What is Financial-market Capitalism?

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Table of Contents
1. Varieties of capitalism
2. Financial-market capitalism
3. Function of stock market: capitalisation
4. The new shareholders: investment funds
5. Boundary roles: analysts
6. Transfer mechanisms: financialisation of companies
7. Conclusions

Summary
Financial-market capitalism is a production regime, which is characterised by a specific
collection of economic institutions. Among these institutions are: the stock markets
(capitalisation); the investment funds (shareholders); analysts and rating agencies (boundary
roles); transfer mechanisms (e.g. hostile takeovers). The control centre of financial-market
capitalism are the stock markets, which trade in virtual capital (capitalisation). Stock markets
are only able to transform uncertainty into risk on a virtual basis. Therefore, stock markets
offer a special environment for opportunism (moral hazard). The investment funds are the
"new” shareholders, which by now hold the majority in the major corporations in the U.S.
They are subject to the operational logic of the market, forcing companies to adopt the short-
term strategy of profit maximisation. Hostile takeovers, the market for corporate control and
stock options are specific transfer mechanisms which transfer the operational logic of the
market to real economics (financialisation of companies).
1. Varieties of capitalism

Different types of capitalism are not only characterised by different institutions of the labour market or the welfare state, but also by different institutions of the financial market. One distinguishes between finance systems which are more based on the external market (market-based systems) and those which are more based on banks (bank-based systems). In the first case, companies are controlled externally by the financial market (e.g. the U.S., Great Britain), while in the second case, they are controlled internally by banks and networks (Japan Inc., Germany Inc.).

Shares and loans are different instruments of corporate finance. These instruments are integrated in a system of institutions, which varies from country to country. The creditors of a company, for instance, have different rights regarding information and control than shareholders. For this reason, we encounter different types of corporate governance in countries, where companies are mainly financed by loans, compared with countries where companies are chiefly financed by shares.

Hilferding highlights the significance of banks for the particular type of “organised capitalism” that developed in Germany as early as before World War I. He shows that a bank commits itself to a company in the long term by providing loans for investment purposes. This results in the bank’s “permanent interest” in controlling that company in order to “ensure the proper use of the loan”. The bank has a number of instruments of control in order to safeguard its influence. These include the presence of bank directors on the board of the debtor company, proxy voting rights and, in times of crises, the conversion of a loan into shares in the company. This way, the bank becomes the shareholder and is able to intervene directly with the management of a company.

The lending banks attempt to commit companies to a specific form of economic reasoning, which can be explained with the peculiarity of loans when used as a financing instrument. The banks are not interested in their debtors pursuing a strategy of profit maximisation (thus committing themselves to relatively high risks). Instead, the banks are interested in a reliable solvency of the company in order to redeem the loans. This interest of the banks can be explained with the legal structure of the loan agreement:

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1 Regarding the term "varieties of capitalism", see Hall and Soskice (2001); regarding the welfare state, see Esping-Anderson (1990); Edwards and Fischer (1994) and Franks et al. (2006) provide analyses of the German finance system.
2 The question of a comparative corporate finance analysis is: "Are market-based or bank-based financial systems better at financing the expansion of industries...?" (Beck and Levine 2002: 147).
5 Some shareholdings, which the Deutsche Bank held in German industrial companies in 1995, were created from earlier financial recovery programmes: e.g. Klöckner-Humboldt-Deutz 45%, Metallgesellschaft 16.6%, Südzucker 12.8%. Source: Business report of Deutsche Bank 1995, p. 52.
The banks receive a fixed interest rate for their loans. If the companies were to decide in favour of high risk investments, the lending bank would also be at risk if the company went bankrupt, while the benefit from large additional profits would only be appropriated by the debtor if high risk investments were to be successful (Williamson 1988: 578).

It is fairly easy to describe the preferences of a lending bank: a bank would prefer monopolistic market structures (cartels), in order to stabilise the profit situation of the company in the long term by limiting the competition. Towards the debtor, the bank is a risk-averse contract partner who attempts to deter management from taking any overly high risks. Normally, loans provided by (German) banks constitute long-term, controlling and risk-averse capital.

The differences in forms of financing are also reflected in the laws of a country. Until the end of the 1990s, accounting rules were in force in Germany that were mainly designed to protect the lenders, rather than minority shareholders. Compared to the U.S., the German stock market was hardly regulated; it was mainly controlled by a cartel of the large banks (corporatist control model).6

2. Financial-market capitalism

The system of institutions, which is termed "financial-market capitalism" here, has a different structure. It is not the loans that are the dominating financing instrument but the shares.7 The relations between the financial market and real economics are not characterised by relational contracting8 between a bank and the company, but by the mechanisms of global financial markets.

The main players of this system are the pension and investment funds, which in the U.S. now own approx. 66% of the shares in the 1,000 largest companies. The 20 largest investment funds hold approx. 40% of the shares.9 If they coordinate their actions, the investment funds are majority shareholders and are able to control the companies (acting in concert). The loan is not the controlling instrument, but the property rights which they are able to assert themselves as shareholders.

There are hundreds of investment funds, whose relationship to each other is characterised by tough competition for the investments (savings) of the customers. The performance of the

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6 Cf. La Porta et al. (1998, 2003).
7 In the U.S., banks of course also give out loans. And in Germany, companies have also financed their operations via the stock market since the late 19th century. Between 1980 and 1989, the banks in Japan and Germany still granted more loans to companies than was the case in the U.S. Bank loans, measured as a percentage of GNP: Japan 96%, Germany 82%, U.S. 66%. Source: Beck and Levine (2002: 177, Table 7).
investment funds can be measured accurately every year. They risk losing the investments of their customers if they lag behind their competitors in regard to profit maximisation.

In the 1960s, economists largely agreed on the fact that the managers of the large companies did not pursue a strategy of profit maximisation but only attempted to reach a "satisfactory" profit and that their prime target was growth. In the large companies, the separation of ownership and control shielded the managers from the influence of the shareholders and largely provided them with autonomy.

In the U.S. of 1960, 88% of the share capital was still owned by small shareholders and families. These shareholders were not forced to compete for the largest dividend possible. In a sense, the share capital of the small shareholders was also long-term capital. The turnover ratio on the stock markets is an indicator of this. In 1960, it was 12% on the New York Stock Exchange, which means that shareholders held their shares for an average of 8.3 years. In 1987, the average turnover ratio had risen to 73%, in 2000 this ratio (churn rate) has risen to more than 100%, i.e. the shareholders already sold their shares after one year.

A change of strategy took place with the introduction of shareholder value. It is no longer growth but profit maximisation that is the predominant aim of managers. Investment funds transfer the pressure of the competition, to which they are subjected on the stock market, to companies. The demerger of major conglomerates in the U.S., the concentration on core business and a stronger focus on share price are indicators that illustrate this change of strategy.

It is now possible to describe the institutionalised configuration of financial-market capitalism more accurately: A reconcentration of share ownership has taken place. The "new" shareholders are competing for the largest profit possible, forcing the companies' management to produce a high return on equity. The investment funds only hold 2-3% in each company. They are able to sell their shares at any time and are therefore liquid (exit). The high turnover ratio also results in shareholders of the large companies being replaced at an average rate of one year.

The competition of the lending banks tends to lead to a lowering of interest rates and thus to a decrease in capital costs. In addition to this, it is in the interest of the banks to limit corporate risk. The competition of the investment funds to achieve a maximum of profit tends to lead to an increase in capital costs. The operating capital of a company consists of equity and borrowed capital. The companies have to produce a much higher return on their equity than the interest rate they have to pay for long-term borrowing. The "first fundamental law of finance" also applies. This states that higher profit can only be obtained at the price of higher

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12 Sources: Froot et al. (1992: 42); cf. Figure A1, Appendix.
risk. For that reason, the competition of the "new" shareholders tends to lead to an increased risk in the economic system (volatility).\textsuperscript{13}

In global competition, a global rate of profit is established as an average expected return by which all companies are measured (benchmarking). In many countries, we observe that production sites of multinational groups are shut down despite being profitable.\textsuperscript{14} Admittedly, they do not achieve the high return on equity that a group expects from all its subsidiaries. At the AGMs, the representatives of investment funds confront the incumbent management with the demand: "Fix it, sell or close!"\textsuperscript{15}

While the institutions of "organised capitalism" tend to result in a weakening of competition, in financial-market capitalism we observe a gradual tightening of competition. The driving force comes from global financial markets in which players are active who are themselves in tough competition with each other.

Section 3 analyses the function of the stock market (capitalisation). Section 4 concentrates on the major players of financial-market capitalism (investment- and pension funds as shareholders). Section 5 examines an important boundary role of the stock market (analysts). Sections 8 to 10 analyse the transfer mechanisms that transfer the operational logic of the market to the internal operations of the companies (hostile takeovers, market for corporate control, stock options).

3. The function of the stock market: capitalisation

In the real economy, goods and services are produced and exchanged. In financial markets, "promises to pay in the future" are traded. A commodity market is past-oriented: a past production process has to prove itself in the market. Promises to pay (shares) are future-oriented: Shareholders are interested in the total future profits of a company. Three theses will be elucidated in the following section:

(1) The central operation of the financial market lies in capitalisation, i.e. the determination of an expected value for promises to pay.
(2) The financial markets do not operate with expectations, but with the expectation of expectations.
(3) In the stock market, the complexity of the real economy (future production processes) cannot in fact be reduced but can only be reduced virtually. For this reason, every share price only represents virtual capital.

\textsuperscript{13} Ghysels et al. (2005: 510); Campbell, J. et al. (2001).
\textsuperscript{14} The Finnish group Nokia closed down its production plant in Bochum (Germany) in 2008 (2300 employees). The production of mobile telephones was moved to Romania. Cadbury has closed down its operation in Keynsham (Great Britain) and moved the chocolate production to Poland (500 employees). Both companies were profitable in the past years but they did not meet the benchmark of the group (return on equity).
\textsuperscript{15} Source: http://boerse.ard.de/key=document_79411 (February 2005).
In the commodity market, the complexity of the production process and the ensuing contingencies are reduced to one figure, i.e. the price. The price that the buyer is prepared to pay continuously answers the question of whether the production process was successful (quality) and whether it was efficient (costs). The market, therefore, is an efficient machine for the reduction of complexity: "The market is a marvel" (Hayek 1945: 527).

While the commodity market determines for each individual case whether a past production process has been economically efficient, financial markets are future-oriented. In order to clarify this, the term capitalisation must be introduced first. Capitalisation means nothing else but the reversal of the interest formula. A sum of money is the basis for the interest formula, the interest rate is fixed (e.g. 5%) and the interest received, or yield, is the result.

<table>
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<tr>
<th>Equation</th>
<th>Description</th>
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<tbody>
<tr>
<td>(1) Interest formula: (€ 200 x 5)/100 = 10 € (yield on interest)</td>
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<tr>
<td>(2) Capitalisation: (€ 10/5) x100 = 200 € (investment)</td>
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The starting point of capitalisation is the profit, i.e. the promise of payment: what amount of profit is the company going to produce next year? If this profit is weighted with an interest rate (e.g. 5%), the capitalisation is the result, i.e. the price one is prepared to pay for a promise of payment.

Equation (2) contains two unknown variables: 1. how does the investor know what profit the company is going to produce in the following year? The forecast of the future profit is encumbered by the entire complexity and all the risks of the production process (= the real economy). 2. What interest rate should be assumed as the average capital cost?

The market converts uncertainty into risk. In every share price that is determined, the complexity of the real economy is in fact reduced. The market can only determine a price for a future promise of payment (= share price) if the total future profit is weighted with a risk factor. The expected value of the total future profit has to be calculated. The central operation of the financial market is the calculation of this expected value.

But let’s return to equation (2) for capitalisation. The company predicts a profit of €10 per share. For this prediction, the company cannot rely on the product market, which is only able to reduce the complexity of past production processes. The prognosis is encumbered with all the contingencies of future production processes. Investors are aware of this, weighting the predicted profit with 0.8, i.e. at that moment they assume that the predicted profit will be realised with a probability of 0.8. This is how the share price will be determined: (0.8x€10/5) x100 = 160. This evaluation can change at any minute.

The second variable in equation (2) is the average interest rate for risk-free assets for the next year. This depends among other factors on the Central Banks’ decisions in regard to the rate
of interest. Only if these variables are defined can the share price be determined with the help of the capitalisation formula (2). Marsh (1991: 68) arrives at the conclusion: "The problem with this procedure ... is that it can provide you with any answer you want."

Financial markets have to deal with all the potential contingencies that may affect future production processes: Will there be a strike at Ford within the next financial year? Will the U.S. health authority approve a drug that has been developed by Pfizer Inc? Will Pakistan (the major export country of a British company) still be politically stable by next year? What will sales in the Chinese market be like for Oracle Corp. in two years’ time?

When assessing the future profitability, the product market is not available as a complexity-reduction machine. In this case, the stock market is confronted with the full environmental complexity and is forced to use market surrogates in order to convert uncertainty into risk.

Hayek (1976: 153-57) argued that the socialist planned economy must fail because of a problem regarding information. No one was to know how much steel would be required next year and whether consumers would still be buying black trousers. But the financial markets had to forecast this exactly if they were to determine the future profitability of a steel works or a clothes factory.

Regardless of how efficient the market may be, there is no mechanism that is able to convert these uncertainties into risk, i.e. into a numerically accurate probability with which future profit can be discounted. The financial markets are not really able to convert uncertainty into risk; they are only able to do this virtually. This is why capitalisation only constitutes virtual capital.

Fama (1991: 1575) defined the efficiency of the market like this: “I take the market efficiency hypothesis to be the simple statement that security prices fully reflect all available information.” Ergo, the financial markets are information-processing machines and as such, they perform a reduction of complexity, similar to the commodity markets. However, one still has to define more accurately what "market efficiency" means in this case. Berle und Means (1997: 259) describe the information processing performed by the market as follows:

"... the market has collected around itself a tremendous mechanism for collection and dissemination of facts.... from moment to moment, through the various ticker services constantly pours into the market a running narrative of facts, figures, amounts, opinion, and

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16 The capitalisation (= share price) can only be calculated if a particular interest rate is exogenously given. If the Federal Reserve Board in the U.S. lowers the base rate to 4%, the equation (2) reads: (€ 104)x100 = € 250. The lowering of the average interest rate for risk-free assets by 1% thus (theoretically!) leads to an increase in the share price of € 50. (We ignore the problem of a risk premium to make the calculation simple.)

17 The problem that is discussed here must be solved regardless of which "capital asset pricing model" is used. In any case, two risk factors must be defined exogenously: one risk factor that defines the probability with which a future promise to pay can be met (dividend). The second factor, which must be introduced exogenously into the model, is the average capital cost. Cf. Fama (1991: 1575f.).

information of all sorts, which does or is thought to bear upon values of the securities traded in. Naturally much of what is disclosed is not necessarily true; and much of what is true never reaches the market.”

In most cases, the market is unable to forecast the (unintended) consequences of current events with sufficient accuracy. It cannot know whether an increase in the oil price by 4% will actually affect the sale of cars or whether a terrorist attack is really going to dampen the travel activities of tourists in the following season. The market processes “information of all sorts, which does or is thought to bear upon values of the securities” (emphasis P.W.).

Luhmann (1977: 68) argues that the internal processing capacity of a system in many cases is unable to cope with the complexity of the environment. This complexity has to be internalised in the form of abstract surrogates. The real economy is an environment for the stock market and the stock market cannot process its complexity sufficiently. The market players therefore use surrogates in order to reduce these uncertainties. Luhmann describes these surrogates as "unanalysed abstractions". Keynes (1970: 156) described such an abstraction in his metaphor of the beauty contest:

"... professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees."

Here, Keynes accurately phrases the problem of double contingency - and ensuing endless loops of reciprocal observation ("the fourth, fifth and higher degrees").

The capitalisation, i.e. the expected value of total future profits determines the share price. It has been argued that this expected value could only be determined with sufficient accuracy if the market was able to process the full complexity of future production processes. Taken one step further, it was argued that no information system would be able to do this. Keynes describes the surrogate – the “unanalysed abstraction”– which takes the place of an internalisation of complexity, which cannot be performed.

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19 Financial markets operate with a low "signal to noise ratio”. This ratio is measured as the ratio between the strength of a signal and the surrounding noise (white noise). In the financial markets, which process a constant flow of (irrelevant) information, the level of “white noise” is particularly high.
If this endless stream of information, which Berle and Means mention, reaches the market, the purpose cannot be to determine how the rise or fall in oil prices, the death of a statesman, a strike or the decline of the coffee price would influence the profitability of a company. Such an evaluation cannot seriously be carried out ad hoc. The issue is to estimate correctly how the other market players would react to this event. And the other market players are in the same position. They attempt to find out ”what average opinion expects the average opinion to be”: buy or sell?

Investors and analysts stand between two mirrors which reflect their own reactions infinitely. Pricing in the stock market is performed - ad hoc and spontaneously – not on the basis of one’s own expectations of the future profitability of a company (which is largely unknown), but on the basis of the expectation of expectations.

I/B/E/S is an institution in the U.S. financial market which continuously publishes the estimates of analysts in regard to the earnings per share of major companies. This average estimate, which takes into account the expectations of all analysts, serves effectively as the “official” publication of the expectation of expectations. In the next step, analysts are able to act on the basis of this information, deciding whether they should adhere closely to “what average opinion expects the average opinion to be” (herding) or whether they should publish calculated deviations (boldness).

In summary, it can be stated that market players observe the expectation of expectations, which are based on a continuous stream of information. A risk factor is estimated on the basis of these and the price for a promise of payment can thus be determined ad hoc. In this sense, the markets are efficient machines for processing information. The complexity of the real economy is however only reduced virtually (unanalysed abstraction).

In various studies, Shiller (2000) has proven that the volatility (variance) of the share price is significantly higher than the volatility of the dividend (company return). In view of the arguments presented so far, this result is not surprising. The company return depends on a path, i.e. it is influenced by the investment decisions of previous periods and by path-dependent changes in the commodity market. The volatility of the share price is based in turn

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20 The point is not to make a decision in one week, i.e. after evaluating all the facts and obtaining additional information. One has to react here and now. According to financial economists, this is exactly what accounts for the efficiency of the financial market. The financial markets are the more efficient the faster they process relevant information in a pricing reaction. If you are late, you have already lost.

21 I/B/E/S (Institutional Brokers Estimate System) is an important (private) institution for the self-regulation of analysts in the U.S. Every quarter, it publishes the forecasts (earnings per share) of all analysts and calculates the consensus forecast, which here is considered an indicator for the expectation of expectations. The data, which is collected by I/B/E/S, facilitates a complete reconstruction of the estimates of the analysts for every company. The data also contains information on the investment banks where an analyst was employed, and therefore enables a reconstruction of his career history (rise/fall). On these data, the study of Hong and Kubik (2003) is based, to which we refer below.

22 “We classify forecasts as bold if they are [significantly] above/below the consensus forecast. We classify forecasts that move toward the consensus as herding” (Clement and Tse 2005: 307). The quote has been abridged. The consensus forecast is the average of all estimates of the earnings per share which are published by I/B/E/S.
on a virtual reduction of complexity and on the expectation of expectations, which may change ad hoc. These spontaneous changes are reflected in the random walk of the share price (high volatility).

If this thesis is correct, that is if the market is unable to process the complexity of production processes and the ensuing contingencies sufficiently but replaces these with market surrogates (the expectation of expectations), this would also explain the relative autonomy and the detachment of the stock market from the real economy. The cyclically returning overestimation (boom) and the underestimation (bust) of the stock market is not an irrational reaction (which could be replaced by a rational one), but such shifts derive from the internal dynamics of the "looking-glass effect". The market reinforces its own expectations permanently - in one direction or another. The market evaluates unanalysed – one could also say unanalysable - abstractions, which can be far removed from the real economy.

This cannot be used to arrive at the conclusion that stock markets can be removed any distance from the values of real economics. Post hoc, they will always be linked to the real economy again, i.e. once the balance sheets have been presented, they will provide information regarding the profitability of the past period (fundamental data). But by then the stock market will already have moved on to the next future period.

Keynes’ quote is from 1936 and points out that the stock markets already functioned in the way described at the beginning of the 20th century. So in what way is it relevant for the institutions of financial-market capitalism that are analysed here?

Berle and Means (1997) coined the famous formula of the “separation of ownership and control“: In companies that have hundreds of thousands of shareholders, small shareholders are no longer able to assert their rights of ownership and control. The paradox of collective action leads to the management, as a small, professional and highly organised group, in fact controlling the company. Due in particular to the separation of ownership and control, major companies were mainly shielded from the turbulence of the stock market (autonomy of the managers). It was sufficient for the management to placate the small shareholders with a "satisfactory" dividend. Another line of reasoning, which however arrives at the same conclusion, applies to companies in which ownership is highly concentrated, which was the case for the majority of German companies: large shareholders were able to determine their strategies autonomously and were not victims of the turbulences of the stock market. The shares of companies with a majority shareholder are only traded at the stock markets in small volumes (free float).

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23 Hilferding (1955: 147) also refers to these decoupling tendencies: "Once created, a share no longer has anything to do with the real cycle of industrial capital which it represents. The events and accidents which they can expect during their circulation leave the cycle of the productive capital untouched." This is of course an exaggeration, only describing a tendency. Post hoc – i.e. if the balance sheets have to be presented for the past period – the financial markets will always continue to be linked to the real economy.

24 Cf. the concept of the “looking-glass self” of Cooley (1967: 179ff.).
It is a different matter if the majority of the shares are held in investment funds that are subject to the logic of financial markets. No individual investment fund is a majority shareholder, but the twenty largest investment funds together constitute a strategic player which is able to control the management of major companies, or is at least able to influence them. Due to market competition, the decisions of the investment funds are directed in the same direction: profit maximisation. The “new” shareholders of major companies must follow the operative logic of the market and must, therefore, try to convert this operative logic into the strategies of the management and the internal methods of control of the companies (financialisation). The buffers with which the real economy used to shield itself from the financial markets become weaker and the turbulences of the stock market are able to cause stronger “resonance vibrations” in companies (Luhmann 1990: 40ff.). The following section analyses the constraints under which the investment funds operate more thoroughly.

4. The new shareholders: investment funds

Between 1990 and 2000, the assets owned by investment funds (IF), rose sharply in all countries. Measured as a percentage of GNP, the assets of IF rose from 127% to 195% in the U.S., from 131% to 226% in Great Britain, and from 34% to 80% in Germany. Investment in shares as a percentage of total assets also rose significantly between 1990 and 2000: from 25% to 51% in the U.S., from 9% to 28% in Germany and from 14% to 43% in the Netherlands. In Great Britain, this share remained stable at approx. 67%. The savings invested in IF by the public have grown constantly, and an increasing percentage of these deposits are invested in shares. As a result, IF have become the largest shareholders in major companies. We have already pointed out that they hold 66% of the shares in the 1000 largest companies in the U.S., and that the 20 largest investment funds control approx. 40% of the shares.

In a study of the period between 1983 and 1989, which was conducted by Lakonishok et al. in 1992, the investment strategies of 341 investment funds were analysed. The study showed that the five largest IF only held a market share of 14.1%. In other words: ” [This market is] extremely unconcentrated … and highly segmented…” (p. 364). The authors also showed that the acquisition of new customers depends on the profit that was generated in the past: if a fund manager achieved a profit that was 1% above the average of her competitors, she could expect customer investments to increase by 1.3% in the following year (p. 367). This study therefore confirms two central assumptions on which our line of reasoning is based: IF are subjected to atomistic competition and the parameter of the competition is the profit that they achieve for their customers.

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25 The separation of ownership and control (managerial autonomy) and the financing of investments out of retained earnings (low pay-out ratios) used to be strong buffers.
26 This section generally calls institutional investors 'investment funds', abbreviated IF. Among these institutional investors are investment-, pension- and hedge funds. Specific private equity transactions (e.g. IPOs), insurances and investment banks can also be allocated to this category.
IF pass the competitive pressure to the companies whose shares they hold. The demand for a return on equity of at least 20% and the additional demand to sell or close those subsidiary firms that do not achieve the profit target are explained here. Shareholder value does not describe the "rational" behaviour of small shareholders but the strategies of IF, which are forced to demand maximum profit from companies. Money managers, who have to submit quarterly reports of the profits generated by the funds managed by them, know that the rule that they proclaim at the Annual General Meetings (AGM) of major companies also applies to them: "Fix it, sell or close." A level of profit that is not competitive will put their own jobs at risk.

The extreme competitive pressure results in the fact that the profits published by IF have often been manipulated. Investment funds use different methods of calculation that cannot be compared, or they only publish the results of those funds that have achieved above average success. For this reason, efforts are being made to make the market more transparent with the help of independent supervisory agencies. These agencies include for instance the CEI Corporation and the Chartered Financial Analyst Institute, which have adopted general standards according to which the profits of investments funds are to be evaluated.

**Investment strategies**

Each IF is structured internally into a number of funds that focus on different investment strategies. Each individual fund is managed by a fund manager who makes the investment decisions. Table 1 shows a schematic classification of the investment strategies. They differ chiefly in the amount of risk that is associated with an investment. The funds that follow an aggressive growth strategy are associated with a relatively high amount of risk whereas funds that follow an "income" investment strategy have a limited amount of risk. Each IF is therefore a conglomerate of individual funds that differ from each other by their various investment strategies.

The allocation pattern of investment in different funds depends on the willingness of investors to take risks. Investors who are reluctant to take risks will concentrate their investments in funds that only bear a small amount of risk (e.g. income funds); clients with a neutral attitude

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29 The study of Lakonishok et al. (1992), which has been quoted above, is based on the data, which was collated by this agency.

30 On the website of CFA, one can for instance find the following note: "On 4 February, 2005, the CFA Institute Board of Governors approved the revised Global Investment Performance Standards, or GIPS, which create a single global standard of investment performance reporting and increases minimum standards worldwide.” Source (April 2005): http://www.cfainstitute.org/standards/pps/gips_redraft_2005.html

31 A further distinction must be introduced here: The term investment fund (IF) is used in order to mark the company or the bank respectively as the owner of the fund; the term 'fund' is used for every individual investment fund and its meaning is often identical with the different investment strategies/styles.
towards risk will concentrate their investments in funds with a large amount of risk (aggressive growth funds).\textsuperscript{32}

The attitude of investment clients to risk can be influenced by advertising, just as the propensity to consume is influenced. However, this advertising does not provide information in regard to the risk. It focuses instead only on the high profit expectations of the aggressive growth funds. IF tend to play down the risk associated with these funds, or even to withhold such information.\textsuperscript{33}

If, as a result of advertising campaigns, IF are able to mobilise a relatively high proportion of savings capital and direct it into their funds, they are obliged as the next step to find a suitable investment object for these investments. There is no mechanism that guarantees that the risk profile of the investors matches the risk profile of the companies’ strategies. If, for instance, as a result of the high profit expectations, a large amount of savings are invested in aggressive growth funds, this does not mean that a sufficient number of companies that pursue a suitable corporate strategy will be available as investment objects. IF are risk converters,\textsuperscript{34} which have to make the attitude of the public towards risk compatible with company strategies.

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<th>Table 1: Investment styles</th>
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<tr>
<td>Investment style</td>
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<tr>
<td>(1)</td>
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<tr>
<td>Momentum-Investor</td>
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<tr>
<td>Aggressive growth</td>
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<tr>
<td>Growth</td>
</tr>
<tr>
<td>Value</td>
</tr>
<tr>
<td>Income</td>
</tr>
</tbody>
</table>


60.7\% of shares of the 203 sample firms are owned by IF. Column 1 gives the distribution of these shares over different investment styles (per cent); sum of column 1: 60.7\%. Column 2 (maximum): Highest proportion of shares owned by a fund that pursues a particular investment style. (Example: 53.1\% of shares of a single U.S. firm are owned by a momentum investor; 58.3\% of shares of another U.S. firm are owned by an aggressive growth fund, etc.). Column 3 shows the period in months before a fund sells its shares. Example: On average aggressive growth funds sell their shares after 11.8 months (turnover period). Columns 4 and

\textsuperscript{32} It can be presumed that there are national differences regarding the attitude towards risk. However, this question has hardly been treated by the empirical social research yet. Some notes can be found in Baker (2002) and Hellwig (1998). Are investors in the United States less adverse to risk than those in Germany?

\textsuperscript{33} Most developed countries have statutory rules, which oblige IF to inform their clients about the risk which is associated with individual funds. Consumer protection agencies have found that this information is often inadequate.

\textsuperscript{34} This can be compared with the task of a bank to convert short-term savings deposits into long-term investment loans. For the banks, the parameter of the transformation is the time horizon, for IF it is the risk level.
5 (high/low proportion): Increase/decrease of share prices after bad news have been published. Example: Share prices of firms with a high proportion of aggressive growth investors decrease by 1.44% within two days after publication of bad news. Share prices of firms with a low proportion of aggressive growth investors decrease by only 0.4% within two days after publication of bad news.

Hotchkiss and Strickland (2003) have studied whether the behaviour of shareholders (investment funds) that follow different investment styles is different in regard to the investment time horizon and in regard to the tendency to sell shares on the indication of bad news (exit). Table 1 first shows the breakdown of shareholders of different investment styles (column 1) and shows subsequently that momentum investors and aggressive growth funds have a high turnover ratio, i.e. only hold shares between 12 and 14 months (column 3). As a third point, it shows that aggressive growth funds react to bad news by selling very quickly (exit) (column 4).

Exit and Voice
One point of criticism that is often levelled at investment funds is that "... Institutional investors ... act as 'traders' rather than 'shareholders'" (Hotchkiss and Strickland 2003: 1470). This criticism is based, however, on a misunderstanding. Investment funds are able to choose both options. They act as "traders" if they choose the "exit" option and they are "shareholders" if they select the "voice" option. It is argued in the following section that "voice" presupposes the consent of investment funds amongst themselves (acting in concert). "Exit" does not preclude the "voice" option but, on the contrary, may reinforce its effect. The sale of shares is a credible threat and it can contribute to make management compliant to the demands of investment funds.

Investment funds only hold small volumes of shares in each company, seldom more than 2% of the share capital. Investment funds are therefore able to sell their shares at any time: they are "liquid". This is a precondition that has to be met in order to exercise the "exit" option. Column 3 of table 1 shows how long funds hold their shares. On average (over all investment styles) investment funds choose the "exit" option after about one year (cf. Figure A1, Appendix).

However, at the same time, investment funds also exercise the "voice" option. Various studies have shown that investment funds are willing to agree to general corporate governance principles. The 20 largest investment funds have the advantage of a small group and are therefore able to coordinate their actions at the AGM. The central aims that investment funds attempt to achieve can be divided into three groups:

- firstly, investment funds attempt to break down all barriers that the management erects against hostile takeovers. These include for example green mail, poison pills and golden

35 Cf. the “logic of collective action” and the difference between large and small groups (Olson 1965: 53-60).
parachutes. The management are to remain as vulnerable as possible to the disciplining effect of a hostile takeover.

- secondly, investment funds attempt to expand their influence on the board of directors. They demand that a high proportion of external directors are elected; that the votes within the board are held in secret; that the CEO cannot be the chairman of the board at the same time.  

- thirdly, in some cases, investment funds attempt to interfere directly with company strategies. Examples of this are breaking up conglomerates, concentrating on core business and preventing takeovers.  

Every year, the largest U.S. pensions fund (CaLPERS) publishes a "focus list" in which up to twenty inefficient managers (underperformers) are pilloried. This negative publicity leads to falls in company share prices and is feared by managers. CaLPERS acts in concert with other funds in order to have demands for more efficiency accepted at AGM.

**Summary:**

- Investment funds are able to select both the "exit" option and the "voice" option. As they only hold small volumes of shares in each company, they are always able to issue credible exit threats. If many investment funds sell their shares in a company, this will lead to a fall in share price and, in extreme cases, may precipitate a hostile takeover. As "exit" is a credible threat, investment funds are able to exert pressure on the management of a company to meet their demands: "... the effectiveness of the voice mechanism is strengthened by the possibility of exit" (Hirschman 1970: 83).

- Investment funds have achieved a reconcentration of ownership and control but do not assume the risk that is associated with their investments and their interventions in the corporate policies. The risk remains with the public, i.e. with those who have purchased shares in the investment funds. This constitutes the innovative character of these institutions: investment funds achieve a concentration of control while at the same time spreading the risk widely.

- Investment funds are leading players in the financial market whose power with regard to companies is based on property rights. They are, therefore, able to exert continuous influence on companies, regardless of whether or not these have a need for external financing. They

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37 In 2005, the hedge fund TCI held a share of approx. 8% of Deutscher Börse AG; Fidelity held 4.5% and Atticus Capital 5.5%. These three funds forced the German Stock Exchange to meet three demands (voice): The German Stock Exchange renounced its attempts to take over the London Stock Exchange. The cash flow that was saved for this purchase would be distributed among shareholders. The chairman of the board, Werner Seifert, and the chairman of the supervisory board, Rolf Breuer (Deutsche Bank) had to resign.

38 "The California Public Employees Retirement System (CaLPERS) named 11 companies to its annual list of underperformers, singling them out for their poor stock performance and resistance to changes in their corporate governance practices." Source: Corporate Accountability Report, Vol. 5, no. 12, 23.3.2007. For 2003, a list of companies and detailed demands can be found in: http://www.calpers-governance.org/alert/focus/2002/default.asp (5/3/08)
have professionalised the ownership function and are able to manage investment funds more efficiently than small shareholders, who are usually amateurs.

- The long-term capital provided by banks is based on different principles: lending banks may also be in competition with each other but this competition does not force them to demand the highest profit possible from their debtors. Competition forces them to offer the lowest possible rates of interest on borrowing. The competition among investment funds tends to lead, however, to an increase in capital costs (shareholder value). Another difference lies in the fact that banks are not able to choose the “exit” option during the term of a loan. Investment funds are able to exit. This constitutes the higher risk of opportunism to which these market players are exposed. Supporting inefficient takeovers or pursuing short-term profit maximisation (short-termism) are indicators of this opportunism.

5. Boundary roles: analysts

Analysts who are employed by investment banks and brokers assume an important "boundary role" in the system. They convert uncertainty into risk by publishing estimates of the possible future profit of a company (earnings per share). Investors expect analysts to issue recommendations: to buy or to sell. In these recommendations, the complexity of future production processes is reduced to binary information. Analysts will recommend buying a share if the expected value of total future profit is higher than the current share price; their recommendation would be "sell" if the expected value is significantly lower. It has already been shown that to transform uncertainty into risk only succeeds virtually as the risks of real economics cannot be forecast with sufficient accuracy (capitalisation as virtual capital).

In a variety of studies, organisation sociology has shown that the successful reduction of uncertainty provides the players with power and influence. Controlling contingency is a source of power. Analysts provide the risk factor that makes this function possible. This is the central function of analysts and is the basis on which their prestige and their power are based. In this case, however, it is more the virtual control of contingencies.

In an empirical survey based on the data of I/B/E/S, 12,336 analysts who worked for 619 investment banks and brokers in the U.S. between 1983 and 2000 were examined. The following profile of the analysts can be reconstructed from the results: U.S. investment banks employed an average of approximately 12 analysts who specialised in monitoring one sector. The analysts are usually responsible for analysing 9-10 companies in their sector for which they publish forecasts regarding future earnings per share. One quarter of the analysts are employed by the top brokers, which include Merrill Lynch, First Boston, Salomon Smith Barney, Morgan Stanley, etc. The top salaries in these companies reach $15 million per year,

39 Cf. Crozier (1963). Hickson et al. (1971) term the formula "coping with uncertainty". "Boundary roles" are specialized on coping with the uncertainty of the organization's environment.
and commonly more than 50 analysts work for these top investment banks (Hong and Kubik 2003: 315-321).

Table 2: Professional experience of analysts

<table>
<thead>
<tr>
<th>Years</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution (%)</td>
<td>29.9</td>
<td>19.6</td>
<td>13.9</td>
<td>9.9</td>
<td>7.4</td>
<td>6.5</td>
<td>5.1</td>
<td>4.3</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Notes: \( \sum \text{row 2} = 100\% \). Example: 29.9\% of analysts have 2 years of professional experience, 19.6\% have three years, etc. \( N= 12,336 \)

Table 2 shows that almost 50\% of analysts only have 2 or 3 years of professional experience and only 3.5\% of the analysts have been in the profession for 10 years or more. Share analysts are relatively young and – compared to the top managers of large companies - have limited professional experience.

A study conducted by Clement and Tse (2005) examined the forecasting performance of analysts. It showed that the forecasts usually cover a period of one year. It can be seen during this period that the variance of their estimates in regard to the future profit of a company decreases over time: At the beginning of a year, the estimates of the analysts are still relatively far apart whereas these tend to converge towards the end of the year. Two conclusions can be drawn from this. Firstly, the period of the forecast is congruent with the investment horizon of those funds that pursue a relatively aggressive investment style (see Table 1). Secondly, the interaction and the reciprocal observations of the analysts reduce the variance of their forecasts, converging to a mutual expectation of expectations after a few months (consensus forecast). Here, one must take into account not only that analysts anticipate the profits of a company but that the companies are also aware of the forecasts of the analysts when preparing their balance sheets. The managers know what reactions they are able to cause in the stock market if they exceed (or fall below) this consensus forecast. The system of reciprocal observation thus includes those for whom the expectation of expectations has been made.

The accuracy of the forecasts that are published by an analyst, is influenced by the following variables: the longer an analyst has been in this profession, the more accurate their forecasts become (professional experience); the smaller the number of companies that the analyst analyses, the more accurate their forecasts become. Analysts at top brokers (who employ a large number of analysts at the same time) publish more accurate forecasts than those analysts who are employed by brokers in the bottom third of the prestigiousness scale (Clement and Tse 2005: 317).

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40 Source: Hong and Kubik (2003: 323, Table VI); own calculations.
41 41\% of the CEOs of major U.S. companies have been with their companies for more than 15 years before they were appointed CEO (Windolf 2002: 139).
42 Example: At the beginning of 2007 analysts start publishing their forecasts for earnings per share for the year 2008. During the last quarter of 2007 their estimates converge. Investment funds start buying shares of particular companies during the last quarter of 2007. On average, they sell them during the last quarter of 2008 (holding period: 1 year).
Hong and Kubik (2003) have examined which variables influence the rise of an analyst who was employed by a low-prestige broker in one year and who rose to the top 10-league in the following year. Two variables are chiefly significant: the accuracy of the forecast (analyst’s accuracy score) and the optimism of the forecast (analyst’s optimism score).  

- Analysts who are among the worst 10% in regard to the accuracy of their prognoses continue to fall down the hierarchy. The system thus selects those analysts whose ability to provide a forecast is deficient. A slight inaccuracy has no influence on their career, i.e. the “analyst’s accuracy score” variable has no influence on the career prospects of analysts who do not produce any obviously false prognoses.

- More important than accuracy, however, is the “optimism” of the forecast. Analysts who forecast greater profits than those that have actually been produced have a greater chance of being recruited by a top broker. Analysts also publish forecasts about companies with whom their own investment bank has business contacts. It can be proven that the forecasts are particularly “optimistic” in these instances. This outcome shows clearly that analysts are not only analysts, but are also brokers.

The accuracy of a forecast and optimism are in a way mutually exclusive: either an analyst is only bound to the accuracy of his or her forecast or he or she publishes “optimistic” forecasts as a selling aid. The results show that those analysts who act strategically have greater career and income prospects: they must avoid publishing absolutely unfounded forecasts but at the same time, they must not lose sight of the fact that they are paid by the investment bank and they are, therefore, also responsible for the business success of their company. The conflict of interests is apparent: on one hand, the analysts are obligated to their investors to publish accurate forecasts; on the other hand, the investment bank expects “optimistic” forecasts as selling aides.

Some employment contracts stipulate that the analysts receive 3-7% of the fees that the investment bank earns as a result of the analyses and the customer advice provided by the analysts. For instance, the investment bank Salomon Smith Barney sold shares in WorldCom worth $24.7 billion to investors. The fees that Salomon received for this amounted to $140.7 million. Jack Grubman, the head of analysis at Salomon, recommended the shares of Worldcom until 22 April 2002 (“buy”); in July 2002, WorldCom filed for bankruptcy. His annual salary was approx. $20 million (Windolf 2004).

In summary, one can say that analysts play an important boundary role in the financial markets. They reduce the complexity of future production and market processes to a figure, i.e. the expected value of future profits. This shows that the institutional context in which this

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43 A forecast is “optimistic” if it features in the upper third of the estimates that were published by all analysts who monitored a particular company.

44 The authors divided the 12,336 analysts into percentiles in regard to the accuracy of their forecasts. The regression coefficient for analysts who featured in the bottom percentile was significant (negative influence on career prospects). The other coefficients were no longer significant.
function is carried out offers a convenient opportunity scenario for corruption. The analysts are paid by investment banks, which at the same time have a great interest in the contents of the forecasts that the analysts publish.

6. Transfer mechanisms: financialisation of companies
Hostile takeovers, the market for corporate control and stock options are transfer mechanisms that transform the operational logic of the financial market into the strategies and internal control structures of the companies. The structural change a company is forced to undergo in order to adapt to the operations of the financial market is termed “financialisation”. In this section, the hostile takeover as a virtual threat is described first, after which the market for corporate control and stock options are analysed.

Credible threat: hostile takeovers
If the share price and consequently the stock market capitalisation of a company fall significantly below the value of the company, it will be worthwhile for a market player (raider) to offer a higher price to shareholders in order to attempt to gain control of the company. Very high profits can be achieved if restructuring measures or the sale of individual company segments is successful.

Hostile takeovers are a “radical” innovation in the market and they are the greatest threat to management autonomy. In a sense, the end of management autonomy began with the “invention” of hostile takeovers. It is somewhat ironic that one precondition for management autonomy, i.e. a wide spread of shares among a large number of shareholders, is also a precondition for hostile takeovers. Companies which have a majority shareholder cannot fall prey to a hostile takeover. A raider makes his public offer to the shareholders of a company at a share price that is higher than the current price (premium) in order to tempt them into selling their shares. Frequently it is the investment funds that decide whether a hostile takeover can be fended off or whether it will be successful. This is the reason why they show great interest in prohibiting management from employing any strategies that might prevent a hostile takeover.

Davis and Stout (1992: 606) support the following thesis: ”Takeovers came to represent perhaps the dominant form of organizational transformation among large capitalist firms.” At first, this statement seems surprising as, so far, there have only been a few hostile takeovers, even in the U.S.

45 Jürgens et al. (2000); cf. the other contributions in Economy and Society, Vol. 29, no. 1, February 2000.
46 There are many factors that determine the value of a company and which could not be analysed. Basically, one can distinguish between capitalisation and book value. In the case of capitalisation, the value of the company lies in the total future profits (expected value of future profits, virtual capital). In the case of the book value, the historic costs/replacement costs of all plants and equipment are taken into account as the basis of the value calculation (property, machines, goods, etc.).
47 Cf. the report of Kohlberg Kravis Roberts (KKR) in Kaufman and Englander (1993).
Hostile takeovers are a virtual threat. It is not necessary to carry them out in order to achieve their disciplining effect. The management of companies that are listed on the stock exchange and which are thus subject to the influence of the financial markets, are aware of the causal mechanism: companies that violate the principles of the market persistently, resisting the interventions of the investment funds, must expect to be punished by falling share prices. Falling share prices are a potential incentive for a raider to organise a hostile takeover and dismiss the incumbent management if he is successful. This mechanism illustrates the leverage effect of a credible threat and the potential nature of power.  

The transaction costs of a hostile takeover are very high in some instances and the long-term consequences can ruin a company (the "victim"). However, as only a few hostile takeovers actually take place and as their strongest impact lies in a credible threat, it is possible to use this virtual force to coerce most managers to submit "voluntarily" to the demands of the financial players. A small number of hostile takeovers which are in fact carried out (with high transaction costs) discipline thousands of major U.S. companies as a result of their deterring effect. The virtual threat of a hostile takeover is among the main instruments of financial control.

The hostile takeover is also an example for what DiMaggio and Powell (1983) call "coercive isomorphism": As a result of the virtual threat of sanctions, managers subject themselves to the dictates of the financial markets with their strategies and structures becoming more and more similar (shareholder value).

For the period between 1979 and 1998, Kini et al. (2004) detected a total of 279 successful takeovers of companies that were listed on the New York Stock Exchange (NYSE). Of these, 118 (= 42%) were hostile takeovers. An average of 1,995 companies were listed on the NYSE during this period. Thus, a total of approx. 7.5% of the listed companies became "victims" of a successful hostile takeover. In their study, the authors highlighted two results that are significant for the theses discussed here. Firstly, companies that have become victims of hostile takeovers had been undervalued on the stock exchange (low market to book ratio) before the takeover. Secondly, after a hostile takeover, top managers (CEOs) are replaced much more often than after an amicable takeover. These studies thus confirm the disciplining effect of a hostile takeover. A low valuation on the stock exchange offers an incentive for a hostile takeover; after a hostile takeover, top managers are usually sacked.

However, a hostile takeover is not only a technical instrument of the financial market (a torture instrument, so to speak) but it is also defended in the context of specific ideologies: In the U.S. of the 1970s, the initiators of hostile takeovers presented themselves as charismatic revolutionaries, attacking management autonomy and the establishment of large companies,

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48 Aglietta (2001) argues that this type of control exposes firms to a permanent screening process on global financial markets.
49 Source: NYSE Fact Book (2004), Historical Data (all NYSE listed stocks), own calculations.
50 Source: Kini et al. (2004), table VII, p. 1534f. (CEO turnover); p.1547f. (market to book ratio).
doing away with outdated privileges. As this instrument can be used by an individual investor to attack even the largest companies, this conflict is often compared with the fight between David and Goliath. The raider returns the right of ownership to the small shareholders. With the sale of their shares, the shareholders are not only able to make a large profit, but at the same time they can also penalise inefficient management.

The problem with this line of reasoning lies in the fact that small shareholders have now become a minority. Investment funds have taken their place. They consent to hostile takeovers in order to bolster the return on their balance sheets.

**Global benchmarking: the market for corporate control**

In the market for corporate control, companies are bought and sold as complete entities. This market can be used to restructure groups by buying or selling subsidiaries or to acquire innovations by taking over small innovative companies. Here, only the disciplining effects that are passed from this market to companies are of interest.

It has already been pointed out that investment funds dictate returns on equity to the companies whose shares they hold (e.g. a 20% return on equity). Subsidiaries which are unable to achieve these return benchmarks, even after a period of grace, are sold in the market for corporate control. "Hostile" takeovers are possible in this way even if a company is 100% owned by a group. The senior management of a group is able to sell a subsidiary against the will of the local management. The virtual threat emanating from a hostile takeover can also have its disciplining effect within a group, thus ensuring that the individual company segments achieve the high benchmark return.

With the market for corporate control, a mechanism was created that tends to facilitate an alignment of the profit margins in globalised markets. The return on equity is a globally comparable indicator by which all companies can be measured (benchmarking). Companies that achieve a lower than average profit margin are potential victims to hostile takeovers, or are put on sale in the market for corporate control. Companies with different profit margins compete in this market for corporate control for investors. Companies that are very profitable are able to push up their purchase price (which makes their individual profit margin fall) while the purchase price of companies that only have small profits falls (which makes their individual profit margin rise).

Marx (1970: 190) argued that a "higher evolution of the capitalist method of production" is required in order to achieve an equalisation of profit margins between the different investment spheres of capital. With the market for corporate control, this "higher evolution" has been achieved, so that the equalisation of the profit margins can not only be achieved between individual production spheres but also on a global level.

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In summary, it can be said that the market for corporate control is an important instrument for realising the normative parameters of the market players, i.e. to concentrate on the core business (= restructuring of the group) and to observe the shareholder value principle (the sale of company segments that do not meet the high profit expectations). In this sense, the market for corporate control is a transfer mechanism, which ensures that the operative logic of the financial markets is incorporated in the internal control structure and the organisation of the companies.

Unintended consequences: stock options

Stock options are intended to tie the interests of the managers to the interests of the shareholders. This is the reason why they are often called "bonding instruments." What interests do the shareholders or the management respectively have and can these interests be aligned with each other?

The relationship between managers and shareholders is characterised by conflicts of interest and an asymmetry of information. The conflict of interest can be attributed to the different resources and market opportunities of the players. Shareholders are able to diversify the risk of their investments in a portfolio. They are able to transfer their capital between financial centres and can choose the option to exit at any time. This is the reason why their loyalty to the companies whose shareholders they are, is limited. In a case of conflict, the investment funds would prefer to choose the option to exit. \(^{52}\) In addition to this, the asymmetry of information between management and shareholders must be taken into account, which is also not suited for boosting the loyalty of the shareholders. Investors are aware that the management knows more about the company than they do and that they are potential victims of opportunism.

The interests of managers are determined by long-term investments in human capital. They are unable to diversify their risk. Their investments are often lost when they leave the company (firm-specific skills). Their interests correspond more with those of the organisation (interest in self-preservation). "Exit" is, therefore, not a dominant strategy for managers.

These differences create a different opportunity structure for opportunism: the asymmetry of information favours the opportunism of the managers. The possibility to choose the option to exit at short notice favours the opportunism of the shareholders.

Stock options do not resolve the conflict between managers and shareholders, but undermine the loyalty of the managers to the organisation. This loyalty is based on the long-term commitment of the managers to the company. \(^{53}\) They invest in social capital (trust, internal

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\(^{52}\) Cf. the average investment horizon of the investment funds in table 1.

\(^{53}\) 41% of the CEOs in the large U.S. companies had been with their company for 15 years or longer before they were appointed CEO (Windolf 2002: 139). These figures prove that the long-term orientation of managers is (was?) still dominant in the U.S.
job market) and in firm-specific skills, and this investment would be worthless outside the company (sunk costs).

The higher the short-term profits from stock options are compared with the long-term profits from income opportunities, which managers could expect on the internal job market, the stronger is the incentive to be opportunistic. The opportunism that derives from the asymmetry of information between managers and shareholders (and which allows the managers to manipulate the share price in their favour) combines with the opportunism of the exit option.

Stock options tend to shift the interests of the managers in favour of the financial markets. Their motives are not so much determined by their role as members of the organization, but by income opportunities on the stock market. Stock options do not strengthen the loyalty of the managers to the shareholders (whom in most cases they do not know) but they weaken the loyalty to the company and exacerbate the problem of opportunism (manipulation of the share price). These are the unintended consequences of stock options.

Stock options are thus a transfer mechanism, which transfers the operational logic of the stock market directly to the operational strategies of the managers. The share price becomes their prevailing motive.

7. Conclusions

Financial-market capitalism marks another stage in the evolution of the capitalist production regime. It can be characterised by a specific configuration of institutions that have been analysed in this essay.

Due to a reconcentration of ownership, investment funds became central players in this system. The ”new” shareholders on one hand are able to influence corporate policy; on the other hand, they are unstable shareholders as they sell their shares again after an average of one year (Figure A1, Appendix). The combination of exit and voice favours a specific form of opportunism, i.e. the focus on short-term profit maximisation.

The investment funds are in global competition for the highest yield possible. They transfer this competition to the companies, forcing management to focus their strategies on the share price and the yield (shareholder value). Hostile takeovers, the market for corporate control and stock options are transfer mechanisms that transfer the operational logic of the stock markets to the internal control structures of the companies (financialisation).

Hostile takeovers are a radical innovation of the financial market, having limited the autonomy of the managers effectively. They mainly show their effect as a credible threat. The

54 In the past decade, all top managers of the 500 largest U.S. companies received share options. The value of the (redeemed) options was approx. 25% of their income; by 1998 this share had risen to 40% (Hall and Murphy 2000: 1).
few hostile takeovers that have in fact carried out have disciplined the management of hundreds of U.S. companies, committing them to the principles of shareholder value. The takeover of Mannesmann by Vodafone was a spectacular case in Germany, whose long-distance effect lies in the threat potential that this takeover has for other companies.

The inherently new constellation in financial-market capitalism can be seen in the fact that the operative logic of the share markets has a more immediate effect on the strategies and the internal control structures of the companies. As a result of the elimination of buffers, the real economy is more vulnerable to the shocks of the financial markets. It is in the interest of the investment funds to remove buffers that might be able to shield the companies from the influence of the financial markets. For instance, the demand to pay out all the free cash flow to the shareholders had negative effects on the internal financing potential of the companies (retained earnings). Another example are company pensions, which German companies have been able to use as sources of financing until now, and which are now increasingly being outsourced and transferred to (external) money managers.  

The regime of financial-market capitalism tends to have the effect of increasing the capital costs (high return on equity). Companies that may be profitable but which are not able to achieve the exorbitant profit targets, have to be sold or closed. This maxim of the investment funds tends not to favour growth but rather hampers it.

Another characteristic of financial-market capitalism lies in the professionalization of the shareholder function. Compared to the small shareholders in the regime of manager capitalism, investment funds are professional shareholders. It has however been shown that these financial intermediaries cause serious agency problems. Various analyses have proven that the higher profits that are made by professional investment funds are not sufficient to cover the transaction costs of these institutions. It is also true for investment funds that every organisation primarily has a dominant interest in self-preservation.

The control that investment funds exercise over companies is anonymous and detached from any personal contact, i.e. it does not appear as personal dependence but is exerted by anonymous and global market forces. However, the controllers are subject to the same control mechanism that they apply to the managers of major companies. The principle "Fix it, sell or close." also applies to investment funds, which lag behind in the competition for the highest yield possible. In their actions, the controllers reproduce a system in which they themselves are controlled as players.

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55 Unlike in the U.S., pension contributions which companies pay for their employees, can be invested directly in their own company.
56 Cf. the analysis of Lakonishok et al. (1992). On average, investment funds achieve profits that are lower than those that an investor would receive if they only invested in one share index (e.g. S&P or DAX). The fees of the money managers must also be deducted from this profit. The authors come to the conclusion that: "These results suggest that ... active money management subtracted rather than added value" (Lakonishok et al. 1992: 349).
Figure A1: Turnover rate (churn rate) and percent of shares owned by investment funds - United States 1960 - 2006.


Figure A1 illustrates that the regime change from managerial capitalism to financial-market capitalism has taken place as a long-term transformation of institutions. In 1960 the share capital of large corporations was widely distributed among small shareholders; in 2006 investment funds were the dominant type of owner (66%).
References


