lambert, reflects more of the risk borne by shareholders in the typical public company. Placing this public debt in the well-diversified portfolios of large financial institutions spreads equitylike risk among millions of investors, who are the ultimate beneficiaries of mutual funds and pension funds – without requiring those risks to be held as equity. Indeed, high yield

> [illegible] Street allocates capital more effectively than public-company CFOs do.

[illegible] Partnerships Keep Staffs Lean

LBO Partnership	*Year Started*	*Number of Professionals*	*Number of Nonprofessionals*	*Number of Business Units*	*Combined Annual Revenues (in billions of dollars)*
Berkshire Partners	[illegible]	14	6	15	$[illegible]
Butler Capital	1979	8	14	33	2.3
Clayton & Dubilier	[illegible]	[illegible]	[illegible]	8	[illegible]
Gibbons Green van Amerongen	[illegible]	6	[illegible]	12	[illegible]
Kohlberg Kravis Roberts	[illegible]	[illegible]	[illegible]	19	[illegible]
Thomas H Lee Co	[illegible]	[illegible]	12	25	8
Odyssey Partners	[illegible]	[illegible]	[illegible]	[illegible]	N.A.

The struggle over free cash flow is at the heart of the role of debt in the decline of the public corporation. Bank loans, mezzanine securities, and high-yield bonds have fueled the wave of takeovers, restructurings, and going-private transactions. The combined borrowings of all nonfinancial corporations in the United States approached $2 trillion in 1988, up from $835 billion in 1979. The interest charges on these borrowings represent more than 20% of corporate cash flows, high by historical standards.[5]

This perceived "leveraging of corporate America" is perhaps the central source of anxiety among defenders of the public corporation and critics of the new organizational forms. But most critics miss three important points. First, the trebling of the market value of public-company equity over the last decade means that corporate borrowing had to increase to avoid a major *de*leveraging.

Second, debt creation *without retention of the proceeds of the issue* helps limit the waste of free cash flow by compelling managers to pay out funds they would otherwise retain. Debt is in effect a substitute for dividends–a mechanism to force managers to disgorge cash rather than spend it on empire-building projects with low or negative returns, bloated staffs, indulgent perquisites, and organizational inefficiencies.

By issuing debt in exchange for stock, companies bond their managers' promise to pay out future cash flows in a way that simple dividend increases do not. "Permanent" dividend increases or multiyear share repurchase programs (two ways public companies can distribute excess cash to shareholders) involve no contractual commitments by managers to owners. It's easy for managers to cut dividends or scale back share repurchases.

Take the case of General Motors. On March 3, 1987, several months after the departure of GM's only active investor, H. Ross Perot, the company announced a program to repurchase up to 20% of its common stock by the end of 1990. As of mid-1989, GM had purchased only 5% of its outstanding common shares, even though its $6.8 billion cash balance was more than enough to complete the program. Given management's poor performance over the past decade, shareholders would be better off making their own investment decisions with the cash GM is retaining. From 1977 to 1987, the company made capital expenditures of $77.5 billion while its U.S. market share declined by 10 points.

Borrowing allows for no such managerial discretion. Companies whose managers fail to make promised interest and principal payments can be declared insolvent and possibly hauled into bankruptcy court. In the imagery of G. Bennett Stewart and David M. Glassman, "Equity is soft, debt hard. Equity is forgiving, debt insistent. Equity is a pillow, debt a sword."[6] Some may find it curious that a company's creditors wield far more power over managers than its public shareholders, but it is also undeniable.

Third, debt is a powerful agent for change. For all the deeply felt anxiety about excessive borrowing, "overleveraging" can be desirable and effective when it makes economic sense to break up a company, sell off parts of the business, and refocus its energies on a few core operations. Companies that assume so much debt they cannot meet the debt service payments out of operating cash flow force themselves to rethink their entire strategy and structure. Overleveraging creates the crisis atmosphere managers require to slash unsound investment programs, shrink overhead, and dispose of assets that are more valuable outside the company. The proceeds generated by these overdue restructurings can then be used to reduce debt to more sustainable levels, creating a leaner, more efficient and competitive organization.

In other circumstances, the violation of debt covenants creates a board-level crisis that brings new actors onto the scene, motivates a fresh review of top management and strategy, and accelerates response. The case of Revco D.S., Inc., one of the handful of leveraged buyouts to reach formal bankruptcy, makes the point well.

> **Efficient companies distribute free cash flow to shareholders. So why is Ford sitting on $15 billion?**

Critics cite Revco's bankruptcy petition, filed in July 1988, as an example of the financial perils associated with LBO debt. I take a different view. The $1.25 billion buyout, announced in December 1986, did dramatically increase Revco's annual interest charges. But several other factors contributed to its troubles, including management's decision to overhaul pricing, stocking, and merchandise layout in the company's drugstore chain. This mistaken strategic redirection left customers confused and dissatisfied, and Revco's performance suffered. Before the buyout, and without the burden of interest payments, management could have pursued these policies for a long period of time, destroying much of the company's value in the process. Within six months, however, debt served as a brake on management's mistakes, motivating the board and creditors to reorganize the company before even more value was lost.[7]

you have to factor out those industry effects, or those macroeconomic effects.

You also have to factor out individual industry effects. Merck is in the pharmaceuticals industry, where high R&D spending is the norm. If you don't innovate, you slowly atrophy. General Motors is in an industry where that kind of R&D spending is less effective. Merck is one of the most effective conductors of research in the pharmaceutical industry. General Motors, by all accounts, has not done very well on the R&D front. So I don't think you can simply use those two companies as an example.

Statistically, the evidence on R&D spending following leveraged restructuring is mixed. A National Science Foundation study of the largest R&D spenders found a significant decline in spending following leveraged restructurings. On the other hand, a much broader study by Lichtenberg and Siegel found that there may even have been an increase following leveraged restructurings. A third study that I discovered only this past week, by two economists at Texas A&M University, showed a decline in R&D spending following mergers. What we have therefore is a very murky picture. I'm not sure one can make sense of it yet.

The Office of Technology Assessment has an interview study going on. The general conclusion that seems to emerge is that on average there hasn't been a lot of negative impact on R&D from leveraged restructurings. But corporate R&D directors are reporting a considerable amount of anxiety about the trend in their spending. Second, they are reporting that they tend to be slanting their R&D decisions toward more short-range opportunities. Now, that's the mixed picture, and it is indeed quite mixed.

There's another piece of bad news that has been very little discussed in the general literature on leveraged restructurings. Most people focus on the problem of bankruptcy. If we have another recession, and sooner or later we are going to, the question is, What will happen to highly leveraged companies as they experience a cash-flow squeeze? Will they go bankrupt? There is a fair amount of evidence that they will in fact be in financial trouble, but it seems to me that that is not the more important question. One could be facetious and ask, what if they don't go bankrupt? What if they successfully take measures to service their debt by cutting back sharply their real investment in new plant and equipment and research and development?

The essence of a recession is a cutback in investment. If many companies are highly leveraged, and if as a result of the pressure of debt service, they cut back their investment even more sharply in order to continue servicing their debt and avoid bankruptcy or financial reorganization, then the intensity of the recession itself will be greater. That is to say, given a high degree of leverage, you will have a sharper drop in real capital investment than you otherwise would have had.

The Federal Government is not in a position to deal with such an intensified macroeconomic decline because of its own debt, budget, and balance-of-payments problems. As a result of this, the high degree of leverage that is being built into the U.S. economy creates a risk of greater macroeconomic instability than we would have had without such a high degree of leverage.

of its expected future cash flows) and a liquidation or salvage value of $10 million. Company A has an equity-dominated balance sheet with a debt ratio of 20%, common for large public companies. Highly leveraged Company B has a debt ratio of 85%, common for an LBO. (See the illustration "The Privatization of Bankruptcy.")

Now both companies experience business reversals. What happens? Company B will get in trouble with its creditors much sooner than Company A. After all, Company B's going-concern value doesn't have to shrink very much for it to be unable to meet its payments on $85 million of debt. But when it does run into trouble, its going-concern value will be nowhere near its liquidation value. If the going-concern value shrinks to $80 million, there remains $70 million of value to preserve by avoiding liquidation. So Company B's creditors have strong incentives to preserve the remaining value by quickly and efficiently reorganizing their claims outside the courtroom.

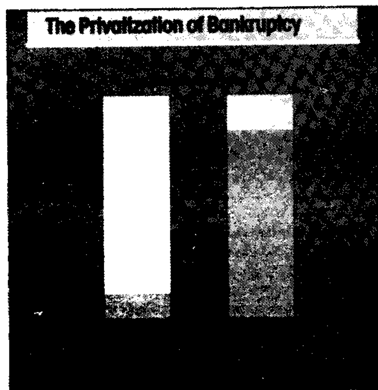
No such incentives operate on Company A. Its going-concern value can fall dramatically before creditors worry about their $20 million of debt. By the time creditors do intervene, Company A's going-concern value will have plummeted. And if Company A's value falls to under $20 million, it is much more likely than Company B to be worth less than its $10 million salvage value. Liquidation in this situation is the likely and rational outcome, with all its attendant conflicts, dislocations, and costs.

The evolving U.S. system of corporate governance and finance exhibits many characteristics of the postwar Japanese system. LBO partnerships act much like the main banks (the real power center) in Japan's *keiretsu* business groupings. The keiretsu make extensive use of leverage and intercorporate holdings of debt and equity. Banks commonly hold substantial equity in their client companies and have their own executives help them out of difficulty. (For years, Nissan has been run by an alumnus of the Industrial Bank of Japan who became CEO as part of the bank's effort to keep the company out of bankruptcy.) Other personnel, including CFOs, move frequently between banks and companies as part of an ongoing relationship that involves training, consulting, and monitoring. Japanese banks allow companies to enter formal bankruptcy only when liquidation makes economic sense – that is, when a company is worth more dead than alive. Japanese corporate boards are composed almost exclusively of insiders.

Ironically, even as more U.S. companies come to resemble Japanese companies, Japan's public companies are becoming more like U.S. companies of 15 years ago. Japanese shareholders have seldom had any power. The banks' chief disciplinary tool, their power to withhold capital from high-growth, cash-starved companies, has been vastly reduced as a result of several factors. Japan's victories in world product markets have left its companies awash in profits. The development of domestic and international capital markets has created ready alternatives to bank loans, while deregulation has liberalized corporate access to these funds. Finally, new legal constraints prevent banks from holding more than 5% of the equity of any company, which reduces their incentive to engage in active monitoring.

Many of Japan's public companies are flooded with free cash flow far in excess of their opportunities to invest in profitable internal growth. In 1987, more than 40% of Japan's large public companies had no net bank borrowings – that is, cash balances larger than their short- and long-term borrowings. Toyota, with a cash hoard of $10.4 billion, more than 25% of its total assets, is commonly referred to as the Toyota Bank.

In short, Japanese managers are increasingly unconstrained and unmonitored. They face no effective internal controls, little control from the product markets their companies already dominate, and fewer controls from the banking system because of self-financing, direct access to capital markets, and lower debt ratios. Unless shareholders and creditors discover ways to prohibit their managers from behaving like U.S. managers, Japanese companies will make uneconomic acquisitions and diversification moves, generate internal waste, and engage in other value-



destroying activities. The long-term result will be the growth of bureaucracy and inefficiency and the demise of product quality and organizational responsiveness – until the waste becomes so severe it triggers a market for corporate control to remedy the excesses.

The Japanese remedy will reflect that country's unique legal system and cultural practices. But just as hostile takeovers, LBOs, and other control transactions went from unacceptable behavior in the United States to a driving force in corporate restructuring, so too will they take hold in Japan – once the potential returns outweigh the costs and risks of challenging the corporate status quo.

Meanwhile, in the United States, the organizational changes revitalizing the corporate sector will create more nimble enterprises and help reverse our losses in world product markets. As this profound innovation continues, however, people will make mistakes. To learn, we have to push new policies to the margin. It will be natural to see more failed deals.

There are already some worrisome structural issues. I look with discomfort on the dangerous tendency of LBO partnerships, bolstered by their success, to take more of their compensation in front-end fees rather than in back-end profits earned through increased equity value. As management fees and the fees for completing deals get larger, the incentives to do deals, rather than good deals, also increases. Institutional investors (and the economy as a whole) are best served when the LBO partnership is the last member of the LBO Association to get paid and when the LBO partnership gets paid as a fraction of the back-end value of the deals, including losses.

Moreover, we have yet to fully understand the limitations on the size of this new organizational form. LBO partnerships are understandably tempted to increase the reach of their talented monitors by reconfiguring divisions as acquisition vehicles. This will be difficult to accomplish successfully. It is likely to require bigger staffs, greater centralization of decision rights, and dilution of the high pay-for-performance sensitivity that is so crucial to success. As LBO Associations expand, they run the risk of recreating the bureaucratic waste of the diversified public corporation.

These and other problems should not cloud the remarkable benefits associated with the eclipse of the large public corporation. What surprises me is how few mistakes have occurred thus far in an organizational change as profound as any since World War II.

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percent below home industry norms in the two years before a tender offer takeover attempt commenced.

Following merger, the typical voluntarily acquired unit's profitability fell on average. Of the units that remained with their new parents, there were three main reasons for the decline in profitability: the stepup of asset values (reducing operating income-to-assets ratios) owing to premiums paid over pre-merger book value; the non-sustainability of unusually high pre-merger profit rates; and less effective management of the acquired units after they moved from independent status into a more complex conglomerate organization. Takeover targets, however, showed no tendency for post-merger profitability either to decline or rise on average after correcting for asset revaluation effects. Although individual exceptions existed, our statistical materials provided no support for the assertion that acquired unit operating efficiency rises on average after acquisition.

The Economics of Sell-Off

However, much more compelling evidence of post-merger managerial failure came to light in connection with the entities that were acquired and later sold off by their new parents, and especially by conglomerate parents (that is, parents whose specialty was a quite different line of business that of the acquired units). The sold-off units had pre-merger profitability statistically indistinguishable from that of units which were acquired and retained through the year 1981. In the year before divestiture commenced, the operating income / assets ratio of lines about to be sold off was <u>minus</u> 1.09 percent on average, in sharp contrast to the <u>plus</u> 13.93 percent average return of units not sold off in the 1974-81 period. Nor was such loss-making activity a rarity. By our best estimate, 46.6 percent of acquisitions consummated during the 1960s and early 1970s ended eventually in sell-off or divestiture.

We conducted field case studies of 15 acquired units that were subsequently sold off by their acquirers. Some of the performance failures that led to sell-off, we discovered, were triggered by the turbulent economic conditions of the 1970s, often aggravated by the inability of conglomerate parent management to discover what the root problem was and to implement timely correctives. In other cases, complex organizational structures, the difficulty of maintaining incentives for good operating level management performance, and parent demands for short-run results that could not be sustained over the long run were causes of failure and sell-off.

When business units acquired during the 1960s and early 1970s got into trouble and were divested, they were most commonly sold off to another company. Quite typically, they moved thereby

it would have otherwise and 61% more in long-term present value. The $12 billion gain associated with the RJR Nabisco buyout will generate net tax revenues of $3.3 billion in the first year of the buyout; the company paid $370 million in federal taxes in the year before the buyout. In the long term, the transaction will generate total taxes with an estimated present value of $3.8 billion.[17]

☐ LBO sponsors do not have to take their companies public for them to succeed. Most LBO transactions are completed with a goal of returning the reconfigured company to the public market within three to five years. But recent evidence indicates that LBO sponsors are keeping their companies under private ownership. Huge efficiency gains and high-return asset sales produce enough cash to pay down debt and allow LBOs to generate handsome returns as going concerns. The very proliferation of these transactions has helped create a more efficient infrastructure and liquid market for buying and selling divisions and companies. Thus LBO investors can "cash out" in a secondary LBO or private sale without recourse to a public offering. One recent study finds that only 5% of the more than 1,300 LBOs between 1981 and 1986 have gone public again.[18]

High debt creates incentives to avoid bankruptcy. Troubled companies are reorganized quickly.

Public companies can learn from LBO Associations and emulate many of their characteristics. But this requires major changes in corporate structure, philosophy, and focus. They can reduce the waste of free cash flow by borrowing to repurchase stock or pay large dividends. They can alter their charters to encourage large investors or experiment with alliances with active investors such as Lazard Frères' Corporate Partners fund. They can increase equity ownership by directors, managers, and employees. They can enhance incentives through pay-for-performance systems based on cash flow and value rather than accounting earnings. They can decentralize management by rethinking the role of corporate headquarters and shrinking their staffs.

Some corporations are experimenting with such changes – FMC, Holiday, and Owens-Corning – and the results have been impressive. But only a coordinated attack on the status quo will halt the eclipse of the public company. It is unlikely such an attack will proceed fast enough or go far enough.

Who can argue with a new model of enterprise that aligns the interests of owners and managers, improves efficiency and productivity, and unlocks hundreds of billions of dollars of shareholder value? Many people, it seems, mainly because these organizations rely so heavily on debt. As I've discussed, debt is crucial to management discipline and resolving the conflict over free cash flow. But critics, even some who concede the control function of debt, argue that the costs of leverage outweigh the benefits.

Wall Street economist Henry Kaufman, a prominent critic of the going-private trend, issued a typical warning earlier this year: "Any severe shock – a sharp increase in interest rates in response to Federal Reserve credit restraint, or an outright recession that makes the whole stock market vulnerable, or some breakdown in the ability of foreign firms to bid for pieces of U.S. companies – will drive debt-burdened companies to the government's doorstep to plead for special assistance."[19]

The relationship between debt and insolvency is perhaps the least understood aspect of this entire organizational evolution. New hedging techniques mean the risk associated with a given level of corporate debt is lower today than it was five years ago. Much of the bank debt associated with LBOs (which typically represents about half of the total debt) is done through floating-rate instruments. But few LBOs accept unlimited exposure to interest rate fluctuations. They purchase caps to set a ceiling on interest charges or use swaps to convert floating-rate debt into fixed-rate debt. In fact, most banks require such risk management techniques as a condition of lending.

Critics of leverage also fail to appreciate that insolvency in and of itself is not always something to avoid – and that the costs of becoming insolvent are likely to be much smaller in the new world of high leverage than in the old world of equity-dominated balance sheets. The proliferation of takeovers, LBOs, and other going-private transactions has inspired innovations in the reorganization and workout process. I refer to these innovations as "the privatization of bankruptcy." LBOs *do* get in financial trouble more frequently than public companies do. But few LBOs ever enter formal bankruptcy. They are reorganized quickly (a few months is common), often under new management, and at much lower costs than under a court-supervised process.

How can insolvency be less costly in a world of high leverage? Consider an oversimplified example. Companies A and B are identical in every respect except for their financial structures. Each has a going-concern value of $100 million (the discounted value

What should be done about this problem? Well, first of all, it may be self-correcting. The markets are already beginning to show some sensitivity to overleveraging. The United Airlines debacle of not long ago suggests that it's becoming harder to sell new high-yield or so-called junk bond issues.

On the other hand, if Mike Jensen and I are correct that leveraged restructurings are making companies more profitable, then I believe leveraging is going to continue, and we are going to have increasing macroeconomic risk and possibly, although not demonstrable, a greater short sideness of investment.

What to do? One set of remedies emphasizes tax policy or government regulation to encourage the use of equity and discourage the piling up of debt. That is a possibility. Such actions have very complex repercussions, among other things for the Federal budget balance, and it's not obvious that that's the direction in which one should go.

Mike Jensen and I seem to agree on another aspect of the problem, and that is, I use the same word he did, we have a failure of corporate governance. These restructurings are correcting failures of corporate governance. Maybe, therefore, the right way to go is to attack the problem of corporate governance. I would suggest moving on two fronts. This can be done by Securities and Exchange Commission regulation. It could conceivably be done by State law, although that is very difficult. Or it could be done by New York Stock Exchange regulation.

One thing that needs to be done is to provide better incentives for board of directors' members who have not been attending to the problem of keeping management running a tight ship. Typically, directors are compensated on the basis of attendance at meetings. A much more effective approach would be to make at least half of the compensation of outside corporate directors dependent upon the long-term stock performance of the companies they are directing. I would put at least half of the compensation on the 5-year performance of the company's stock.

A second problem is that the typical director is beholden to the chief executive officer of the corporation on which he or she sits. As a result, except in crisis situations it is normally considered not cricket to ask embarrassing questions about the tightness of the company's operations.

One way to escape from this problem is to increase the number of truly independent outside directors. This could be accomplished by having a nomination mechanism through which major outside stockholders, such as pension funds and mutual funds, independently nominate directors to serve on the board of directors. Those nominations then go before the entire group of shareholders for a final choice.

One way to try to solve this problem is to discourage high debt through tax policy and the like. That has many difficulties. The other way, it seems to me, is to attack the problem at its root and try to improve our mechanisms for corporate governance. That is the solution on which I would put emphasis.

Thank you very much.

[The prepared statement of Mr. Scherer follows:]

PREPARED STATEMENT OF F.M. SCHERER

It is a pleasure to assist the Committee in its inquiry into the consequences of recent industrial changes for the health of the American economy.

Mergers, Profits, and Efficiency

My principal perspective on the matter comes from a five-year study of mergers and sell-offs with National Science Foundation, Federal Trade Commission, and Brookings Institution support. My co-author in the project was David J. Ravenscraft of the University of North Carolina. The findings from our research were summarized in a book, Mergers, Sell-offs, and Economic Efficiency, published in 1987 by the Brookings Institution

Our study had several unique features. Perhaps the most important was tapping the Federal Trade Commission's Line of Business financial reports data for the years 1974-77, permitting us to track mergers to the narrowly-defined units in parent corporations where they were located organizationally, and thereby to study in detail how the financial performance of lines with an intensive merger history differed from lines originating largely through internal growth and development. Altogether, we linked roughly 6,000 mergers occurring between 1950 and 1975 to 4,409 manufacturing industry "lines of business" operated by 471 U.S. corporations. Most of the mergers took place in the late 1960s and early 1970s, during the third great merger wave in American economic history. (The earlier waves peaked in 1901 and 1929.) A similar study is not possible for the fourth great merger wave, occurring during the 1980s, because the collection of Line of Business financial information was discontinued after 1977.

We found that for the most part, the mergers of the 1960s and early 1970s were not very successful. Before being acquired, the target firms were quite profitable -- more profitable on average than similar non-acquired firms in the industries they inhabited. The smaller the acquired firm, the more its pre-merger profitability exceeded industry norms. Tender offer targets were somewhat different; their profitability averaged 8

Representative HAMILTON. Thank you very much, Mr. Jensen.
Mr. Scherer, please proceed.

STATEMENT OF F.M. SCHERER, PROFESSOR, JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY

Mr. SCHERER. Thank you very much, Mr. Chairman.

I come here as President Truman's bete noire, the two-armed economist. On the one hand, there's good news. On the other hand, there's some bad news in the leveraged buyouts, management buyouts, and other kinds of restructurings that are going on in the American corporate economy.

On the good news, I agree with my colleague Michael Jensen. I think there has been a considerable amount of inefficiency in American industry. The evidence is showing that leveraged buyouts and similar types of leveraged structurings are on average leading to more tightly run operations, manifested in the form of higher operating profits in early years following LBO's, lower central office costs, and higher rates of productivity growth. That's the good news.

The bad news comes in two parcels, one of which is less clearly defined than the other. The one that is less clearly defined seems to be the main focus of the committee at this time—that is to say, the impact of these restructurings on investing for the long run. The work by Stephen Kaplan, which Professor Jensen directed, shows that after leveraged-going-private transactions, the companies that have gone private spend less on capital investment than nonrestructured companies in the same industries. Work by Lichtenberg and Siegel shows the same thing—that following leveraged restructuring, there tends to be a decline in capital investment relative to comparable industry norms. In my own research, I did a series of case studies of divisional selloffs, some of which were leveraged buyouts. There, too, we found that under the heavy pressure of the debt collector at the door, the companies found themselves forced to scrimp on capital investments, at least until they could liquidate enough of their debt to take off some of the pressure. So, there does tend statistically to be some negative impact on capital investment as a result of leveraged restructurings.

The R&D question is even more complex. One can't simply look at the macroeconomic trends in R&D, because they're influenced very strongly by at least two things and possibly three.

First of all, there was an 8-year slump in R&D spending during the 1970's. The strong growth that occurred after 1977 and during the first half of the 1980's may simply reflect a rebound from that very slow pace of research and development growth.

Second, the so-called company financed, that is to say, private, R&D spending of U.S. companies, according to very convincing studies by Frank Lichtenberg, seems to be heavily influenced by developments in defense. When the Department of Defense was expanding its procurement rapidly, R&D spending on companies' private accounts soared. In the last few years, there's been very slow growth in company-financed R&D, and that probably has at least something to do with the slowdown in defense procurement. So,

numerous leveraged companies, those firms' managers will have to take stern measures to avoid default. It is almost certain that they will react by cutting real plant, equipment, and R&D investment more than they would had they been less heavily burdened with debt. That incremental fall in real investment (in addition to the drop that always accompanies recession) will in its own right deepen the recession. And as additional workers in the capital goods industries lose their jobs, their spending on consumption will fall, with the negative multiplier effect reverberating through the economy. In short, a recession in a heavily leveraged economy is almost certain to be more severe than one in an economy populated by corporations whose financial structures have more shock absorption capability.

Although other factors played a more important role, such a debt-induced reaction is believed to have contributed to the severity of the 1930s depression. To see how the situation now compares to that of 1929, I assembled data on the ratio of debt as a percentage of the book value of debt plus stockholders' equity for 1929 and the first quarter of 1988. The comparisons are as follows:

	1929	1988
Manufacturing sector	15%	39%
Mining sector	15%	49%
Retailing sector	23%	50%
All three combined	17%	40%
Public utilities	42%	n.a.

The degree of leverage built into manufacturing, mining, and retailing corporation capital structures last year was much higher than it was in 1929. It approaches the leveraging of 1929's public utilities sector, which was a key locus of subsequent financial failure!

Although the coverage of debt service obligations by cash flow seems adequate for most corporations under currently prosperous conditions, that situation could change rapidly when a significant recession occurs. In a simulation analysis, Professors Ben Bernanke and John Campbell of Princeton University found that if recessions as severe as those of 1975 or 1982 were to take place, ten percent or more of the large public firms on which data are available would be pushed into bankruptcy. Brookings Papers on Economic Activity, 1988, no. 1, p. 121. Presumably, the problem for more heavily leveraged private corporations would be even more severe.

To the argument that we are approaching a peril point, two counter-arguments can be raised. For one, the economy is more

Year	Value of Recorded Divisional LBO Transactions ($ millions)	Value of Whole Company Going Private Transactions ($ millions)
1979	47	636
1980	363	967
1981	484	2,339
1982	1,361	2,837
1983	2,499	7,145
1984	3,833	10,806
1985	5,005	24,140
1986	9,542	20,232
1987	5,957	22,057

The year 1989 will no doubt set a new record for going private transactions on the strength of the RJR Nabisco deal alone.

Sell-Offs and "Going Private" Transactions

Going private transactions are similar to the leveraged divisional sell-offs covered by our case study research in two respects: a high level of debt financing is typically assumed, and the new management, which is often the previous operating-level management, acquires an important equity stake in the enterprise. They are different in two other ways. For one, the whole companies that go private were often sustaining good financial performance before restructuring, whereas the divisional sell-offs covered by our statistical sample and our case study research were typically performing poorly. For many of the divisional sell-offs, the mandate was "improve or die." Also, with the divisional sell-offs, a substantial simplification of organizational structure usually followed, whereas with the whole company going private transactions, the organizational structure remained essentially unaltered, at least initially.

From these differences, one might suppose that performance improvements would have been more likely to emerge following divisional as contrasted to whole-company LBOs. Our study provided no comparative data on this point. However, Professor Steven Kaplan of the University of Chicago has conducted impressive research on the financial performance of some 76 companies that were taken private during the 1979-85 period, and for which (an important limitation) published data were available. "Management Buyouts: Efficiency Gains or Value Transfers?," forthcoming in Edward Altman, ed., <u>The High Yield Debt Market: Investment Performance and Economic Impact</u> (Dow-Jones Irwin). He found that after controlling for changes in over-all industry conditions, operating income as a percentage of assets improved relative to pre-restructuring values by 1.8

percentage points in the year after restructuring and by 5.6 percentage points in the second year after restructuring. Similarly, using Census data for a large sample that included both whole-company and divisional LBOs, Frank Lichtenberg and Donald Siegel found that a crude measure of cumulative 1981-86 productivity growth averaged 2.8 percentage points higher for plants involved in leveraged buyouts than for other plants. For plants with LBOs entailing substantial management participation, productivity grew by 3.9 percentage points more than in the non-LBO group. "The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior," U.S. Census Bureau Center for Economic Studies Discussion Paper CES-89-5 (July 1989).

In this important respect, the findings of Kaplan, Lichtenberg, and Siegel parallel those by Ravenscraft and myself. Going private led to operating cost savings and increases in operating profitability. But with Kaplan's sample in particular and to a mixed extent in the Lichtenberg and Siegel sample, the behavioral changes appear to have been precipitated by changes in capital structure and managerial ownership participation only, whereas for our sample, there were organizational changes and a history of poor past performance too.

The implication of this research is that the pressure of heavy debt service obligations, and/or the recognition that improvements in profitability will be rewarded by substantial increases in the value of management's stockholdings, makes management run a tighter ship. This is good news in one respect, but it is bad news in another. It suggests that the top managers of large "public" American corporations, despite being paid an average of $760,000 in salary and bonuses in 1988 (according to Business Week's October 20, 1989 survey of the 1,000 most valuable public corporations), are not on average running as tight a ship as they might. (In contrast to the situation in LBO companies, only 77 of 1987's top 1,000 public companies' CEOs owned 10 percent or more of their wards' common stock.) Thus, the evidence may be pointing to the persistence of a problem identified by Adolf Berle and Gardiner Means in a famous 1932 book: the top management of large public corporations is less than fully diligent in striving to maximize profits and thereby to serve the interests of absentee owner-stockholders.

The Problem of Long-Term Investment

One caveat must be brought out before I move the argument forward. The operating profitability of a company can be increased by cutting fat, or by cutting muscle and bone. From extended observation, I do not doubt that there is fat to be cut. But there is also reason to believe that the pressure-cooker environment of a highly leveraged buyout also leads sometimes to

Representative HAMILTON. Thank you very much, Mr. Scherer. I want to say again that I'm grateful to the leadership of Senator Roth on these questions that we are addressing on Corporate Time Horizons. We are very pleased for his leadership. I think he has put his finger on a very, very important aspect of the U.S. economy. Your testimony has us off to a good start and I'll turn now for questions to Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

First, let me express my appreciation to Mr. Jensen and Mr. Scherer for their fascinating testimony. Let me at the outset tell you where I am coming from. I happen to think that the most critical problem we face as a nation is whether or not we're going to be competitive in the emerging global economy. And so what we are seeking here today are some answers to that question. I might say, Mr. Chairman, and you're certainly a leader in the international area, we're witnessing what looks like the dissolution of the Soviet empire. Maybe that's hopeful thinking. But at least it is moving with a rapidity that none of us would have foreseen a few weeks or even days ago, particularly in the case of Germany. But I think the reason we're witnessing this is that the Soviet Union is not able to compete. It does not have a viable economy.

So, I think it is important for everyone here to understand that when we're talking about corporations and corporate governance, this is not a theoretical matter of little importance except to companies, but it is of critical importance to this nation. Many people see us as being in economic decline. For many years, with no question about it, we were the predominant economic power in the world. Today Japan, West Germany, and others seem at least in some sectors to be more efficient than we. The question is, What are we going to do about it?

Part of the answer is corporations and their efficiency. So, I want to congratulate you, Mr. Jensen, for putting forth in your article some very provocative thoughts.

I am not sure what the answer is, but let me ask both of you gentlemen this question. We hear a great deal of discussion that one of the key problems in the United States on the part of business management is that it's too shortsighted, that it is too interested in short-term profit and not where they're going long term. Time and again it is said that Japanese businesses are better because they have a long-term view, because they're willing to forgo short-term profits in the hope of getting a larger share of the world market.

Corporate management is said to be short-term oriented for many reasons. Partly because of government requirements, the SEC requires a corporation to report quarterly on their profit or loss. Companies are concerned about hostile takeovers. Managers are constantly looking over their shoulder, more worried about takeovers than about long-term development.

Then we talk about LBO's. If I hear you gentlemen correctly, you're saying that short term they're more efficient. So, I'd like to ask you to comment on what I've just said. How important is this question of long-term planning? If it is important, what do we do about it? And finally, you say LBO's certainly are more efficient in the short term. Please explain.

from a conglomerate organizational structure into a horizontal merger (where the new parent operated in the same industry) or one in which there was a vertical buyer-seller relationship between the parent and the new subsidiary. On average, our statistical analysis revealed, financial performance improved substantially following this change. A less typical but increasingly important form of divestiture was into a leveraged buyout, usually with a high level of debt and substantial operating-level management participation in the new enterprise's equity ownership. Since the sold-off LBO units typically "went private," we have no systematic statistical data on their post-divestiture performance. Case studies of several such restructurings revealed that after sell-off, the new managements implemented a broad and impressive array of efficiency-increasing measures. However, three of the sold-off LBO units were in such desperate shape at the time of sell-off, and/or were so heavily burdened with debt, that they failed and ceased operation. One other sold-off unit was closed by its new parent, and its equipment was transferred to a plant in another state.

The New Merger and Sell-Off Wave

With only a few exceptions tracked by our case studies, our research ended with sell-offs taking place in the year 1981. However, our research is directly relevant in one respect to the merger wave that followed during the 1980s. Some of the "bust-up" takeover activity that has become prominent in the 1980s was motivated in part by the same kinds of problems we studied in detail. That is, conglomerate corporations were operating numerous divisions, some requiring skills alien to those possessed by the conglomerate's management and performing relatively poorly. Because of the ill fit between parent and subsidiary, the subsidiaries were worth more standing alone, or in the hands of a new and more closely related parent, than they were as part of the conglomerate. The desire of parents to ward off takeover by getting rid of such subsidiaries, or the decision of acquirers to "bust up" an ill-fitting organization that was slow to divest, has been a prominent feature of merger activity during the 1980s. Many such restructurings are recorded simultaneously as sell-offs and mergers. For every 100 mergers reported by W. T. Grimm & Company over the period 1980-87, 37.5 divestitures were recorded.

The 1980s have also witnessed a new phenomenon similar in some ways to the creation of LBOs through divestiture, but different in others. That is the "going private" transaction, when a whole company, not just some subsidiary, is reorganized and established with a highly-leveraged financial structure. Indeed, from data published by W. T. Grimm & Co., whole company "going private" transactions bulk larger than divisional buyouts, as the following tabulation shows:

stable intrinsically now than it was in 1929. We know more about how to combat recession, and we have more automatic stabilizers such as the income tax and unemployment compensation. This is true, but our flexibility to act upon the knowledge we possess is declining. If a recession hits, the Federal deficit is likely to balloon quickly into the $200 billion-plus range. Will we be able to take aggressive counter-cyclical fiscal measures under those conditions? Our newly-won position as a net debtor nation also limits our flexibility. If the Federal Reserve were to react by massively creating reserves, any sharp counter-cyclical decline in real interest rates would drive the dollar lower, and fears of inflation could trigger a run against the dollar.

It is also argued that extensive leveraging of U.S. industry is acceptable because other nations, such as Japan and Germany, have long had much higher industrial leverage than we, and they have survived macroeconomic shocks well. But there is an important difference. In Japan, when financial crisis looms, the government, powerful banks, and industry work together to ensure that a financial rout is avoided. Affiliated companies bail each other out, recession cartels are authorized, import restraints are imposed, and so on. In West Germany, the Big Three of banking have wielded sufficient power to prevent ordinary shocks from being aggravated, and government-industry-bank cooperation, although less close than in Japan, can be expected to facilitate concerted action against larger shocks. We in the United States have a different, more decentralized, more adversarial system. Unless we are willing to make significant changes in that system, it is unlikely that we would be able to deal with the interacting problems of recession and high leverage as quickly and effectively as Japan and Germany.

Possible Remedies

Thus, I see serious risks in a continued movement toward the leveraging-up of American industry. The question remains, what should be done?

One approach would be to discourage debt financing and/or encourage equity financing by revamping the tax structure. I have long favored exempting corporate earnings paid out as dividends so that they are taxed only once, when received by stockholders. But if this change were to be adopted in isolation now, Federal revenue losses would exceed $30 billion annually, and the distribution of income would be skewed even more sharply in favor of the wealthiest stratum. I could support the change only if the marginal rates for higher-income taxpayers (including myself) were adjusted upward sufficiently to achieve a revenue-neutral result.

A revenue-neutral outcome might also be attained by reducing by some fraction the tax deductibility of interest and exempting a commensurate fraction of paid-out dividends from taxation. I know too little about the precise effects of marginal tax changes on merger and going-private transactions to predict the extent to which heavy leveraging would be discouraged thereby.

Proposals have also been advanced to eliminate the tax deductibility of interest on debt that exceeds some stated fraction of total capitalization, or on debt that is used in certain kinds of takeover and going-private transactions. I suspect that implementing such an approach would be an administrative nightmare, violated inter alia as clever financiers and attorneys discover diverse loopholes and dodges. Small businesses heavily dependent upon debt financing might also be hurt disproportionately by such changes.

Some of the speculative behavior that encourages takeovers and going-private transactions would be discouraged if capital gains on short-term stockholdings (e.g., on shares sold before a holding period of two years elapses) were taxed more heavily than on long term-holdings. If President Bush's proposal to restore the differential taxation of capital gains survives the current debates in Congress, I would urge that an appreciable holding period (much longer than the six months in recent tax law) be required. A much better solution would be to index asset bases for inflation, as urged by the "Treasury I" study some years ago. I would also advocate applying a significant capital gains tax to sales by pension funds and other tax-exempt intermediaries when common stocks are held less than one or two years.

Finally, if the findings of Kaplan, Lichtenberg, and Siegel are sustained by further, more comprehensive research, it must be recognized that the incentives for going private stem at least in part from a failure of traditional public corporation governance mechanisms. Going private alleviates an incentive problem, which is good, but it carries in its wake a serious macroeconomic risk. A better approach would be to attack the corporate governance problem directly -- e.g., through reforms that force outside directors to take their responsibilities more seriously. Among other things, a substantial fraction of directors' compensation could be made contingent upon the long-term (e.g., five-year) common stock performance of the companies on whose boards the directors sit. And to make directors less beholden to the CEOs who currently appoint them, the New York Stock Exchange and/or the Securities and Exchange Commission could require that a significant fraction of outside directors be nominated by the pension fund, mutual fund, and other institutional managers who now control nearly half of the outstanding common stock in U.S. industrial corporations.

spending reductions, e.g., for research and development and investments likely to pay off only slowly, in ways that impair long-term strength.

Kaplan, Lichtenberg, and Siegel found that LBO and MBO companies increased their capital investments more slowly than non-LBO companies in comparable industries. A National Science Foundation study of the leading 200 U.S. industrial R&D performers revealed that eight companies involved in buyouts or other leveraged restructurings reduced their R&D spending between 1986 and 1987 by 12.8 percent on average, while companies subjected to no such restructuring increased their spending by 5.4 percent. "LBOs Implicated in Slowed Industrial R&D Spending," National Science Foundation News, February 1989. However, Lichtenberg and Siegel report a contrary finding: for 43 manufacturing companies involved in whole-company going-private transactions, R&D/sales ratios increased on average by somewhat more during the 1980s than those for all R&D-performing corporations. The difference in results may be explained by NSF's focus on the most R&D-prone companies, whereas the companies in the Lichtenberg-Siegel LBO sample were only about half as R&D-intensive on average as the universe of R&D-performing corporations. Perhaps even more important, but more difficult to observe, companies with pricing discretion may be tempted to set product prices high and harvest substantial profits in the short run, accepting long-term market share losses as the entry and expansion of foreign and domestic competitors are stimulated.

The managers who cut back investment spending following the LBOs covered by our case studies "expressed unease and hope that, once their debt burdens became lighter through repayments, they would be able to invest more in future-building activities." Mergers, Sell-offs, and Economic Efficiency, p. 155. But I must conclude by cautioning that very little is known about the extent to which heavy leverage and the incentives of the "going private - going public" cycle lead to real sacrifices of long-run economic strength.

The Macroeconomic Risks of Leverage

To the extent that operating efficiency and profitability are higher under heavily leveraged financial structures in which managers have substantial equity positions, we can expect the going-private phenomenon to continue. But if it does, there are clear risks to the U.S. economy as a whole. Sooner or later, we are going to experience another serious recession. It could come from deliberate Federal Reserve Board actions stronger than those underway in the past year, or from a sudden flight from the vulnerable dollar. If the rise in interest rates (ratcheting short-term financing costs upward) and the decline in economic activity with the onset of recession cause cash flow problems for

gitimate concern. When one of these transactions takes place and these organizations go through the kinds of large changes that they have to go through to get back onto the efficient track, lots of changes have to be made. That makes people uncertain and insecure. And even though it may not reduce employment in the aggregate, which is what the statistics indicate, I have no doubt that if we had the individual data we would find out that there are some groups of employees who are leaving, while other new ones are being hired. So, the net change appears to be close to zero or even slightly positive. But it's less positive than the employment growth in the industry.

This is perhaps a good example of where there is a shortrun/longrun tradeoff. I think we do have to bite the bullet. In the long run a high standard of living and solid desirable employment opportunities for American workers depends on having organizations that are efficient, that are tough, hardnosed competitors both domestically and in the world markets.

In order to get the fat out of these organizations, people have to leave, and the ones that by and large have to leave are middle managers, and sometimes even fairly high level managers. They are visible and they are very powerful. I don't see any way around some of that until we get some changes made.

Senator ROTH. What about the blue-collar worker? Let me ask if you can also comment on so-called fringe benefits, pension plans, and so forth. You have seen some criticism in the papers that in some buyouts, the first thing they do is terminate pensions or other benefits. Has any study been made of that?

Mr. JENSEN. Yes, there has been a pretty good study made by Andrei Shleifer of the University of Chicago and Michael Weisbach of the University of Rochester. They find that in about 10 percent of all mergers and acquisitions and LBO situations, there are changes in the pension plans, in particular reversions where the plan is canceled and moneys are taken out. As you know, that represents a very small fraction of the total amount of this activity that is going on, and what they find is——

Senator ROTH. If I could just intercede—10 percent is not to me small. If it's my pension, it's pretty significant.

Mr. JENSEN. Well, the point is to my knowledge there's no evidence that indicates that the existence of the buyout or a merger or acquisition or hostile takeover is more likely to generate a pension reversion than if it hadn't happened, and it amounts to maybe 1 percent of the total value that is created in the transaction.

A lot of this stuff is happening. It doesn't seem to be concentrated in these transactions. It's generated across the map. And I think it's being encouraged—now it's being encouraged by the threat of legislation, which is, in effect, going to take the property rights and the overfunded moneys that are in many of those plans and turn over a substantial fraction of it to employees. So, that provides incentives for people to pull out more quickly than they would otherwise do.

Senator ROTH. Mr. Scherer.

Mr. SCHERER. Once again I have to be a two-handed economist. I agree with Mike Jensen, but I'd put it in slightly different terms. Since the early 1970's, perhaps the most important economic prob-

for-performance profiles for their CEO's as well as their divisional managers.

What we are seeing in these organizations is not only a cutback, as Fred Scherer points out in capital investment, not so much a cutback in R&D, but we're seeing the fat cut out of these organizations. We're seeing a renewed emphasis on the core business, very much more like what the Japanese have proven so adequately can be done.

I've also argued that if we look at what is going on in Japan that is only a slight oversimplification to say that the major Japanese corporations are now in a situation which is comparable to what ours were in 1965, nominally riding the top of the mountain. There are fundamental changes going on in their governance structure, and in their market structure that are taking them down the same road that we traveled. So, they're going to end up committing the same kinds of mistakes that we made. The summer before last when I was in Japan studying their situation I gave a talk to the Kai Dou Rou, a sort of combination Business Roundtable and Chamber of Commerce. I predicted then that unless they were a lot smarter than us they were going to end up making the same mistakes.

We are now seeing the Japanese launching diversification programs, acquisitions, and wasting huge amounts of the cash-flow that they now have. They are also running their debt levels down substantially. The banks who used to be the active investors no longer have any power. The top 40 firms on the Tokyo exchange no longer have any net bank borrowings and they are falling into the same trap that we did. So, while we're getting better, my prediction is we're going to see over the next 5 years the Japanese substantially crippling themselves.

Senator ROTH. Are you saying that debt is essential to efficiency?

Mr. JENSEN. We look around the world at our toughest competitors and we find—obviously this varies with the nature of the company and the nature of the industry—that higher debt ratios than we experienced in the past are in fact a strong competitive weapon.

Senator ROTH. Mr. Scherer.

Mr. SCHERER. I agree with some of what Mike Jensen has said, but I would put emphasis on other aspects. First of all, what's the major problem as far as the time horizon is concerned? I believe the major problem here is that U.S. firms on average face a relatively high cost of capital. I did a little study 8 or so years ago, and I found that on average, the discount rate that American corporations applied to future earning projections in their capital investment decisionmaking was on the order of 16 percent.

Now, at a 16-percent discount rate, nothing that has a long-term payoff, unless it is extraordinarily high, can be justified. There's lots of evidence that especially the Japanese, but to a lesser degree some of our European competitors, face lower costs of capital, therefore apply lower discount rates, and therefore rationally make longer term investment decisions than American corporations. Why are the discount rates for American corporations so high? Some of it is risk aversion, but a significant fraction of the problem is attributable to our low savings rate in the United States relative to other countries, and especially relative to Japan and the tiger

countries of the Far East. When you have high savings rates, you're going to have lower costs of capital, and you're going to make longer term decisions. That's probably the major problem in the domain that the committee seems to be exploring.

I think, however, there is a secondary problem. That is to say, the pressure of debt service in a highly leveraged environment, at least according to our case studies, does force managers to forgo investments they think for strategic purposes they really should make, but they just can't do it right now. They want to do it, they plan to do it as soon as their debt service obligations have been reduced somewhat, but debt pressure does lead to some shortening of horizons.

This is very weak anecdotal evidence, but sometimes what you see from the worm's eye tells a lot. I was flying on a plane the other day with a very junior employee of RJR Nabisco. This was not any kind of high managerial position, but a salesperson who was very much concerned because, this employee said, RJR is cutting back advertising support for some of its strong brands. It was cutting back promotional support for some of its strong brands to meet its debt service obligations. And the consequence of those actions, according to my informant, was that gradually those brands were going to atrophy in market share. Now, from my standpoint, the insight reflected very good economics. It's a kind of tradeoff you make when you're under very heavy pressure. I do think this sort of thing has been going on.

Senator ROTH. Mr. Chairman, I happen to feel very strongly that we have to turn this country around and become more of a savings nation. As I understand it, the cost of capital here is roughly four times what it is in Japan, and as you say this makes it very difficult for American business to enter fields with long-term promise in comparison to our competitors.

Mr. SCHERER. Senator, could I just interject here, because there is something that is very frequently overlooked. I fully agree with you, but that's not the only dimension of the problem. When you're rolling out a new product, you also have to make an investment decision. You can try to price to be profitable right away, or in the first couple of years, or you can take losses early on in order to obtain market position, get further down the learning curve, and eventually in the long run have lower costs. I believe this difference between the United States and the Japanese shows up on that dimension too.

The U.S. semiconductor manufacturers got themselves, perhaps unavoidably, into trouble because they found learning curve type pricing to be unprofitable, and they decided they couldn't do it. The Japanese were willing to take losses early on in the semiconductor learning curve, and as a result of that, they virtually own the merchant dynamic random access memory device market. The Japanese in their pricing decisions, as well as in their classical investment decisions, are going for the long run.

Senator ROTH. They're going for a long-term market share; isn't that what they're going for?

Mr. SCHERER. Surveys show that Japanese managers, asked the same kinds of questions as American managers, place much more emphasis on market share and much less emphasis on short-term

serious bias into the problem. I think it will make the pension system less healthy.

Representative UPTON. Mr. Scherer, would you like to comment?

Mr. SCHERER. This is a problem I know very little about. I don't think the major problem here is LBO's and similar restructurings per se; rather, what happened is that a lot of these defined benefit plans funded themselves on the assumption that the Dow Jones average was going to be in the range of 1200 to 1400. It went up into the range of 2300 to 2700. And of course, they had excess funding.

The difficulty, as we have seen on a couple of occasions, is that what can go up can also go down. And somehow or other, we need to work out a policy. I can't suggest to you what the answer is. Somehow or other, we need to work out a policy so that pension funds do not find themselves overfunded one day because the market happens to be particularly strong and underfunded the next day because the market has suffered a severe setback. That, it seems to me, is basically what has been going on. Overfunding, of course, creates an opportunity to use those funds for various types of acquisitions.

Representative UPTON. Mr. Jensen, one of the major points that you made in your testimony was the rate of R&D versus the number of mergers and acquisitions. Mr. Scherer, your comments seem to poke some holes in that; the data was mixed and from a variety of sources.

Mr. Jensen, I am wondering did you, were you, or are you able to break that out in defense and nondefense areas with regard to R&D to show us the differences in those areas? How would you respond to some of the charges and differences in question that Mr. Scherer brought up in his testimony?

Mr. JENSEN. As I hinted when I started out, I thought Professor Scherer has made a number of legitimate points. Simply looking at the data I have submitted is not sufficient to prove the point. But I think it's well to pay attention to the fact that in this concern that we have, if you look at table 2 in my prepared statement, the fact is in 1988 R&D expenditures grew at a rate of 11 percent. Prior to that they grew at 7 in the years before that 10, 10, 10, 14, 9, and 11. These are not numbers that show declines. In one year where the rate of growth went down there were headlines in the newspapers about R&D spending falling. It simply wasn't true. What was happening was that the rate of increase had tapered off and we were still growing. So, if there is this major disaster going on out there it is not showing up in these aggregate statistics.

I think the point about defense versus private spending is a very good one. My purpose was not to review all of that detailed literature, and there have been very careful company by company, merger by merger studies done trying with very sophisticated econometrics to try to sort this out.

Probably one of the best studies was done by Brownyn Hall at Berkeley and the National Bureau of Economic Research. She finds virtually no effect of acquisitions on R&D on a transaction by transaction basis. There is always going to be sample noise. We can find samples where we find it, and other samples where we don't find it.

Mr. Jensen.

Mr. JENSEN. I would like to change the focus of the discussion a little bit. As I hinted at in my article and opening remarks, I think that when we talk in terms of short-term versus a long-term orientation, we're missing the point. It really has to do with the efficiency of our corporations versus their competitors in the rest of the world. As I think I may have said before you came in, what I see out there is new organizational forms that are arising in spite of the barriers we've placed in front of them, to make up for some sins that we in the public arena have committed in the past. What has resulted from that mistaken policy is a vast amount of inefficiency and a bureaucratized corporate sector, and I don't think it's really accurate or useful to characterize it as a short-term versus a long-term discussion.

The fact that Goodyear Tire has 6,200 people in its corporate headquarters in Akron to manage that empire is not a matter of short-term orientation. That is just bureaucratic inefficiency and waste.

Senator ROTH. Let me interrupt. I have to disagree when you say short term/long term is not important. Having watched with some care what the Japanese have done, you can have a large bureaucracy in respect to long-term action or short-term action. I happen to agree with you that I think the Federal Government is partly responsible for the development of those bureaucracies. In the 1960's and 1970's, we developed more and more rules and regulations, but some of them were essential and I strongly support them. Environmental regulations, for instance. They had to create bureaucracies to deal with that. Your law firm goes into your corporation.

But the question I really want to get back to is this. You don't think that the question of whether management is aiming at short-term profits, for whatever reason, is not important? Compared with, say, the Japanese, who apparently will forgo short-term profits in order to get a larger market share?

Mr. JENSEN. I'm not saying that there aren't instances or sectors or corporations or industries where this overemphasis on short term is important, it is. There are situations like that. What I'm trying to say is if we start down this road with the notion that that's the major problem in the United States versus the Japanese and the Germans, I think we're wrong. I think they are just more efficient than we are. I think that you put your finger on it when you say it isn't the fact that we have this large bureaucracy, it's whether it's efficient or not. It's whether it's productive. As I point out in my Harvard Business Review article, we're being shown in all kinds of ways through the private entrepreneurs, the family funds, the LBO's and management buyouts, that it is possible by taking companies private to cut out a lot of this bureaucracy.

There's really a new form of organization arising. It has never even had a name. I took the opportunity to name it. I call it the LBO Association. KKR is a diversified conglomerate, but it runs very differently, it has a very different structure from the typical diversified conglomerate. It has a headquarters staff measured in the 10's. It has very large equity interests by the managers. They're partnerships, not corporations. They have very high pay-

lem that this nation has had is low productivity growth. If we don't get a high rate of increase in output per worker, we cannot raise real standards of living. That is the fundamental problem.

Now, to the extent that LBO's and other leveraged restructurings give us increases in efficiency, in effect we get one-time increases in productivity. That is to say, we jump suddenly to a higher level of efficiency, and that shows up in the productivity growth statistics. We still, however, have not done very well in the 1980's. Manufacturing has done pretty well, but the rest of the economy has not done well in terms of productivity growth.

But there is another hand here, unfortunately, and that relates to your phrase about "decent treatment of employees." When employees, especially middle management employees, realize that at any moment, their 15 or 25 years of service can be terminated, they will devote a substantial amount of their effort to keeping their ears attuned to executive search organizations, and not to what is going on inside their organization.

The Japanese manage to avoid this problem of disloyalty. Here at least is one advantage of conglomerates. When a Japanese organization finds business declining in one field, it is forced to make cutbacks. They find ways to transfer their people, both blue collar and white collar, to other parts of their organization and absorb them in one way or another. But to the extent that all of this turbulence from corporate takeovers is making American middle managers, and to a lesser degree lower level employees, less secure, they are going to have a shortrun orientation to the job they're doing. That has to show up in long-term performance. The linkages are subtle, but they have to show up.

Mr. JENSEN. I don't think that we can say that at all. Fred Scherer and I seem to find ourselves agreeing on more and more things and that might be the result. But I can show you organizations where this kind of turmoil in fact has exactly the opposite result where people become concerned with the fact that they see the fat around them, they understand the ax is coming and they have to be efficient, in fact, decide they want to be amongst those who are staying around and significantly increase their efforts and productivity.

There is again nothing about this that seems to be particularly unique to mergers and acquisitions or leveraged buyouts. The summary of my remarks summarized the evidence on the employment history of General Electric and General Motors, certainly two organizations that have never been subject to corporate control activities or hostile takeover threats.

GE over the past 10 years has fired, laid off, gotten rid of 100,000 people of its total employment of 400,000 people at the beginning of that period. General Motors has gotten rid of, laid off, 250,000 people out of its total of 1 million over the last few years. In fact, half of those came over the last 3 years. These are major declines in employment like we have not seen in buyouts or mergers or acquisitions. I am not saying they are bad. I think they're healthy for the economy, but when we are talking about these effects, I think it's important to keep in perspective that it is the large corporate sector, in fact, that has lost jobs over the last decade or decade and a half. Virtually all of the employment growth in this country has

come from smaller organizations. That's not because of M&A activity.

Senator ROTH. In a sense, doesn't that reflect the point you gentlemen made earlier that corporations did become somewhat bureaucratic at every level? But I guess the policy that would bother me is if we were suggesting that leveraged buyouts and constant reorganization was the wave of the future regarding corporate efficiency. I would hate to have as a policy that the American worker, and I am including the blue-collar worker as well as middle management or anyone else, constantly is facing reorganization. That leaves workers in a stage of uncertainty. I just don't think that that's a practical approach.

Let me make just one other observation. Your comment, Mr. Jensen, that the Japanese are on the same road we are traveling and that you expect them to have some of the same problems: I've heard that kind of conclusion a number of times, that they only copied, they couldn't develop new products, their research and development was not that good, they just knew how to borrow. I don't find that to be true.

Then we heard when the value of the yen went up that that was going to turn around our trade imbalance and so forth. We have found that Japanese management has been able to deal with that problem very well. We have not seen the dissipation of the imbalance. So, I'm not at all persuaded that the Japanese will not deal with this problem as well. You may be right.

But I think one of the problems here in American management and by observers is that we always underestimate our competition, and that concerns me very much.

Mr. Chairman, I have taken a lot of time. I will yield now.

Representative HAMILTON. Thank you, Senator.

Congressman Upton.

Representative UPTON. Thank you. I want to do a quick followup on what we were talking about on the pensions and their relevance to LBO's. I presume, Mr. Jensen, that from your testimony, statistics you presented and the study which I am going to get a hold of from the University of Chicago, that you would probably be opposed to Congress establishing any type of firewall around any pension fund that may interfere with future LBO's. Is that correct?

Mr. JENSEN. Yes, and let me explain why. It depends exactly on the nature of the regulation, the firewall. But let me take the most extreme kind. If we pass a set of laws or regulations that in effect grants property rights in all overfunding in a pension plan to beneficiaries, what we will do just as sure as we are sitting here is we will guarantee that pension plans in the future will be underfunded. We will then have to pass a set of laws because people are not going to voluntarily put more resources than they're contractually obligated to into an environment where those resources are going to be taken away from them by law or regulation. It's because of that unfortunate effect that if we establish this policy we're sure to either eliminate or substantially cripple employee benefit plans. Maybe that's a good thing, but if they remain they will surely not be overfunded. We are going to be constantly facing the problem of underfunded pension plans and all of the regulatory apparatus and regulatory risks to solve that problem. So, it will introduce a major

return on investments. But that for them is probably a longrun profit-maximizing emphasis.

Mr. JENSEN. I think it's very important, if I might interrupt, to be careful about interpreting those statistics on market shares in the RAM business because in fact those market shares are calculated as a fraction of the merchant market, the resale market, and exclude virtually all of the American production which happens to be pretty much contained in organizations like IBM, AT&T, and to some extent Digital which have simply incorporated that capacity inhouse rather than gone outside.

So, those who are talking about the dominance by the Japanese and the American semiconductor market, are simply not being careful about how to look at the data. We are making a vast amount more than those statistics indicate. Much more than half of the total market of semiconductors consumed in this country is, in fact, being produced here. But it is not sold.

Senator ROTH. Nor are we able to sell in world markets in competition with the Japanese.

Mr. JENSEN. That's true.

Senator ROTH. You talk about the bloated bureaucracies that have developed in corporations. I understand and agree that has been a problem. One of the things that concerns me as I read your very provocative article and some of the comments on it is, what does it do to employment? I don't see much reference to that. And I think as you look at companies, they're not just capital and equipment markets, but they're people. Obviously, we have to be efficient and effective, but one of the keys presumably of the Japanese success is their decent treatment of their employees, whether it's a long-term contract or their involvement in management decisions or whatever.

I note that in your article, Mr. Jensen, you did indicate that it didn't seem to reduce employment, but I think this is a key question. What do leveraged buyouts mean to employees and their attitudes, and not only toward their employer? I know that you said that in the case of a recession or threatened bankruptcy, a leveraged organization will react much faster than, say, a corporation. Does that mean that they will just fire a lot of employees to be more efficient? I think whenever we develop policy, we must remember that, after all, the purpose of a strong economy is to have meaningful jobs for the American workers and to keep the economy from being constantly at risk. And I haven't seen that question really addressed in any detail.

Mr. JENSEN. It isn't addressed as much as we would like to have it addressed. For one thing, the data are hard to come by, especially data on compensation which we'd really like to have. But to the extent that we're able to measure these effects of leveraged buyouts and it's even more difficult in mergers and acquisitions—we just don't find strong evidence of substantial decreases in employment brought about by these buyouts.

There's one study that tends to be overweighted. It uses Michigan data on small acquisitions. It deals with acquisitions by whatever means. It shows no effect on employment on the average, yet employees of labor unions are certainly, if you believe the press, concerned about these activities. I think that comes about as a le-

I refer you for detail to I think the best survey I've seen of that literature, the one that was done by SEC Commissioner Grundfest recently. It's referenced in my testimony. He comes down by and large on the same side I do in the interpretation of the evidence, not that it's one sided, but it just doesn't support the kind of crisis atmosphere that's generated by some. It just doesn't pass what my old teacher Harry Roberts used to call the interocular test, that is, if it hits you between the eyes it's significant. And this doesn't hit you. It's really hard to find it. It's very hard. But please don't take that as a God given truth. We need to do much more careful studies.

Representative UPTON. I expect a vote at 11, so let me ask one more question.

Within a couple of days after the United Airlines deal fell through—of course that was one of those supposed causes of the 109-point drop in the stock market that Friday—we in the House—I serve on the Public Works Committee—passed legislation out of the committee which ultimately passed on the House floor. It will give the Secretary of Transportation much more authority with regards to restricting LBO's by foreign investors with the airlines.

You made some comments with regard to public policy that the Antitrust Division has been pretty much neglected over the last number of years. Obviously, this is a matter of prime public service. We've seen the number of airlines go from 20 or 30 down to really 7 or 8 carriers. Braniff, of course, dropped out this week. Many of us feel that the Government does have a responsibility to protect us, particularly if we do get into a recession.

And, Mr. Scherer, your comments with regard to that, what are they going to do if a recession hits? Where will the R&D or capital improvements go? What are your comments with regard to the legislation that we passed in the House last week?

Mr. JENSEN. I think it is terribly unfortunate. The airline industry is one that had enormous inefficiencies prior to the freeing up of the regulatory structure. By and large the evidence is pretty clear that the economic rents didn't go to the shareholders. The rents were caused by the cartel-like provisions that were enforced through regulation. The rents went to the Labor Unions. And what happened was that with the deregulation came entry, declines in prices, much lower cost for travelers, and the necessity for those labor unions to take wage cuts.

It was our own domestic version of the international competition that is facing us in all kinds of other markets. I think it was highly desirable.

What's happening now is a recartelization of that industry right under our nose. It's not being brought about by mergers and acquisitions. It's being brought about by a combination of things that mostly have to do with the rules and the procedures that we have for allowing entry into gates, into the building of gates.

We have a situation, and I don't propose to be an expert on it, but my understanding is we have a system which is equivalent to asking Burger King to fund any expansions in McDonald's franchises, and we then give Burger King a veto or voting rights over whether in fact McDonald's will be allowed to expand its franchises. That's why we have the restricted entry situation.

This is one of the reasons why we have the situation in Denver which requires the destruction of the old airport. The existing airlines would agree to the building of a new airport—after the referendum—only if the old one were destroyed. They know very well what happens to fares if you have an excess of gates around. So, you have a combination of the hub system coupled with what are very peculiar and counterproductive rules for the building of gates and entry into local markets that is, in effect, creating monopolies and cartels in the industry.

The solution to the problem is not to ban leveraged buyouts because this will simply encourage inefficiency. The solution to the problem is to arrange entry into the gate building business. I don't know how easy or hard that is. But if you look at the prices that are being obtained for the sale of gates, new ones are apparently very valuable. Eastern Airlines recently sold some gates to US Air in Pittsburgh. My memory fails me, but I think the number was approximately $300 million. My guess is you could build practically a whole new terminal for that sum. What does that represent? It represents the present value of the monopoly profits that exist due to controlling those gates. They are now in the hands of US Air which controls most of the rest of them in Pittsburgh. So, it is a very unfortunate set of circumstances for American travelers.

I would love to see the Congress take action to correct it.

Representative UPTON. Mr. Scherer, your comments.

Mr. SCHERER. I agree with Mike Jensen that gates are a major problem in the airports that still have air space to land additional flights. I also agree that through deregulation, we have in fact squeezed a lot of the fat out of airline operations. I do worry a bit about very highly leveraged airlines. During World War II there was a song that was quite popular. It came from bombers flying home with lots of holes in them. It was "Coming in on a Wing and a Prayer." Well, now the song may be, "Coming in on a Wing and a Junk Bond." It's a bit worrisome. There are lots of incentives not to cut corners, but then when the crunch is on, you're concerned.

I don't know the details of this bill. Certainly, I don't think the Secretary of Transportation has had a distinguished record in preserving what competition we had in the airline industry. The Secretary approved the merger of Northwest and Republic over the opposition of the Department of Justice. A similar story unfolded on TWA and Ozark, so that Minneapolis/St. Paul and St. Louis are hub airports dominated as a result of merger by a single carrier. So, I'm not sure the Secretary can be trusted to carry out this important function.

I am not particularly worried about some modest degree of foreign ownership of U.S. airlines. There are some very good foreign airlines, and if they were to pick up some marginal U.S. carriers, it might indeed improve the state of competition in the U.S. industry.

Representative UPTON. Thank you both.

Representative HAMILTON. Mr. Jensen, you make the case that these new organizations are making remarkable gains in efficiency and productivity, and in shareholder value. The question it raises in my mind is whether there are such things as good and bad leveraged buyouts. Or are they all good?

Mr. JENSEN. We're going to find some that haven't worked or won't work. I used to run my life by what I call the "airport principle" which was that if you never miss an airplane you are getting to the airport too early. My wife can't take that philosophy, so as I have become older I've changed it.

For a long time the historical evidence in the leveraged buyout field indicated that we weren't pushing the limits far enough because there weren't enough problems. You know, any banker that never has a loan go bad is not making enough loans and is not taking enough risks.

So, I think we were underinvesting in LBO's for a long period of time, because we didn't understand them. They were underpriced and we weren't doing enough of them. There's always the risk that the market will overreach, but we have to find the limits somewhere, and I think we are finding them.

Representative HAMILTON. The criticism I hear on leveraged buyouts, and I'm sure from your point of view it's an unsophisticated criticism, but the criticism is that they just shuffle financial wealth around without creating wealth, that they are just redistributing wealth. You're taking away from workers, from suppliers, from customers and you're giving it to some very fast dealers up here at the upper levels of corporate America.

How do you respond to that? You acknowledge yourself that the rewards are very great here for the people at the top.

Mr. JENSEN. I mean there's enormous value being created. We're roughly doubling the value of these enterprises on average. That's a big plus. On this particular set of issues Fred Scherer and I don't disagree. I don't know of any economists, maybe Fred Scherer can correct me, who looking at the evidence doesn't come down pretty much on the same side, that is these things are creating real wealth. They're creating real efficiencies.

Representative HAMILTON. It's good for America?

Mr. JENSEN. Absolutely. It's not that every single one of them is good.

Representative HAMILTON. Not all of them work.

Mr. JENSEN. Right.

Representative HAMILTON. When 1989 began it would seem to me that there was a lot of doubt and question about LBO's and we in the Congress were beginning to look at measures that we ought to take to restrict them, to restrain them.

Senator Roth, I'm sure, on the Finance Committee, remembers discussions about LBO's. Now, it seems to me, that we backed off, and we've decided that we might make it worse rather than better, and we don't really know what we ought to do to constrain LBO's. I gather from your comments that you would approve the Congress backing off here.

Mr. JENSEN. Yes, sir.

Representative HAMILTON. You don't think we ought to meddle in this area?

Mr. JENSEN. Not yet.

Representative HAMILTON. Let me give you the experience of one corporation I know about that was subject to a targeted leveraged buyout attack. I heard about it and know about it strictly from the standpoint of the corporation that was possibly going to be taken

over. So, it was a limited perspective. But I know what happened in that particular corporation. I know the executives of it very well. And what happened was that for 6 or 9 months, maybe a year, the entire top level management of that corporation gave their time, energy, and resources to fighting that takeover. They weren't talking about improving productivity out there. They weren't talking about how to strengthen their market share. They were trying to save their corporation. And what impressed me in all of that was that all of this high-powered talent, and it's considerable in this particular corporation, was diverted from their task in the end. In this particular situation they succeeded. They blocked the LBO takeover.

Now, what about that? How does that fit into the scheme of things here?

Mr. JENSEN. Well, if we look at the evidence on what happens in these situations, even where the company's managers are successful in preventing the takeover or change of control, and in some sense keeps their jobs, in some real sense the companies are not the same. I can't speak to the particular company you're talking about because I don't know who it is——

Representative HAMILTON. I think I had better not identify them. I don't want to embarrass them.

Mr. JENSEN. With some small exceptions, depending on exactly how the victory is won, what we see happening over and over and over again is that in this process—which I agree is costly in terms of management time—causes the top level managers, the middle manager, and even the lower managers to reassess the strategic direction of the company. We find that time and time again, and I would predict solely on the basis of some fairly large samples, that if you go back and look at that company you will find that they have made major changes in the way they're operating.

Goodyear is a good example in their defense of the Goldsmith takeover attempt. They made major changes in that company, and I don't think there is any doubt that it has made them a lot better outfit, and by the statement of their own current CEO, all that really hasn't prevented them from investing in their core businesses, and they have gotten rid of a lot of things that they didn't really want.

So, I am sure that you can find a particular company that really didn't change, and even shouldn't have changed, and that there is simply months' worth of enormous cost in terms of management time. From my understanding of the evidence, that would be a relatively rare occurrence.

What tends to happen is that these targets really do make changes. They often make some of the same changes that the raiders are recommending and the result is you see much the same thing in successful takeovers.

Phillips Petroleum in Bartlesville, Oklahoma, is an example. The best thing that ever happened to that company was Carl Icahn who got them to make a lot of very tough decisions—which I think now they will deny was due to him—which should have been made a long time ago. It has restructured and formulated a new strategy for the company. It's much healthier and much better able to withstand the downturn in the energy industry.

Representative HAMILTON. Do you agree with these comments, Mr. Scherer?

Mr. SCHERER. I don't know the specific cases well enough to know whether I agree or disagree. I am somewhat skeptical. I suspect, Mr. Chairman, you may be talking about Cummins. And Cummins' objective, as nearly as I could tell, was to be the best damn diesel engine maker in the world. I think that's a laudible objective. It didn't always make them attractive to the market. I don't know the facts, but to the extent that a company like that is deflected from such an objective, I think our national competitiveness is going to be hurt.

You asked more broadly, are there such things as good and bad LBO's? I believe it's important to get some historical perspective on the dynamic process that's been going on. In the 1970's, when the LBO first became public knowledge, the typical deal was 30 or so million dollars. And it was being done by a very few houses, Kohlberg, Kravis, Roberts; Forstman Little, and a couple of others. There wasn't a lot of competition. The standard technique was, you would assess the economic prospects of your LBO target, you'd do a best guess dollar estimate of what their cash-flow was going to be, an optimistic estimate, and a pessimistic estimate. And because there wasn't a lot of competition for these deals, you could take the deal by offering terms that were somewhere between your best guess estimate and the pessimistic estimate, which assumed that there will be a recession or two. So, you could get the deal on fairly favorable terms, and the financiers made a lot of money.

Well, they made a lot of money, and other firms swarmed into this activity of making LBO's. With General Electric, the major investment banking houses, and others, the competition got tougher, so you couldn't take the deal somewhere between best guess and pessimistic, and that is what led to the first $400 million deals. The Houdaille Industry deal was one of the very first. KKR moved out of the $30 million deal because it got too risky, it got too competitive and too risky. So they moved up to the $300 to $400 million deals. At first, they could take those on relatively pessimistic terms, but then the competition heated up, and then you had a flight to the $5 billion deal, Beatrice Foods. And then the competition heated up there, and you had your first $25 billion deal, RJR Nabisco.

Now, the point of my example is that as the investment firms gain experience with various size LBO's, they have to bid more and more optimistically to take the deal. And when you bid more and more optimistically, and when that inevitable day of reckoning comes, that is, we have a significant recession like 1975 or 1982, those optimistic deals are going to shed a lot of blood.

Representative HAMILTON. How do you respond to this Industry Week survey? Are you familiar with that, published in July, which finds that two-thirds of 800 surveyed managers involved in takeovers said that the takeover or LBO has had a negative effect on morale, and that their company's underlying efficiency had suffered, even if cash-flow had improved. Do you know anything about that survey? Is that familiar to you? It's not familiar to you? I don't mean to surprise you with anything.

Mr. SCHERER. I don't know the survey. The reaction doesn't surprise me. Managers for the most part do not like these kinds of threats, partly for good reasons, partly for bad reasons. The bad reasons are, they would like to maintain life the way they're accustomed to living it.

The good reasons are, these restructurings are obtrusive, they disrupt the normal course of events, they disrupt planning, a lot of people get hurt, they lose their jobs. Certainly, morale is going to go down.

Mr. JENSEN. Let me point out——

Representative HAMILTON. Go ahead Mr. Jensen.

Mr. JENSEN. Fred Scherer puts it exactly right. Here you have the capital markets exerting this control on managers, and they don't like it one bit. I'm not surprised by that survey. I have some doubts about whether the conclusions are right about whether it has decreased efficiency. But I am certainly not surprised by the fact that on average the managers don't like it.

Look at the case of Inland Steel. When it finds out its Japanese competitors can deliver steel to its door or to its customer's door at a price which is lower than Inland's cost of production, that causes a big crisis in the organization. They have laid off a large number of people. And if you asked them whether they liked it, the control from the product markets, they would tell you no, heck no.

My point is that we're better off when the system is working. We're much better off to have that adjustment brought about before an organization gets into the kind of difficulty that Inland Steel and many of our other steel producers have. We're better off to have the adjustment occur through the capital markets before we've gone down this inefficiency road so far that it is enormously difficult to bring them back? There will be dislocations, there will be concern and people won't like it. But if we are going to be efficient, we have to have a system that keeps a club over people who are getting too comfortable.

Representative HAMILTON. Let me ask you the question of what in your view a corporate executive's objective ought to be? Should that objective be maximizing earnings, profits, stock market value? Is that what he's aiming at? Or is his objective broader than that?

Mr. JENSEN. Let me answer that question from the standpoint of an economist or a policymaker that is interested in having the economy work as well as possible, to have the largest possible standard of living, and have the most efficient productive plant that we can. We want managers to behave so that they maximize the value of their enterprise using the appropriate discount rates. And the small exceptions to this have to do with some technical things that Fred Scherer and I can explain if necessary.

Much of the inefficiency that I see out there comes about not because managers are responding too much to these forces in the capital markets. It is that they are responding too little.

Representative HAMILTON. How do you judge the value of the enterprise? Is the stock market the way you judge it?

Mr. JENSEN. The stock market is the way you judge it, although that is only one particular way. We have these buyouts of firms that are being taken private. There isn't any day-to-day trading in those, and yet those managers are motivated because of the incen-

tives that they have in large equity ownership. They are motivated along with the board of directors to maximize the value of the company at some point when they sell and take it public or do another secondary buyout.

Representative HAMILTON. How does your answer fit in with the view. I've heard some corporate managers express that they should be concerned with a community responsibility, philanthrophy, care of workers, and all of these other things.

Mr. JENSEN. Certainly, sometimes views like I just expressed are interpreted as meaning that the corporate manager has no concern at all for his employees, has no concern for his customers, and has no concern for the suppliers. It has no concern for its community.

If a CEO or an executive behaves that way, they are surely not going to end up maximizing the value of their company.

Representative HAMILTON. Over the long run.

Mr. JENSEN. Yes, or even over the short run. They will very quickly find themselves in an unfriendly community. If they dump pollution on it and behave as a poor citizen, they are going to be subjected to all kinds of problems. It's not hard to find examples of that. It has proven to be very costly if they mistreat their employees, if they're irresponsible, or if they're untrustworthy and they are going to find that they can't get as good employees or that they have to pay more, and right on down the line.

General Motors and the automobile industry in the United States in the past has behaved atrociously with respect to their suppliers. They are now learning from the Japanese that that is no way to treat your suppliers. They are behaving in a much more——

Representative HAMILTON. Do you agree with this, Mr. Scherer?

Mr. SCHERER. I agree with almost everything Mike Jensen has said. I do think that the objective should be to maximize longrun value. If you try to maximize a dozen objectives, you will end up doing them all badly. I believe that part of maximizing longrun value is maintaining a highly motivated and loyal work force. And that does mean smoothing that work force against some of the inevitable fluctuations and turbulence that will occur.

I probably disagree with Mike Jensen on one major point, and that is, I think part of maximizing the longrun value of a corporation is seeing the corporation through the ups and downs, the shortrun ups and downs, of the financial markets. In the early 1980's we had 21 percent prime rates, and the corporation that made any farsighted investments during that period was certainly not meeting the demands of the financial markets.

Representative HAMILTON. How much do you look to the stock market to determine whether or not you're maximizing value?

Mr. SCHERER. In the long run you should look to the stock market, but the stock market goes up and the stock market goes down. I believe that managers have to engage in some kind of a smoothing process.

Representative HAMILTON. When you say maximizing value, are you thinking basically of what the value of the stock is?

Mr. SCHERER. No, I don't mean that they should try to make the value as great as possible today, tommorrow, or the next day. I think they should be looking 5 or 10 years into the future and

asking, where is our company going to be? Maybe the stock market hasn't quite figured out where it's going to be. But they should be moving on the trajectory that leads to the highest value.

Representative HAMILTON. If you're the corporate manager, what do you look to other than the value of the stock or the stock market for maximizing value?

Mr. SCHERER. I think you look at the underlying indicia. Are we engaging in the right kinds of new product development investments? Are we building a loyal, well-educated, well-trained work force?

Representative HAMILTON. What if the stock market doesn't recognize all of that?

Mr. SCHERER. Then I believe that management should try to override the judgment of the stock market if they think they know more about the long run of the company than the stock market. I feel frequently that that's the case. And that's where we disagree.

Mr. JENSEN. No, we don't.

Representative HAMILTON. But the stock market is obviously one very important index, but not the exclusive one.

Mr. SCHERER. Right. There's a marvelous discussion of this problem in the most recent issue of Fortune magazine. They have an extended article about the Time-Warner merger and the Paramount threat to that merger. It is quite clear that the managements here were saying, look, the stock market doesn't understand us today. Let's do what we need to do to be in a strong position 5, 10, 15 years into the future. I applaud that, but I think it is also dangerous in the present environment.

Representative HAMILTON. Senator Roth.

Senator ROTH. Yes. Mr. Jensen, Mr. Scherer in his opening remarks made a point about an economic downturn and the question of how the LBO's might behave, whether or not they would cut back on investment and make the downturn worse. We really haven't had that experience yet. What's your feeling about it?

Mr. JENSEN. We have had some of these experiences.

Senator ROTH. But not in a broad recession.

Mr. JENSEN. But enough that we get some information. First of all, leveraged buyouts have been going on for close to 20 years and we've had a pretty steep recession in 1982 and again another one in 1984, a short-lived one.

In addition, we had sectors of the economy, the agricultural sectors, textiles, oil, going through their own recessions while the rest of the economy was going along quite fine. And there have been LBO's in those industries. I have taken the trouble to look at those.

One of the things that amazes me about this past evidence is the underpricing and the fact that people weren't forecasting the real level of productivity increases that would take place.

As far as I can tell, there have been less than 10 LBO's that have ever formally gone bankrupt of the well over 1,300, maybe close to 2,000 LBO's that have taken place. There have been less than 10 that have gone into formal bankruptcy over this period of time. This is an absolutely astonishing piece of evidence. They do get into trouble, and they get into trouble frequently; insolvency, financial difficulties, more frequently than AAA rated corporations.

But they get reorganized within months, oftentimes with a change of control.

Campeau was not an LBO and it didn't make a whole lot of sense when First Boston did the deal. But we saw the same thing in operation last August and September when Campeau began to have cash-flow problems. It was within a month that Campeau himself had by and large lost control of the enterprise, $250 million had been put in. There was a new executive committee and a new control process at the board level, and the organization was changing its strategy. The strategy never made any sense to start with.

We find other examples. Fruehauf is a recent one where, in fact, the company got into difficulties, and was sold, at least there has been an offer to buy it. The offer I think was close to a billion dollars.

There are other examples. I have forgotten the name now. There is a company out on the West Coast, not an LBO, but it was actually a bankruptcy and it did a new equity issue and brought itself out of bankruptcy. If you have valuable projects and you have cash-flow shortages in the sense that your interest payments are larger than your cash-flow, if you're in the position that Fred Scherer talks about, and if it looks like you're really going to miss valuable projects simply because you have to give the cash over to the debt-holders, by and large we find that people are able to reorganize the firm and to get on with the projects if they are valuable enough because it pays the banks and the creditors not to miss these valuable projects.

I am not saying that there are not costs, there are costs to get people to come to an agreement on what it's all about. And there will be some of the effect that Fred Scherer talks about in some cases. But I don't think that it will be bad. And it doesn't show up in the data at all.

One thing that I might add is that the UAL deal didn't involve any junk bond issues. It was all bank financing. So, the failure of that deal didn't have anything to do with what's going on in the junk bond market.

Senator ROTH. I guess the thing that keeps me wondering is that if we have a major turndown, hopefully we won't, but if we do, it does seem that your business community might be less able to cope with it than under other circumstances. I would assume that if you have a major turndown, that it's not going to be that easy to reorganize and there won't be that many buyers out there because they in turn may be having their own problems.

Do you want to comment any further, Mr. Scherer?

Mr. SCHERER. I have trouble with Mike Jensen's statistics here for two reasons. First of all, by nature, these LBO's and MBO's are private. Therefore, we lack good statistics on what is happening on them.

Second, the financial institutions that loan money to advance these LBO's don't crow about their failures. So you really don't hear much about failures. I can't believe the failure rate is that low.

When we did our study of mergers and selloffs in the early 1980's, we chose 15 selloffs for case studies. Mind you, none of these selloffs had failed at the time we chose our sample. Well, three of

them subsequently failed, subsequently went bankrupt. I will name them; Bendix Home Systems was sold off to Commodore and went bankrupt as a leveraged buyout. Let Handbags was sold off to a Texas holding company and was liquidated to stave off bankruptcy. S.S. White, one of the leading makers of dental supplies in the United States, was in the process of arranging LBO-type financing when it went under. And we were going to choose a 16th case study, Mystik Tape. But they were an LBO that went bankrupt before we could interview them. So, they weren't part of our sample.

Well, there's 4 out of 16 right there. None of these got any significant newspaper play, so I think there's more going on than we see, even though, of course, these were failures at the time of tight financing around 1982. Since then, we've had basically continuous prosperity, and I agree with Ben Bernanke's paper I cite in my prepared statement that if we have another 1975- or 1982-type recession, we're going to have a lot of trouble with these highly leveraged companies.

Mr. JENSEN. Can I ask you, Mr. Scherer, has Mr. Bernanke actually rerun his study? Because they made a mistake. They didn't understand when they did that study the nature of SWAPS and interest rate caps. In virtually all of these deals, SWAPS play a very important role in converting the floating rate debt to a fixed rate, and they didn't allow for that in their simulations.

Do you know whether they have redone that because it will surely reduce the rate of default that they would produce.

Mr. SCHERER. I don't know that. It's true, you can convert bonds into some kind of equity security with a reduced return to the bondholders.

Mr. JENSEN. What I'm talking about is the SWAPS that make variable rate obligations into fixed rate obligations.

Mr. SCHERER. No, I don't know whether they reran it.

Mr. JENSEN. I don't think they have.

Senator ROTH. I'd like to ask a question with respect to the impact of pension funds and similar activities on the business community.

You hear a lot of comment that pension managers are not particularly interested in, and I go back to my term "short run," probably because as a noneconomist I can understand short run and long run, but that there really is no particular long-term interest. I think one of you, maybe it was you, Mr. Jensen, in reading the material for today, who argued that pensions can take a long-term point of view because they know what their requirements actually are. And so they can anticipate what they need. But there seems to be at least a common belief that pension managers are very short range motivated. They come in and go out quickly in order to make significant profits.

I would be interested in the comment of both of you gentlemen on this.

Mr. Scherer.

Mr. SCHERER. This is something about which our ignorance is vast. I think your statement is correct that the typical pension fund manager is in and out fairly quickly on many securities. What we don't understand is the transmission mechanism. The pension

fund manager has a shortrun orientation and wants to pull down a good performance this quarter, so that they'll be selected to continue to manage the fund next year; that we know. What we don't know is how that affects the decisions of operating managers. They know their securities are in the hands of people who turn them over rapidly, but does it affect their decisions? I don't think we know the answer to that. Columbia Law School has a major project underway right now to try to get some answers. But right now, we don't know the answer.

Senator ROTH. Mr. Jensen.

Mr. JENSEN. I agree with Fred Scherer. I don't think we have any knowledge at all about the way that this is transmitted to managers. I think we do know, however, from observation, although not large quantitative studies that managers most definitely do not want active investors in their companies. I think they are very happy with the state of affairs that they have now, with the institutional holders. Lazard Freres Corporate Partners Fund has found considerable difficulty finding places to invest up to a billion dollars. They have made some investments, but managers don't want long-term investors, large investors, who are sitting on their boards monitoring them with a big interest in the outcome. They don't want that at all. They want lots of small investors who are passive, sitting on the sidelines and don't have any knowledge of what's going on.

One of the reasons that we're in the situation that we're in now, is because we don't have these types of active investors, and that's what's being recreated in the corporate control market. That's what has existed in Germany and Japan for a long period of time.

There was an article in the New York Times the day before, maybe it was yesterday, on the German campaign to do the same things that we did in the past, that is, for the Germans to undo this system where basically the banks play the role of active investors. The fact is, the Japanese have undone it at the behest of corporate managers who didn't like the banks monitoring them. They are now subject to maximum holdings of 5 percent of their equity, which gives them far less incentive to do this monitoring.

A very important part of this problem is, as I discuss about in the prepared statement, is the inadequacy in the executive compensation and reward system. Without this type of effective monitoring and without the kinds of incentives that are given by high pay-for-performance systems that we see in LBO's and other small firms, we really to have top-level managers and middle-level managers that don't care about efficiency and productivity and aren't motivated to make the hard decisions that are necessary to keep us competitive.

You see, it is very complicated to understand why the executive compensation system ends up being as it is, but basically if you're—pardon the word—paid like bureaucrats—in the sense that they're paid in a way that's independent of performance—performance suffers. Such pay systems are the result of strong pressures in the political sector which I think you all witnessed recently when the congressional pay fiasco came up. The public refused to allow the proposed congressional and governmental salary increase which would have brought the Congress back in real terms to what

they were earning back in the 1960's. There is tremendous opposition to large increases in pay, for whatever reason, for whatever validity.

You see the tremendous costs that that's imposing on the Government. We have problems that are at least that large, in the corporate community. There the problem has to do with not the level of compensation, but the way they're paid. CEO's compensation basically is independent of their performance, and it doesn't even vary substantially differently than compensation for a random sample of workers.

Now, this is a real puzzle, and I think it's a disaster for our performance.

Senator ROTH. Let me ask a followup question on individual investors. Are we going to see LBO associations limit investment opportunities for individual investors? Are they a thing of the past? Should they be out of the market?

Mr. JENSEN. They're getting out of the market, and basically the reason is because they don't have an important role to play. Those funds are being institutionalized, and the institutions can figure out ways, complicated ways, to get around Glass-Steagall and other kinds of restrictions that prevent the banks who are the natural people to do this, to appoint outfits like KKR, to be their agents as equity investors. I don't think it's a serious problem if investors are getting out of the market. I think it's a wise thing to do.

Senator ROTH. Mr. Scherer, any comments?

Mr. SCHERER. It is true that the trend is away from individual investors, although that has a cyclical component. When individual investors get burned, as they did in 1929 and again in 1969 and 1987, they tend to exit the market. They tend to exit from common stock ownership, and they tend to return later on as things look better.

I do believe the trend, however, with LBO's is away from the individual investor. It seems to me the real problem is, which way are we going to go? Are we going to restructure with highly leveraged corporations that have strong monitoring and control mechanisms, as Mike Jensen has emphasized, but that pose macroeconomic risks for our economy, or are we going to target the corporate governance failure itself and try to make the directors do a better job monitoring the corporations on whose boards they sit?

Senator ROTH. As long as it's done by Delaware. [Laughter.]

Mr. SCHERER. Sure, and, of course, it will be the way things are structured.

Mr. JENSEN. Might I comment on that. I agree with Fred Scherer, but it depends on how we interpret that, because one of the most dangerous potential outcomes that I see from concern over this issue is an attempt to reform the corporate governance process. Goodness knows it needs reforming. The problem is that we will end up worse off because it's so pleasing to the heart to apply the democratic model that comes with the political system to independent elected representatives to the board of directors. One reason offered for this is to get rid of the CEO as an important determinant of who's on his board. I think this would result in the politicization of the corporation and would be an utter disaster for

American productivity. There are lots of reasons for this, but I think it's an enormously dangerous outcome.

I do think that the corporate governance process needs to be revised, but having a bunch of academics like myself serving on boards with no interest in the outcome and through a process that looks much more like the political sector without all of the controls that the political sector has, would seriously hamper us in international competitiveness.

Senator ROTH. Would the elimination of double taxation of dividends and favorable treatment of long-term capital gains help to serve the same purpose as LBO's.

Mr. JENSEN. It will help a lot with freeing up trapped equity and wasted resources. It won't in and of itself solve the entire problem. It will also free up some of the pressures leading to the increased use of leverage. But it won't stop the increase in the use of leverage. Some of that increase reflects fundamental forces that are above and beyond the tax bias in the system. But I don't know of any economist who would argue that we should maintain the current double taxation on dividends, and the tilt that it induces toward debt.

There are some arguments that we ought to double tax debt. That's like shooting ourselves at least in the knee, if not the foot in the international competitive sphere. But we're moving down that route with legislation.

Mr. SCHERER. I agree with Mike Jensen's analysis. Eliminating the double taxation of dividends would move us away from LBO's, but one has to point out the consequences. Assuming that the same dividend payout ratio was maintained, it is going to cost $30 billion of Federal revenue to do so. And if, as would not be surprising, corporations pay out more in dividends, it is going to cost even more in Federal revenue. So, you have a budget balance problem, or a greater budget imbalance problem, that will ensue.

The second thing that troubles me a lot is that the tax reforms of the past decade have been slanted toward helping the wealthier taxpayer. This would also be the case with eliminating the double taxation of dividends. Of the privately held securities, that is to say, those not held by pension funds, university trusts, and that sort of thing, of the privately held common stock, which is about one-half of all common stock, the wealthiest 2 percent of American families own roughly half. So this would be a benefit bestowed preponderantly upon the wealthiest families, making the existing tax structure even less progressive, or if you will, somewhat less equitable. So even though I endorse this step in principle, I think it would need other changes in the tax structure, increases in marginal brackets for the highest income taxpayers, and, of course, I see that presently as politically infeasible.

Mr. JENSEN. There's something wrong with the way we do this analysis, because the reason we want to reduce the double taxation on dividends is in fact to encourage the payout of those resources.

Senator ROTH. Encourage what?

Mr. JENSEN. The payout of those resources so that they don't get wasted, thrown away on acquisitions and other wasteful investments that we've seen over and over again. If this waste stops, that's a good thing, not a bad thing. And it has to increase tax rev-

enues to the Government and certainly has to increase overall living standards to the extent that those resources are then reinvested through the venture capital market or whatever in more productive uses.

When we do these calculations of the tax losses we assume that all of these real effects are zero. Now, that's the reason for doing it. If there weren't any of those real effects we wouldn't do it. And the other place that it will come out is that we don't have a choice about whether it's going to get paid out. It is a choice of whether it gets paid out in a simple, direct, straightforward way or whether it gets paid out without benefit of double taxation through increased leverage and stock buy backs, and all of the other financial legerdemain which are ways to get around this constraint, which bring with it so many other risks, which make people unhappy. So, we're in a bind. I agree with what Fred Scherer is saying, but if we don't bite the bullet, we can't then turn around and complain about the high leverage and all of the other things. This is one way to undo that, and it will accomplish exactly what we want it to do, which is to move the corporate sector to more productive, efficient internationally competitive pastures.

Representative HAMILTON. Should we do it and take our licks on the budget?

Mr. JENSEN. Absolutely. I think it's much more important than the capital gains reduction.

Representative HAMILTON. In other words, just go ahead and eliminate the double taxation of dividends and you might have a sharp drop in revenue to the Government? Short range, but you think you'd make that up in time; is that it?

Mr. JENSEN. Well——

Representative HAMILTON. Take our licks and go ahead.

Mr. JENSEN. It's a shortrun/longrun tradeoff. I think there are some shortrun costs that the Government bears. I heard it said and I hope it's not true that nowhere is there more short-term thinking than in Washington, DC. I can understand it with a 2-year horizon.

Representative HAMILTON. That's an outrageous attack. [Laughter.]

Mr. JENSEN. Then I agree.

Senator ROTH. About half of the pensions or the stocks and securities are owned by pension plans; aren't they?

Mr. JENSEN. Roughly 40 percent.

Senator ROTH. And most of those are not subject to tax?

Mr. JENSEN. Well, partly that's the result of the tax system that we have. Those dividends aren't going to just sit there. They are going to go back into the economy putting them into venture capital operations which are at an alltime boom in recent times. We get this payout of capital from the corporate sector. But it's occurring in this complicated way. If we could eliminate this double tax on dividends it would make things much simpler.

Senator ROTH. That's all of the questions I have, Mr. Chairman.

Representative HAMILTON. I just wanted to pursue one other topic with you which is a little broader than what we've been talking about.

The Joint Economic Committee has an interest in economic statistics. You may have seen an article in the New York Times the

other day. Just from your standpoint as professionals, what's your judgment about economic statistics? Are they better or worse than they used to be? Do we have a real problem here? How do you assess it?

Mr. SCHERER. You are asking this question to a fanatic on the matter, having been involved in trying to get government statistical programs going and keep them going. I feel that we've taken some hard hits in the last decade.

Take the most fundamental statistic of all, productivity growth. We really don't know how seriously, indeed, if at all, our productivity growth has been lagging because it depends upon the price indices we use to deflate nominal output.

Representative HAMILTON. Do you have less confidence in the statistics you deal with today than you did say 5 years ago?

Mr. SCHERER. Yes, sir, I do, because the economy changes, and in order to keep the statistics good, you have to invest resources in changing your bases, and we have not had those kinds of resources.

Representative HAMILTON. So, you think we have a pretty formidable problem here and you agree with the thrust of that New York Times article the other day?

Mr. SCHERER. I do indeed so believe, especially on this question of LBO's, although there are data available that can be tapped. They've not yet been fully tapped. However, there is a project being proposed to use the quarterly financial report to get a big sample, not just a publicly available sample, but an exhaustive sample of LBO's and study what has happened to them.

Representative HAMILTON. Mr. Jensen, I would like to get your general view on that question as well.

Mr. JENSEN. I guess I'm more like Fred Scherer on some other issues, on the one hand, but on the other—there's some good and some bad here. It turns out most of the statistics that I find valuable and use in my activities are being produced in the private sector now, and I am quite confident in them. One can always ask for more, and it is very easy for us as economists as long as we are spending someone else's money and not our own, to say yes, we want a lot more.

I am not enough of an expert on the broad range of statistics being produced by the Government—since I don't use them all—to make a strong statement about that.

Mr. SCHERER. Could I just add there that one area where the publicly available data are grossly inadequate is on LBO's. Stephen Kaplan has done one of the most careful studies and was able to get data on roughly 70 corporations that went private. There are thousands of them, and Mr. Kaplan found that the 70 or so on which he had data were not necessarily representative of the universe. So, in order to tackle that we need private data.

Mr. JENSEN. Let's be careful. What Stephen Kaplan set out to do was to get all LBO's of more than $50 million that had occurred between 1979 and 1986, and he did. He got data on every single one of them. Not all of them have come back public, and he couldn't get transaction data, valuation data, and things like that. I don't think a public agency could have done any better in at least part of his job because of the power of the subpoena and the ability to get

detailed data. They certainly could have obtained more than he was able to get, but he did get them all.

Mr. SCHERER. The public agencies have those data. The Census Bureau, through the quarterly financial reports, has data on hundreds, probably thousands of companies that went private.

Mr. JENSEN. He could get data on more, but he wanted to look at the largest ones and left it at that. Now, I am not saying that it would be a bad idea to look at another 300 as you go down the size spectrum, but he wasn't inhibited enormously from getting his sample.

Representative HAMILTON. I gather, Mr. Jensen, you don't really have a judgment with respect to that New York Times article?

Mr. JENSEN. I can see the answer going either way. It doesn't impinge on me enough so that I have a strong opinion.

Representative HAMILTON. OK. We've had a good hearing. We've had you working pretty hard here for well over 2 hours.

Thank you Senator Roth and thank you gentlemen for your participation.

Senator ROTH. We appreciate it very much.

Representative HAMILTON. We stand adjourned.

[Whereupon, at 11:45 a.m., the committee adjourned, subject to the call of the Chair.]

CORPORATE TIME HORIZONS

TUESDAY, NOVEMBER 14, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room B-352, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Upton; and Senator Roth.

Also present: Chad Stone, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

Today's is the second in a series of JEC hearings on Corporate Time Horizons, in which we examine whether corporate executives have the right incentives to make the kinds of long-term investment decisions that are necessary for encouraging economic growth, boosting productivity, and making the U.S. economy as competitive as possible.

Our focus today is on the impact of institutional investors, especially pension funds, on capital markets and corporate decision-making.

Our witnesses are Ira Millstein, a senior law partner in Weil, Gotshal & Manges, and chairman of the New York State Pension Investment Task Force.

David Feldman, corporate vice president, investment management, AT&T, who is testifying as chairman of the Committee on Investment of Employee Benefit Assets of the Financial Executives Institute.

And Roland M. Machold, director, Investment Division, State of New Jersey, and cofounder of the National Association of State Investment Officers and the Council of Institutional Investors.

Gentlemen, we're delighted to have you with us this morning. We look forward to your comments and your discussion.

Your prepared statements, of course, will be entered into the record in full. We would appreciate it if you would summarize those statements before we turn to questions.

Mr. Millstein, you may proceed, sir.

STATEMENT OF IRA M. MILLSTEIN, SENIOR LAW PARTNER, WEIL, GOTSHAL & MANGES, AND CHAIRMAN, NEW YORK STATE PENSION INVESTMENT TASK FORCE

Mr. MILLSTEIN. Congressman, it's a pleasure to be here today. I particularly commend the JEC for getting into this subject. I think it's an important one.

There is a tendency to focus on the short term, and I think it has become a cultural characteristic of the 1980's.

Budget Director Darman recently, in what has become known as the "Maypo speech," lamented what he called the "now-nowism" and the lack of a collective sense of moral obligation to the future. He lamented also our collective shortsightedness, our obsession with the here and now, our reluctance adequately to address the future.

This focus on the present is particularly reflected, I think, in corporate behavior, with its penchant for highly leveraged acquisitions.

Peter Rona put it very well in this current issue of the Harvard Business Review. He said, "the very foundation of an LBO is the current actual distribution of hypothetical future cash-flow." He said it's "shifting the risk of future uncertainty to others." Although some say that in a leveraged buyout the trade of equity for debt is a corrective influence on management; a lot of other people feel that it's too much leverage and it really represents nothing more than the mortgaging of a corporation's future to pay out some current cash, one way or the other.

Our declining focus on the future in corporations is also evidenced in R&D. I'm just picking a few examples.

In 1986, the U.S. expenditures for nondefense research and development were 1.8 percent of the GNP, compared to 2.6 percent in West Germany and 2.8 percent in Japan.

These are frightening characteristics because all of us know R&D is important for the future.

Today, what I'd like to talk about is the complex relationship between the institutional investor, particularly the pension fund, and the major U.S. corporations. I believe they have common goals and I believe they bring unique qualities to the table when they meet with one another, so that they can plan for the long term.

I believe that the means of insuring that the private sector goes forward and does become strengthened in international competition absolutely lies in the hands of the corporate governance system, not in any new laws.

I believe that the competitive capability could improve, by virtue of the dominant role large institutional holders are now playing, if they decide to play a responsible, long-term role. And that's the big "if."

I don't think we need to eclipse public corporations. I don't think we need to turn to LBO associations, as Professor Jensen notes. I think, if the corporate governance system works well with the new institutional shareholders, we have the chance of a lifetime to create more competitive corporations.

I suspect what I've been doing recently is acting as a public scold to try to urge everybody to get into that mold. That's what I did as

head of the task force in New York for Governor Cuomo. Our report really was a consciousness-raising effort to tell people how big the pension funds were; how important they were; and to call to the attention of the public, as well as the private pension funds, that it was time for them to start thinking about their broader interests—not just financial, but economic.

And in order to get this into perspective, let me skip away from my prepared statement and talk a little bit about—summarize what it is I'm trying to say, because it's a very simple message.

The universe of investors has changed. It's not a universe of little investors who don't have much of an ability to impact on corporations. This was the old Berle and Means model that everybody worried about.

Today, we're going from diverse individual shareholders to very large institutions who collectively can really determine the outcome of life for many major corporations.

As today's New York Times reports, CALPERS, the California pension fund system, has submitted an enormous array of changes in proxy fund voting to the SEC, intended to give the funds more ability to actually participate in corporate governance.

That it's going to be an important thing that's happening, I don't know. I haven't seen it. But I suspect that we'll be debating it for months to come. And it's good that we'll be debating it.

Now, what's the problem? The problem is that the collective size of these funds has created a perception on the part of management that they are short term; that they are interested only in moving the price of stock up, even if it requires a take over to do it; that they want excess cash-flow distributed; that they want asset values which have been built up and distributed; and that in this way, they are disturbing management's ability to go long term.

Moreover, the funds use money managers who look at the short term, are paid on the short term and are encouraged to go short term. In turn, management fears looking at them because they are all to short term oriented, and management is being driven by financial concerns rather than economic concerns.

Is this reality or perception? I don't care. It doesn't make any difference. The fact of the matter is, that's what management thinks, and if you talk to the CEO's as I'm sure you will in due course, that's what you're going to hear.

So whether, in fact, they are short term or not, the important thing is the funds are perceived to be short term. And this is the way managements are reacting.

Also, it doesn't really make any difference, Congressman, whether it's true or not, because—forgetting about whether they act as short term, long term, whatever—they ought to positively change their attitude and begin to act and support long-term management.

This is the point I'm trying make.

I don't think we have to get into a big fight about whether or not they, in fact, do operate short term and what their turnover is and so on. I think it's interesting, but not outcome determinative.

What is outcome determinative is, will they, the pension funds, take a positive view? Will they take a long-term view? And what does that mean?

Now, I submit that they not only should, but they have to and they can. I don't think that there's any problem with their taking a long-term view.

Now, what do I mean by a long-term view? First of all, I mean they have to begin to think about how big they are and how important they are. They are not small investors whose investment decisions don't impact on the United States. They are very large investors. By the year 2000, institutional investors will own two-thirds of the biggest companies in America. If you take a peek at some of the big corporations today, they're owned 70 to 80 percent by institutions. So they're big. They're important. Collectively, they're very, very significant.

They can no longer invest as if what they do doesn't make any difference to anybody else. It makes a big difference. If they keep their blinders on and do nothing but financial outcome investing, they're going to have a significant, serious negative impact on the economic outcomes of this country.

They have to be aware of the fact that there are other stakeholders, important stakeholders, to whom they have a legal obligation. And I want to underscore that. I am not saying that any other stakeholders can sue them for anything. Their principal and exclusive concern should be the beneficiaries of the fund.

But granting that, they still have to recognize that everything they do impacts on these other stakeholders. Like who?

The sponsor of the fund who puts the fund into being. Whether it's the New York State Legislature or a corporation, that sponsor has a very direct interest in how that fund operates.

The fund, in turn, has an interest in the health of the sponsor. If New York State goes downhill, the employees of the State are not going to do very well. If a major corporation with a pension goes downhill, the pension fund beneficiaries are not going to do very well either.

And they have an obligation to other stakeholders, for example, the companies in which they invest. The funds are the major shareholders of the corporations in which they invest. Accordingly, those corporations are stakeholders in how they act.

The Government is a big stakeholder. Congressman, you created these funds. You created them by giving them enormous tax incentives and tax benefits. I don't think that's a bad thing, but these pension funds don't exist in a vacuum. They exist by virtue of public policy. Public policy decided there ought to be major concessions made taxwise to these funds. Public policy should have a big say in what they do. And if they don't perform the way public policy wants, public policy should do something about it.

The taxpayers, obviously, also have a great interest. Everybody has an interest. That's why we called our report, "Our Money's Worth." We meant it. It is our money's worth. It seems to me we have a right to insist that these funds consider the impact of everything they do. This is a public policy issue.

Now, are there any constraints on this? There are those who will tell you that ERISA says they can't do it; that ERISA says they can only concern themselves with the interests of the beneficiaries and they can't look to the left or the right.

I don't believe that. I believe ERISA, as any fiduciary standard does, has elbowroom. There's plenty of room for discretion. You can still act on behalf of your beneficiaries and, at the same time, worry about the impact of what you're doing. There are ways and ways of investing and there are many ways of doing a variety of things so as to bring about long-term outcomes which impact favorably upon those who are your beneficiaries.

My argument is, they do not have to be blind to the realities of who they are and their new dominant role. And I submit, Congressman, there is no inconsistency at all between meeting your fiduciary duties to the employees and retirees and, at the same time, paying careful attention to the impact of what you're doing. I think that they can pay attention to the long term. They have to pay attention to the health of the economy. And if they do, they'll be meeting their obligations to the fiduciaries.

And, by the way, if they don't and they claim that ERISA won't let them, then I would suggest we take a look at ERISA and see whether it needs changing. I don't happen to think it does. I think it gives them the elbowroom they need right this minute.

Now, if there are any real barriers to changing the activities of pension funds, they don't lie in the law, in my opinion. They can be good, honest, loyal fiduciaries and, at the same time, consider the impact of what they're doing.

To me, the key issue is the attitude. Fiduciaries traditionally take a safe course. That's what they like to do. A bird in the hand is worth a long-term risk—much more valuable than a long-term risk. What we have to do is to see if we can't convince funds by jawboning, public policy discussion, et cetera, that they have an obligation to change.

Now, what kind of things do we want to convince them to do? We want to convince them to vote their proxies, for example, simple things like that. As we can explain later on, a great deal of money today is in index funds. Even pension fund money is in index funds. Index funds traditionally have not voted their proxies. And that means that big quantities of votes don't get voted. Or if they do, they get voted mechanically.

We have to find a way to get the pension funds directly and through their index funds to vote. Vote their proxies. Take an interest in corporate governance. Don't always vote for management. Don't always vote against management. Think and vote, as you should.

Moreover, you ought to also—besides getting involved in corporate governance—and that's a subject in and of itself, which, obviously, we don't have time for this morning—if you're a pension fund, begin to think about optimizing your profits, rather than maximizing. In our view, the job isn't to make the pile as high as possible; it's to make it as good as possible.

We would urge, I, personally would urge, more active management; that is, investing with knowledge of the performance of the companies in which you're investing; taking an interest in the performance of the companies in which you're investing.

If you have $39 billion in your fund, which some funds do, or even if it's only $10 billion in your fund, as little as that, you have a lot of corporations in your portfolio.

So the question is how do you take an active interest in all of them? Well, don't be put off by that question. You can take an active interest in some of them. You can take an active interest in the poor performers. You can screen. You can determine which ones aren't doing well and try to get involved with those.

As to the others, the great, great numbers of them, you can invest with money managers who do take an active interest in performance, rather than simply indexing funds. And to the extent that you're in index funds because you have to be because you have so much money and you can't simply invest in individual companies and pay attention—to the extent that you're in index funds, that's the place where you vote your proxies; that's the place where you pay attention to poor performance; and that's the place where you try to get involved by screening out the poor performers and trying to do something about it.

So there are ways to become an active investor, even if you have $30 or $20 or $10 billion in your fund. In conclusion, what's Congress' role? To me, Congress' role at the moment is consciousness raising. It's an awareness of the need to change attitudes and doing anything you need to do that; it's monitoring the Department of Labor and making sure the DOL speaks correctly on the issue of ERISA and doesn't hobble fiduciaries by narrow interpretations; and it's also monitoring the developments in the field and making sure that attitudes are changing.

Finally, if things don't change, it might be worthwhile to consider a change in the law to encourage a change in attitude. But I don't think it's necessary at this point.

Let me close by simply pointing out what we're doing up at Columbia. As you noted, I am the chairman of the Institutional Investor Project at the Columbia Law School. And what we're doing there, we've just started, believe it or not, is an anthropological study of why fiduciaries behave the way they do.

We are so convinced that the problem is attitudinal, that we're trying to find out what is it in the attitude of fiduciaries that makes them resist being scolded into taking the longer term view.

That is, of course, an exaggeration of what we're doing, but, truthfully, what we're doing is we're trying to take a look at fiduciaries by a couple of professors who have done this work in the law courts. The prior job they did was a study of why people don't like to go to court. They're not lawyers, and they came out with some very interesting results. So now we've turned them loose on why fiduciaries behave the way they do. We'll be done—it's going to take about a year to do—when we get done, I hope there's no problem. Maybe it will all have gone away. But if it's still a problem, we'll be happy to come back and share the results.

Thank you, Congressman.

[The prepared statement of Mr. Millstein follows:]

PREPARED STATEMENT OF IRA M. MILLSTEIN*

Mr. Chairman and Members of the Committee:

It is a pleasure to testify before the Committee today on the role of institutional investors in corporate governance and the capital markets.

INTRODUCTION

The tendency to focus on the short-term has gained recognition as a cultural characteristic of the 1980s. In what has become known as "The Maypo Speech,"[1] Budget Director Richard Darman lamented what he termed our "now-

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* Ira M. Millstein is Chairman of the New York State Pension Investment Task Force. He is also Chairman of the Board of Advisers of the Institutional Investor Project of Columbia University School of Law's Center For Law & Economic Studies and Senior Partner at the law firm of Weil, Gotshal & Manges. He is assisted in these remarks by Holly J. Gregory, an associate at Weil, Gotshal & Manges. The views expressed are informed by these affiliations, but are strictly his own.

1. "I want my Maypo; I want it now."

now-ism" -- our lack of a "collective sense of moral obligation to the future;" "our collective shortsightedness, our obsession with the here and now, our reluctance adequately to address the future."[2] This focus on the present is reflected in corporate behavior, and particularly in today's market for corporate control, with its penchant for highly leveraged acquisitions. Peter Rona put it well when he noted that "[t]he very foundation of the LBO is the <u>current</u> actual distribution of hypothetical <u>future</u> cash flows . . . shifting the risk of <u>future</u> uncertainty to others . . . ."[3] Although some posit that in a leveraged buyout the trade of equity for debt acts as a corrective influence on management,[4] others fear that many such transactions merely reflect the mortgaging of a corporation's future to support current cash distributions.

Our declining focus on the future is also evidenced in our research and development expenditures. In 1986, U.S. expenditures for non-defense research and

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2. Address by Richard G. Darman, Director of the Office of Management and Budget, National Press Club (July 20, 1989).

3. Rona, <u>Letters To The Editor</u>, 89 Harv. Bus. Rev., Nov.-Dec. 1989, at 200 (Rona is President and CEO of IBJ Schroeder Bank & Trust).

4. Jensen, <u>Eclipse of the Public Corporation</u>, Harv. Bus. Rev., Sept.-Oct. 1989, at 61.

development were 1.8% of the gross national product (GNP, far lower than the percentage of GNP our trading partners West Germany (2.6%) and Japan (2.8%) expend.[5] As a percentage of the GNP, our total R&D expenditure has fallen from 2.8% in 1967 to an estimate of 2.6% in 1987.[6] Many other indices of the "Maypo" characteristic have been and will be presented to this Committee. Suffice it to say that most agree that to succeed in global markets, American corporations must adopt a longer-term view.[7] They must overcome the short-term pressures.

Today I would like to talk about the complex relationship between institutional investors -- particularly pension funds -- and major U.S. corporations, their common goals, the unique qualities each brings to their complex relationship, and the opportunity that their relationship

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5. Bureau of the Census, 1989 Statistical Abstract of the United States, Table No. 973 (National Research and Development (R&D) Expenditures as Percent of Gross National Product, By Country: 1972 to 1987), at 578 (1989).

6. Id., Table No. 970 (Research and Development (R&D) Outlays: 1955 to 1987), at 576.

7. See Morita (Chairman, Sony Corp.), Something Basic is Wrong in America, N.Y. Times, Oct. 1, 1989, § 3, at 2, Col. 3; Hennessy (Chairman/CEO, Allied Signal, Inc.), Japan's Market is Closed Drum Tight, N.Y. Times, Oct. 1, 1989, § 3, at 2, Col. 3.

affords in planning for the long term and meeting the challenge of global competition.

I believe that the means of ensuring that our private sector retains and strengthens its international competitive capability lies within our developing corporate governance system. Indeed, competitive capability may well improve because of the now dominant role of large institutional holdings, assuming institutional investors -- and chief among them pension funds -- recognize that they must play a responsible role in corporate governance. What we must seek is a harmony between corporations, with their needs to plan and act over the long term to achieve real economic growth, and pension fund investment and voting policies. We needn't "eclipse" our public corporations by relying only on "LBO associations" organized by Wall Street to achieve a congruity of interest between management and shareholders, as Professor Jensen posits.[8] Rather, we can -- and should -- encourage managements, boards, and pension funds as shareholders -- mutually dependant groups -- to interact in a manner that creates real value over the long term for shareholders and supports the corporation in its struggle for global competitiveness.

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8. Jensen, supra, at 61.

My interest in the positive influence that pension funds -- the largest single institutional investor group[9] -- can have on U.S. corporations and our economy as a whole is informed by my experience as chair of the New York State Task Force on Pension Fund Investment, which was appointed by Governor Cuomo as the first of its kind in the nation to study the broad impact of pension fund investments on our economy. The Task Force's Report[10] recognized that the tremendous accumulation of capital by pension funds imbues their investment and shareholder decisions with substantial and broad economic impact. For that reason, the Task Force Report asserted the importance of public policy in shaping a model for pension fund decision-making. It pointed to the inevitable need to harmonize the public policy objective of providing retirement security to workers with other public policy objectives, such as economic growth and prosperity, which are dependent upon the competitive position of U.S. corporations.

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9. As of 1987, pension funds comprised approximately 43.5% of all institutional investors. _See_ Brancato, _Institutional Investors and Corporate America: Conflicts and Resolutions_, Prepared at the Request of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate (October 3, 1989).

10. _Our Money's Worth: The Report of the Governor's Task Force on Pension Fund Investment_ (June 1989).

THE PERCEIVED SHORT-TERM FOCUS OF PENSION FUNDS

To understand the basis for this need to harmonize, it is necessary to step back and observe how dramatically the nature of shareholding has changed. Within the past fifteen years, corporate shareholders have changed, with the number of private individual investors decreasing significantly and a relatively small group of large institutional investors -- most notably pension funds -- attaining a dominant role. The shift of shareholding in corporate America to pension funds -- fiduciaries representing current and retired employees -- represents a major change in the locus and concentration of power. We are moving away from a universe of very diverse shareholders without much power to effect changes in the corporate system of governance. We are witnessing a shift in the corporate governance balance as pension funds adopt similar investment and shareholding patterns, reacting to situations in a like manner and, sometimes, acting in concert to influence corporate policies.

Corporate managements view this trend with concern because they view pension funds as transients who tend to seek maximum short-term profits and thereby inhibit managements' ability to take risks and innovate -- the core

function of the private sector, if it is to remain globally competitive.

Pension funds are viewed by management as interested solely in maximizing short-term gains on "stock picks" generated by computer programs or some current fashion in investment, not as shareholders supportive of risk and innovation and consequent long-term growth. Whether or not in fact pension funds act as transient shareholders who always seek the quick premium is less important than the fact that managements perceive them to do so. Many managements report that they feel pressured to forego long-term strategies in favor of short-term considerations. A takeover-driven stock market is frequently cited by managers and others as causing an increased corporate focus on maintaining an artificially high stock price, or disposing of free cash flow or built-up asset value to shareholders, all to ward off takeovers. Indeed, many managements cite fear of a takeover as a major reason why long-term concerns such as market share, research and development, innovation, quality and service are subordinated to these short-term stock market concerns, including consistently "pumped up" quarterly earnings and excessively high leverage. And pension funds are cited as a key driving force behind this takeover-focused market,

because many of them seem to perceive it to be their legal obligation -- or at least the safest and least objectionable course to follow -- to sell off their holdings whenever someone bids more than the market price.

The manner in which money managers for the funds are selected has also been cited as adding to short-term pressures on corporations. A year ago, I moderated a colloquium between money managers on the topic "Are Corporations and Institutional Money Managers Caught in a Short-Term Investment Vise?" The discussion, sponsored by the Institutional Investor Project at Columbia Law School's Center for Law and Economic Studies, sought to explore the pressures that inform money managers' investment decisions. The participants cited as a contributing factor to a short-term focus the fact that money managers are often evaluated, hired, compensated and fired based on short-term performance. All too often, that performance is measured quarterly, perhaps only over a year, and principally through market indicators that are strongly influenced by takeover activity and easily become captive to investment fads. As a result, money managers act and tend to move money around based on the "Bird in the Hand" theory: A certain return

now is better than an uncertain return later, regardless of the long-term consequences.[11]

Some suggest that we should not worry whether investors are sufficiently focused on the long term, on the theory that an efficient market will attract each investor to the liquidity and risks he can tolerate.[12] However, this theory fails to recognize that a large group of investors -- pension funds -- have much the same requirements and legal responsibilities and are subject to practical constraints that may limit and channel their behavior with respect to liquidity and risk to produce less than optimal results. Is this the efficiently operating market posited by economists?

THE POTENTIAL POSITIVE IMPACT OF PENSION FUNDS

Reality or perception, pension funds and their money managers appear more disposed to the short term, and their decisions impact on the financial markets and on management. However, the potential positive aspects of the new shareholders is what I'd like to emphasize. Few would

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11. Colloquium sponsored by Columbia University School of Law's Center for Law and Economic Studies (Oct. 21, 1988) (entitled "Are Corporations and Institutional Money Managers Caught in a Short-Term Investment Vise?").

12. See e.g., Allen, From the Bunkers of Index Arbitrage, It's a Fundamentalist Jihad, Wall St. J., Nov. 2, 1989, at A18.

dispute former Deputy Secretary of the Treasury Peter McPhearson's statement that "U.S. management should have a balanced decision-making horizon -- short and long term -- in order to preserve and advance our competitive position in the world." Likewise, most would agree with his statement that pension funds, because of their huge and growing shareholdings in U.S. corporations, "are in an ideal position to help assure that American management takes a balanced time-horizon approach to running their companies."[13] Pension funds are ideally suited to assist U.S. corporations focus appropriately on long-term time horizons for another reason as well: Like corporations, pension funds have long-term, ongoing obligations and, in theory at least, may exist in perpetuity. Thus, as a group, pension funds function in a time frame similar to corporations.

Pension funds are not only a source of retirement benefits for millions of retirees, but also are a primary source of capital in the United States, a dominant force in the capital markets and an increasingly important influence

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13. U.S. Prods Pension Funds Toward Long-Term Planning, The Washington Post, Apr. 5, 1989, at F5 (quoting Deputy Treasury Secretary M. Peter McPhearson).

on corporate management.[14] By the year 2000, it is projected that pension funds will hold over two-thirds of all shares in the large publicly traded corporations. As a primary source of the "patient" capital needed for long-term economic growth (for example, investment in research and development), pension funds hold in trust not only the retirement income of their beneficiaries but also this nation's opportunity for present and future economic vitality.

Coincident with the power they now wield, pension funds can have a substantial positive impact on corporate America and, ultimately, on the course of the American economy. But pension funds must come to recognize that they do not operate in a vacuum; their investment and shareholding decisions impact in direct proportion to their growing size.

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14. Pension funds hold approximately $2.3 trillion in assets, and ownership of an increasing percentage of U.S. public corporations. Pension fund assets have grown at a rate of about 14.6% per year, from $891 billion in 1981 to over two trillion dollars in 1987. In one year alone, institutional ownership in the top 50 corporations has increased from 49% to 52%. Brancato, supra note 7, at 5.

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THE STAKEHOLDERS

Because pension funds have a direct impact on American corporations and our economy, numerous diverse groups -- which, for lack of a better term, I call "stakeholders" -- are beginning to express concern, and rightfully so, about how pension funds operate. The Task Force Report is evidence of that concern. "Stakeholders" are not limited to those with a cognizable or enforceable legal interest in the funds. Rather, they include the wide range of individuals and organizations who have an interest in the investment and shareholding decisions of pension funds. Stakeholders include current retirees and workers,[15] who are the traditional and primary stakeholders as beneficiaries, as well as corporations, both as sponsors of funds and as the entities in which the funds invest.[16] Stakeholders also

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15. Current retirees and present employees have a multiplicity of interests, including but not limited to the payment of retirement benefits. For example, a present employee who is a plan participant has an interest not only in his future retirement security but in his present job security, which requires a healthy employer and a healthy economy. His retirement security may well require a healthy plan sponsor.

16. As sponsors of pension funds, employers generally take on the dual obligation of contributing financially to the funds and participating in the selection of fiduciaries for the funds. As long as they remain going concerns, the health of the funds is inextricably linked to the health of their corporate sponsors. Moreover, as entities in which the funds invest, corporations also have an interest because of the impact that pension funds have on their ability to (continued...)

include the government and taxpayers[17], as well as the general public.[18]

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16. (...continued)
take risks and innovate. As corporations face the threat of takeover, or restructure themselves to enhance their competitiveness, pension funds become an increasingly important source of capital. Corporations themselves have many stakeholders -- including their shareholders, employees, suppliers, customers, and the communities in which they operate -- who are impacted by these decisions. The network of concerned entities is very broad.

17. Taxpayers and government have a substantial interest in how pension funds behave, since these funds -- unlike most other investors -- receive favored treatment. Government and taxpayers promote these funds because of the vital public purpose they serve in providing retirement security. Indeed, the funds have proliferated and have been enabled to amass their substantial assets so quickly because of their favored status: Corporations are accorded tax deductions for contributing to pension funds; the funds themselves are tax-exempt; and employees are generally not obligated to pay income taxes on employer contributions made on their behalf throughout their working years, but are taxed only as benefits are received by them. <u>See</u> I.R.C. § 404(a) (3-a)(i); I.R.C. §§ 501 (a) & (b) (1986). Some state governments provide additional tax benefits to employees by excluding retirement benefits, particularly government pensions, from state income taxation. Finally, the retirement benefits of ERISA pension funds are insured to a certain extent by a government-sponsored pension benefit insurance program. Due to the significant tax benefits and incentives granted -- designed to encourage employers to establish and contribute to pension plans -- taxpayers and government both have a legitimate interest in how these funds operate and how their assets are invested.

18. The general public has an interest in pension funds to the extent that these funds play an important role in corporate ownership decisions and in the functioning of the capital markets, and hence on the functioning of the corporations in which they invest, thereby impacting on the health of our economy and our standard of living.

As the funds become larger and increasingly powerful economic institutions, some observers argue that pension funds may be making investment and governance decisions without considering the obvious impact of their actions upon these varied stakeholders. The world of concern for the fiduciary has, in fact, broadened considerably and become far more complex. But, because of the emphasis put on the fiduciary duty to safeguard fund assets and to invest prudently to avoid any large loss, pension funds, as a collective block of investors, are widely perceived as committed to pursuing traditional, narrow, short-term financial strategies. This role offers little positive reinforcement for a management dedicated to risk, innovation and competitiveness.

Through their "patient" capital, pension funds wield the power either to ensure the stability and the continuity of ownership essential to long-term corporate growth, or to destabilize credible managements by ignoring their plans to achieve real long-term economic growth. Pension funds, whether or not they bear the legal responsibility, do in fact have a substantial responsibility for the course of the American economy.

PENSION FUNDS' UNIQUE CHARACTERISTICS AND CONSTRAINTS

In fairness, one must question the extent to which pension funds can discharge this responsibility. Pension funds have unique characteristics that determine how they invest; they are not investors like you and me, they are fiduciaries. I believe the laws governing them encourage a short-term approach, perhaps not formally -- although this is debatable -- but at least in spirit.

Pension funds are governed by ERISA, the common law and a web of other laws and regulations created in an earlier era. This web of constraints may be perceived to cause fund fiduciaries to invest or vote on shareholder issues in a manner that emphasizes yield, risk aversion, and direct and immediate benefits over (and perhaps to the exclusion of) broader, long-term and more indirect benefits to plan participants. But these traditional legal standards were not designed to guide investment managers in making complex shareholding and investment decisions having a broad economic impact on our corporations and society. Rather, they were intended to ensure that retirement assets are protected against malfeasance.

The law's explicit focus on the duty owed to plan participants gives little guidance on the extent to which

the health of the other stakeholders or the long-term impact of a decision may be factored into investment and shareholding decisions by fiduciaries. Yet, can there be any doubt that being blind to such considerations can have a disastrous future impact on beneficiaries? In my view, the law does not foreclose the fiduciary's consideration of these broader concerns.

THE NEED TO CONSIDER THE MODERN REALITY

Perhaps at the time of their inception, it was reasonable and prudent for pension funds to focus, just as private trust funds normally do, exclusively on short-term financial returns, relying on a market of diverse buyers and sellers (many of them individuals and entrepreneurs) to produce, automatically, an optimal allocation of capital. However, with the enormous impact of the funds' power on our economy, it is clear that pension funds should now take a broader view. Given that pension funds are the largest single investors in our equity markets and thus play a key role in the allocation of capital, it is fair, prudent -- and in the public interest -- that these funds act as our other economic institutions do; that they consider the full impact of their actions, and act in a manner that will foster long-term growth and our country's economic prosperity.

There need be no inconsistency between this obligation and the funds' legal duties to provide retirement income. It seems obvious that without a strong economy, America's workers will not be assured their retirement security, and that this conclusion militates in favor of an economic institution removing the short-term blinders when making shareholder and investment decisions.

The new reality is that the ability of pension funds to provide benefits to plan participants depends on the financial viability of the sponsoring entity, the strength of the corporations that the funds invest in and the health of local and national economies. Pension funds have become so large that they must invest in virtually all investment media, making it difficult for them to grow in an economy that is not growing. There just aren't enough "safe harbors" and "countercyclical niches" for a multibillion dollar pension fund to retreat to if the economy sours. As former SEC Chairman David Ruder recently commented: "In the long run, institutional investors cannot meet the investment objectives of persons whose savings they invest without the existence of healthy corporations and capital

markets . . . . [I]nstitutional managers . . . must take into account the broader effects of their actions."[19]

Because the security and growth of pension funds are inextricably tied to the health and viability of the companies in which they invest and the general health of the economy, the interests of beneficiaries over the long term are largely compatible with the interests of the other pension fund stakeholders. The reality of multiple and mutual interests mandates that pension fund investment goals -- i.e., the best interests of the beneficiaries -- be viewed broadly enough to include not only the traditional concern for risk and return of each investment, but also concern for the economic vitality of the fund's sponsor, the long-term prospects for the corporations in which the fund invests, the integrity of the capital markets through which it invests and, generally, the health of our economy.

THE NEED TO CHANGE ATTITUDES

To the extent that barriers to taking such a broader, longer-term view of the interests of beneficiaries reside in interpretations of the current legal standards governing pension fund decision-making, they should be

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19. Council of Institutional Investors, CII Central Newsletter at 2 (Oct. 1988).

removed. I do not believe legislation is necessary to do so. As we indicated in the Task Force Report, the fiduciary standards imposed by ERISA do not foreclose consideration of the broad, long-term interests of multiple stakeholders. Nor would I suggest imposing on pension fund fiduciaries legal obligations owed to multiple stakeholders -- my recommendation for a broad view of pension fund investment policy is precatory.[20] However, I do believe that clarifying statements by the Department of Labor to the effect that ERISA does not foreclose such considerations would be helpful. At this stage, it is not the law but the attitude of pension fund fiduciaries that must change to meet the challenge posed. I believe that their attitude will change if all the stakeholders (sponsors, investees, government and the public) urge that it change.

I will cite a few examples of how a change in attitude might make a difference. Pension funds have a disturbing history of abdicating their shareholding responsibilities by not participating in the corporate governance process -- either by not voting proxies (as sometimes happens in the case of indexed investments), by

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20. See e.g., Letter from Joseph L. Wyatt to Ira M. Millstein (Nov. 3, 1989), and Letter from Ira M. Millstein to Joseph L. Wyatt (Nov. 6, 1989) (appended hereto as Appendix A).

always voting automatically with management or, on certain issues, by always voting against management without regard to the particular situation of the corporation involved. Although proxies are viewed as plan assets under ERISA and the same fiduciary duties apply to proxy voting decisions as apply to investment decisions, pension funds should think about the impact of their proxy votes on all the stakeholders, not simply vote mechanically so as to show that they have some voting policy. Deliberation on proxy voting requires more active management of investments than now appear to be the case.

The maximization of shareholder profit and the maximization of fund assets -- legal models for accountability written for early twentieth century business conditions -- if followed absolutely may lead too often to short-term asset stripping and speculative gain. A more appropriate model for our times should stress promoting real long-term economic growth -- optimizing the investment.

Optimizing investments requires more knowledge about individual company performance, and, again, more active management of investments than now appears to be the case. With more deliberation by pension funds about proxy voting, shareholder and investment decisions -- all based on

better knowledge of individual company performance and awareness of the impact of their decisions on all the stakeholders -- I believe credible managers will be freed of unnatural short-term pressures, thereby enabling them to better plan for the long term.

THE ROLE OF PENSION FUND SPONSORS

Lest I be charged with day dreaming, I assert that these goals are achievable by fund managers. It may require effort and the careful monitoring of money managers, but it can be done. And if plan sponsors urge that it be done, it will be done.

Just as legislatures may step in to assist pension funds to consider the broad impact of their decisions, sponsors of pension funds -- corporations and again, government -- may assist the funds they sponsor to act as more responsible shareholders.

With respect to the private sector, the board of directors is uniquely positioned to harmonize the corporation's need to plan and develop in a manner that fosters innovation through risk taking, with the funds' concerns -- encouraging the growth of investment assets to ensure the availability of sufficient funds to satisfy retirement obligations. To this end, I urge that through boards,

corporate sponsors articulate responsible investment and shareholder policies for the funds they sponsor, and specifically apply their knowledge of corporations to inform the proxy voting of those funds.[21]

Boards of directors should apply their expertise to the complex corporate governance issues faced by funds as owners of shares with voting rights. Pension fund investment policy should be recognized as an important part of corporate strategy and therefore a commonality of goals between corporations and the pension funds they sponsor should be encouraged. Boards of directors should play a key role in forging this synergy, not by usurping the duties of plan administrators and investment managers, but by setting broad policy.

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21. Because of the ever-increasing complexity of pension funds' shareholding and investment decisions, they require expert guidance. However, the complex legal standards governing the funds' investment and shareholding decisions have led sponsors of pension funds to fear legal liability arising from their fiduciary relationship. This, when coupled with the protection granted by ERISA to a specific investment decision if made by an independent investment manager, has led most corporate boards to encourage their pension fund administrators to delegate control over their funds' investment and shareholding decisions to professional money managers.

THE ROLE OF CONGRESS

What is the role of Congress in this area? The consciousness raising that hearings like this one encourage is a large step toward changing attitudes. And, of course, what public policy and legislatures created, public policy and legislatures can modify and change. What was suitable policy for one era -- encouraging the establishment and growth of pension funds without regard for their broader economic consequences -- may not be for the next era, in which pension funds have amassed outcome-determining power in the financial markets. If pension funds and their sponsors do not voluntarily consider broader investment and shareholding strategies that take into account the long-term concerns of their multiple stakeholders, I have no doubt that Congress can ultimately help them.[22]

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22. In another context, recent legislation has signaled a recognition of the broad interests of various stakeholders in the actions of entities organized to produce goods and services -- the modern corporation. New York recently amended Section 717(b) of the New York Business Corporation Law, to allow directors of corporations -- in determining what the long and short-term interests of the corporation and its shareholders are -- to consider the impact of the corporation's actions upon its current and retired employees, its consumers, suppliers, distributors and creditors. And New York is not alone in taking legislative initiatives which consider non-traditional stakeholder groups. These initiatives indicate legislative recognition that traditional concepts governing fiduciary like relationships are broadening.

A consensus is building -- in academia, the legislatures, and increasingly in business circles -- that any institution whose very being is the result of governmental policy, is obligated to consider the impact of its actions. It cannot blindly pursue a single objective -- be it profit for a corporation or retirement benefits for employees -- without considering the consequences of its actions.

CONCLUSION

I have just articulated a rather broad mandate for how the interests of corporations and pension funds can be harmonized. I recognize there are gaps in implementing this mandate yet to be filled in. But with consciousness raised and thoughtful participants setting out to work, the answers will come. We surely don't have all the answers yet, but these hearings are raising the right questions.

As Chairman of the Advisory Board of Columbia Law School's Center for Law and Economic Studies I am pleased to tell you that we are funding fundamental research on some of these issues. For example, we have just commissioned a study entitled "Strategies, Goals and Motives in Institutional Investor Behavior" by William O'Barr, an anthropologist from Duke University, and John Conley, a

professor of law from The University of North Carolina. Using qualitative anthropological techniques, these researchers will study the decisions made by pension funds concerning the acquisition, holding, and disposition of equity instruments, and the role of institutional investors in the corporate governance process. I will be glad to share the results of the study with the Committee when they are available.

APPENDIX A

Hufstedler
Miller
Kaus &
Beardsley

November 3, 1989

VIA TELECOPIER

Ira M. Millstein, Esq.
Weil, Gotshal & Manges
767 5th Avenue
New York, NY 10153

Dear Mr. Millstein:

It was helpful and instructive to talk with you at the NAPPA committee meeting last Wednesday (November 1), from which I have just returned.

I think much of the controversy surrounding the New York Task Force Report--and opposition to its broader message--would be put to rest if you would make clear publicly what I understood you to tell us Wednesday, namely, that the proposals pose no threat to traditional principles of trust law. More specifically, I understood you to say, during our dialogue, that:

1) pension plan trustees will still be accountable only to the plan beneficiaries, not to any of the five "constituencies" identified in the Report;

2) while the trustees may take comfort in the propriety of considering the five constituencies, they are not required to do so; the suggestion that they do so is but precatory;

3) none of the five constituencies has any enforceable right against the pension plan trustees; and

Ira M. Millstein, Esq.
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November 3, 1989

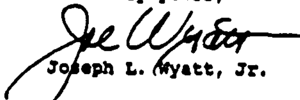
4) the Report does not purport to govern pension plan trustees by the corporate business judgment rule rather than by the traditional trust rule of prudence, or to abrogate the duty of loyalty solely to the beneficiaries.

It follows, then, that pension trustees won't be breaching their trust if they neglect to (or choose not to) consider any of the five constituencies, nor will they be excused from a breach of the duties of prudence or loyalty by attention to any of the constituencies.

Have I got it right? Please advise, because if I do, we all can have further constructive discussions on broader aspects of the Report, especially those relating to public investments and their costs and pre-conditions.

It was enjoyable to meet with you, and I hope we shall see each other again soon.

Sincerely yours,



Joseph L. Wyatt, Jr.

JLW:sls

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November 6, 1989

Joseph L. Wyatt, Esq.
Hufstedler Miller Kaus & Beardsley
35 South Grand Avenue
Los Angeles, CA 90071-3107

Re: New York Pension Fund Investment Task Force Report

Dear Mr. Wyatt:

Thank you for your letter of November 3rd, which I have shared with Lee Smith, Director of the Task Force and Editor of the report. It was a pleasure meeting with you and your colleagues and having a serious conversation on the important matters addressed in the Task Force report, free of the "political hype" about the report thrown about in some quarters.

Lee and I agree that the short answer to the question posed in your letter is "yes." The discussion of multiple stakeholders in the report was directed toward examining the public policy effects of pension fund investments, and was not intended to redraw the legal obligations of trustees and other fiduciaries. In that regard, the Task Force intends that the traditional fiduciary duties (notably, the duties of prudence and loyalty) imposed under ERISA or by applicable state laws should continue to prevail. We agree that consideration of multiple stakeholders by responsible pension fund fiduciary policymakers should be precatory and is to be undertaken only within the scope of their fiduciary duties. In fact, we included language in the report to that effect (pages 21-22 and 58). While we wished to advocate in the report the importance of multiple stakeholders in public policy matters, we did not advocate

WEIL, GOTSHAL & MANGES

Joseph L. Wyatt, Esq.
June 7, 1989
Page 2

changes in a fiduciary's legal obligations to beneficiaries or the creation of legal rights against pension fund fiduciaries on behalf of stakeholders other than beneficiaries.

A plan sponsor (such as a state legislature or the Board of Directors of a corporation) may choose to clarify that pension fund trustees and other fiduciaries may take into account all the economic interests of beneficiaries through the consideration of the fund's multiple stakeholders, to the extent consistent with the fiduciary duties imposed under ERISA or applicable state law.

Having said all that, we wish to emphasize the Task Force's view that consideration of the diverse interests of multiple stakeholders remains the key to conceptualizing an economic strategy and function for large pension funds. After all, as large (and growing) economic institutions, they have a critical role to play in our economy. As suppliers of capital and owners of enterprises they require a broad perspective in order to fulfill over the long-term their objectives in the interests of their beneficiaries. We urge plan sponsors to focus on the appropriate economic goals for their pension funds and to communicate such goals in the form of guidance to their trustees and other fiduciaries.

I hope this letter responds to your concerns and look forward to further discussion with you and your colleagues over the emerging public policy issues relating to pension fund investment.

Sincerely,

Ira M. Millstein

cc: Lee Smith
Richard Koppes

bcc: Phil O'Connell
Jeanne Connelly
Institutional Investors Group

Clifford L. Whitehill
Austin P. Sullivan, Jr.

Representative HAMILTON. Thank you very much, Mr. Millstein. Mr. Feldman, please proceed.

STATEMENT OF DAVID P. FELDMAN, CORPORATE VICE PRESIDENT, INVESTMENT MANAGEMENT, AT&T, AND CHAIRMAN, COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS OF THE FINANCIAL EXECUTIVES INSTITUTE

Mr. FELDMAN. Thank you, Mr. Chairman.

I'm representing CIEBA, an arm of the FEI, and we have within our organization about $450 billion in plan assets. So I think I have to concur with Ira Millstein that it is a very substantive role in the economy today.

I would like to first express my support for the committee's exploration/examination of these issues. They are very complex and they have far-reaching implications, I think, for the capital markets, for corporate governance, and finally, for the global competitiveness of American business.

I also applaud and share your beliefs that any congressional action, if it's required, should be based on the full knowledge of the facts and not on allegations or misconceptions.

One of the concerns my organization has had is in the area of piecemeal legislation. We think piecemeal legislation, each piece of which was well considered, perhaps, and well meaning, can lead to bad policy overall, and it can generate results that are entirely undesirable.

So I hope that your committee's explorations will provide the umbrella under which we can really put together a policy approach.

I'd like to touch briefly on two subjects, some issues that affect the cost of capital for American corporations, and then some observations about pension funds as corporate shareowners.

First, cost of capital issues. As Ira Millstein indicated, with private and public pension plans combined, we've become the single largest source of institutionalized savings in the United States today.

We continue to be a growing and dependable source of capital for investment in the economy.

One area of concern we have as we look forward is that if we adversely affect the formation of pension plans and their continued growth, when you look at the cost of capital, it may in fact be driven upward. And if that happens in a global environment, it makes it even tougher for our businesses to compete.

So we're very much concerned in the long run with helping to keep our own cost of capital down.

Since the enactment of ERISA in 1974, the assets in the private sector have grown from approximately $200 billion to approximately $1.3 trillion. About 45 percent of that, or more than $500 billion, is invested in equities. And that accounts for about 16 percent of the total equity investment in American business.

As you consider legislation, anything that would serve to make defined benefit plans, which are typically substantially invested in equities, less attractive to corporate sponsors than defined contribu-

tion plans, which tend to favor fixed-income securities, is, in our view, counterproductive.

The net effect would logically be that the overall demand for common stocks would decrease and the cost of capital would then increase.

So we think it is very important for Congress to step back and assess the bigger picture in the area of pension fund legislation. The laws affecting the investment of pension assets can't be made in a vacuum and however praiseworthy the various goals may be, they need to be coordinated.

There will be effects on the markets and, therefore, on the cost of capital.

I think it's also important to realize that offering a pension plan is a big-ticket item for most American corporations. And with the changing demographics we're seeing, it's going to get bigger.

We should be looking for ways to encourage the continuation of plans and not make them more difficult and costly. And, in my belief, we should also encourage them in the form of defined benefit plans because that's what our employees tell us they would prefer to have as they look forward to retirement.

On a more general note on the cost of capital, I would like to offer one observation.

There has been a lot of talk about whether program trading, or maybe they mean index arbitrage, should be banned or somehow restricted.

Two years ago, it was portfolio insurance. Two years from now, it may be something else—tactical asset allocation or a variety of other techniques.

What's really causing this concern, I think, is not specific activities; it's market volatility. I think we have to be very careful in terms of banning and restricting and taxing with the aim of reducing volatility, as to what will come from that.

We'd all like higher returns and less volatility. Or at least less downside volatility. If it's volatility going up, that seems to be OK.

But we're in a very dynamic world today and we have to be careful we don't impair market depth and liquidity, which have been the hallmarks of the American markets and the envy of the markets around the world. And, again, in a global situation, if the American capital markets, which are the world leaders today, don't meet the needs of global businesses, I think we'll lose that. And with that loss, we'd lose the control that we would like to see over future actions.

So we want to be sure that we don't end up with less liquid markets that are just as volatile or perhaps more so than they are today.

Toward that end, I would applaud the initiative the committee is undertaking in investigating this. I've also been involved with the committee of the New York Stock Exchange and they are looking to organize a similar blue ribbon panel of CEO's, educators, professional investors, to start looking at what's really happening and what's good and what's not so good about it.

Now I'd like to turn to just a couple of comments on pension funds as corporate shareowners.

In spite of, or perhaps because of, our overall successes, we've had quite a bit of attention focused on pension funds and the role of institutional investors in corporate governance.

The feeling, as Ira Millstein has expressed on occasion, that institutional investors and, particularly, pension funds, may be driving an undue short-term focus on the part of corporate managements.

And as somebody who has that responsibility, I'd like to give you a brief summary of what our practices and investment horizons are as we see them.

We feel we do invest for the long term. We don't think it's prudent to look only at the short term. And I fully agree with Ira Millstein—the ERISA does not require us to do so. Many of us have outside investment managers and we look at their performance over a 3- to 5-year period, or longer.

We did a survey, completed just before I came down here, of one of the large management groups, pension management groups, as to what manager turnover among our outside money managers has been. And it was about 5 percent a year.

So we have been very slow to terminate managers.

Of course, we look at quarterly results. So do corporate managements. But we don't make hire or fire decisions on that basis.

On proxy voting decisions, we do what ERISA requires. We decide on a case-by-case basis what is best for the long-term interests of our beneficiaries.

Takeover-related issues are judged against that same standard. We may, and have, voted with management and against management.

I should add that, in terms of whether the proxies are voted inside the pension management function or by our hired managers, it is our view that they are bound by the same standards, and we have communicated this to each of our active and passive outside managers as to what our policy is in the overall area of proxies and that they should vote on a long-term basis.

And I should stress both of those: they should vote and the vote should be on a long-term basis.

As far as our trading activity is concerned, some funds have actively managed equity portfolios. Some have index funds that have essentially no turnover. And some have a combination of both.

Even active equity portfolios may or may not have high turnover.

In conclusion, I don't doubt that corporate managements are feeling pressure for short-term performance. Most of us, whatever our line of work, feel that pressure.

But speaking for myself, in the 10 years I've had the pension fund responsibilities at AT&T, I have never been pressured to make an investment decision on shortrun considerations, nor have I consciously exerted such pressure on others.

Trying to somehow put restraints on investment behavior of pension funds is not going, in my judgment, to eliminate the pressure managements are feeling.

I should also add that I concur with Ira Millstein's comment that we very much need to be responsible and aware of what actions we are taking over the long term. We are an important part of the process and have to take our actions in a very measured manner.

And to that end, the CIEBA group has been working and is about finished with a code of conduct which would go to issues like this, as to how someone should, in a responsible position, overseeing a lot of money, act on an ongoing basis.

I think we need to talk about solutions and not just list what won't work. I'd offer a couple of thoughts in that direction.

I think perhaps we do need, as institutional investors, to improve our communications with management. We need to help the understanding on both sides of what we're looking for and what the law requires us to do, and what our fiduciary responsibilities are for our pensioners.

On management's side, I think clear communication with the public and their shareowners about their strategies and plans and what they're trying to do makes it much easier for investors to understand and look through dips in short-term earnings, looking for the payoff in future growth.

I think AT&T stock has been a good example. We've had a very longstanding commitment to basic research and long-term investing and the markets have rewarded us for those efforts.

I hope the comments of this dialogue will be helpful. My goal is to make sure American industry is No. 1 in the world and to keep our markets healthy at the same time. If we don't have healthy markets and a healthy financial environment, all the investing skill in the world is not going to make it come out right in the end.

CIEBA is very ready and willing to work with Congress, the CEO groups, and others toward that end.

Thank you.

[The prepared statement of Mr. Feldman follows:]

PREPARED STATEMENT OF DAVID P. FELDMAN

EXECUTIVE SUMMARY

This testimony is presented by the Financial Executives Institute's Committee on Investment of Employee Benefit Assets (CIEBA). CIEBA is a group of corporate benefit plan sponsors with collectively more than $450 billion in ERISA-governed plan assets.

The private pension system is primarily made up of defined benefit (DB) plans, defined contribution (DC) plans, and combinations of the two. In DB plans, the sponsor has a legal obligation to deliver a promised level of benefits, regardless of the level of the fund or how much the fund earns on its investments. Higher fund earnings, therefore, reduce the amount the corporation has to pay to support the promised benefits, and increases the dollars available to reinvest in the company's growth or to pay dividends. This, in turn, can help sponsor corporations be more competitive globally. A recent study found that 80 cents of each benefit dollar in a DB plan is paid for from investment earnings, and only 20 cents from contributions.

In DC plans, the corporation and most often the employees make contributions to the plan. These contributions and the earnings thereon determine the level of benefits to be paid.

The following is a brief outline of the comments and observations set forth in more detail in the testimony:

1. Pension funds continue to be a growing and dependable source of capital for investment in the economy. At year-end 1988, about half of the total $1.3 trillion private sector assets were invested in equities, accounting for some 16% of total equity assets.

2. We believe that the current plethora of pension fund legislative proposals has negative implications for the competitiveness of American corporations in two ways.

The pension obligation is a prominent one for most American corporations. If legislation or other restrictions makes plans more expensive or difficult to provide, the financial health of sponsoring

corporations will be directly affected: even a 1% decrease in net investment earnings over the life of a DB plan can raise required contributions by 20-25%.

If DB plans are affected, employers may shift from DB plans to DC plans. Since DC plans are typically more heavily invested in fixed income securities than equity securities, total investment in equities would logically decline. The overall demand for equities could be expected to fall, raising the cost of equity capital.

We feel that we need to be looking for ways to encourage the provision of pension plans, and further, to encourage DB plans, not make them more difficult and costly to provide.

3. Arguments to ban or restrict or tax various investment strategies to reduce market volatility will have the effect of impeding liquidity, and may not in fact reduce volatility. Since market depth and liquidity have been hallmarks of the American markets, the question must be asked whether or not it is good policy for the competitiveness of American industry to consciously try to cripple liquidity in an uncertain attempt to reduce volatility.

4. Private pension funds are investors for the long term. We attempt to balance short- and long-term considerations to capture the greatest long-term value for our plan participants, and ERISA is consistent with that approach.

5. Many of us employ active equity management strategies, which attempt to outperform the market averages; many of us are entirely "indexed" in our equity holdings, meaning we attempt to replicate the performance of the overall market; and many use a combination of both strategies.

Active equity management, which has been reported to have turnover rates that some consider too high, is not an accurate representation of pension fund equity turnover. Index fund turnover is extremely low, and many who use active management also have very low turnover.

6. Many funds employ outside investment managers. We generally evaluate their performance over a three- to five-year period or longer. We do not make hire-or-fire decisions based on short-term performance.

7. We make proxy voting decisions on all issues, including takeover-related ones, by seeking the best long-term value for our participants, as ERISA requires. That sometimes requires balancing short-term gains against the ability of management to produce longer-term value. We may and have voted with or against management.

TESTIMONY OF

THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

OF THE

FINANCIAL EXECUTIVES INSTITUTE

November 14, 1989

INTRODUCTION

These observations are presented by the Committee on Investment of Employee Benefit Assets (CIEBA), which is a committee of the Financial Executives Institute (FEI).

FEI is an association of approximately 13,000 financial executives representing some 7,000 American corporations. CIEBA itself has 40 regular members and approximately 150 advisory members, all of whom are corporate ERISA-governed benefit plan sponsors with collective assets that total more than $450 billion.

The corporations represented in CIEBA cover a broad range of industry groups and asset size. However, it is important to note that CIEBA members - who manage their plan assets on behalf of more than 6,000,000 union and non-union plan participants - speak from the vantage point of those charged with fiduciary responsibilities under ERISA.

These comments are presented to the Joint Economic Committee to provide some background on the investment of pension fund assets and to comment on related issues being considered by other Congressional committees.

THE PRIVATE PENSION SYSTEM

We believe that, as currently structured, operated, and regulated, the retirement system in the U.S. has been successful in securing retirement income for U.S. workers. It has remained healthy through the best and the worst of times in the financial markets and in the world for some fifty years (and, in some cases, longer), and benefits are more secure today than ever before. It is estimated that the aggregate private plan asset to liability ratio stood at 1.38:1 in 1987, and only about 17% of private plans are estimated to have been funded at less than 1:1 in that year.[1]

This mark of success can be attributed to a number of factors: the tax law which allows assets to accumulate without a tax burden; healthy financial markets over the past several years; and prudent asset management and funding strategies on the part of plan fiduciaries, working under the governance of ERISA since 1974. Besides establishing standards for investment practices, ERISA wisely, in our opinion, gives plan sponsors the flexibility to have investment policies that can evolve with the markets, subject to prudent expert tests. As a result, sponsors have been able to enhance fund returns and improve diversification by investing in a broad range of financial instruments and investment opportunities, some of which did not exist in 1974 when ERISA was crafted.

For American companies with defined benefit pension plans, enhanced returns have contributed to lower sponsor contributions, which in turn frees up more cash for investment in growth. According to a recent study at the Frank Russell Company, at least 80 cents of each benefit dollar in a defined benefit plan comes from investment returns, while 20 cents comes from contributions. For companies with defined contribution plans, retiree benefits have been directly enhanced, providing a better quality of retirement life for employees without added cost to the corporations.

Few countries in the world place the retirement income burden so heavily on the private sector as does the U.S., and thus far, the results speak eloquently for caution in considering any changes. *We urge the*

[1]Source: Employee Benefits Research Institute

Committee to hold that thought in mind, and to be alert in examining the issues to the unintended implications for pension funds, in terms of benefit security, corporate competitiveness, and general economic efficiency. It is crucial that policy in such a critical area as employee benefits not be made in a piecemeal, disjointed way.

THE PRIVATE PENSION SYSTEM: DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

Corporate plan sponsors operate within a system of economic checks and balances that goes beyond the essential legal framework. It is created by the economic nature of the pension system itself. Corporate plan sponsors understand that economic prudence, not just legal prudence, on behalf of both the plan participants and the corporate shareholders, requires a careful and continuous assessment of the tradeoffs between the opportunity to reap investment gains and the risk of loss.

In defined benefit plans, the sponsor has a legal obligation to deliver a promised level of benefits to the participants. Employees generally do not make contributions to defined benefits plans. The benefits are paid for by a combination of corporate contributions and the earnings on the investment of those contributions, although the *obligation* to pay benefits is independent of the level of fund assets and earnings thereon. In 1987, defined benefit plans comprised approximately 27% of private plans, but accounted for 66% of trusteed private plan assets and, in 1985 (the most current data available), covered 72% of private plan participants.[2]

Defined benefit plan participants and the corporate shareholders both benefit from investment policies aimed at maximizing pension fund returns subject to prudent risk-taking. For participants, higher fund earnings increase the security of benefits, and create less reliance on the corporation's ability to make future contributions. For shareholders, *higher earnings reduce the amount they will ultimately have to pay to support a given level of benefits, and increase the dollars available to reinvest in the company's growth or to pay dividends. This, in turn, can help American companies be more competitive globally.*

[2] Source: Employee Benefits Research Institute

Similarly, participants and shareholders alike have a stake in controlling pension investment risk. *If the value of contributed assets is decreased by investment losses, the participants will have to depend more heavily on future corporate contributions to secure their benefits. The shareholders will be required to pay more to deliver promised benefits, possibly detracting from the company's competitive position.* Ultimately, it is the corporation and thus the shareholder - not the participant - who bears the risk of inadequate returns or investment losses in a going concern's defined benefit plan.

Many companies provide both defined benefit and defined contribution plans; some offer only one or the other. In a typical defined contribution plan, both the plan sponsor and the plan participants contribute specified amounts to the pension fund These contributions, together with the earnings thereon, provide the funds available for paying benefits. The participant, therefore, again stands to benefit from investment strategies aimed at maximizing return and controlling risk. The shareholder, although he has a less direct stake in a defined contribution plan than in a defined benefit plan, has an interest in prudent asset management because significant losses or relative underperformance would result in lesser benefits and undoubtedly adversely affect employee welfare, morale, and productivity.

THE PRIVATE PENSION SYSTEM, THE CAPITAL MARKETS, AND AMERICAN CORPORATIONS

In addition to its achievements in securing benefits and helping to keep pension obligations from detracting from corporate earnings, the private pension system, in combination with the public sector system, has become the single largest source of institutionalized savings in the U.S. today. Despite a savings rate in the U.S. that compares unfavorably with that of other industrialized nations (4.4% in 1988, compared with, for example, 15% in Japan and 13% in West Germany[3]), pension funds have continued to be a growing and dependable source of capital for investment in the economy. *As of the end of 1988, 16% of total equity assets,*

[3]Source: The Organisation for Economic Co-Operation and Development (OECD), June 1989 Outlook

and 7% of total bond assets, were held by private funds. Public funds held some 7% of total equity assets and 8% of total bond assets.[4]

There is concern among our members that some measures being actively considered by various Congressional committees may, either separately or in concert, have an effect on the distribution and/or level of this investment and an adverse effect on corporate capital formation. The reasoning for our concern is as follows. Some of these measures, such as anti-reversion and taxation proposals, make defined benefit plans less attractive to employers, since any added cost or risk must be borne by the employer, not the employee. This in turn will likely cause more employers to shift from defined benefit plans to defined contribution plans. *Since defined contribution plans are typically more heavily invested in bonds or bond-like fixed income securities than defined benefit plans, total investment in equities would logically decline. A shift away from equities would tend to lower the demand for equities and might thus make it more difficult and expensive for corporations to raise equity capital.*

Our view is that there is a need for Congress to step back and consider the larger picture of what comprises sound retirement income policy, and what the effects of adhering to such a policy are for the competitiveness of U.S. corporations. *Laws and regulations affecting pension fund investments cannot be made in a vacuum; there will be effects on the markets, and therefore on the cost of capital for corporations.* Measures should be taken only with full knowledge of what these results might be.

Pension plans are a prominent item in the financial pictures of most American corporations, and they will only become more so as the population ages. We believe that public policy in the pension area should encourage the continued provision of pension plans. *If providing plans becomes more expensive and difficult, the financial health of the sponsoring corporations will be directly affected: if, for example, new laws were passed that would cause even a 1% decrease in net investment returns over the life of a defined benefit plan, required contributions would increase by 20-25%, according to an actuarial rule of thumb.* Further, we believe that

[4]Source: Employee Benefits Research Institute

particular care should be taken to encourage plans in the form of defined benefit plans, which, besides being relatively more beneficial for capital formation, are generally held to be most advantageous for participants.

INVESTMENT OF PLAN ASSETS

ERISA requires that fiduciaries discharge their duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan".[5] This requirement means that plan fiduciaries must make investment decisions to provide the best possible assurance that the pension promise will be honored; therefore, the overall fund return should be maximized subject to a prudent level of risk. The appropriate level of risk is determined by a variety of factors, including the plan's projected payout obligations, the extent to which assets already in the fund cover projected liabilities, and the ability of the corporation to make future contributions.

In the investment process, the first and most fundamental decision made is the asset allocation decision, or what proportions of the fund should be invested in various asset classes such as stocks, bonds, real estate, etc. The allocation decision is based on analysis of the risk/return characteristics of alternative investments, the correlations among their return patterns, the fund's liquidity needs based on anticipated contributions and payouts, and other factors. The risk of the total portfolio is reduced by diversifying investments among and within asset classes, because judicious diversification serves to offset underperformance in some assets with overperformance in others. ERISA, in fact, explicitly charges fiduciaries to "diversify . . . the investments of the plan so as to minimize the risk of large losses . . .".[6]

Some of the investments included in a well-diversified portfolio could be judged in and of themselves to have a relatively high element of risk. These kinds of investments can prudently be included if analysis of

[5]Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(A)
[6]Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(C)

the factors listed above indicate a good fit with the rest of the portfolio and a beneficial effect on the financial health of the total portfolio. If the pattern of expected returns has a low correlation with other assets in the fund, the inclusion of such assets can increase the expected return of the total portfolio without proportionally increasing (and sometimes actually lowering) the total portfolio risk.

LONG-TERM INVESTMENT HORIZON OF PRIVATE PLAN SPONSORS

After the asset allocation decision is made (or revised), the funds are committed (or shifted), either by means of "in-house" investing or through independent investment managers. *It should be emphasized that the asset allocation does not typically change significantly over the short term, and plan sponsors, governed by the long term nature of pension payout obligations, generally invest with a long term view.* Although liability profiles differ among corporations, sponsors are generally less concerned with short term movements in valuations of asset classes than with longer term expected returns of the entire diversified portfolio.

Recently, attention has been brought to bear on increased short term asset turnover among "active" investment managers (i.e., those who attempt to exceed the return level of the overall market), some of whom manage pension fund dollars and, it has been postulated, trade more frequently because of pressure for short term performance from plan sponsors. It is our belief that *most sponsors generally evaluate the performance of their investment managers on a three- to five-year time horizon or longer*, which suggests that longer term evaluations are the more general rule.

As noted above, pension funds differ with respect to their funded status, their risk tolerance, and their liability profile; their investment behavior necessarily differs as well. Pension funds do not all sell at the same time, or all buy at the same time. In addition, their equity investment strategies differ due to the factors noted above as well as to differing views as to the best way to achieve maximum returns over the long term.

Some funds are entirely "indexed" in their equity holdings; that is, they invest in funds that replicate the returns of the overall market. These funds have extremely low turnover rates. They are long-term suppliers of capital that essentially ignore short-term performance. Other funds attempt to outperform the market by utilizing active management strategies, or use a combination of both strategies. The latter case may *or may not* result in a high turnover rate. Active management does not necessarily translate into high turnover.

If trading volume among active managers has in fact increased, *it is important to note that it does not necessarily follow that total equity turnover in pension funds has increased.* As noted above, active equity is only one strategy for equity exposure that some funds use. There are other trends in pension fund management that we believe would balance out an increase in active management turnover across the total fund. First, pension funds have substantially expanded their investments with "index" investment managers. As of the end of 1988, approximately 34% of private funds used equity index strategies.[7] Trading activity in these accounts is initially non-existent, and is extremely low overall. Second, pension funds have increased their investments in the private markets, such as real estate investments, venture capital, etc. Such investments are long term in nature and normally are not traded actively nor through the public markets at all.

The Financial Executives Research Foundation (FERF) is undertaking a project to study the investment behavior of private pension funds. We hope that the results will provide some hard evidence in support of the beliefs of our members.

It should also be noted that many of our members do not subscribe to the view that active trading per se is necessarily undesirable for the markets. Active trading contributes to overall market efficiency and investment liquidity, which adds to the attractiveness of an investment for most investors and to a lower cost of capital for corporations.

[7]Source: Merrill Lynch Capital Markets

In fact, the liquidity and level of market efficiency in the U.S. markets have been a model for markets all over the world. Markets in other countries are today still striving to compare favorably. While some now say, citing market volatility, that we may have "gone too far," *the question must be asked whether or not it is good policy to consciously try now to impair liquidity in an attempt to "fix" volatility.* Since a less liquid market will make owning equity investments more risky, *it must be understood that almost certainly the cost of capital for American corporations will increase, and that will re-situate American industry in terms of its competitiveness with its international counterparts.* Japanese companies, for example, already enjoy a lower cost of capital than do American companies.

It is certainly true that volatility exerts upward pressure on the cost of capital as well. *But we must carefully weigh the hopeful benefits of the fix against the by-products:* how does impeding market liquidity, in order to attempt to reduce volatility and thereby lower the cost of capital, balance out against the certain increase in cost of capital that American corporations will be forced to pay *because* of impeded liquidity? Moreover, we cannot know whether or not measures to impede liquidity will in fact be effective in reducing volatility. We could be left with markets that are less liquid and as volatile, or more so, than they are today.

PENSION FUND INVESTMENTS IN LEVERAGED BUYOUTS (LBOs)

The 1980s have been a time of heightened corporate restructuring activity of many kinds, including divestitures, asset sales, mergers, acquisitions, and LBOs. Much of this activity, we believe, can be attributed to changes in the optimal mix of corporate assets and business ventures demanded by a rapidly-changing business and economic environment that is growing increasingly globalized and increasingly competitive. Another impetus, we believe, is an unwinding of some of the conglomeratization activity seen in the 1970s.

LBOs, not unlike venture capital, are long-term, illiquid investments, typically structured with a four- or five-year time horizon with only minimal returns, or none at all, expected in the early years. Contrary to conventional wisdom, LBOs are another kind of long-term investment that some pension funds engage in.

According to our CIEBA member survey, about 30% of our members commit funds to these investments in an amount totalling approximately 1% of our assets. Sponsor fiduciaries who do invest in LBOs do so because they provide a high level of expected return and they enhance the return of the overall fund.

PROXY VOTING ISSUES

Although pension funds purchase equity securities for investment rather than control purposes, we are ipso facto owners of corporations as well. With ownership comes the responsibility to exercise ownership rights, including the voting of proxies. *In accordance with ERISA, these voting decisions, like investment decisions, must be made solely for the purpose of furthering the interests of plan beneficiaries. For a change of corporate control or other takeover-related issue, this requires approaching the decision with no bias toward either the existing management or the potential acquirer (if there is one), and analyzing each issue to assess where the greatest value lies.*

In a takeover situation, where a tender offer has been received, the same rules apply. We may tender our shares, or we may decide to hold on the belief that the existing management is most able to make profitable use of the corporation's assets. *We do not favor one course of action over the other, nor does ERISA require us to do so.* The Departments of Treasury and Labor issued a joint statement earlier this year in support of that view, and we are on record in previous Congressional testimony as early as March 1986.

Observers of pension fund investment activity note that pension funds are often involved in a significant way at a time of takeover activity, especially in voting proxies or tendering shares in response to an offer. This is neither an indication of a short-term orientation nor of a policy of investing in takeover candidates. Large funds with broad-based equity investments will often hold stocks that at some point become involved in takeover activity and must respond, as all investors must, to tender offers or proxy voting questions. *They may have held these stocks for long periods of time and may or may not have any funds*

committed to LBO investments -- they are involved simply because they have a broad base of investments and must respond as any investor to issues of corporate governance that require shareholder action.

As required by last year's Department of Labor opinion letter regarding proxy voting decisions, such decisions are made either solely by the sponsor, or solely by the investment manager who is managing the investment. If the sponsor does not reserve the right to make the voting decisions, it cannot interfere with the decisions of the investment manager, who will have been charged to vote according to the best interests of the plan beneficiaries.

Representative HAMILTON. Thank you very much, Mr. Feldman. Mr. Machold, please proceed.

STATEMENT OF ROLAND M. MACHOLD, DIRECTOR, INVESTMENT DIVISION, STATE OF NEW JERSEY

Mr. MACHOLD. I appreciate your invitation to appear before you and I hope that I can add to your store of knowledge on the complex issues which you are considering today.

As you noted, I'm director of the Division of Investment of the State of New Jersey and affiliated with the National Association of State Investment Officers and the Council of Institutional Investors.

In the aggregate, these organizations, which are not related to one another, have over 100 union and public fund members with in excess of $600 billion of assets under management.

However, I should stress that I'm not empowered to speak on behalf of the members of these groups, who, in every case, reserve the right to speak on their own behalf.

My summary response to the question of whether institutional investors influence corporate horizons is to express surprise that investors such as ourselves have any influence at all over corporations.

It has been my experience that, with one exception, no corporation has ever advised us of their forward planning and solicited an opinion from us.

The division of investment holds over 4 percent of the stock of about 20 corporations and only 1, the Barnett Banks of Florida, has made a courtesy call on the division and discussed their forward planning, even though we've invited many.

The Council of Institutional Investors has tried to improve the nature of the dialogue between investors and corporations about the level of just formal disclosure and public relations by proposing to form advisory committees to corporate boards, but corporations have turned down this proposal at every turn.

While there's no evidence of direct influence by institutional investors on corporate horizons, there is public concern about indirect influence, through short-term trading horizons, computerized trading, passive investments, portfolio insurance, program trading, and index arbitrage.

In lobby lingo, this has been reduced to the concept that institutions are traders and are only interested in the next quarter's investment performance and, consequently, corporations are penalized if their investments in research and capital expenditures detract from current earnings.

The spokesmen for this point of view then go on to conclude that short-term trading should be penalized and that shareholders should not be empowered to influence management's decisions and, not incidentally, its continuity.

This concept and line of reasoning are simplistic and are not supported by the facts. To be sure, there are some investment portfolios which are actively traded. But the analysis of the October 19, 1987, crash showed that at that time, such investors were few in

number and that, on balance, institutional investors were significant net purchasers on that day.

The contention that institutional investors are only interested in short-term gains is also inaccurate. I recently attended the annual meeting of the National Association of State Investment Officers and I asked for a show of hands of those who had in excess of 20 percent turnover in their portfolios, which is a very low number, reflecting only simple portfolio rebalancing and straightforward investment decisions.

Of the 37 funds present, representing about $450 billion in assets, only six hands were raised. And when I asked how many had in excess of 50 percent turnover, no hands were raised.

Similarly, the Council of Institutional Investors has polled its members and the average turnover is in the 10- to 15-percent range, which represents an average holding period of over 5 years.

In our own case, our stock portfolio turnover was 19 percent in fiscal year 1989, which includes the final stages of our South African divestment program which incurred additional turnover.

The average holding period of our stocks is presently 5.6 years.

In addition, I have asked the NASIO group how many were engaged in index arbitrage. And out of 37, only 1 raised his hand and such activity represented only a very small portion of his portfolio.

Insitutional investors are also depicted as supportive of corporate takeovers in order to realize short-term gains. Again, the issue is more subtle and complex than depicted.

For instance, individual takeovers have virtually no effect on large diversified portfolios.

In the case of the Pillsbury merger, our funds held over 2.6 million shares of the company, and when the merger was announced, we instantly generated a paper profit of over $20 million.

However, this amount was only 0.1 percent, one-tenth of 1 percent of the portfolio and have virtually no effect on portfolio performance.

Institutional investors are also depicted as being so short-term oriented, that corporate investment in research and in capital expenditures are penalized. Again, this is not an accurate statement.

Many companies with such investments command high prices in the market place relative to their earnings and asset values, particularly pharmaceutical companies, telecommunications companies, and other technology-related companies.

Furthermore, it is simplistic to say that long-term planning and expenditures for research and capital are intrinsically good and short-term horizons are intrinsically bad.

Both planning horizons must meet the test of performance. The Nation's largest automobile company has spent billions for many years for new technologies and new plant and equipment and yet, the company is not profitable in the United States and its competitors have performed better with fewer resources.

Similarly, short-term horizons are important in rapidly changing economic circumstances, as was illustrated by the case of many of the Nation's oil companies who sharply expanded capacity at a time when oil prices were at an all-time high.

Finally, I should take note that expenditures for research and development seldom exceed 2 percent of a company's revenues, and

are not a significant factor in the considerations of corporate takeovers. Even in the case where a corporation was taken over, it's unlikely that the acquiring company would abandon research and development projects which would assure a fair return and the continuity of the company.

I believe that the shorter term corporate planning horizons may be due to a variety of complex economic factors. For one, at present, over 80 percent of American manufacturers are subject to international competition, compared with only a small percentage as recently as 1970.

Second, the rate and dissemination of technological change have accelerated.

Third, high real interest rates have increased the discount rates which are used to calculate the present value of future returns on investment. Factors such as these have combined to increase the risk of corporate investments and to shorten the time horizon for such investments.

The reasons for passive investment management are clear. For one, our portfolios are very large and require broad diversification. Furthermore, stock markets in the United States are extremely efficient and corporate information and analysis is widely and quickly disseminated, so that any investor would have to outguess the combined wisdom of the market place in order to gain a trading advantage.

Consequently, the investment of new money, or the reallocation of portfolios between asset classes, which are routine decisions, can readily take the form of program trades, where substantial transactions in a large number of stocks are executed simultaneously. Program trades are facilitated by the enhanced computer capability of the exchanges and are reasonable in view of the time-consuming and expensive alternative of executing orders one at a time.

I am concerned about program trades which are executed as an arbitrage between the cash value of a basket of stocks and the value of stock futures. I am concerned that such arbitrage, which is performed primarily by professional traders and not large institutional investors, creates greater market volatility. This is a subject of considerable academic analysis and the papers every day present a new conclusion.

My own instinct is that index arbitrage may add to volatility over the short term of a day or two, but I have no conviction that it does over the longer term.

As I have indicated, I believe that it is inaccurate to characterize institutional investors as being only interested in short-term returns, corporate takeovers, and high levels of trading. The facts show that the large institutions with which I am familiar, which in the aggregate represent a significant portion of the market for corporate equities, invest for the long term, do not penalize corporate investments in research, and are deeply concerned with the level and quality of communication with corporate managements.

I would like to turn to the second part of the simplistic postulate; namely, that having assumed that institutional investors have short-term horizons, then corporate managements should not be accountabe to their shareholders, but, instead, perhaps to a larger

and undefined group of stakeholders. And, further, that such investors should be penalized by taxing short-term gains.

There has been a concerted effort by corporate managements over the past 10 years to modify the rights and roles of shareholders. These efforts are illustrated by the introduction of corporate managements of shark repellants such as staggered boards of directors, blank-check preferred stocks and poison pills.

The Securities and Exchange Commission has reviewed the effect on the market of these modifications and has concluded that shark repellants have a negative effect of between 1 and 6 percent on stock prices, and that poison pills have a negative effect of 2 percent on average.

The introduction of such changes in corporate charters and bylaws has had the effect of disenfranchising shareholders and changing the very essence of corporate ownership, with a consequent devaluation of securities and potentially negative effects on the cost of capital for prospective issuers of similar securities.

Stocks without full voting rights have no contractual integrity and no assurance of any returns or any recourse. In effect, a new class of securities is being invented, one which is subordinate to all other classes—a junk stock.

My second concern is the question of accountability. If corporate managers are not accountable to shareholders, then who are they accountable to?

A concept is being advanced that the shareholder is only one of numerous stakeholders, and that the corporation's obligation for performance is diffuse and at the discretion of corporate management.

As advanced, this is a very imprecise concept. I believe that the stakeholders concept is already defined by many laws which define equal opportunity, environmental responsibilities, labor rights, community interests, et cetera.

Institutional investors such as ourselves support all the laws which define good citizenship by corporations, which collectively define the social responsibilities of U.S. corporations by common standards.

However, I am concerned where the stakeholder concept is undefined and is left to the discretion of individual corporate managers, who are themselves parties in interest to their own decisions. In this respect, I cannot help but notice the sharp increases in management compensation which have occurred over the period that corporations have become more insulated from shareholder votes. This compensation has been measured in the tens of millions of dollars, and in one case, has exceeded a billion dollars.

If corporate managers are to be accountable only to themselves, then as a nation, we have regressed to the oligarchies of many years ago. I believe that the accountability to shareholders provides the necessary focus to maximize the effectiveness and competitiveness of American corporations.

Finally, I would like to reflect briefly on proposals to penalize investors, such as the Dole/Kassebaum bill to tax short-term profits of pension funds.

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My own view of the bill is that it would not reduce short-term trading, since the trading community is not affected and, in any event, trading could easily move offshore.

Second, the proposed tax is unlikely to raise a stable source of revenue for government since the payment is at the discretion of the taxpayer.

Third, in the case of public funds such as ourselves, the bill would impose a tax on our taxpayers and our pension fund beneficiaries. And to the extent any taxes were paid, such shortfall would have to be made up over time by appropriations from our State treasury.

Finally, as in the case of most taxes, the cost would eventually be passed on to the users of capital in the form of higher capital costs.

Thank you for the opportunity to address you today. I welcome any questions you might have.

[The prepared statement of Mr. Machold follows:]

PREPARED STATEMENT OF ROLAND M. MACHOLD

Chairman Hamilton, members and staff of the Committee, fellow speakers and members of the general public, I appreciate your invitation to appear before you, and I hope that I can add to your store of knowledge on the complex issues which you are considering today. The issue you defined in your invitation is the role of institutional investors in influencing the decision-making of corporations and corporate time horizons. I will try to address this issue directly, and also reflect briefly on the many complex issues that are related to corporate governance, active and passive investment, index funds, program trading, index arbitrage, the stakeholders concept, taxation of short term profits, conflicts between state and federal law, the nature of the "ownership" contract, the changing economic circumstances of corporations, and other issues.

For the record, I am Director of the Division of Investment of the State of New Jersey. In addition, I am a founding trustee of the National Association of State Investment Officers and the Council of Institutional Investors. On two occasions I have been Chairman of the former organization and I am presently Co-Chairman of the latter organization. In the aggregate, these organizations (which are not related to one another) have over 100 members with in excess $600 billion of assets under management. However, I should stress that I am not empowered to speak on behalf of the members of these groups, who in every case reserve the right to

speak on their own behalf. Furthermore, the views I set forth are my own and not those of the administration in New Jersey.

My summary response to the question of whether institutional investors influence corporate horizons is to express surprise that investors such as ourselves have any influence at all over corporations. It has never been my experience that, with one exception, any corporation has ever advised us of their forward planning and solicited an opinion from us. The Division of Investment holds over 4% of the stock of about 20 corporations, and only one, the Barnett Banks of Florida, has made a courtesy call on the Division and discussed their forward planning. The Council of Institutional Investors has tried to improve the nature of the dialogue between investors and corporations about the level of formal disclosure and public relations by proposing to form advisory committees to corporate boards, but corporations have turned down this proposal at every turn. A true dialogue is very difficult due to the fears of corporate managements in regard to takeovers. However, from our point of view, we are the shareholders and significant owners of American corporations, and such a dialogue would be valuable to both parties.

While there is no evidence of direct influence by institutional investors on corporate horizons, there is public concern about indirect influence, through short term trading horizons, computerized trading, passive investments, portfolio insurance, program trading and index arbitrage. In lobby lingo this has been reduced to the concept that institutions are traders

and are only interested in the next quarter's investment performance, and, consequently, corporations are penalized if their investments in research and capital expenditures detract from current earnings. The spokesmen for this point of view then go on to conclude that short term trading should be penalized, and that shareholders should not be empowered to influence management's decisions and, not incidentally, its continuity.

This concept and line of reasoning are simplistic and are not supported by the facts. To be sure, there are some investment portfolios which are actively traded, but the analysis of the October 19, 1987 crash showed that at that time such investors were few in number, and that, on balance, institutional investors were significant net purchasers on that day. For my own part, I invested over $100 million of our state pension funds on the afternoon of October 19, 1987. Similarly, when the stock market fell 190 points this October, we quickly doubled all of our buy orders. It is the natural inclination of professional investors to take advantage of market weakness and to initiate buy orders under such circumstances.

The contention that institutional investors are only interested in short term gains, and will sell a stock at the slightest whiff of an earnings downdraft, is also inaccurate. I recently attended the annual meeting of the National Association of State Investment Officers (NASIO), and I asked for a show of hands of those which had in excess of 20% turnover in their portfolio, which is a very low number reflecting only simple

portfolio rebalancing and straight forward investment decisions. Of the 37 funds present (representing about $450 billion in assets), only six hands were raised, and when I asked how many had in excess of 50% turnover, no hands were raised. Similarly, the Council of Institutional Investors has polled its members, and the average turnover is in the 10% to 15% range, which represents an average holding period of over 5 years. In our own case, our stock portfolio turnover was 19% in fiscal 1989, and the average holding period of our stocks is presently 5.6 years. In addition, I asked the NASIO group how many were engaged in index arbitrage, and out of 37 only one raised his hand, and each activity represented only a small portion of his portfolio. I cannot speak for corporate pension funds, endowments and foundations or mutual funds, which are not members of these organizations, but it is evident that a significant amount of institutionally managed funds are not active traders and do have long term investment horizons. Furthermore, in speaking with these investors, I have never heard of any pressure for quarterly performance. In my own case, I report in full to our State Investment Council only once a year.

Institutional investors are also depicted as supportive of corporate takeovers in order to realize short term gains. Again, the issue is more subtle and complex than depicted. For one, individual takeovers have virtually no effect on large diversified portfolios. For instance, in the case of the Pillsbury merger, we held over 2.6 million shares of the company, and when the merger was announced, we instantly generated a paper profit of over $20

million. However, this amount was only 0.1% of the portfolios and had virtually no effect on portfolio performance.

Institutional investors are also depicted as being so short term oriented that corporate investment in research and in capital expenditures are penalized. Again, this is not an accurate statement. Many companies with such investments command high prices in the market place relative to their earnings and asset values, particularly pharmaceutical companies, telecommunications companies and other technology - related companies. Furthermore, it is simplistic to say that long term planning and expenditures for research and capital expenditures are intrinsically good, and short term horizons are intrinsically bad. Both planning horizons must meet the test of performance. The nation's largest automobile company has spent billions for many years for new technologies and new plant and equipment, and yet the company is not profitable in the United States and its competitors have performed better with fewer resources. Similarly, short term horizons are important in rapidly changing economic circumstances, as was illustrated by the case of many of the nation's oil companies, who sharply expanded capacity at a time when oil prices were at an all time high. Finally, I should note that expenditures for research and development seldom exceed 2% of a company's revenues, and are not a significant factor in the considerations of corporate takeovers. Even in the case where a corporation was taken over, it is unlikely that the acquiring company would abandon research and development projects which would assure a fair return and the continuity of the

company.

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The reasons for passive management are clear. For one, our portfolios are very large and require broad diversification. Furthermore, stock markets in the United States are extremely efficient and corporate information and analysis is widely and quickly disseminated, so that any investor would have to outguess the combined wisdom of the market place in order to gain a trading advantage.

In very large portfolios, the investment of new moneys, or the reallocation of portfolios between asset classes, which are routine decisions, can readily take the form of program trades, where substantial transactions in a large number of stocks are executed simultaneously. Program trades are facilitated by the enhanced computer capability of the exchanges and are reasonable in view of the time consuming and expensive alternative of executing orders one at a time.

The New Jersey Division of Investments executed over $1.5 billion of program trades in 1987, prior to the market crash. The volume of such trades was mandated by a state law which required that the state pension funds divest all securities of companies doing business in or with the Republic of South Africa. Such trades were effected through competitive bidding on a net basis before the opening of the stock market, and in fact, when compared with the market opening for that day, were without cost, since the purchasing dealers could hedge their exposure through the futures market or through sales on the London exchange. I believe that this example illustrates the commendable liquidity and efficiency of markets in the United states. However, I do have one reservation about program trades which is the potential of brokerage firms to "front run" such trades in either the stock market or the future market. Nevertheless, I am satisfied that the trades were efficiently executed on the best possible terms for our beneficiaries.

I am also concerned that program trades which are executed as an arbitrage between the cash value of a basket of stocks and the value of stock futures. I am concerned that such arbitrage, which is performed primarily by the professional traders, and not large institutional investors, creates greater market volatility. This is a subject of considerable academic analysis, and the papers everyday present a new conclusion. My own instinct is that index arbitrage may add to volatility over the short term of a day or two, but I have no conviction that it does over the longer term.

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I would like to turn to the second part of the simplistic postulate; namely, that having assumed that institutional investors have short term horizons, then corporate managements should not be accountable to their shareholders, but instead, perhaps, to a larger and undefined group of stakeholders, and, further, that such investors should be penalized by taxing short term gains.

There has been a concerted effort by corporate managements over the past ten years to modify the rights and roles of shareholders. These efforts are illustrated by the introduction by corporate managements of "shark repellents", such as staggered boards of directors, blank check preferred stocks and "poison pills." The Securities and Exchange Commission has reviewed the effect on the market of these modifications, and has concluded that "shark repellents" have a negative effect of between 1% and 6% on stock prices, and that "poison pills" have a negative effect of 2% on average. The introduction of such changes in corporate Charters and Bylaws has had the effect of disenfranchising shareholders and

changing the very essence of corporate ownership, with a consequent devaluation of securities and potentially negative effects on the cost of capital for prospective issuers of similar securities. Stocks without full voting rights have no contractual integrity and no assurance of any returns or recourse. In effect, a new class of securities is being invented, one which is subordinate to all other classes, a "junk" stock.

My second concern is the question of accountability. If corporate managers are not accountable to shareholders, then who are they accountable to? A concept is being advanced that the shareholder is only one of numerous stakeholders, and that the corporation's obligation for performance is diffuse and at the discretion of corporate management. As advanced, this is a very imprecise concept. I believe that the stakeholders concept is already defined by the many laws which define equal opportunity, environmental responsibilities, labor rights, community interests, etc. Institutional investors such as ourselves support all the laws which define good citizenship by corporations, which collectively define the social responsibilities of U.S. corporations by common standards. However, I am concerned where the stakeholder concept is undefined and is left to the discretion of individual corporate managers, who are themselves parties in interest <u>to</u> their own decisions. In this respect, I cannot help but notice the sharp increases in management compensation which have occurred over the period that corporations have become more insulated from shareholder votes. This compensation has been

measured in the tens of millions of dollars, and in one case has exceeded a billion dollars. If corporate managers are to be accountable only to themselves, then as a nation we have regressed to the oligarchies of many years ago; if they are to be accountable to the government, then corporate managers will share the diverse agendas of government and lose the focus that drives the enterprise system. I believe that accountability to shareholders provides the necessary focus to maximize the effectiveness and competitiveness of American corporations.

Finally, I would like to reflect on proposals to penalize investors, such as the Dole/Kassebaum bill to tax short term profits of pension funds. My own view of the bill is that it would not reduce short term trading, since the trading community is not effected, and in any event, trading could easily move off-shore. Secondly, the proposed tax is unlikely to raise a stable source of revenue for the government, since the imposition of the tax is voluntary, and payment is at the discretion of the taxpayer. Third, in the case of public funds such as ourselves, the bill would impose a tax on our taxpayers and our pension fund beneficiaries, and to the extent any taxes were paid, such shortfall would have to be met over time by appropriations from our State Treasury. Finally, as is the case with most taxes, the cost would eventually be passed on to the users of capital in the form of a higher cost of capital.

Again, thank you for the opportunity to address you today. I would welcome any questions you might have.

Representative HAMILTON. Well, gentlemen, thank you very much for your statements.

Let me just begin with a factual question. Institutional funds now account for what percentage of total stock ownership?

Mr. FELDMAN. I believe it's about 16 percent, Congressman.

Mr. MILLSTEIN. Institutional funds.

Mr. FELDMAN. Oh, institutional funds.

Representative HAMILTON. Institutional funds. Your 16 percent is pension funds.

Is that correct?

Mr. FELDMAN. About 25 percent, I think, overall. Mutual funds have 7 or 8 percent.

Representative HAMILTON. I have a figure up here of 40 percent. Does that sound high to you?

Mr. MILLSTEIN. Yes. Ms. Brancato, who works with the Institutional Investor Project at Columbia, I think has estimated over 40 percent in a paper she submitted to Congress in October of this year.

Representative HAMILTON. Do you think that's a good figure?

Mr. MILLSTEIN. It's the best one we have.

Representative HAMILTON. I see. Now, you said, Mr. Millstein, in your comments, that by the end of the century, institutional fund ownership would go up sharply.

Mr. MILLSTEIN. Yes.

Representative HAMILTON. As high as two-thirds, did you say?

Mr. MILLSTEIN. As high as two-thirds, of which about half, 40 to 50 percent, will be pension funds. I just checked that approximation this morning. So that by the year 2000, assuming we don't get deflected out of defined benefit and into defined contribution, if it stays on the current trendline, it should be about 50 percent or two-thirds, or one-third in pension funds by the year 2000.

But that, Congressman, I think understates it a little bit because you then have to do another cut of very major public corporations, the ones that we're most worried about. And there I think you'd find institutional holdings probably a little higher and you'd find pension fund holdings a little higher.

For example, the companies in the indices are always going to be held heavily by pension funds because they're in the indices.

Representative HAMILTON. OK. I want to turn to the objectives of pension fund managers. And, of course, I could not help but be struck by how differently you three articulated them.

You, Mr. Millstein, talk about the broad mandate for these pension funds and you use the word "stakeholder." You define stakeholder very broadly, including the public interest.

Mr. Feldman, you talk about how investment decisions must be made solely for the purpose of furthering the interests of plan beneficiaries. That's a very, very different formulation from Mr. Millstein's.

And Mr. Machold, you express concern about the stakeholder concept.

So I'd like to just open that up a little more for you. What really are the objectives, then, of pension fund managers? What are they, in fact, and what should they be? And how much difference really is there among you on this question?

Is it a difference in articulation? Is it a real difference among you?

Mr. MILLSTEIN. Can I kick it off?

Representative HAMILTON. Yes.

Mr. MILLSTEIN. I want to get an argument going.

Representative HAMILTON. It never occurred to me. [Laughter.]

Mr. MILLSTEIN. If you look at an exchange of correspondence which I appended to my testimony between myself and Joseph Wyatt—he is a pension fund lawyer, and an outstanding one in California—we tried to classify this difference. He had come to listen to a discussion and participated in it. He asked me, point blank, was I saying that there was a responsibility of fiduciaries—other than a legal responsibility—to anyone other than the plan beneficiaries?

And I responded by saying, no. I said, no, the only legal responsibility you have is to your beneficiaries. And that remains my view.

Then he said, what are you talking about when you talk about stakeholders? And I said, what I'm talking about is that I think you have an obligation, in determining what is in the interest of your beneficiaries, to think about stakeholders. Not a very complicated concept. Your decision as to what's good for the retirees should take into account what's good for the company sponsor, what's good for the companies that you invest in, and what's good for the economy, for example. And that's what I'm saying.

However, you can't get sued by the sponsor for making your judgment. You can't get sued by the company in which you invest in for making that judgment. I'm not suggesting for a minute that there's a legal obligation. I'm simply saying, as a fiduciary, you ought to take these matters into account in determining what's good for your plan beneficiary.

For example, if you should make a determination as a plan fiduciary that a company in which you're investing is now subject to a takeover offer, for example, and you call your investment adviser in and he can tell you that, in the long run, you would be better off staying invested in the company because, in the long run, the beneficiaries would do well. And also, by the way, there won't be a breakup and there won't be people put out of work and there won't be a whole host of other things that you don't want to see happen. That's not a bad thing to think about, provided you have good investment advice, that the interest of your fiduciaries is not going to be prejudiced by staying with the company rather than going into the takeover.

Now, there are a host of things like that, that a fiduciary can take into account, I say can—not must. He can grab the premium if he wants.

Representative HAMILTON. Could?

Mr. MILLSTEIN. Can.

Representative HAMILTON. Could take into account?

Mr. MILLSTEIN. It depends. Case to case. That's exactly what I've been preaching now for 3 years. I think there are no universals. In each case, the fiduciary ought to consider what's good for the beneficiaries as a result of that takeover.

For example, in New York State, or any State where the public fund owns stock in a corporation that's located in the State. Is it

wrong for the fiduciary to take into account the impact of some corporate maneuver, whatever it is—takeover, stock buyback, whatever—of some corporate maneuver on employment in the State?

Why not? He can take it into account. I would not suggest he must take it into account, but he can take it into account.

Representative HAMILTON. How do you react to this, Mr. Feldman? Your statement actually comes from the language of ERISA, doesn't it?

Mr. FELDMAN. Yes, it does.

Representative HAMILTON. When I quoted that.

Mr. FELDMAN. Yes, it does, sir. And I think we do take into account a variety of circumstances which are directed toward the long-term best interests of the pension plan recipients.

An example might be program trading—I'm sorry—portfolio insurance.

When we, in my group, looked at portfolio insurance several years ago, we studied it, tried to decide whether it would add to the overall returns or not. And our conclusion was that it might, but we had two serious reservations. One, we weren't sure that it would work in a portfolio the size of ours, which was $31 billion. And second, we thought it might be destabilizing in periods of market distress, which is when you want it.

It turns out, in that instance, we happened to be right. There was some difficulty. And I think that was an example where we felt that, for the health of the financial markets, generally, we do have a stake in what happens because it enables us to continue to do business in an effective manner.

Representative HAMILTON. How do you react to Mr. Millstein's articulation of the objective here? Do you find yourself in total agreement with what he is saying, or partial agreement?

I'm going to ask you the same thing in a minute here, Mr. Machold.

Mr. FELDMAN. Today's statement, I find myself substantially in agreement with. [Laughter.]

Representative HAMILTON. And where is the area of disagreement?

Mr. FELDMAN. I think where we begin to get nervous is in an area like employment within a State or investment within a State. If you are subject to doing business in a lot of States, your pension plan covers business in a lot of States. We are leery of politicizing that process to where everybody wants a piece of the investment pie flowing to their jurisdiction because then I think you run the risk that, in the long run, the pensioner does not have the money to fund his pension.

So you take into account general economic health and well-being. But there has been a tendency in a variety of instances for folks to say, well, there's an awful lot of money there and $5 million or $10 million or $100 million put to good use, you wouldn't miss.

That gives us real concern.

Representative HAMILTON. Mr. Machold, how do you respond to all of this?

Mr. MACHOLD. Well, I didn't cite the law specifically because we're under common law, as well as ERISA. And I think it's well

established in law that the sole benefit provision tended to clearly identify what the purpose of the pension fund is.

Representative HAMILTON. There's really no dispute among you on the point about what the law is.

Mr. MACHOLD. I do have trouble with the so-called stakeholder concept. Not so much with the idea that there aren't other stakeholders, as I indicated in my testimony. There are parties of interest. But my concern is who has discretion over the determination of that interest?

If there is a common, level playing field where all companies have to obey the same pollution requirements, the same labor requirements, and so forth, which do set the standards in the community, then I'm entirely supportive of those because we're all in the same boat. And that is something determined by legislatures, rightly, in balancing public interest.

But if it's left to corporate managements themselves as a dodge to prevent takeovers or something like that, to say that they have an interest of their own that they're identifying separate from the shareholders, then they're intruding on the shareholders.

Representative HAMILTON. I've been sitting here trying to think of an example, an extreme example which raises this question about the responsibility of the fund.

Suppose, on the one hand, you have a casino that looks like a very, very good investment. Short term, long term.

Mr. MACHOLD. No such thing.

Representative HAMILTON. Well, you're not following my hypothesis here, Mr. Machold. [Laughter.]

Suppose you have the casino. Big bucks. Short term. Everything's going well.

You know a lot more about casinos in New Jersey than we do in Indiana.

On the other hand, you have a cancer research institute who has a genius there. And it may take him 10 years to find the solution to cancer. Obviously extreme here. And you're the investor.

What's your choice here under present law, and how would you go about that? Suppose the returns in the cancer institute are going to be negligible, if any.

Mr. MACHOLD. For a while. But presumably, substantial over the long term.

Representative HAMILTON. Yes. Maybe a gold mine at the end of 10 years. But who knows?

Mr. MACHOLD. But you don't know that, yes. This is a typical example of trying to balance risk and return. And under the whole plan principle of ERISA, one could make both investments, logically.

Now, the actual returns and risks are very extreme. First of all, I don't take casinos as being particularly good. One of our largest, and our first, is now going bankrupt.

But let's assume a good company that's been in business for a long time.

A good fiduciary could consider investing in both. Now, I have to be careful here because, when you get into very risky investments, there's some question under the prudent man law how one measures the risk and return. Frankly, in the area of research of the

nature you're discussing, that normally is borne by government in some form or another—through research grants and so forth. And should be because the rate of failure of that sort of research is so great, that it really goes over the risk barrier that most pension funds can encounter.

Representative HAMILTON. Do you agree that the pension fund manager has an obligation other than to achieve the highest possible return consistent with prudent management?

Mr. MACHOLD. The answer is, yes, he has to achieve the best possible return for his beneficiaries. That's in our law. That's in prudency law. And I think that's my understanding of it.

But let me just say this, and this is what we say in our public policy statements and our annual report.

That good community investing is not—there's an overlap. It's not exclusive. These are not two mutually exclusive types of investments, by any means. And that community interests are—a company with good community relationships, with good policies relating to all the things that you would hope for, is a good investment.

Representative HAMILTON. Do you find—this is to all of you—instances where a pension fund manager, in serving his primary beneficiaries, faces conflicts with the broader mandate that Mr. Millstein talks about?

Does that arise for pension managers or not?

Mr. MACHOLD. That is a matter of subjective judgment because you're introducing a new subjective criteria as to what is good and bad.

I'm very reluctant to do that. The law does that in many respects, as I've said.

What I have found where people come to us with, if you like, extracurricular objectives, and many do because we're very publicly visible. Inevitably, there's a very powerful private interest behind it.

I have not known the case of a pure abstraction of a good person walking in and saying, please do this for the good of the community. What I find is people who want to make a quick buck. And that's what it quickly degenerates to in a public environment.

Representative HAMILTON. I'll let you both comment here.

Mr. FELDMAN. OK. I think, getting back to your first example, one of the premises of investing large amounts of money is to be adequately diversified and hedged in a variety of circumstances. And you probably would, if the payoff in the cancer research looked to be at the end of the road, you probably would make both because you need to balance security in the short run, the next 5- to 7-year investment performance, against something that's going to take much longer to mature.

Pension funds today provide, I would guess, the bulk of venture capital investing, for example. It is not a large part of our portfolio. It's about 5 percent or so. But it provides the seed capital in technology and medicine and a variety of other areas which is probably going to take 7 to 10 years to mature.

But what lets us be able to afford to take that additional risk for the higher returns is that we do have a sizable, stable pot of stock and bond investments that we can count on in the somewhat shorter run.

So, you do look at both.

Representative HAMILTON. You don't, as an investor here for big funds, you don't see a conflict, as a practical matter, between investing for the benefit of your beneficiaries and investing for the broader social purposes? Or do you?

Mr. FELDMAN. It depends. It depends on the situation.

Representative HAMILTON. A conflict does arise sometimes. That's what you're telling me?

Mr. FELDMAN. Well, there was a lot of discussion and debate on the South African divestiture issue, for example. That was an area of political concern. It was an area of great concern to our employees.

In our case, we felt it was not good policy for a variety of reasons to ban investments with any company doing business in South Africa in the pension plan, but we did offer to our employees an option in their savings plan, that if they wanted to so direct their equity money, they could do so.

That's an area where some people very sincerely felt that was the right thing to do. We had very serious reservations. From a portfolio standpoint, you knocked out large portions of drug companies, computer companies, automobile companies, and so forth.

So, depending upon definition, that could have been a problem.

Representative HAMILTON. Mr. Millstein. And then we'll go to Senator Roth.

Mr. MILLSTEIN. I think it would be helpful, in thinking through what we're talking about, since I don't want to be misunderstood. And I know nobody misunderstands me.

To break this kind of investing down into three pieces—one of which I'm not that excited about at the moment because it's going to go on anyhow—social investing; economically targeted investing; and then the public corporations themselves.

Social investing, I consider the South African problem and so on. In that, the funds are going to do willy-nilly and some will and some won't. They have the right to do as they see fit. Their public trustees and others will make their own judgments.

Economically targeted investments I think are another story. Those are—and I'm going to leave with you something that I just got yesterday; it's published by the Institute for Fiduciary Education; it just came out—surveys of economically targeted investments, a reference for public pension funds. I'm not aware that anybody had ever done a survey like this.

What they did is they took a number of public funds, a great number of public funds, and said, do you have economically targeted investments? Those are the kinds of investments we're talking about. What do they include? Residential housing loans, for example, New York City is big in low-income housing for its pension funds, other real estate investments, small business loans, and venture capital—that's what they called—economically targeted investing.

Now, they found that there are quite a number of such investments going on. And I think those are the ones which you've been focusing on, Congressman. And certainly, I think we would all agree, yes, you can do that.

And all I've been suggesting is, yes, you can do that and it wouldn't hurt to do more of it. And I'm urging that.

The third category, is the public corporation, which is the more interesting for the moment since I think economically targeted investing is something that has been on the agenda for a long time and a lot of funds do it and I think more funds will do it.

Just as another footnote, in New York State, we were urging the State fund, the State common retirement fund, to do more of it. And that has created quite a to-do.

But there's nothing wrong in the Governor and others urging them to do more of it. And I think Roland Machold is right. That's where the political process comes to play.

Now, as long as the political process doesn't destroy the return to the retiree, I don't see anything wrong with it. I don't think the Governor or anybody else came in and said, you ought to make these investments and destroy your fund. That's not the point at all. You can make these investments and you can make more of them without hurting the beneficiary.

The problem is that the trustees get nervous when the politicians come around and say, do more. I don't blame them. That's part of the process. But, nevertheless, the nervousness about politicians ought not deter them from taking a look at some of these broader aspects.

Last but not least, and the one I think that you'll wind up focusing a lot of time on—is the public corporation, the big public corporations in which the public and private funds equity is largely invested.

There, I think the real question is, what should they do about it? Should they simply be passive investors who, when things don't get good or aren't too good, simply sell? This is the old "Wall Street Walk," and they will tell you it is not so possible any more. They just can't sell every time something goes wrong. They're too big to do that, and that's a subject in and of itself.

Or, do you somehow become involved in proxy voting, in talking to corporate management, and somehow or other, try to improve the situation of the poor performers?

That's a largely unexplored area, Congressman and Senator, and it's the one I think we're all sort of playing with at this point.

How do we get funds to get themselves involved in talking to managements of underperformers? And equally important, how do we get managers to listen?

I don't say that this is an easy job or that the fault lies in either one. It's lack of communication, I think; what David Feldman talked about is right. It's difficult for managements to realize that they really have large shareholders today. And it's difficult for the large shareholders to realize that all the managers aren't hiding under a rock, that we have to somehow or otherwise get this communication line open.

That's the really interesting area.

Representative HAMILTON. You want to say something, Mr. Machold?

Mr. MACHOLD. I would, if you like.

Mr. FELDMAN. Could I make just one comment on the economically targeted investments?

I think where we really get nervous—my experience has been that good investments never run short of money. If it is a good, attractive investment with all of the risks considered and it offers the appropriate rewards for making that investment, it will find money.

Roland Machold mentioned, and my own experience has been that when people come in and are having trouble making the investment attractive on economic terms and begin talking about other things, one begins to get very nervous about it.

So that's where my point of discomfort comes in on that side.

Mr. MACHOLD. I would second that. I think that there's a very efficient capital market for all forms of investment. When you have to target investment, basically, what you're doing is providing a subsidy, standing still and letting somebody, in effect, put money to you.

Mr. MILLSTEIN. Well, I suppose my answer to that, Congressman and Senator, would be so what? If you take part of your funds and you invest them in something that's good for your State, or your city, or your community, or whatever, what's wrong with that? Corporations do it. I don't see why the funds can't take a smaller part of their investment and put it at a little more risk.

I think David Feldman himself said there are enough—if you have $30 billion or $20 billion or $10 billion—in New York State, there's a law called the Basket Clause. Supposing you take 5 percent and invest it at a little higher risk for things that might be good for the economy?

I'm not saying throw money away, but if the legislature of the State of New York should take the position that 5 percent should be a set-aside for economically targeted investments, it's certainly public policy to do that. And it's certainly within the right of the public to determine that that's a possible thing to do.

I think, however, that that has to be a democratically decided process. It must be something that the people decide is worth doing; namely, a set-aside. And if they do, there's nothing wrong with it.

Mr. MACHOLD. What it will become is a political slush fund, inevitably.

Representative HAMILTON. How do you get around that word "solely" in the ERISA? The fiduciary has to discharge his duties solely in the interest of the participants and the beneficiaries?

Mr. MILLSTEIN. Does that mean financially—my argument is simply that it doesn't mean financial. It doesn't mean you have to make the pile as high as possible.

If you want to read it solely as your only obligation is to make as much money as you possibly can. If you noticed, when Roland Machold answered your question about highest, he didn't say, "yes, highest"—he said, "yes, best."

I would agree with him on "best." I don't agree on "highest." I don't think your obligation is to make as much money as humanly possible with this investment. I believe in optimizing and I believe in "best." And I think "solely" means, as long as you're meeting your fiduciary responsibilities to this retiree, you're doing your job.

I don't want to prejudice his ability to retire and get his funds. That's the last thing in the world I want to do. But I don't think you have to make it "highest."

Remember, many funds are overfunded today. How did that happen? They made it "highest." What did they do in the process? Look at the last 10 years.

Representative HAMILTON. Senator Roth.

Senator ROTH. Well, first, let me apologize, Mr. Chairman, for being late. But, unfortunately, I think we're working to get out before Thanksgiving. I'm not certain that we'll make it.

Representative HAMILTON. Well, then, you should have stayed longer at the meeting. [Laughter.]

Senator ROTH. I have a number of amendments on the floor, so I can only stay briefly for what I think are extraordinarily important hearings.

If I repeat some of the things that have been covered already, I apologize. Let me start out by saying that I think the most important problem this country faces is being competitive in the emerging global economy.

What I'm particularly concerned and interested in is this: What kind of effect and influence are these pension and other similar institutions having on that problem?

There are many people, many economists, and many foreign observers such as Morita of Sony, who say one of the problems the United States faces as a nation in being competitive is that business is too short-term oriented.

So I'd like to ask each of you whether you think American business is too short term in its perspective? If you think it should be more long term, I'd like you for a moment to be a Congressman or a Senator, statesmen in both cases, not politicians, and let us know what you would do in the area of legislation to bring about competitiveness and a long-term focus, if you think that's important? Mr. Millstein.

Mr. MILLSTEIN. Are you going to go from left to right with those tough questions?

Senator ROTH. Yes, right.

Mr. MILLSTEIN. Well, do I think there is a short termism in American management? I can't prove it empirically, but in my day-to-day activities, my firm is a large corporate law firm and we counsel many managements. My private function in making a living is to counsel with boards and managers.

I would have to answer you on a nonstatistical basis. But based on my observations, the answer is yes. Today, I think many managements are enormously concerned with the Wall Street situation of the last 10 to 15 years. They find that they are being financially driven, rather than economically driven. Their worry is one of watching over their shoulder; recognizing that markets respond the way they do to takeovers, everything jumps, everything moves. The program trading is a problem.

The market is extremely volatile and it seems to be focusing exclusively on financial, rather than economic. It seems to be focusing on your stock price. And so they watch over their shoulders.

And I have seen them forgo R&D. I've seen them forgo long-term programs in favor of doing things which improve their stock price.

Now, that may be a good or a bad thing, but that is a fact. That's what I've observed. So, yes, I do think there has been a market-driven, short-term focus put on managers and they are nervous about what happens if they don't pay attention.

Senator ROTH. Now, have institutional investors, pension plans, accentuated that problem? Caused that problem?

Mr. MILLSTEIN. "Caused" is too harsh. I think "accentuated" is probably the right term, in this sense.

I think that the index funds, for example, normally will jump at a premium. They're not thinking "this is not deprecatory." This just happens to be a fact. They're not paid to think. They are paid to invest in baskets of stock.

Now, one of the stocks in the basket becomes subject to a takeover, it's going to get sold without a lot of thought. Why? Because the premium is there and the function of the index fund is to grab the premium and go, go. And that's what happens.

Now, other funds will or will not jump at the premium. But it seems as though many do. And I think it's a strong fund indeed, that can withstand a 20 or 30 percent premium and say, no, I'm not going to sell because I have confidence in the future.

That's not the way fiduciaries act, Senator. They're much more likely to go for the bird in the hand.

So does it accentuate it? Yes. There are fewer contrarians in the market because there are fewer people in the market. And the big funds tend to act alike. Yes, I think it has accentuated.

Now, that's a fact. I'm not blaming anybody and I'm not saying they should be punished for doing that. But it is a fact. And what I'm calling on them to do is to think a little bit about what they're doing, as to whether that's necessarily a good thing. They don't have to be that way. Indeed, I think we can go forward in these hearings, Senator, without worrying too much about what happened. I think we could go forward in these hearings by saying, for the future, it would be a good idea if people thought affirmatively about what they could do to support managements which are going long term; not the noncredible managements, but the credible managements.

Supposing, as I posited to my friends here on other occasions, a management was to call in its institutional investors and say, "I'm going to invest an enormous sum in a new plant, and because of that, it's likely that I'm not going to pay a dividend or I will be paying a smaller dividend for the next 5 years, but at the end of tha 5-year period, I really believe I'm going to be home free and have a great internationally competitive company here. Will you stick with me? And if a raider shows up or somebody shows up demanding, offering a premium, will you hang in there?"

In my great world, in my dream world, it would be great if the institutional investors could respond and say, yes, we'll stay there.

Now, in other countries, that happens. It doesn't happen in the United States. We have no mechanism for having that happen. But I would say, my challenge would be to build a model of corporate governance which permitted that to happen. I'd like to see credible managements who had credible plans for making internationally competitive companies, the toughest competitors we can, being able to turn to their investors and say, "hang in there with me while I

get this thing turned around"; or "hang in there with me while I make the enormous investment that's necessary."

I don't know of a mechanism to do that, and I don't know how you pass a law to do that. In fact, I don't think you can pass a law to do that. But that's what I'd like to see happen.

Senator ROTH. Mr. Feldman.

Mr. FELDMAN. I would share in your concerns, Senator. I think we do need more long-term focus. And I think there is real pressure in today's markets because, in the short run, if the goals of the corporation have not been adequately explained to its shareholders, management is vulnerable to somebody coming in and making a short-term offer that might be attractive.

I would disagree with Ira Millstein. I think index funds are no more likely to accept or reject a tender offer than actively managed funds.

In fact, our own guidelines we give to our managers explicitly say that they must consider the longrun horizon and what the likely returns would be in holding versus tendering.

Part of the problem in recent years has been that, for a variety of reasons, the prices offered after taking into account, as best we could, what the long term looked like, still looked very, very attractive.

There is a subtle distinction between saying you ought to hold for the long term and you ought to hold forever, or come hell and high water. In a number of takeovers and acquisitions, managements have just had a very difficult time in getting their act together or finding a direction that would give the long-term investor confidence.

So I think the solution probably lies in the area of better communications. I think I agree that we are entering into a situation that neither management nor pension fiduciaries foresaw a number of years ago.

We all of a sudden are very big shareowners. They all of a sudden have a bloc constituency, as it's viewed, that is, hopefully, more sophisticated, certainly more inquisitive, than the little, individual shareowners used to be who would show up at an annual meeting and hear what management said and go take that as gospel.

So there is more of a challenge here than there used to be, and I think we probably haven't talked to each other as much as we should. There's kind of a getting used to one another, too.

I am not real sure in our fund management responsibilities how warm the welcome would be in a number of corporations if we showed up and said, we'd like to hear what your long-term plans are.

So I think we need to work at the communications side. R&D and so forth is very important to remaining competitive. I think, in other areas, the Congress has looked at helping that process along. I would certainly applaud that as an investor because R&D does make a difference in the long run.

As Roland Machold said, in terms of putting short-term pressure on a price, that, in and of itself, is simply not enough of a consideration. Nobody has ever come to me and said, I'm going to put a plant in so and so and it's going to be bad for 5 years, but then it's

going to be great. What typically happens is they put the plant in. We take a look at it. Sometimes we agree and then our managers agree that we would hold it. As often as not, we'd say, gee, that doesn't really look like it's going to be such a good investment, and maybe they're putting good money after bad. And you might lighten up your position at that point.

That's saying management made a bad decision. Managements don't like to hear that very often.

Mr. MACHOLD. I did address those points in my testimony. I'm not sure if you were here at the time.

Senator ROTH. No.

Mr. MACHOLD. I won't cover them in depth, but I would say that, first of all, it's certainly been my experience, the funds that I'm affiliated with, largely public funds and union funds, to my knowledge, are long-term investors almost of necessity because they don't have a lot of turnover in their portfolios. They are very diverse and very broad and they continue to own shares of stock for a long period of time.

I also made the point that we are not active traders for short-term gains, that individual mergers make a very small effect on any kind of performance because of the diversification of the portfolios, that research and development is usually, along with other features of the company, are built into the price.

There are many companies that are recognized for very high-price earnings ratios, very high-price book ratios, because of the credibility of that company in the market place.

I also made the point that it isn't necessarily true that all long-term investing is good and all short-term investing is bad, given the very rapidly changing nature of markets and the difficulty of some companies, frankly, to properly manage their long-term investment programs.

So that you can say that as a generality, but it's not necessarily the case in every company.

I would make these points. I think the point of communication is very critical. Communication is limited by law, as well as by what appear to be some natural apprehensions about the investor and corporate community. Many companies feel that they don't want to disclose what they're doing, what their new directions are, because of competitive pressures. They also feel that, under the SEC rules and so forth, that they'd be bulling the stock if they were to come out with very rosy types of projections and so forth.

So we, as institutions, are quite in the dark as to what their planning really is.

Senator ROTH. Would there be a danger of insider information?

Mr. MACHOLD. Of course there would. That's the danger. The real danger to me is that people would not realize the risk implicit in those long-term projections, that there would be unscrupulous people out there who would make a great case that a company's plans were going to go way up, and so forth.

This was the reason why the original rules were put in.

Senator ROTH. What is your feeling with respect to business, generally? Is it long term enough in its point of view?

Mr. MACHOLD. I think there are all kinds of businesses. There are some which are financially oriented. No question about it. There are some companies that buy and sell corporations.

Senator ROTH. But as a general rule, how would you characterize it? Obviously, you'll find all within a group.

Mr. MACHOLD. Yes. I think that there is a long-term focus by businesses. When I say long term, I don't necessarily mean a 20-year focus or something, unless it's a pipeline or utility, something like that.

But for manufacturing companies, I think that many of them look to a horizon of, say, 5 to 10 years. There are some companies like technology companies that make computer chips and their horizon for a new chip is a year because that's the pace of change in that area.

So a lot of it depends. And our whole economy is changing, where all of these decisions are more short term.

I do happen to think also that one of the features of our economy which is troublesome is the very high real interest rates. And that's due to the insecurity of investors. If we have what appear to be volatile levels of inflation, then, in effect, real interest rates remain high. And they create a barrier in the form of discounting. You have to overcome those investment hurdles, provide a premium over that. And if you have 10-percent interest rates and 3-percent inflation, you have to have a return that's going to be 12 or 15 percent in order to ensure some sort of a return.

Senator ROTH. Going back to people like Mr. Morita, who, obviously, is very successful. He's the cofounder of Sony. He certainly would not agree that American business is long term enough.

And certainly, if there's any country that's successful in the area of new technology, in the development of new products and commercialization, it's the Japanese.

Mr. MACHOLD. I think that deserves close scrutiny, if I may make a point on that.

I think that they do have a sense of stability because of the very close working relationship between the banks and the investment community and the corporate community and the Government. This has been a matter of national policy and also part of the national culture that has been historic there.

But if you look at where their successes are, remember that the great Japanese companies are called trading companies. They are short-term companies. And that many of the types of investments that they are making are very quick replications of previous investments.

I think the rate of return over their whole capital base is at a tremendously high rate. But it doesn't necessarily mean that they're making technologically more efficient equipment. They're bringing these changes to market much quicker. And that's a little different.

They have a strong short-term focus in order to develop these rapid rates of change.

Senator ROTH. Mr. Millstein.

Mr. MILLSTEIN. I don't agree at all. I think if you look at the issue which Roland Machold touched on, in a study we did up at Columbia, we invited in the West Germans and the Japanese to

talk about why their systems work differently than ours. And the answer was exclusively, stability.

The network of bank ownership and cross ownership in both Japan and Germany has given those companies freedom from the excesses of the financial markets. They simply haven't been subject to takeovers. They haven't been subject to wild fluctuations in the market. Their managers are not looking over their shoulders and worrying about whether they're going to be bought out tomorrow.

On the other hand, they're under enormous accountability pressures. They're not out there having a good time, management's flying around in airplanes or whatever. They're under enormous accountability pressures from the banks—who sit on their boards, who lend them money, and who are intensely interested in how they're doing. But they're not short-term pressures; they're long-term pressures.

Now, that's a different system than we have, but it's a system which has pushed both countries into an enormously technological lead and, unfortunately, we have to find a way to catch up and turn ours around.

Senator ROTH. Let me just make one comment. Mr. Jensen, a Harvard Business School professor, commented at a hearing last week that Japanese business was going the same direction that we were, and cited the separation between ownership and the companies, and that banks and leverage were less important. So that maybe they were going to make some of the same mistakes.

As I said then, I'm not that optimistic. But, again, thank you, gentlemen.

Mr. MILLSTEIN. We can always hope, Senator. [Laughter.]

Representative HAMILTON. OK. Let's take up a few more matters before we finish up here.

Just the fact that these institutional funds are going to be such big actors, are such big actors today and will become even bigger actors, according to your testimony, in the future, is that a good thing for capital markets?

Mr. MACHOLD. Is that directed to——

Representative HAMILTON. Anybody. Is that a trend? I take it it's going to happen whether we like it or not. But how do you assess it? Is that good or bad?

Mr. MACHOLD. I think it's going to pose more responsibility on both parties. And to the extent that——

Representative HAMILTON. Both parties being——

Mr. MACHOLD. The corporations and the investors. I think the era of passive investors is gone. And I think that that's not a bad idea. I think that, in effect, the level of accountability will be increased. And I think that that's probably a good idea.

So I think that there is a positive side to it. And I think that there is far more common ground between the two parties here and, for that matter, public policy, than might appear on the surface.

Representative HAMILTON. How is that accountability going to be increased?

Mr. MACHOLD. Well, I think that there's a difference between professional investors and individual investors or people who are just investing in the abstract. I can't speak for all investors, but

I'm speaking for myself, and I think that Mr. Feldman would agree with me, we take all of our investments very seriously. We try to maximize our communication with the company and our information about the company.

I can easily see situations where we would not support. In fact——

Representative HAMILTON. Is there a lot more accountability in the Japanese and German systems, Mr. Millstein?

Mr. MILLSTEIN. Yes, I think so.

Representative HAMILTON. Is it a legal accountability or does it just work because of the structures?

Mr. MILLSTEIN. It works because, culturally, it works. They are responsible. In Japan, it's a cultural cross ownership and it works and the banks are involved. And in Germany, it's the banks actually having enormous control by sitting on the boards and lending money and paying very close attention to their investments.

Representative HAMILTON. Just a very broad question. Are you all reasonably satisfied with the way U.S. capital markets work? Do they in fact get money into the most productive investments?

Mr. MILLSTEIN. I wonder if I could address that for a minute?

Representative HAMILTON. Yes.

Mr. MILLSTEIN. Because I am worried.

Representative HAMILTON. If you don't feel that it does, how do you think it can be shifted?

Mr. MILLSTEIN. Well, I don't know the answer to the second question, but I am worried about the first. I think Roland Machold put his finger on it. There's going to be more responsibility on both sides, and that's what I was testifying about.

But let's take a look at the stock market. I am concerned about the stock market, as fewer major holders become players in the market.

At the moment, I'm serving on a committee of the New York Stock Exchange trying to figure out what it all means. I don't know what it all means, but it isn't like it used to be. There aren't a lot of small investors who can be contrarians.

Think about it. It's really the problem. You know, I had the right to go into the market and make a fool out of myself, and nobody could charge me with breaching any fiduciary duties as a result of it. I could do whatever I wanted. And there were a lot of "me's" around who used to do that—take fliers, not take fliers, go against the market bet, do, et cetera.

There aren't a lot of "me's" around. I'm out of the market. I don't like the market any more. Most of us individuals don't like the market any more because we know we're in there against some monster machines and computers who are thinking, working every minute of the day, and we don't know who we're playing against.

So we're out. And we're either going in through a fund, if we're going to be in at all, but we're not sitting in most—that's why the retail brokerage business is so terrible at the moment. There aren't a lot of——

Representative HAMILTON. Is that one reason the percentage of funds, total percentage, is rising for the pension funds? Not just that funds are getting larger, but because the smaller contrarians are getting out?

Mr. MILLSTEIN. I think he's getting out and I think he's putting his money into mutual funds and other professionally managed funds.

Now, when the market consists of major funds, institutional funds, many of whom buy baskets of stocks and index funds, they're putting their money into market. They own the market because they're in an index fund. Then what's the market?

I have a big problem perceiving that it's the same stock market I used to know.

Representative HAMILTON. I want to go back to my question that he was responding to about how you perceive U.S. capital markets to be operating today, with regard to getting the most productive investment, and so forth.

Mr. FELDMAN. I think basically the markets are working well and are efficient. As I said earlier, I think a good investment binds people to put the money up.

I am concerned that, as the concentration of ownership shifts, and it has, I would agree that that trend is likely to continue somewhat, although there is still a large number of individual shareowners out there who will hold the stock for a long, long time.

But I am concerned that the mechanisms not cause disruptions. We have another committee—the New York Stock Exchange has a lot of committees going nowadays——

Representative HAMILTON. You have more there than we have in the Congress. [Laughter.]

Mr. FELDMAN. We're working from the vantage point of institutional investors trying to be sure that they understand what we're trying to do and don't get caught short in terms of capacity and so forth.

But, as the Times editorial pointed out this morning, I didn't know this, but after the crash in 1929, they wanted to ban trading of stocks by telephone because it was alleged to have contributed to the crash. And I think some of the technology that is there, as Roland Machold indicated in his testimony, you can argue whether it's good or bad, but it does facilitate the process and is just not going to go away.

Representative HAMILTON. How about the stock market itself? Should we rely on the stock market, the judgment of the stock market, as to whether corporate management is making the best use of its assets?

Mr. FELDMAN. I don't think the market itself judges. That's up to the individual participants in the market. I think they provide the liquidity that enables people to get in and out easily, and to raise new capital. The ability to raise new equity capital is very important.

Representative HAMILTON. Sure.

Mr. FELDMAN. The stock exchange, I think, is also very aware of the need to change and progress.

Representative HAMILTON. Did you see the article on the Times editorial page that Tom Eagleton wrote, or was that in the Post, on the futures?

That was in the Times. Did you see that? I don't know if any of you saw it.

Mr. FELDMAN. I don't know whether I saw that one or not.

Representative HAMILTON. It's really not targeted on what we're discussing here. He's very critical of that futures market.

Mr. FELDMAN. Speaking for AT&T, we've not used the program trading, index arbitrage, options, futures, a lot, if any. But they're there. And I think they're not likely to go away.

One can argue whether the world was better in 1970 without them. Maybe not. We might have more stability in the market, but the Dow would be at 1900 rather than 2500.

So they're there. I think they're facts of life we're going to have to work with.

Representative HAMILTON. Mr. Machold, I want you to comment, too, on this question of how you perceive U.S. capital markets to be operating.

Mr. MACHOLD. I think that U.S. capital markets are the envy of the world. We have incredible breadth and liquidity in these markets. There may be certain parts of the market which are not perhaps adequately served in view of some of the objectives that, say, other people might have. Those in the past—for instance, venture capital has been tax advantaged to the capital gains tax and so forth. Those are legitimate issues which I'm sure you're familiar with.

I think we have a fabulous capital market.

Now, with respect to the use of futures and so forth, we did 1½ billion dollars' worth of trades which we had to accelerate under our South African divestment program. We did those through competitive bidding. The net cost was actually a gain. We actually had positive transaction costs because when we went out with our programs, people could hedge themselves either through futures or in foreign markets.

So it was an astonishing fact to me, the breadth of the liquidity of the market.

Representative HAMILTON. Let me ask a question about corporate governance that's come up several times here.

Do you have any suggestions as to how that can be improved? Now, that's largely a State matter, not so much a Federal matter. But, for example, are outside directors doing the kind of job they're supposed to do?

We've had proposals that tie compensation of the outside directors to performance. How about those? Do any of you have any specific ideas that you would recommend to improve corporate governance?

Yes, Mr. Machold.

Mr. MACHOLD. We have some concerns about the quality of corporate governance. Maybe this is an undue suspicion, but we do believe in confidential voting, for example. We think that that gives people an opportunity to make a vote that won't be compromising to them in some way due to pressures by the corporation. It gives the corporations an additional strategy, a strategic advantage.

We also——

Representative HAMILTON. You're not recommending that for the Congress, are you? [Laughter.]

Mr. MACHOLD. We're recommending it for anybody who's interested. [Laughter.]

I think we're interested in trying to set up some sort of an advisory relationship with corporations. For example, in the case of the Texaco case, a number of our funds got together and wanted very much to have a direct insight into the negotiations that were going on there. I think that we have actually—we'll probably try to advance that as an idea of having a direct relationship directly between the corporate boards and major institutional investors.

We're conscious of the fact that we don't want to preempt the role of other investors in there. We feel the line of communication would be very useful.

Representative HAMILTON. There are proposals to require a fraction of the directors to be nominated by pension funds, aren't there?

Mr. MACHOLD. Well, I'm not sure whether it would be pension funds or others. I think there may be other parties at interest. Unions, and so forth. I haven't resolved that.

But I think that the level of communication definitely should improve. And I think that if that does happen, we will find very loyal corporate shareholders.

Representative HAMILTON. Mr. Feldman, on the corporate governance question.

Mr. FELDMAN. Two comments. One, I think, at least my experience with boards of directors, certainly over the last 5 years and probably over the last 10, is that the old stereotype of being noninvolved and just showing up and ratifying what management does is pretty well gone.

Today, perhaps in part because of all the takeover activity, et cetera, everybody who's on a board is very well aware of their duties and responsibilities.

So I think the passive, rubber stamp board, to the extent it once existed, is largely history at this point.

The other area relative to directors and boards, I am concerned philosophically about fragmenting the board into various constituencies representing environmentalists, labor unions, et cetera. I think our own experience would suggest that the board ought to be collectively involved in bettering the fate of the corporation. And I would really hate to see anything that would push us in the direction of fractionalizing where everybody who had an interest had their own director.

I think that would be bad.

Mr. MILLSTEIN. I subscribe to pretty much what everybody has said. I think the issue of corporate governance is not a cookie mold issue. I would not be in favor of mandating any particular design for a board or any particular grouping of directors or whatever, although, clearly, outside directors are better.

I think companies should create their own boards as it suits their own purposes. I think there is a 45-degree angle up, Congressman, in improvement. I think enough guidelines have been laid down by pension funds; by the Business Roundtable; by others; as to what's expected of a board, and it's getting better every day.

I don't think we're there yet, but it's getting better every day, and I think we have to keep the pressure on.

So I really don't think that's the problem. I wouldn't be in favor of legislating constituency boards or anything of the sort.

I do subscribe, and I think we're all happily in agreement, that communication between management and shareholders—inside information to the contrary—is a problem that can be dealt with, and is what's called for, and the communication ought to be focused on performance.

I don't think people should be focusing on how many outside directors there are, or whether we need an advisory committee, or whatever.

The job we all have is to get to the issue of performance and how do we do that? And if the pension funds focus on that and managements focus on listening, maybe we'll get the performance going. I think the three of us are in complete agreement there. I don't think we're in agreement on how, but we certainly are in agreement on the objectives.

Representative HAMILTON. I wanted to just check with you to see if you had any opinion on this statement I found in Business Week about the Federal oversight of pension funds being inadequate.

One gentleman, the acting inspector general of the Labor Department, warned that Federal oversight of the pension system is inadequate to root out fraud, abuse, and mismanagement that threatened the system's soundness.

Do any of you have any reaction to Federal oversight of this?

Mr. FELDMAN. Yes, sir. We had Mr. Demaria to a dinner meeting of CIEBA after his report came out. And we spent the evening discussing that. And that has not been our experience. We thought at the time that perhaps he agreed with us.

But certainly, waste, fraud, and abuse are not to be condoned, ought to be rooted out, et cetera. But in the large- and medium-sized pension area, there is a complete body of law that already exists. We have a congruence of interest on the corporate side, anyway, with the corporations and good fund management because if there is something going on in our pension plan that shouldn't be, it's not only disadvantageous to our pensioners, but it's costing the corporation a lot of money.

So, in addition to our external auditors, we have internal auditors which regularly look at the practices and procedures. I think there have, of course, been problems in very small plans. When we asked the Department for some statistics on where all of these cases were, the instances cited were very small plans. Taft-Hartley plans have had a history of some problems there.

But I think we're very well taken care of at this point and both the corporations and the Federal Government are on the same side of that one.

Representative HAMILTON. Let me phrase the question a little differently.

Does the current administration by ERISA, by the Treasury and the Labor Department, provide the proper guidance for pension fund managers to pursue policies that contribute to growth?

Mr. FELDMAN. I think it does.

Representative HAMILTON. You're satisfied with that?

Mr. FELDMAN. Yes. They cleared up the point which was of some contention about whether we could be long-term investors or not. We always felt that was the case.

Representative HAMILTON. Does it protect beneficiaries, I guess?

Mr. FELDMAN. Yes.

Representative HAMILTON. You think it's sufficient to do that?

Mr. FELDMAN. In my view, it is, yes, sir.

Mr. MILLSTEIN. I think it certainly is. I think it could be loosened up.

Representative HAMILTON. Got too much.

Mr. MILLSTEIN. A little bit. Just to take the nervousness away from these fiduciaries. I'm not talking about honesty and loyalty. I don't see any reason to loosen it up. We're not talking about honesty. Clearly, they're doing a good job there and I have no problem with it.

What I'm talking about are the standards. I think they could make it a little clearer that fiduciaries can use their heads.

Mr. MACHOLD. We are not covered by that.

Representative HAMILTON. You're not covered by it. Now, there are some suggestions that have come up that some of the State funds are becoming politicized and caught up in issues that have nothing to do with providing the greatest rate of return to the beneficiaries.

Is that true? And if it is, does the Federal Government need to intercede?

Mr. MACHOLD. I guess I'm the one for that.

Representative HAMILTON. Yes, I guess you are.

Mr. MILLSTEIN. I'm not. I don't know which funds they're talking about that are being caught up in politics.

Mr. MACHOLD. Let me answer that. I think that the great majority of public funds, State funds, are very closely supervised and cross regulated with laws out the kazoo.

I mean, we're right in the public fishbowl. We disclose every transaction we make. Everybody has a say in what happens to us.

I do think that there is a much higher level of political conflict that's possible in the State area. There are State funds which have gone beyond the simple targeted investing to what you would call politically preferred investing, with all of its emoluments attached thereto.

Generally speaking, public attention comes full cycle and finds out those people. But they're the great exceptions, the great exceptions.

Representative HAMILTON. OK. Anything else, gentlemen, for the good of the order here?

This has been a very good and productive session. I've appreciated your prepared statements, as well as your responses to the questions.

If there are no further comments, then the committee stands adjourned.

[Whereupon, at 11:45 a.m., the committee adjourned, subject to the call of the Chair.]

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