Investment Insights
May 2020

# The End of Shareholder Primacy and Its Impact on Equity Valuations

## Authors

Robert M. Wilson, Jr.
Research Analyst

Barnaby Wiener
Portfolio Manager
and Head of Sustainability
and Stewardship

Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist


Watch related video featuring Rob Almeida

## In brief:

- In our view, society has started to shift away from the shareholder primacy model.
- The COVID-19 pandemic is likely to accelerate this shift, requiring investors to understand the value companies have been creating for and extracting from all stakeholders.
- We believe this shift suggests that margins could be lower versus expectations in coming years.

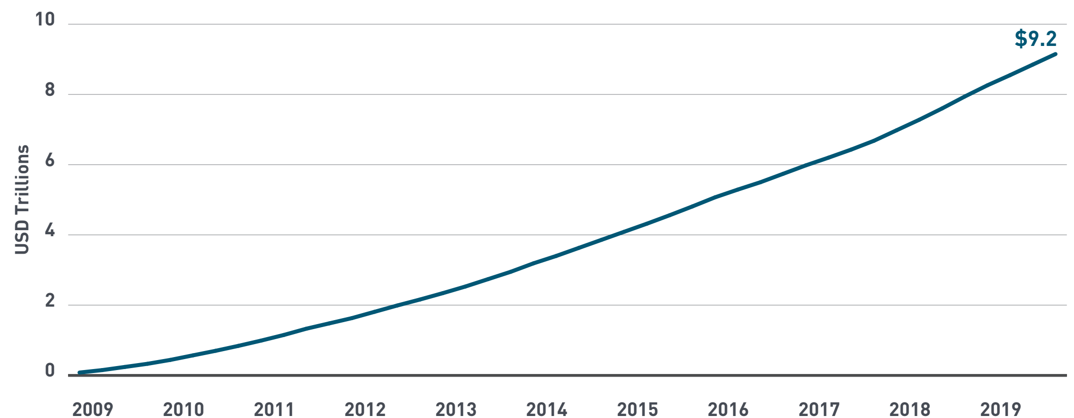
Despite its length, the recently ended eleven-year business cycle created meager economic growth relative to the generous returns that financial markets provided to investors. Central bankers expected low interest rates to spur corporate animal spirits, growth in capital expenditures and inflation aimed for the benefit of all. Instead, rather than creating wage growth and other broad societal benefits, the ballooning of central bank balance sheets unintentionally financed asset price inflation as dividends and share repurchases boomed.

This failing occurred alongside a peak in investor short-termism. Against a backdrop of below-average revenue growth early in the cycle to midcycle, corporations recognized the market's thirst for capital return amid slight regard for long-term value. Corporates gave the market what it wanted.

During the last business cycle, companies in the S&P 500 Index returned more than $9 trillion to shareholders, a sizable chunk of the index's $23 trillion market capitalization, mainly by leveraging their balance sheets. This helped push equity valuations higher in a way that was grossly inconsistent with the pace of US or global economic growth. The shareholder primacy model — the idea that corporations exist primarily to serve the interests of shareholders — was on full display.

Exhibit 1 illustrates the combined amount of nominal dividends and stock buybacks in the S&P 500 Index during the cycle.

### Exhibit 1: Cumulative S&P 500 Index buybacks and dividends since 2009




Source: Haver Analytics. Quarterly data from 31 March 2009 to 31 December 2019. Cumulative S&P 500 buybacks + dividends is calculated as the aggregate value starting from 31 March 2009 to each quarter. Past performance is no guarantee of future results.

The foregoing has laid the foundation for a full-scale assault on the shareholder primacy model. Dissatisfaction with the model may result in material changes in the margin profile and the valuations that investors will be willing pay for certain companies. We believe the importance of security selection is likely to increase as a result of these changes. We next evaluate this risk along three dimensions: income inequality, supply chain and governance.

## Income inequality

Many structural factors, such as automation, have driven a surge in income inequality in most developed markets over the past 40 years. COVID-19 has shined a bright light on these inequalities, and we believe society and regulators will aim to reverse many of the margin-enhancing steps companies have taken to reduce labor costs over the past few decades. Among many possible examples, we note the following:

- The number of temporary, contract and "gig" employees has increased dramatically while the path to full time jobs for these workers, which offer better benefits and worker protections, has evaporated.
- The value of many service-sector jobs has diminished substantially. Few offer a living wage, health and retirement benefits or consistent schedules, which has forced society to pick up the cost of the negative externalities associated with the employee practices of low-wage employers.

Companies that were overearning as a result of unsustainable wage suppression are at risk in a post-COVID-19 world. Conversely, companies that already manage their workforce well or have sufficient margin and pricing power to absorb these increased labor costs likely face less margin pressure and possibly possess unique scarcity value when compared with their peers.

## Supply chain

Society's increased focus on inequality has extended to supply chains. There have been numerous stories of workers facing economic hardship because of factory closures in the wake of the pandemic. Many have called for some fashion brands, for example, to protect not just frontline workers in developed markets but workers along the supply chain as well. We feel few companies will be able to support this level of expense if shutdowns lasts longer than a few months. Additionally, new factors resulting from the pandemic are combining with preexisting ones — such as modern slavery regulations designed to prevent forced and child labor, among other provisions — to potentially add to the supply chain cost pressures affecting corporations.

## Governance

Historically, sustainable investors have focused their attention on governance topics such as board structure and executive compensation; however, the debt-fueled binge that abruptly ended with the pandemic is likely to shift their attention to long-overlooked governance topics, such as capital allocation and return, which we feel will have as much — if not more — of an impact on the sustainability and resilience of a firm over the long term. Corporate practices such as increasing debt to fund buybacks and dividends will likely face considerably more scrutiny going forward.

In addition, as firms seek government grants and bailouts, we anticipate a closer look at companies that pay low corporate tax rates. Even before the pandemic, tax transparency was growing, with many companies being required to report employees, sales, profits, assets and other data points on a country-by-country basis. Separately, we have seen countries develop digital revenue taxes, which are likely only the beginning of the revenue-based taxes that will be levied on companies that shift profits out of higher-tax jurisdictions.

Naturally, we feel the growing government debt associated with the response to the coronavirus outbreak is likely to hasten an increase in corporate taxes or the development of new forms of taxation such as carbon, sugar and revenue-based taxes. As with the strains cited above, these changes could put downward pressure on corporate margins over the intermediate and long term.

This is all a lot to consider, and there is much that we have left out. We could debate the speed of change, for example, or even if the shareholder primacy model will end at all amid higher-than normal levels of uncertainty. This is why, as investors, we aim to invest in companies that we think can grow their earnings sustainably over a full economic cycle and for which the risk/reward tradeoffs are attractive.

At the very least, we know profit margins reached all-time highs in the last cycle against one of the weakest economic backdrops in history because, in our view, massive economic value was extracted from nonequity stakeholders.

Every economic cycle has produced imbalances. During a crisis or recession, those imbalances are redressed painfully and expensively by those at fault. With that in mind, we believe the only way to be truly responsible stewards of capital is through rigorous fundamental research and security selection.

"Standard & Poor's®" and S&P "S&P®" are registered trademarks of Standard & Poor's Financial Services LLC ("S&P") and Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). The content has been licensed for use by S&P Dow Jones Indices LLC and sublicensed for certain purposes by MFS. The S&P 500® is a product of S&P Dow Jones Indices LLC and has been licensed for use by MFS. MFS' products are not sponsored, endorsed, sold, or promoted by S&P Dow Jones Indices LLC, Dow Jones, S&P, or their respective affiliates, and neither S&P Dow Jones Indices LLC nor Dow Jones nor S&P nor their respective affiliates makes any representation regarding the advisability of investing in such products.

The views expressed are those of the author(s) and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice from the Advisor.

No forecasts can be guaranteed.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S.** – MFS Institutional Advisors, Inc. ("MFSI"), MFS Investment Management and MFS Fund Distributors, Inc.; **Latin America** – MFS International Ltd.; **Canada** – MFS Investment Management Canada Limited. No securities commission or similar regulatory authority in Canada has reviewed this communication; **U.K.** - MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorized and regulated in the conduct of investment business by the U.K. Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS, has its registered office at One Carter Lane, London, EC4V 5ER UK and provides products and investment services to institutional investors globally. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore** – MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand** – MFS International Australia Pty Ltd ("MFS Australia") (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong** – MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO").; **For Professional Investors in China** – MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company regulated to provide financial management consulting services.; **Japan** – MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments.