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Shareholders Are Stealing Our Jobs

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SHAREHOLDERS ARE STEALING OUR JOBS

By Andrea Armeni and Tensie Whelan

Imagine the United States economy as Company USA, a corporation that is publicly owned. Just 20% of the country's citizens are shareholders in Company USA. The company is managing to short-term stock gain metrics in response to activist investors and quarterly analyst demands, even though most of its shareholders own their stocks through large index funds (which are passive investors) and are in the investments for the long term.

In order to meet demands for short-term stock price performance, Company USA drastically reduces its biggest cost--labor. It offshores some labor and outsources other labor to contract workers, to whom it pays no benefits. It automates as much as possible, which gives it more tax breaks than hiring labor. It takes the money it saves and buys back shares, which momentarily increases its stock price and shareholder returns (and also the President's bonus).

While its stock price is inflated in the short-term, there are immediate and long-term consequences for the company and for society.

The employees that remain at Company USA are poorly paid and have low morale. The best employees go elsewhere. Customer satisfaction tanks because employees are not motivated to help. Innovation tanks because profits have gone to share buybacks. The former employees that are jobless or who are contract workers have less money to spend on Company USA's products and services.

Workers out of jobs or out of benefits need society's support in the form of unemployment stipends, emergency health care, and housing.

So Company USA has turned its labor into a negative externality — something from which its stock price will benefit in the short-term, but which imposes costs that all US citizens will have to pay, including those that are not shareholders of Company USA.

But this is OK, right, because the shareholders will benefit? And the shareholders will spend their money so Company USA and society will be just fine. That is the wisdom of the markets today.

Or really, its fundamental stupidity.

A Real Life Example: Hostess Transfers Money from Employees to Hedge Funds

Let's look at real life example of the type of financial engineering that has become commonplace. In 2012, private equity firms Apollo and Metropoulos bought Hostess for $186 million while it was in bankruptcy. They parlayed that into $2.3 billion for themselves and the investors in their funds, which include firefighter and nurse pensioners. They did this through arranging for Hostess to borrow about $1.3 billion, $900 million of which they kept for themselves. They also arranged to collect as much as $400 million over the next 15 years, based on Hostess's future earnings, with the tax savings going to the funds, not Hostess. They reduced jobs from 8,000 to 1,200 and paid no severance or pensions. The percentage of unionized employees dropped from 83% to 30%.[1]

Quite an irony: nearly half of private equity's invested assets now come from public and private pensions around the world and it is common practice to use this type of financial engineering that destroys the livelihoods of the very people they are holding pensions for.

Fun fact: as a result of the Trump tax cut, Hostess offered its workers a one-time bonus, plus snacks. Let them eat Twinkies?

Shareholders Are Coming For Our Jobs

It's not the robots that are coming for American jobs. It's not the immigrants. It's not evil offshoring CEOs either. It's the shareholders.

Politicians, from the small town mayor to the U.S. President, wax lyrical about how American jobs are threatened by immigrants and off-shoring. Investors make a compelling case for the need for human capital management and the risk of underinvesting in labor. Rating agencies classify human capital management risk as one of the main factors leading to a lowered corporate rating.[2]

Yet companies that buck the short-termist trend and pursue quality jobs practices – from paying living wages to providing opportunities for advancement – are often penalized in the public markets by investors seeking quarterly returns.

In April 2017, American Airlines announced a significant investment in its team—increasing salaries for pilots and flight attendants. Chief Executive Officer Doug Parker wrote in a statement: "Investing in our product… is not enough to retain our customers' loyalty if we are not investing in our team. As a service business, it is our team who will differentiate American from the competition." Yet American's shareholders revolted at this notion, sending the stock price tumbling by 8.6%.[3] Analyst comments

[1] Michael Corkery and Ben Protess, "How the Twinkie Made the Superrich Even Richer", *New York Times*, December 10, 2016

[2] See S&P Global, "How Social Risks and Opportunities Factor Into Global Corporate Ratings", April 2018, available at www.spglobal.com/ratingsdirect

[3] In the quarter after the policy changes, the stock rebounded with earnings above expectations: https://www.reuters.com/article/us-american-airline-results/american-airlines-revenue-adjusted-profit-beats-forecasts-idUSKBN1AD1F3

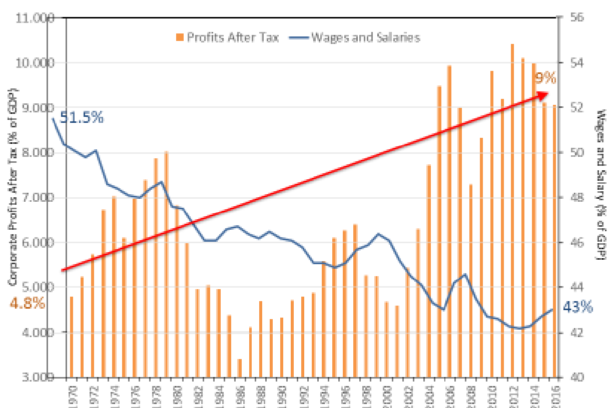
could have left one thinking that the Bolshevik Revolution had arrived: "Labor is being paid first again. Shareholders get leftovers."[4] "We are troubled by AAL's wealth transfer of nearly $1 billion to its labor groups."[5]

Investor concern is misplaced. There is no risk of shareholders suffering while labor extracts all the wealth. Wages as a percentage of GDP have fallen from 50% in the 1970s to 43% in 2017.[6] Corporate profits after taxes rose from $527 billion in 2000 to $1.928 trillion in June 2018.[7]

Importantly, not all shareholders are alike. While short-term, shareholder primacy investors are driving significant pressure on corporate leadership to cut labor costs—long-term institutional investors, many of whom hold the savings of millions of middle class Americans, are increasingly concerned about the negative impact of short termism on society.

In this article, we will examine the devastating impact on American jobs of short-term shareholder primacy strategies, the emerging backlash by investors, and suggest some remedies.

Wages & Salaries vs. Corporate Profits as a Share of GDP



Source: St Louis Fed

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[4] Citigroup analyst named Kevin Crissey in a note that was sent to the bank's clients, as quoted in LA Times: http://www.latimes.com/business/la-fi-american-airlines-raises-20170427-story.html

[5] Jamie Baker of JPMorgan, also quoted in CNBC: https://www.cnbc.com/2017/04/27/airline-shares-decline-amid-worries-the-stocks-will-become-a-poor-investment-again.html

[6] http://www.thirdway.org/report/why-not-a-minimum-pension and U.S. Bureau of Economic Analysis, Compensation of Employees: Wages and Salary Accruals [WASCUR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/graph/?g=2Xa, July 16, 2018.

[7] U.S. Bureau of Economic Analysis, Corporate Profits After Tax (without IVA and CCAdj) [CP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CP, July 16, 2018.

The Deteriorating Quality of American Jobs

Under shareholder capitalism, the U.S. labor force has become a liability--a cost to be contained--rather than an asset, and the decrease in worker well-being is a simple externality to be placed off-books and ignored.

There has been a major shift to low wage, no benefit work. In 2009, 24% of Americans were in low-wage jobs, with 41 million on minimum wage; this is projected to double to 48% by 2020. In fact, two-thirds of new jobs created by 2020 are projected to be low wage.[8]

Corporate leaders have also switched from wage increases to paying bonuses: The North American compensation practice leader for Aon, Ken Abosch, says that spending on "variable pay" is 12.7 percent of employers' payroll budgets, and salary increases is 2.9 percent. In 1992, those numbers were 5.7 percent and 4.6 percent, respectively.[9]

The gig economy, which requires workers to fund their own sick days, vacations, insurance and retirement, is also growing exponentially. 34% (53 million) of the total US workforce is freelance today. While there is limited consensus on the numbers,[10] due in part to differences in definitions, by 2020, over 50% (82 million) of US workforce may be "contingent" workers with no job security and no benefits.[11] A 2012 study revealed that temporary workers earned 18% less than non-temporary workers, and were twice as likely to live in poverty and rely on social safety nets.[12]

According to the Intuit 2020 Report, "the long-term trend of hiring contingent workers will continue to accelerate with more than 80% of large corporations planning to substantially increase their use of a flexible workforce."[13]

A flexible workforce means that the risks associated with work are transferred from employers – who are generally in a better position to bear them – to the individual worker who now has no job security and no benefits; no coverage under the National Labor Relations Act, no rights to employee protections including the minimum wage and state anti-discrimination laws.

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[8] Andy Stern, Raising the Floor, Public Affairs, June 2016, pg. 34

[9] Jena McGregor, "Why Many Companies are Giving Bonuses—Not Raises—After the New Tax Cuts," Washington Post, January 18, 2018.

[10] Ultimate Guide to Gig Economy Data: A Summary of Every Freelance Survey We Can Find, https://nation1099.com/gig-economy-data-freelancer-study/. See also the accompanying Key Takeaways from the Freelance Workforce Data, http://nation1099.com/wp-content/uploads/2018/05/Key-Takeaways-From-the-Freelanc-Workforce-Data.pdf for most recent figures.

[11] Andy Stern, Raising the Floor, Public Affairs, June 2016, pg. 88.

[12] Miranda Dietz, "Temporary workers in California are twice as likely as non-temps to live in poverty: Problems with temporary and subcontracted work in California", UC Berkeley Labor Center, August 2012.

[13] http://about.intuit.com/futureofsmallbusiness/

Compounding the bad news for American workers: 45% of labor could be automated today using existing technologies and could reach 58% with projected AI improvements.[14]

While in the past major technological shifts have created more employment, rather than less, it is not clear that this will continue to be the case. A 2017 McKinsey report identifies middle-income jobs such as office clerks and the truck drivers (the major source of employment for men in 29 states) as the most susceptible to automation, and finds that the growth in labor demand for similar and lower-waged jobs won't match the displacement.[15]

For example, when the Kroger supermarket chain implemented Quevision, a predictive software program that estimates the number of cashiers that will be needed based on customer arrivals it was heralded for "resulting in a 3.5-minute reduction in wait time and $250 million in labor cost savings."[16] In other words, Kroger workers lost $250 million – workers who made an average of less than $10 an hour and needed the money.[17]

What About the Tax Breaks to Stimulate Investment in Work?

The corporate tax rate drop this year from 35% to 21% was ostensibly meant to stimulate investment and create jobs, according to President Trump and the U.S. Congress. This could have represented a $1.3 trillion investment in the future of the US economy, and specifically in future jobs.

The evidence thus far demonstrates a focus on increasing benefits to shareholders, rather than employees, through share buybacks, which boost stock price (and executive compensation). In the first three months after the tax bill, CNN found that while there was no increase in reinvestment, there was a burst of $178 billion in share buybacks.[18] There was an extra $8.3 billion compared to the same period in 2017 to shareholders in the form of company dividends.[19]

Just Capital's analysis of public announcements by companies regarding the use of the tax break found that just seven percent was allocated to workers, with half of that going to one-time bonuses.[20]

Wells Fargo announced that the tax cut will enable it to increase dividends and buy back shares. Barely 2% of the tax rate drop windfall will go to an increase in minimum wage from $13.50 an hour to $15 an hour for the bank's US employees ($78 million across 25,000 employees). Wells Fargo is in good

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[14] Andy Stern, Raising the Floor, Public Affairs, June 2016, pg. 64.

[15] McKinsey Global Institute, "Jobs Lost, Jobs Gained, Workforce Transitions in a Time of Automation," p. 84. https://www.mckinsey.com/~/media/mckinsey/featured%20insights/future%20of%20organizations/what%20the%20future%20of%20work%20will%20mean%20for%20jobs%20skills%20and%20wages/mgi%20jobs%20lost-jobs%20gained_report_december%202017.ashx

[16] Cornerstone Capital, "Retail Automation? Stranded Workers", https://cornerstonecapinc.com/wp-content/uploads/2017/05/Retail-Automation_Stranded-Workers-Final-May-2017_corrected.pdf

[17] https://www.payscale.com/research/US/Employer=The_Kroger_Company/Hourly_Rate

[18] http://money.cnn.com/2018/05/20/investing/stocks-week-ahead-buybacks-tax-cuts/index.html

[19] https://www.usatoday.com/story/money/2018/04/13/how-companies-spend-tax-windfall/505122002/

[20] https://justcapital.com/reports/the-just-capital-rankings-on-corporate-tax-reform/

company: according to a tally kept by Reuters; at least two dozen companies have announced buybacks and dividend increases since the tax bill vote.[21] Harley-Davidson did so just days after closing a plant in Kansas City.[22]

Towards a New Job Compact with American Workers, Companies, and Investors

Ironically, companies pressured to focus on short-term results and shareholder primacy appear to perform less well for shareholders. A study published in the Harvard Business Review[23] found that firms focused on the long-term out-performed their short-term brethren, with 47% higher average revenue and 36% higher earnings growth over a 14-year period. Long-term mindset companies each added 12,000 more jobs on average.

In another study of 250 companies' treatment of workers (as measured by technology, physical surroundings and culture) the top 6% outperformed their peers in terms of profit by a multiple of four (Morgan 2017). Fortune magazine's "100 Best Companies to Work For" earned, over the long-term, excess risk-adjusted returns of 3.5%.[24]

Tellingly, the HBR study found that US GDP over the last decade could have grown by $1 trillion more and created five million additional jobs if all companies had pursued a long-term approach[25].

These considerations are not merely the purview of leftists and workers-rights activists. Larry Fink, CEO of BlackRock put CEOs on notice with his 2018 annual letter, writing that they must make a positive contribution to society as well as make a profit: "Since the financial crisis, those with capital have reaped enormous benefits. At the same time, many individuals across the world are facing a combination of low rates, low wage growth and inadequate retirement systems."[26]

The CECP Strategic Investor Initiative, a coalition of managers representing $15 trillion in assets, wants to see long-term growth plans and risk analysis, including their human capital management. The Human Capital Management Coalition, which represents $2.3 trillion in assets under management, has pushed the Securities and Exchange Commission to require human capital disclosures as material to financial performance and risk.

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[21] https://www.reuters.com/article/us-buybacks/update-1-u-s-corporate-buybacks-dividends-since-tax-bill-vote-idUSL3N1OC4EQ

[22] https://www.vox.com/policy-and-politics/2018/5/22/17350180/harley-davidson-tax-buyback-kansas-city-factory

[23] HBR (Barton, Manyika, Williamson 2017)

[24] Edmans, Alex. "Does the Stock Market Fully Value Intangibles," Journal of Financial Economics 101 (2011): 621-640. See also Bernstein, Aaron and Larry Beeferman, "The Materiality of Human Capital to Corporate Financial Performance," Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, April 2015.

[25] HBR (Barton, Manyika, Williamson 2017)

[26] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

To help American workers and shareholders, we suggest asset managers and owners move to reject shareholder primacy and embrace stakeholder capitalism, invest in positive approaches to quality employment, and help workers regain a voice in corporate decision-making.

1. REJECT SHAREHOLDER PRIMACY; EMBRACE STAKEHOLDER CAPITALISM

Support multi-stakeholder corporations

There are three potential ways for investors to help effect the shareholder-to-stakeholder capitalism transition. The first is the steward ownership model, which builds on a distinguished history of European companies being managed for the long-term benefit of stakeholders. These companies accomplish this by assigning to a trust veto rights over fundamental issues and by distributing shareholders' traditional rights among a broader range of stakeholders. Governance is distributed among those connected to the operation and its mission (shareholders, workers, customers, and suppliers) and profits above the cost of capital are deployed to advance the company's mission.

Several companies in the United States are in the process of converting to a steward ownership model.[27]

Second is a new corporate legal entity developed in the U.S., the benefit corporation, which provides legal standing for a corporation that seeks to maximize benefit for stakeholders in addition to shareholders. Legislatures in 34 states (the majority Republican), have passed legislation enabling benefit corporations to be formed. Seven thousand companies have become benefit corporations, from early adopters such as Patagonia to Dannon Wave.

Adoption of benefit corporation status among major public companies has been slow, so in August, Sen. Elizabeth Warren introduced the Accountable Capitalism Act, which she summarized in a Wall Street Journal op-ed. "The Accountable Capitalism Act restores the idea that giant American corporations should look out for American interests. Corporations with more than $1 billion in annual revenue would be required to get a federal corporate charter. The new charter requires corporate directors to consider the interests of all major corporate stakeholders—not only shareholders—in company decisions. Shareholders could sue if they believed directors weren't fulfilling those obligations. This approach follows the 'benefit corporation' model, which gives businesses fiduciary responsibilities beyond their shareholders."[28]

A third approach is to support employee owned companies. Current US tax law encourages Employee Stock Ownership Plans (ESOP) through tax benefits. Employee ownership can promote job security and resilience to shocks while giving workers higher average wages and a stake in the upside of their businesses. And research shows that broad-based employee ownership increases firm productivity and decreases turnover.[29]

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[27] https://wwwforbescom.cdn.ampproject.org/c/s/www.forbes.com/sites/annefield/2018/07/21/anovelrestructuringallowsan-organicspioneertomaintainitsmission/amp/

[28] https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687

[29] See Research Evidence on Prevalence and Effects of Employee Ownership, Douglas Kruse

Investors can encourage the development of multi-stakeholder corporations by investing in them, supporting state and national legislation and encouraging companies in their portfolio to adopt these models. Investors can also finance the conversion to employee ownership, especially as the "silver tsunami" of retiring baby-boomer business owners creates a pipeline of businesses that could be sold to their employees. And finally, with union membership at historically low levels, investors can shun de-unionization and focus instead on ensuring that the inclusion of worker voice is part of sound management practices.

Decouple executive compensation from stock price

Executives should be incentivized to produce value for employees and society in addition to financial returns. Warren's editorial makes the point: "…executives have a strong financial incentive to prioritize shareholder returns. Before 1980, top CEOs were rarely compensated in equity. Today it accounts for 62% of their pay. Many executives receive additional company shares as a reward for producing short-term share-price increases. This feedback loop has sent CEO pay skyrocketing. The average CEO of a big company now makes 361 times what the average worker makes, up from 42 times in 1980."[30]

In practice, CEO compensation does not correlate with better stock performance, let alone better long-term company performance; indeed, the shares of companies with most overpaid CEOs typically underperform.[31]

Investors can support changing executive compensation norms through shareholder proposals, engaging with management, and devaluing companies with outmoded compensation policies, as well as opining via resolutions and other means to exclude the effects of buybacks on share price when setting executive compensation.

Reject excessive share buybacks that undermine the company's ability to reinvest

Of $976 billion in net income generated by the S&P 500 in 2014, total payout ratios topped 93%, skewed toward buybacks. This left just 7% for re-investment in the current workforce or to fuel future growth. In the U.S., shareholders have no say over whether a company decides to issue a share buyback and investors can press the SEC for change.[32] According to the Roosevelt Institute, "By ending the practice of stock buybacks and spending $10 billion on increasing wages instead, 1 million low-wage Walmart employees would see an hourly wage increase of over $5.66." [33]

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[30] https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687

[31] See As You Sow, The 100 Most Overpaid CEOs, 2018, https://www.asyousow.org/report/the-100-most-overpaid-ceos-2018/

[32] https://www.thestreet.com/investing/sec-commissioner-calls-for-review-of-buyback-rules-amid-surge-14618216

[33] http://rooseveltinstitute.org/making-case/

2. INVEST IN POSITIVE APPROACHES TO QUALITY EMPLOYMENT ACROSS ASSET CLASSES

There are a number of successful investment opportunities across asset classes that center on a quality jobs thesis and human capital approach that have provided solid returns.

Publicly Traded Companies

The JUST U.S. Large Cap Diversified Index (JULCD) categories were developed through surveying American citizens on what makes a company "just" –and found they were most focused on a just approach to labor. Just Capital found that the cumulative investment returns for JUST companies outperformed the Russell 1000 by three points between November 2016 and January 2018.[34] Goldman Sachs and Just Capital recently announced a new ETF that is based on the Just Capital Index.[35] There have been concerns raised about the validity of the index[36]; regardless, this is an initial foray into tracking criteria related to jobs and provides an interesting example.

Parnassus Endeavor Fund, a primarily large cap fund, which picks companies based on their positive workplace attributes, has been named No. 1 among *all* large-cap growth stock funds over every long-term period measured by research firm Morningstar, from one year to 10 years, and has delivered annualized returns of 12.2%, compared with just 8.5% for the S&P 500.[37]

The HIP Great Places to Work ESG Portfolio similarly beat its benchmark in 2017, realizing gross returns before fees of +34.2%, outperforming the benchmark by more than 13 percentage points, or a 50% premium.[38]

Private equity and Hedge Funds

Investors can reallocate their portfolios away from strategies that squeeze workers and pressure companies to disgorge cash by relying on short-term wealth extraction. In the hedge fund context, even in cases where activist hedge funds create financial value for target firms, they systemically negatively affect workers. According to research published by the National Bureau of Economic Research, even when a hedge fund-targeted firm achieves higher labor productivity, workers do not see their compensation increase; that means that wealth created by the improvements is captured almost solely

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[34] https://justcapital.com/investor-resources/

[35] https://www.forbes.com/sites/jeffkauflin/2018/06/13/feel-good-get-rich-with-new-goldman-sachs-paul-tudor-jones-etf/#5a673b8a6a5c

[36] https://www.theguardian.com/business/2018/sep/28/is-goldman-sachs-new-fund-really-just-greenwashing-stocks

[37] (Jen Weiczner 2017 Fortune)

[38] See https://hipinvestor.com/blog/2017-hip-strategy-performance-outperformance-in-risky-times/

by investors.[39] Econometric studies also show that, in general, job destruction exceeds job creation in private equity-owned companies, as compared with publicly traded companies.[40]

More recently, some private equity transactions have focused on the improvement of job quality as a value driver – correlating, for example, high rates of workplace injury with poor overall management. KKR Industrials has invested in several turnarounds over the last few years that have focused on good worker practices. Blue Wolf Capital, a middle-market private equity firm, takes an approach to value creation that focuses on a broad array of stakeholders, including workers, unions, and regulators, rather than seeing them as antagonists.

Private debt

Asset owners may consider private debt funds that support their portfolio companies in moving toward quality jobs. For example, the mezzanine debt fund HCAP Partners invests in companies that prioritize quality jobs and supports them throughout the life of the investment to improve wages, benefits, opportunities for advancement, and profit and ownership sharing. Its approach goes beyond measurement of quality jobs to focus on management of quality jobs.[41]

Community Development Finance Institutions

Investors can support Community Development Finance Institutions that finance quality jobs. One such institution, Coastal Enterprises, Inc., engages employers to improve job quality and livelihoods as a competitive advantage; advocating for policies and forming partnerships that boost job quality; and launching a "Good Jobs" public outreach campaign, highlighting its investee employers that are champions of quality employment. MetaFund, another CDFI, operates a private equity fund that finances projects that create or sustain quality jobs and provide employment opportunities to individuals facing barriers to employment.[42]

Fixed Income Instruments

Investors can provide capital for fixed income instruments for public infrastructure that support workers. HIP Investor rates over 50,000 bond issuances, including municipals, sovereigns/TIPS and

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39 The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, And Labor Outcomes http://www.nber.org/papers/w17517

40 Eileen Appelbaum and Rosemary Batt, Private Equity at Work, 193-94.

41 See https://static1.squarespace.com/static/55551ab4e4b0d98a040765f6/t/5afb5a7e88251bdbb85ab9d1/1526422153605/HCAP+2017+Impact+Report+Rev+04-18-B.pdf

42 See http://www.metafund.org/about-us/programs/investing/

agencies, quantifying the human, social, and environmental impact of each investment relative to financial performance. High HIP ratings take into account such factors as workforce and management diversity, pay ratios, and employee satisfaction and correlate to better financial performance and lower default rates.

Conclusion

Extensive damage is being done to Company USA in the name of shareholders, most of whom are passive investors who have no idea what is being done in their names. The massive growth of offshored, automated, outsourced, low paid, contingent jobs with no benefits is externalizing the real costs of business onto society. In order ensure a healthier, more sustainable US society and economy, Americans must have dignified work that allows them to support their families, pay for health care, and set aside money for retirement. Much of the damage is being wrought by a small number of activist investors and short-term focused analysts. Asset owners and managers must fight back and support companies that are investing in their workforce. That will ensure better returns for investors and for society.

ABOUT THE AUTHORS

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