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Corporate strategy financialized: Conjuncture, arbitrage and earnings capacity in the S&P500

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ABSTRACT

The conjuncture that ushered in the era of shareholder value served to embed capital market expectations into corporate governance aligning management and shareholder interests. Market arbitrage focussed on modifying contractual relations with stakeholders to extract a (higher) return on invested capital. In this article we focus on cash earnings on capital employed generated by the S&P 500 survivor group of firms covering the period 1990–2008. We use this financial data to construct three complementary perspectives on corporate financial performance: firm, firm-relative and macro. Within this framework the financial numbers and perspectives are analogous to a 'hall of mirrors' where ambiguity and contradiction are in play frustrating straightforward performative narratives that connect purpose with financial transformation an era of shareholder value.

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1. Introduction

> From being a sporadic trait, of doubtful legitimacy, in the old days of the "natural" and "money" economy, the rate of profits or earnings on investment has in the nineteenth century come to take the central and dominant place in the economic system. Capitalization, credit extensions, and even the productiveness and legitimacy of any given employment of labor, are referred to the rate of earnings as their final test and substantial ground. (Thorstein Veblen, 1904, p. 47)

> The primary goal of the corporate managers of such companies was to maximize the value of their common stock. Veblen put corporation finance as the centerpiece of his analysis of large, acquisition-minded companies. In Veblen's analysis, the corporate finance structure was capitalized on the earnings capacity of the corporation as a going concern. (Ganley, 2004, p. 398)

In *Business Enterprise* 1904 Veblen is concerned with owner-managers quest to increase the rate of 'profits or earnings on investment' or as Ganley (2004) observes corporate earnings capacity because this is the platform for stock market valuation, and thus wealth accumulation for stockholders. Veblen observes that in the modern corporation a complex network of business relations are managed where contractual negotiation and shrewd manipulation are at the centre of things. This position on the firm as a network of contracts up for continual re-negotiation contrasts with Coase (1937), whose objective was to understand why there are firms. That is, under what circumstances do firms establish contracts and consolidate financial transactions that, might otherwise, have been executed by a market mechanism. Veblen's observation about how owner-managers manipulate contracts with stakeholders for the purpose of boost-

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ing earnings capacity and wealth accumulation for owner-managers is insightful and informs the structuring of this paper.

Jensen and Meckling (1976), in a later period, were concerned with the gap that operated between what managers were doing with corporate excess cash resources and the demands of investors for maximum return on capital employed. Jensen's and Meckling (1976) and Jensen's (1986) argument was that debt finance, with its contractual obligation to pay interest, would force managers either to invest in positive Net Present Value (NPV) investment projects or distribute the free cash back to shareholders. The conjuncture that ushered in the era of shareholder value during the past two decades progressively aligned managerial and shareholder interest closing the principal–agent gap identified by Jensen and Meckling (1976), Jensen (1986) (see also Rappaport, 1986; Stern Stuart Consultants, 2002). A critical literature identifies contradictory outcomes, for example, suggesting that the era of shareholder value encouraged a policy of "downsize and distribute" by US firms that undermined competitiveness (Lazonick, 2008; Lazonick & O'Sullivan, 2000). Furthermore, Froud et al. (2006) reveal a discrepancy between managerial narratives and the financial numbers arguing that transformation is often limited and performance outcomes disappointing.

This paper builds on the approach taken by Froud et al. (2006) where financial numbers are deployed to construct alternative critically engaged narratives. Our 'financial numbers' framework of analysis is grounded in accounting to make 'visible' earnings capacity (cash return on capital employed) and our approach takes the form of series of *perspectives* on financial performance: firm, firm-relative and macro using the S&P 500 survivor group[1] of firms. Froud et al. observe that:

> [C]ompany narratives exist in a context that often includes industry narratives and grand narratives of macro-economic trajectory' recommending that analysis 'needs to distinguish different micro-, meso-and macro narratives whose interrelation can involve contest and challenge as much as support and confirmation'. (Froud et al., 2006, p. 126)

Our financial framework of analysis in this paper reveals contradiction and ambiguity within and across firm, firm-relative and macro boundaries of analysis which, we argue, in a manner similar to Froud et al. (2006), can support the construction of critical narratives that engage with a tendency to exaggerate the connection between corporate purpose and financial outcome(s) in an era of shareholder value.

Micro-level financial analysis reveals how a firm's earnings capacity is the product of complex often contradictory market arbitrage interventions across a wide ranging network of stakeholders. Firm-relative performance influenced by both the actions taken by individual firms as by the strategic interventions carried out by competitor firms. Whilst macro benchmarks reveal the extent to which in aggregate firms, in the S&P 500 survivors group, are able to transform both the level and trajectory of their cash earnings on capital employed. All three perspectives are, we argue, necessary because collectively they reveal the extent to which earnings capacity has been transformed and form the basis upon which alternative critical narratives can be constructed.

2. Corporate strategy financialized

In this section we conceptualise corporate strategy financialized using three organizing elements: first the notion of conjunctural break where managerial and shareholder interests align in an era of shareholder value, second market arbitrage to describe how managers (as agents) exploit disturbances between and within markets to modify stakeholder contracts, and third a financial framework to reveal firm, firm-relative and macro perspectives on earnings capacity. Our purpose is to employ the financial numbers and perspectives on financial performance to construct alternative critical narratives about financial transformation in the S&P 500.

2.1. Conjunctural break: aligning managerial and investor interests

In Veblen's text on Business Enterprise owner-managers are at the centre of things in terms of understanding how corporate finance and physical resources can be deployed to increase earnings capacity and market capitalization for investors. In a later period, Chandler (1990) observes that family owner-managers became increasingly decoupled from the strategic and day to day management of the American corporation.

> Owners continued to participate as full-time executives in decisions establishing top-level policy and resource allocation. But in making even these decisions the family members worked closely with full-time salaried top-and middle-level managers who had little or no equity in the enterprise. (Chandler, 1990, p. 48)

During the period 1917–1936 General Motors external stockholders increased from 1900 to 343,000 and over 80 percent of these stockholders held less than 50 shares each (General Motors Archive, 1937). Hannah (2007) reveals the extent of the separation of ownership and control in the US but is more cautious about using capital market modernity as an explanation for US superior economic performance.

[1] S&P 500 firms listed continuously in the S&P 500 composite index 1990–2008.

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