Size Matters: Why Managers *Should* Pursue Corporate Growth, Even at the Expense of Shareholder Value

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Introduction

The fact that managers pursue corporate growth and diversification as a primary objective, and that this objective might be contrary to other corporate goals, is well established. For example, Adams and Brock in *The Bigness Complex* note that "America's corporate giants have not performed well over the last fifteen years…Bigness has not delivered the goods, and thus fact is no longer a secret" (1986, p. xi). Recent evidence to support this claim is provided in an extensive empirical study by Ramezani, Soenen, and Jung who analyze several thousand firms over a period of eleven years from 1990 through 2000. They define corporate growth in terms of the growth rate in sales, and shareholder value in terms of both economic value added (EVA) and abnormal stock-market returns. (These definitions of corporate growth and shareholder value are used throughout this paper.) They conclude that "although the corporate profitability measures generally rise with earnings and sales growth, an optimal point exists beyond which further growth and sales growth, an optimal point exists beyond which further growth destroys shareholder value…" (2002, p. 56). They note that many firms go beyond this optimal point and conclude that "corporate managers need to abandon the habit of blindly increasing company size" (p. 65).

In this paper I argue that managers' pursuit of corporate 'bigness' may not be as myopic as the above studies imply. I provide arguments to the effect that managers simply recognize their obligations to *all* stakeholders: they realize that their obligation to shareholders, albeit real, must be balanced with obligations to employees, customers, communities, and society at large. These broader obligations may, in many circumstances, be best served through a primary focus on overall corporate growth- even when this growth compromises the financial return to stockholders.

Before I provide ethical justifications for managers' pursuit of growth, I will begin with a brief summary of the several ethically *unjustified* reasons commonly found in literature. These reasons can be roughly grouped into two categories: economically rational reasons, and economically irrational reasons.

Economically Rational Reasons

The economically rational reasons for pursuing corporate growth can be further subdivided into those relating to wealth maximization and those relating to risk reduction.

Wealth Maximization

By pursuing corporate growth, managers might be pursuing their own personal material wealth at the expense of the shareholders. This is the classic agency problem of financial contracting (Jensen and Meckling, 1976). Because managers are not full residual claimants in a public corporation, they essentially hold a call option on the underlying assets of the firm. This asymmetric incentive structure might induce managers to take actions that are not in the nest interests of shareholders. For example, manager' total remuneration is often correlated with the absolute size of their firm (Hill and Jones, 1992). As Greider observes, "[t]he bigger the organization, the bigger the surplus is likely to be…; the larger the organization the greater the multiple of earning of top officials over the lowest rank" (2003, p. 220). Given this agency-cost scenario, therefore, managers grow their companies because by doing so they expect to grow their own remuneration, regardless of the effects of such growth on shareholder value.

Risk Reduction

To the extent that managers are risk averse, growth through corporate diversification may have particular value to them. Managers typically hold large, nondiversified wealth positions in the firms they manage: their salary, executive stock options, and direct stock holdings are all dependent upon the performance and survival of this one firm. Formally, managers are not fully diversified; they are exposed to significant idiosyncratic risk (Jin, 2002).

Sine they cannot fully diversify exogenously to their own firm, managers may attempt to diversify endogenously through corporate growth. Managers may use the corporate assets under their control to buy other firms, to form conglomerates, and thereby diversify their own wealth position. For example, May (1995) finds that CEOs with more wealth tied up in their own firms' equity engage in acquisitions that are more diversifying. Large corporate conglomerates are formed, therefore, not to maximize shareholders' wealth, but rather to decrease the risk exposure of senior managers.

Economically Irrational Reasons

There is significant evidence that managers pursue corporate growth at the expense of stockholder value for reasons other than personal wealth or risk reduction, in other words for reasons beyond the rubric of conventional economic rationality. For example, Hill and Jones observe that "stock-holders are wealth maximizers, while managers maximize a utility function that includes remuneration, power, job security, and status as its central elements" (p. 137). They go on to observe that "satisfying the[se] claims of management requires increasing the size of the firm…Increasing the concentration of management power requires strategies that increase the amount of resources under management control (pp. 137 and 147 respectively). Thus Hill and Jones invoke a broader and more nuanced managerial utility function than that generally entertained by financial economists: risk-averse wealth maximization *a la* conventional agency theory is too simplistic; managers' motivations are more complex and multifaceted.

Formally, these motivations for corporate growth come under the nomenclature of behavioral psychology and can be grouped into four basic categories: *overconfidence*, *framing*, *confirmation bias*, and *regret aversion*.

Overconfidence

Probably the most familiar behavioral glitch that managers succumb to is a tendency to be overconfident about the likely outcome of their decisions. Evidence of an overconfidence bias is extensively in the psychology literature (Shefrin, 1999), and even has a pedigree in financial economics dating back to Roll's "Hubris Hypothesis" (1986). Roll explains shareholder-value-destroying corporate acquisitions in terms of managerial overconfidence: in corporate acquisition decisions, managers simply overestimate the probability of success and underestimate the probability of failure.

More recently, Shefrin describes the dramatic rise and fall of Palm Inc.- maker of handheld computers- as a classic example of managerial overconfidence:

> Palm's managers turned out to be overconfident that past growth rates for its main product would continue. In an attempt to revive disappointing demand, they accelerated the next version of their device. In doing so, they committed the same over-confidence-induced error that Sony made years earlier with the Chromatron. (p. 13)

Thus managers, such as those at Palm Inc., may genuinely believe that their pursuit of corporate growth is consistent with shareholder value. However, they are blinded tot eh value destroying results of their actions by their economically irrational overconfidence.

Framing

The psychological concept of framing concerns the way in which the human brain processes information. In order not to be swamped by the massive amounts of information it receives, the brain forms mental accounts with which is 'frames' the amount of information considered relevant to any given decision. Information not contained within this decision frame is ignored, even though from a broader perspective it might appear critically relevant. This is similar to the concept of bounded rationality in economics: "individuals simply cannot conceive of all the possible eventualities that may occur…" (Hart, 1983, p. 23).

In current context, framing becomes problematic when managers do not frame their decision-making around shareholder value. For example, Jensen argues that the power of market analysts leads managers to frame their decisions too narrowly. Managers focus entirely on meeting analysts' earning forecasts:

> Over the last decade companies have struggled more and more desperately to meet analysts' expectations. Caught up by a buoyant economy and the pace of value creation set by the market's best performers, analysts challenged the companies they covered to reach for unprecedented earnings growth. Executives often acquiesced to increasingly unrealistic projections and adopted them as a basis for setting goals for their organizations. (2002, p. 42).

Thus the power of market analysts is inducing managers to adopt the wrong frame of reference: short-term earnings rather than long-term earnings rather than long-term value. Shefrin recounts a specific example of this supplied by Elizabeth Nickel, CFO of Herman-Miller Inc.:

> Nickel described another occasion when Herman-Miller was analyzing an online initiative that would have created value. However, her team was reluctant to go ahead because of the negative impact the initiative would have had on short-term earnings per share… In other words, the financial managers at Herman-Miller made their decision based on framing- on how the financial implications of the decision were packaged. (2003, p. 11)

In current context, the implication of framing is that managers tend to frame their decisions in terms of sales and earnings growth, perhaps to meet analysts' expectations, rather than in terms of shareholder value creation. Thus it is not that managers consciously choose not to serve the interests of shareholders, but rather that such a choice simply does not enter into their decision-making frame.

Confirmation Bias

This is a psychological bias captured succinctly by the expression, 'shoot the messenger.' None of us like to hear bad news, or more specifically information that fails to confirm our preferred view of reality. Thus, in decision-making, we tend to give more weight to information that confirms our pre-existing worldview, while dismissing information that does not confirm it.

As a psychological phenomenon, confirmation bias is similar to framing. The essential difference is that framing defines the parameters of the information's set that we deem relevant, whereas confirmation bias concerns the relative weight we give to information received within that frame.

In the context of a manager's pursuit of corporate growth, Aggarwal and Samwick (2003) explain how Jill Barad, CEO and chairman of Mattel, suffered from confirmation bias in making her decision to acquire The Learning Company, Glenn Bozath, senior vice president of corporate communications at Mattel, made it clear that Mattel was framing this acquisitions decision strictly in terms of corporate sales growth: "at Mattel we knew we wanted to build this to be a large business and we never could have build it so quickly without this merger" (p. 77). In a similar statement, Barad confirmed this frame: "It made great sense for us to seek out a partner to help us realize out $1 billion [sales] goal" (p. 77).

Concern over the wisdom of the acquisition was expressed both by Mattel insiders and by outside analysts. This concern generally centered on the fact that The Learning Company was an educational software company, not a toy company. Mattel had no experience in the software industry or indeed in any industry other than toys. However, Barad summarily dismissed these concerns and focused entirely on the perceived benefits of the merger: she focused on the information that confirmed her beliefs concerning the wisdom of the acquisition, observing "[t]his merger will provide Mattel with tremendous opportunities for synergies, cross branding, age expansion, consumer relevancy and channel expansion" (p. 77).

Mattel went ahead in 2000 and purchased The Learning Company for $3.5 billion. Almost immediately the merger began to unravel as The Learning Company amassed huge losses. Within a year Mattel divested itself of its acquisition, selling The Learning Company to a third party for no cash up front. Shortly thereafter, Mattlel's board of directors fired Barad. The board admitted that it had placed too much trust in Barad's judgment.

In the current context, the board of Mattel had acquiesced to Barad’s confirmation bias by failing to pressure her into taking a more balanced view of the acquisition. Not only did the board fail to question Barad’s apparent pursuit of sales growth in preference to shareholder value, but they also failed to question whether the acquisition of The Learning Company would further either objective over the long term.

Regret Aversion

Continuing with the example of Mattei, why did the board wait so long before it acted? By the time Barad was finally fired by the board, MatteI's stock price had declined by some sixty percent from its value two years prior to The Learning Company acquisition. One likely reason is that the members of Mattei's board were reluctant to admit, both to themselves and to stockholders, that backing Barad's decision was a mistake. For example, Staw and Ross note that a certain personal and social esteem accrues to those individuals who "stick to their guns" in the face of adversity (1987, p. 59). Thus managers may pursue a *psychic* payoff ff, in the form of maintained status and reputation, by continuing an unprofitable project in the hope, rather than any realistic expectation, that the project will become profitable in the future. This could lead to a 'ratcheting effect' whereby projects and acquisitions are initiated far more readily than they are later abandoned, even though abandonment--to the unbiased eye-is clearly the value maximizing decision. So corporate growth continues and the total size of the firm ratchets up as the firm becomes burdened with loss-mak.ing 'pet' projects (Dobson and Dorsey, 1992).

Under the regret aversion scenario, therefore, levels of corporate growth beyond those that maximize shareholder value are the result of managers' unwillingness to admit defeat by reversing prior decisions. Managers may know full well that these prior decisions now have a negative value, and so should be abandoned immediately. However, managers will continue the projects rather than pay the psychic cost resulting from the projects' abandonment.

Method or Madness

Our discussion so far has clearly not been very flattering to managers. We have depicted them in their headlong pursuit of corporate growth either as charlatans, or as idiots, redistributing wealth from shareholders to themselves, or succumbing to some psychological pathology.

Viewed from either an economic or a moral perspective none of the reasons proffered so far to explain managers' pursuit of corporate growth appear normatively justifiable. Managers have a fiduciary duty to stockholders, not to mention contractual obligations to bondholders and other stakeholders, and none of the behavioral motivations attached to managers so far in this paper could be construed as meeting these duties and obligations.

The remainder of this paper, however, identifies two other reasons to explain managers' pursuit of corporate growth. These reasons *are* normatively justified, from both the perspectives of economics and of ethics.

The Problem with Stockholder Value

What *should* managers be trying to achieve? This seems a simple question, and finance textbooks will typically supply a simple answer: "Throughout this book we operate on the assumption that management's primary goal is stockholder wealth maximization, which translates into *maximizing the price of the firm's common stock"* (Brigham and Houston, 2004, p. 15; emphasis in original). Some business practitioners, namely Warren Buffett, hold a different view: "We do not want to maximize the price at which Berkshire shares trade. We wish instead for them to trade in a narrow range centered at intrinsic business value" (200], p. 4]).

Michael Jensen attempts a reconciliation with his suggestion that managers should be "[m]aximizing the total market value of the firm-that is the sum of the market values of the equity, debt and any other contingent claims outstanding on the firm ...." (2000, p. 42). So, given Jensen's answer to our original question, we can conclude the following. If managers are pursuing corporate growth in sales or earnings at the expense of the market value of the firm, then they are acting wrongly-where 'wrongly' is defined as acting in a way that is inconsistent with the accepted definition of what they should be trying to achieve.

But, returning to the original question, is maximizing the total market value of the firm or maximizing shareholder value really what managers should be striving to achieve? Consider the following statement from Buchholz and Rosenthal's business ethics textbook: "There is no justification for shareholders holding such an important position ... and having first priority as regards corporate activity.... The idea that shareholders are the group that takes the greatest risk and thus deserves special treatment is a fiction" (] 998, p. 169). Or consider the following statements by other business ethicists: the "primary obligation ... [of business] is to provide meaningful work for ... employees" (Bowie,]99]); "if in some instance it turns out that what is ethical leads to a company's demise ... so be it" (De-George,]990); "[p]rovision to meet need is the highest purpose of business; provision to satisfy unreasonable and socially harmful desire, ... perverts the purpose of business" (Byron,]988).

This conceptually broader and more nuanced answer to our original what-should-managers-be-trying-to-achieve question is often referred to as 'stakeholder" theory:

> Stakeholder Theory is distinct because it addresses morals and values explicitly as a central feature of managing organizations. . . . [F]or stakeholder theory, attention to the interests and wellbeing of some non-shareholders is obligatory for more than the prudential and instrumental purposes of wealth maximization of equity shareholders. [Phillips, Freeman, and Wicks, 2003, p. 481].

A stakeholder-type answer to our what-should-managers-be-trying-to achieve question is increasingly reflected in corporate credos and mission statements. As Chang points in his recent survey of Alternative views on corporate objectives, "actual corporate credos and mission statements practically never give priority to the interests of stockholders" (1998, p. 5). These mission statements invariably place emphasis on some broader obligation of the firm to groups other than stockholders: employees, the environment, society at large.

Given that a corporation's mission statement represents its formal proclamation of ultimate objective, should not the content of this statement provide the answer to our original question') What managers should be trying to achieve is the stated mission of the corporation. For example, Johnson & Johnson Inc. begins its mission statement: "We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services." Only toward the end of the statement are shareholders mentioned as deserving a "L1ir return." For a manager at Johnson & Johnson, therefore, should this not be the manager's objective? If the manager believes that pursuing corporate growth, even at the expense of shareholder value, will best achieve this mission, then is not the manager fully justified in pursuing growth? Formally, the pursuit of corporate growth at the expense of shareholder value might be justified in terms of either deontological or utilitarian theories.

Deontological Justification

A deontological moral defense is one based, at least in part, on consideration of factors other than the consequences of the act under consideration. In the context of managerial objectives, the following is a deontologically justifiable principle:

Managers should be guided by the stated mission of their corporation; they should choose whichever action is most consistent
with this stated mission.

So if a manager believes that pursuing corporate growth in preference to shareholder value in some situation is more consistent with the firm's mission statement, then this manager is *prima facie* justified in pursuing corporate growth. But how likely is this? Specifically, under what circumstances would the pursuit of corporate growth better serve a firm's stated mission than would the pursuit of shareholder value? For which stakeholders does the firm's mission statement emphasize corporate size?

One likely candidate is employees. Consider Norman Bowie's earlier definition of a corporation's objective in terms of the provision of meaningful work for employees. Presumably any work is better than no work, and growing firms are more likely to be employment providers. Also, a large diversified firm will] provide greater variety of assignments within the organization, and greater chance of advancement. Large corporations also tend to offer employees more extensive retirement and health benefits.

Employees, and other stakeholders, may also benefit from superior corporate governance in larger companies. Second, boards of directors of larger firms are likely to better represent employee diversity: "women and minorities have less presence on smaller firms' boards of directors" (Daily and Dalton, 2003, p. 426).

A focus on growth in preference to shareholder value may also create a more stable environment for a] I stakeholders. Greider makes this point:

> The disciplinary doctrine of "shareholder value" deliberately induces financial insecurity on the company-the opposite of the secure financial commitments a company needs to think beyond its immediate horizon. The recurring managerial initiatives to "downsize" and "rationalize" may deliver short-term financial gain, but they can also hollow out the company's dynamic integration of its many working parts. [2003, p. 232]

A similar point was made in a 2003 *Financial Times* special report on the US biotechnology industry:

> The US biotechnology market is dividing into two distinct groups- atop tier of big companies ... and the rest of the industry, comprising hundreds of smaller companies. The success of the top tier companies reflects several developments. First, they are generally very liquid stocks, second, they have grown to a stage at which they have sustainable business models and a pipeline of successful products and, third, they have the financial muscle and resources to "buy in" promising new drugs as well as developing them in house.... While the big companies halve done very well this year, the outlook for the smaller ones remains grim as they scrabble for cash. [2003, p. 4]

In the biotechnology industry, therefore, the absolute size of the company may provide specific benefits in terms of profitability and long-term sustainability. A manager of a smaller biotech company who pursues long term growth in preference to some other measure of shareholder value could clearly be construed as acting entirely in the interests of the 10ng-tenl1 health of the company. If the mission of the company is to serve the interests of all significant stakeholders, *a 10* Johnson & Johnson, then the pursuit of growth, even at the expense of short-term shareholder value, could well be the best way to achieve this mission. In short, corporate growth achieves market power and stability, which is likely to serve all stakeholders and the corporate mission over the long term.

Utilitarian Justification

Managers' pursuit of corporate growth could be defiladed on utilitarian grounds if it could be shown to improve aggregate social welfare. This improved welfare could be defined in simple economic terms, such as higher GNP per capita, or it could be defined in terms of its contribution to what society perceives as its "common good," where the common good is defined as the "overlapping consensus of reasonable citizens in a pluralist society" (Riordan, 1996, p. 4). Thus if "reasonable citizens" in aggregate place intrinsic value solely on large companies, independent of the contributions the company might make to shareholder value, then on utilitarian common-good grounds a manager's pursuit of growth would be justified. Indeed, one could even argue that such a pursuit would be mandated because for the corporation to even exist requires societal consent that the interests of the corporation and society converge. But does contemporary US society equate the common good with corporate size, independent of contributions to shareholder value?

One individual manager who has attracted broad attention in recent months is Dennis Kozlowski, former chief executive of Tyco corporation. Kozlowski was accused of defrauding Tyco of some $600 million via unapproved bonuses, compensation, and share deals. Kozlowski's one primary pillar of defense is the rapid rate of growth that Tyco Inc. achieved under Kozlowski's stewardship (Bowe, 2003, p. 20). Of course, even if such a defense were generally recognized, it would in no way in and of itself justify Koslowski's alleged defrauding of Tyco.

One reason why society may place value on large companies is that they tend to be associated with large economies in aggregate: the US is the largest economy in the world and its corporations dominate any ranking of the world's largest. A society may place particular value on a large economy, regardless of per capita wealth levels, because it is associated with military security. As Kay observes, "[o]nly in military spending does the size of the economy really matter" (2003, p. I*S).* He notes that society tends 10 view economic size, independent of wealth, as something intrinsically worth striving for: "international economic competition [is] another spotting World Cup ... in which countries vie with each other to be 'Top Nation'" (p. I5). Note also the attention given to company size rankings: whether it be the *Fortune 500* or the *Financial Times Global 1000,* to society as a whole size does matter.

In the US corporate sector, as perhaps elsewhere in US society, big really is regarded as beautiful. An inherent worth is attached to big companies. Thus big companies, in and of themselves, and specifically as a function of their size, serve what society perceives as its common good. Managers who pursue corporate growth as an ultimate objective, therefore, are fulfilling their social mission: these managers are pursuing the common good as defined by social consensus. On utilitarian grounds, even if it is at the expense of shareholder value, a manager's pursuit of growth is justified.

Conclusion

Empirical evidence exists that managers pursue corporate growth, even at the expense of shareholder value. Conventional explanations for this tend to focus on either agency theory or behavioral psychology: managers are either pursuing their own personal wealth at the expense of stockholders, or they are succumbing to some behavioral bias that leads them to inadvertently pursue corporate growth.

In this paper I suggest an alternative explanation. Managers consciously pursue corporate growth, even at the expense of shareholder value, for one or both of two morally justified reasons. First, they believe that the pursuit of growth is most consistent with the corporation's stated mission, and so this pursuit best serves all corporate stakeholders. Second, they recognize that their firm is a publicly sanctioned institution and that the pursuit of growth best serves the interests of society at large and as such society's conception of its common good.

As discussed in the Introduction, in titling their book *The Bigness Complex,* Adams and Brock implied that bigness was a 'complex' in the sense of a managerial pathology. The arguments I provide here, however, indicate that bigness is more accurately viewed as 'complex' in the sense that managers pursue it in order to satisfy a complex mix of deontological and teleological moral obligations.

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