CHAPTER

1 The Importance of Investor Confidence

One scandal rocks investors after another. The problems with Enron, Arthur Andersen, Rite Aid, WorldCom, Adelphia, Global Crossing, Martha Stewart, Merck, etc., have been blamed on greedy accountants, analysts, executives, and directors. The intense media frenzy and investor attention has allowed many people to grab the limelight, and much grandstanding has occurred. Regulators have gone after high-profile companies for fraud. Politicians have suggested and enacted new regulations and laws. Prosecutors have indicted individuals at these scandal-ridden firms. Yet the actions and proposals do not seem to be enough to satisfy investors.

In order to reverse the crisis in investor confidence, investors need to believe that two things will happen. First, those individuals in the corporate system that have misbehaved will be punished. The tough rhetoric from regulators, prosecutors, and politicians makes punishment seem very likely. Second, investors need to see changes in the system that will preclude bad behavior in the future. In general, there are two ways to change behavior—the carrot and the stick. The U.S. government is good with the stick—that is, deterring misbehavior through a fear of legal punishment. The government can make the stick thicker, harder, and more accurate. Indeed, nearly all the proposals have dealt with more laws, better laws, and more regulation. Such measures can change some behavior, but if you really want to change behavior, offer the carrot. In fact, a well-designed incentive system can be a far more powerful motivator than regulation. In a nutshell, this idea has been the triumph of capitalism over socialism. The U.S. government, however, is terrible at offering solutions with the carrot.

When corporate scandals are viewed from an understanding of the corporate system, then solutions can be designed that enhance the system, not drag it down. For example, many view the recent corporate failures as a problem with accountants and auditors. However, the accountants in a firm are operating in an environment created by the company's management in which the accounting department is directed to act like a profit center. Instead of a tracking and evaluation function, accounting departments have also been assigned the task of smoothing earnings and even generating profits. Managers do this to boost the stock price and cash in millions of dollars of stock options. These incentive packages are offered to top managers by the firm's board of directors—the stockholders elect this board of directors. Sure, the accounting profession must share some of the blame for the recent financial meltdowns. But blame can also be shared by managers, the stock option incentive, boards of directors, analysts, and even shareholders. Trying to fix the system by looking at only one piece of it in isolation is a doomed approach. A failure to examine the entire corporate system will only lead to temporary patches and not long-term solutions.

The purpose of this book is to examine the entire corporate system, identify the problems, and propose remedies that both fix the problems and enhance the system without creating more layers of costly government bureaucracy.

Asleep at the Wheel

To gain some perspective, it should be noted that these scandals originated from the excesses of the late 1990s. Indeed, there were strong signals in the late 1990s of forthcoming scandals. However, investors did not seem to care. As long as the stock market was going up, investors did not want to ask too many questions about the behavior of the corporate system that was earning them profits.

Consider SEC Chairman Arthur Levitt's speech to CPAs, lawyers, and academics in New York. The chairman attacked accounting chicanery and earnings management practices, and promised that the agency would go on the offensive. Although the speech was given in 1998, it is reminiscent of the post-Enron environment of 2001 and 2002. In the couple of years after the speech was given, the SEC took actions against many firms for accounting manipulation and fraud. Some firms were mega firms like Bankers Trust, Cendant, Sunbeam, Waste Management, and McKesson HBOC. Other well-known firms with accounting problems included Boston Chicken, Mercury Finance, Telxon, and Oxford Health.[1] But were investors upset about these corporate misdeeds? Were Congressional inquiries made? For the most part, no.

Even the largest two firms (in market value) have been under suspicion—General Electric (GE) and Cisco. The media expressed concerns about the earnings management practices of GE, and, while the company is notorious for producing increased profits every year, *Money* magazine claimed that earnings would have been down in 1997 and flat in 1999 had it not been for some accounting maneuvering.[2] *Barron's* questioned the long-term viability of Cisco's practice of financial engineering.[3] The article specifically questioned the accounting used in Cisco's endless string of acquisitions. Indeed, the article went so far as to call Cisco a "modern house of cards." Again, investors did not seem too concerned about the accounting problems. After all, investors had made a lot of money investing in Cisco and GE.

However, the stock market declined (along with the economy) in 2000 and 2001. Then came the failures and collapse at Enron in the fall of 2001. Enron's managers, accountants, analysts, and board of directors all failed the investors and employees of Enron. Investors became angry at the enormous fraud at Enron and at the other firms that have subsequently announced problems. However, the problems have been brewing for a while. It has only been since the Enron debacle that investors, the media, regulators, and politicians have taken notice and demanded accountability.

The outcry against corporate greed and fraud is a manifestation of the failing confidence of investors in the corporate system, which, in turn, is partially caused by the decline in the stock market. The following sections illustrate this crisis in investor confidence and how it affects the stock market. Eventually, the lack of confidence can become a drag on the economy. The crisis needs to be reversed before too much damage is done.

Investor Attitude

A crisis in investor confidence means that the very people who support the corporate system become disillusioned with the system. The corporate form of business relies on investors to fund a company with capital through the purchase of its stock. The dynamics of the corporate system are described in the next chapter. However, the role of investors is a critical component to the corporate system and to capitalism in general. So, is there really a crisis in investor confidence? One way to find out is to simply ask investors.

United States Trust Company frequently surveys Americans deemed to be in the wealthiest 1 percent. Their 21st survey occurred in 2002 and included several questions about confidence in the corporate system.[4] Before we examine the responses, we should get to know the people considered to be in the wealthiest 1 percent of Americans. People are considered to be in the top 1 percent if they either have a net worth of at least $3.75 million or earn at least $300,000 annually. In addition, most of these people created this wealth themselves—only 5 percent inherited wealth. Indeed, nearly 70 percent of respondents said that they grew up in a middle class or lower household. So, how did they create this wealth? Generally, they became wealthy in the business world. For example, 41 percent thought their corporate employment was a very important source of their wealth. Family-owned business was a very important source of wealth for 37 percent of those surveyed. In other words, these people know about business. They have worked in the business world for several decades and were able to create wealth for themselves. They are business insiders.

How do these insiders feel about the corporate system? Figure 1–1 shows the percent of those surveyed who agree with various questions about investor confidence. First, 38 percent are wary of investing in public companies. These affluent Americans mostly obtained their wealth through the business world, yet more than one third of them are wary of public companies! Why are they concerned? The graph shows that 76 percent of those surveyed do not trust public company financial statements, 73 percent do not trust equity analyst recommendations, 66 percent do not trust corporate management, and 58 percent do not trust auditors. If these business insiders lack confidence in the corporate system, then the rest of us should too!

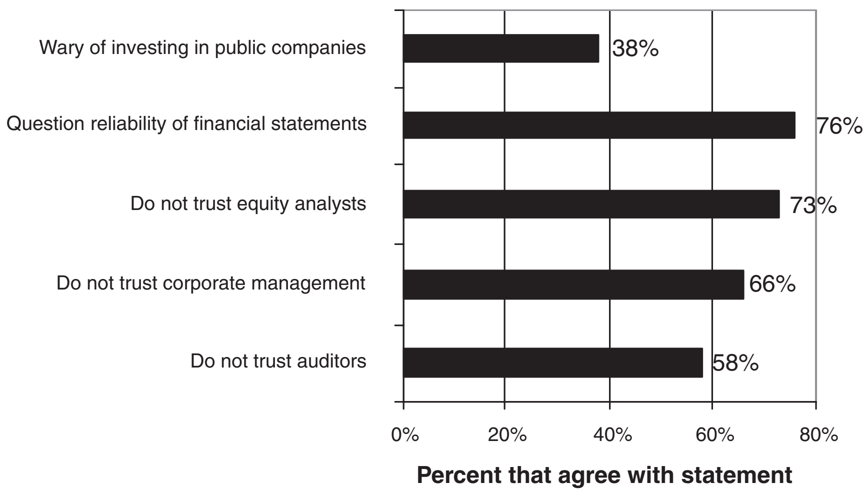


FIGURE 1–1 This graph shows the percent of affluent Americans who agree with the statement about confidence in the corporate system. Source: U.S. Trust Survey of Affluent Americans, June 2002

These attitudes are bad news for the economy because the wealthy are likely to reduce their spending as a response to their drop in wealth and mistrust of the corporate system. For example, 41 percent of those surveyed stated that they were likely to postpone home improvements, 39 percent will cut back on big-ticket purchases, and 37 percent will postpone the purchase of a new car or boat. If this reduction in spending actually occurs, it will hurt the economy. Both consumer spending and business spending drive the economy. If consumers reduce spending, the economy will be adversely affected.

The average investor also seems to have lost confidence in corporate America. CBS News conducted a poll of 685 people on July 8 and 9, 2002.[5] When asked, 79 percent of the respondents thought questionable accounting practices were widespread, 68 percent thought insider trading was widespread, 67 percent thought American corporate executives were not honest, and 57 percent thought white-collar crimes happen very often. Investor reaction to the scandals can be seen in the media, which often reflects an audience's mood. Print, radio, and TV media frequently bring up the crisis in investor confidence. Newspapers are printing many letters to the editor from readers on the subject, and thousands of messages are being posted on stock-oriented discussion boards. Will the lack of investor confidence also translate into changes in consumer spending?

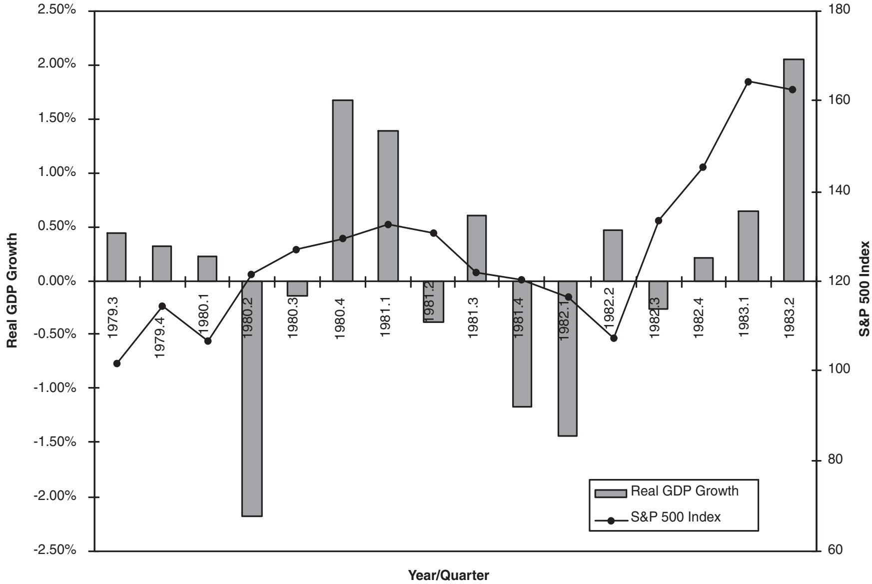
Investor Confidence and the Stock Market

It seems clear that investors lack confidence in the corporate system. However, does this translate into changes in investing behavior? One way to examine this issue is to look at the stock market's performance. We expect the stock market to decline in conjunction with a decline in the economy. In fact, it usually declines in anticipation of an economic downturn. The economy actually did contract in the third quarter of 2001. Since that time, the economy has been growing. Shouldn't the stock market be rising along with the expansion of the economy?

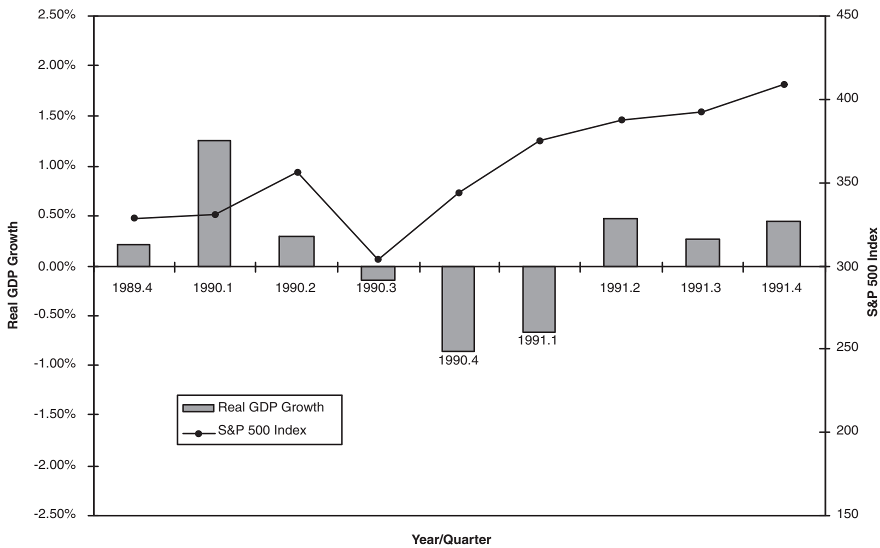
The following analysis describes the stock market reaction to the last four instances of economic contraction.

Consider the four graphs of the stock market and the economy in Figure 1–2. They illustrate that the bear market in the 2002 stock market is not related to the economy. Each of the four graphs is structured the same. The bar graph shows the real GDP growth rate in the economy in several quarters (the term “real” means that inflation has been removed). The scale for the growth rate is on the left-hand side and is the same in all four graphs. Therefore, the height of each bar is comparable between graphs. The line represents the level of the Standard & Poor’s (S&P) 500 Index at the end of each quarter. The level is denoted on the right-hand side of the graph. Since the level of the stock market changes over time, the right-hand scale is not the same among graphs.

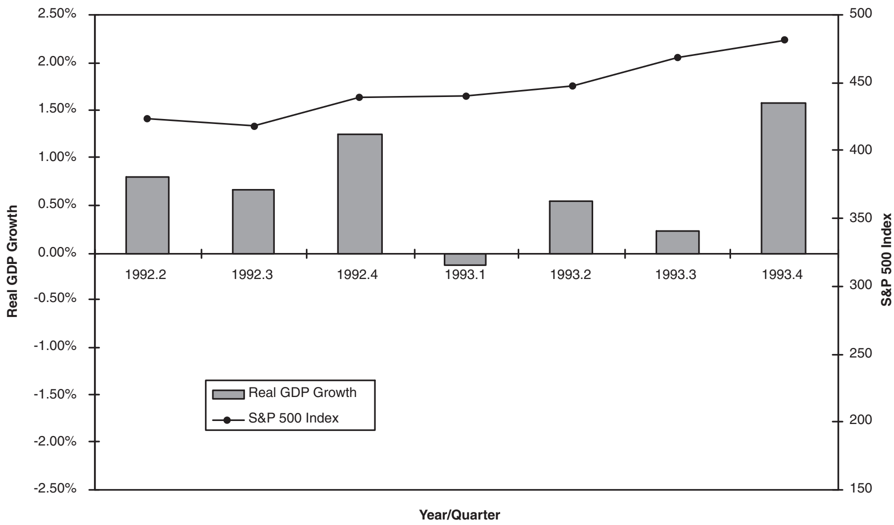
The figure shows the last four times the economy has shrunk for at least one quarter. The period between the second quarter of 1980 and the third quarter of 1982 experienced several quarters of recession. This is depicted in Panel A of the figure. The graph begins with three quarters of growth starting in the third quarter of 1979. Then, in the second quarter of 1980, the economy experiences a severe recession that continues for six months. Note that the stock market anticipates the recession and declines before the recession begins. Indeed, by the middle of the recession, the stock market has predicted the ensuing recovery and has already moved upward. While the recovery was strong, it was also short. By the second quarter of 1981, the economy was shrinking again. Real economic growth was negative in four out of six quarters between the second quarter of 1981 and the third quarter of 1982. The stock market declined through the tough times and again predicted a recovery and started moving up during the third quarter of 1982. The graph ends with three quarters of continued economic expansion. At the end of the three quarters of expansion, the stock market was well higher than when it started three quarters before the beginning of the economic decline. In fact, the S&P 500 Index was up nearly 60 percent from before the recession to after it.



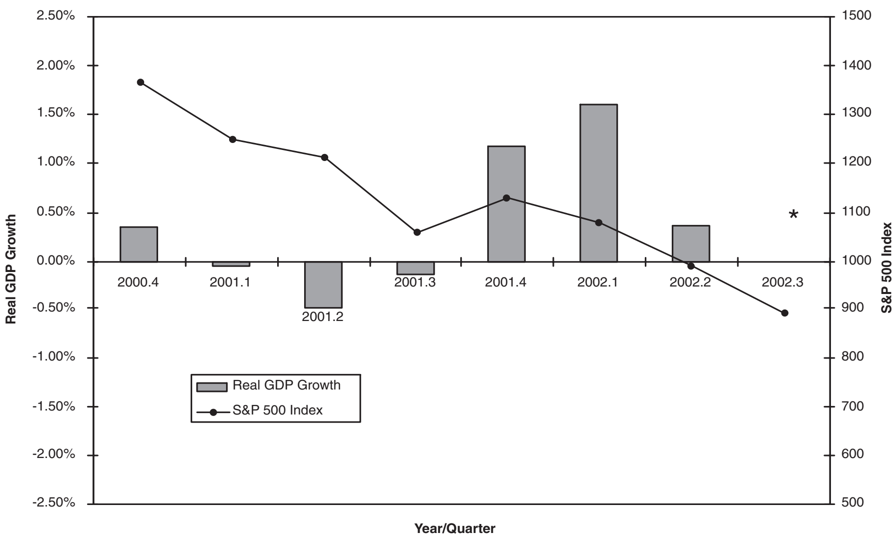
Panel A Early 1980s recession.



Panel B Early 1990s recession.



Panel C Mid-1990s recession.



Panel D Recent recession. (S&P 500 Index data ended on Friday, September 13, 2002. * indicates that economic growth data for the quarter was unavailable at the time of printing.)

Figure 1–2 The four figures show the real GDP growth by quarter for the past four recession periods. The level of S&P 500 Index for the periods is also shown.

The next economic recession occurred in the early 1990s. Panel B of the figure illustrates what happened. The real economic growth rate for the economy was negative in the three consecutive quarters starting in the third quarter of 1990. The stock market declined early in the recession and then rose higher in anticipation of the recovery. Three quarters into the recovery, the stock market had risen nearly 25 percent from its pre-recession levels.

The next interruption in the growth of the economy occurred in first quarter of 1993. Note from Panel C of the figure that the economy only shrunk for one quarter and only by a small amount. The stock market hardly noticed the economic decline and continued to rise during the period.

That brings us to the most recent period of economic contraction. Panel D shows the economic growth and stock market level around 2001. The real growth in the fourth quarter of 2000 was modest. Beginning with the first quarter of 2001, the economy contracted. However, the recession was small compared to the contractions of the early 1980s (Panel A) and early 1990s (Panel B). The stock market anticipated the decline in the economy and trended downward before it started to decline. The stock market also anticipated the recovery that began in the fourth quarter of 2001. Indeed, the growth of the economy in the three quarters after the recession was large compared to the three previous recessions depicted in Panels A through C. Yet the stock market did not recover.

The stock market has continued its decline in the face of the economic recovery. The S&P 500 Index fell to less than 800 in July 2002. Why? If the stock market had recovered as strongly as in previous recessions, the S&P 500 could have been more than 1,500 in June 2002. At the beginning of 2002, Jeffrey Applegate, strategist at Lehman Brothers, forecast the S&P 500 to finish the year at 1,200. Thomas McManus at Banc of America Securities forecast 1,150. Instead, the index was less than 1,000 in June and plummeted to less than 800 in July. The market was down a lot. Why? We argue that investors have lost confidence in the corporate system and that has affected the stock market.

Investors have not totally lost confidence. Investors do not appear to be moving all of their money out of stocks. Large masses of employees do not appear to be liquidating the equity in their retirement plans. However, investors seem to be holding back new investment money from the market and a few are getting out of the market. For example, in June and July 2002, there was a net $70.9 billion withdrawn from equity mutual funds.[6]

The crisis also seems to be affecting foreigners who invest in the U.S. stock market. Consider what happens when a foreign investor sells his or her U.S. stock. The investor sells the stock in the stock market and receives U.S. dollars. Then, the investor must sell the U.S. dollars and buy the currency of his or her own country. If many people are selling U.S. dollars and buying their own currency, then the U.S. dollar's price will fall. That is, selling of the U.S. dollar will cause its value to decline relative to other currencies. Has this happened? It appears that it has. From February to mid-summer 2002, the U.S. dollar has lost 12 percent of its value against both the euro and the Japanese yen. The lower U.S. dollar will affect your pocketbook. It makes the foreign products you buy more expensive.

Long-Term Economic Effects

The level of the stock market is very important to the economy. Both consumer purchasing and business investment drive the economy. We have already discussed the association between investor confidence and consumer purchasing. When investors lose confidence, they tend to purchase fewer big-ticket items and postpone buying a new car. A prolonged slowdown in consumer purchasing will slow down the economy as well.

However, a depressed stock market also affects business investment. To see this relationship, first consider the effect of a high stock market. Indeed, consider what happens when the market is overvalued, as it was during the bubble of the late 1990s. If a company manager thinks the stock price is overvalued relative to the true fundamentals of the firm, then he or she will be inclined to issue new stock. In other words, the stock can be sold at an inflated value. The company can receive more money for it than it is worth. Thus, it seems easy and cheap to raise capital when the stock is overvalued.[7] Corporations can issue new stock and use the capital to make business investments. Business investments are the equipment needed to conduct and expand business operations. Corporations buy trucks, machines, factories, computers, and other capital items. These purchases improve the economy.

Now consider what happens if the company's stock is perceived by the managers to be undervalued. If the firm wants to raise equity capital, it would have to issue new stock at a low price—a price lower than the managers think it is worth based on the fundamentals of the firm. This seems like a poor deal. Thus, firms tend to issue less stock and, therefore, make fewer business investments when the stock market is low. Or, at least, firms take such actions when managers feel the stock market is undervalued. This relationship between the stock price level and business investment is particularly strong for smaller firms with good growth opportunities.[8] Larger firms have better access to other capital markets (like the bond market), and firms without growth opportunity do not need capital.

An example of the relationship between the stock market level and business investment is illustrated by the real (inflation adjusted) Gross Private Domestic Investment, a measure that the U.S. Department of Commerce uses to track the business investment made in the United States. The record amount of investment was $1.7 and $1.8 trillion in the quarters near the top of the stock market bubble in late 1999 and early 2000. Since then, business has dropped off to less than $1.6 trillion per quarter—a decline of $100 billion per quarter. Consider also how the level of the stock market affects the ability of new firms to raise capital. During the height of the market bubble in 1999, a record 548 companies obtained capital through initial public offerings (IPOs). The first half of 2002 can be characterized by a depressed market with concerned investors. It is no wonder that only 46 IPOs were offered in the first six months of 2002.

Company executives are under attack for being loose with the books. Often, the public's perception is that executives are spending their time rebuilding profits and balance sheets. Executives must certify their financial numbers to the SEC and defend against a sustained media and political attack for misdeeds, and they are not spending as much effort on business expansion activities requiring new capital spending. Companies that sell products that support expansion—like the hardware and software, respectively, of IBM and Siebel Systems—report that they are seeing reduced sales and orders for their products.[9]

If the stock market is only temporarily depressed, it should not create a big problem for the economy. As argued above, the recent market depression is caused more by a lack of investor confidence than poor economic conditions. However, if the stock market remains depressed for long, it may begin to slow down the economy as well. The lack of investor confidence causes consumers to delay their spending. The lower stock market, caused by the confidence crisis, will eventually affect business investment too. With lower consumer purchases and business investment, the economy could sink into another recession. Therefore, it is imperative that investor confidence is restored quickly.

Our Approach

Before remedies can be offered to fix the system, one must understand how the system works. We detail how the American corporate system works in the next chapter. Afterward, we can discuss where and why the failures have occurred in the system. In many instances, the executive leadership of companies failed. In Part 1 of the book, we describe how executive compensation systems can lead to unethical and greedy behavior.

To keep corporate managers working hard for the shareholders and to prevent them from undesirable behavior, several different groups monitor them. This monitoring system is made up of people such as boards of directors, accountants and auditors, analysts, and professionals at investment banks.

Part 2 of this book illustrates how the monitoring system has failed. Were these monitors also greedy? Were they complacent? Indeed, in most cases the corporate system had developed conflicts of interest and incentive problems that distracted monitors from their main duty; we illustrate these problems. The American corporate system also includes regulatory agencies to watch over the system. We discuss the role of these regulatory agencies in the current investor crisis in Part 3. We also discuss how investors themselves have failed to watch over their own companies.

Once the system and its failures are known, we will then be in a position to offer solutions that improve and enhance the system for the long term. Most of the solutions coming from political leaders and regulators are focused on either punishment of offenders or more regulatory oversight. In our view, these proposals are analogous to changing behavior using a stick. Alternatively, we propose solutions in Part 4 that are incentive driven. That is, we offer ways to change behavior by offering the proverbial carrot. It might be useful if corporate leaders avoided wrongdoing because of fear of being caught, but we would rather they work very hard to do the right thing because they want to—because they are rewarded by doing so.

In short, we think that a clear understanding of the interrelated incentives of the many individuals in corporate business will allow for the formulation of targeted policy changes that will both fix and enhance the American corporate system. A complete solution may also convince investors that U.S. companies and the U.S. stock market are the best places to invest for the long term. However, fixing the system may not be enough to restore investor confidence. In Chapter 14, we discuss what it will take to regain investors' trust in the corporate system.

Endnotes

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