
SHAREHOLDER DESERT WORKS WITH A RISK-RETURN MODEL

Gordon G. Sollars and Sorin A. Tuluca¹

A RESPONSE TO Kenneth Silver (2019), “Modern Portfolio Theory and Shareholder Primacy”, *Bus Ethics J Rev* 7(6): 34–39,
<https://doi.org/10.12747/bejr2019.07.06>

ABSTRACT

Kenneth Silver (2019) criticizes our (Sollars and Tuluca 2018) use of the Capital Asset Pricing Model (CAPM) to determine the return on investment that is deserved by shareholders, and suggests shareholder primacy follows from the principal/agent model, rather than a concern for risk. We argue that Silver has misunderstood CAPM and our use of it, and that, under current law, more is required from articles of incorporation or corporate bylaws for the principal/agent model to apply to corporations.

IN A RECENT Commentary, Kenneth Silver (2019) critiques our use of the Capital Asset Pricing Model (CAPM) to determine the return that shareholders deserve from management. Further, he suggests that the agency theory of Jensen and Meckling (1976) provides a better justification for the principle of shareholder wealth maximization as a “managerial imperative” (Silver, 2019: 34). Silver’s remarks suggest that our argument is easily misunderstood, and we welcome the opportunity he provides to clarify our views.

Silver (2019: 38n3) describes it as “telling” that we apply our approach only to public corporations. All we are telling here is the domain of application of our approach. We think that the emergence of robust financial markets for equity, and the concomitant development of financial theory, makes a difference in the way we think about pub-

¹ Fairleigh Dickinson University (both). Email: gsollars@fdu.edu, tuluca@fdu.edu

licly traded corporations. We do not believe that our approach applies to the close corporation, and we say so explicitly. We have not (yet) developed an approach for what the shareholders of the close corporation deserve. Having a single theory for all versions of the corporation would be more elegant, but, as the saying goes, theories should be as simple as possible, but no simpler.

CAPM and Desert

Silver (2019: 36) states that, “Price is not a function of fairness; it’s a function of supply and demand.” Although this is what price theory teaches with regard to goods, the price of a stock is determined in quite a different fashion. Price theory relies upon a “supply curve” that indicates the quantity of a good that would be supplied at each price by a set of firms. A higher price for the good results in more of the good being produced by these firms for sale. Equity shares, however, do not function in this way; a higher price for a share does not imply the issuance of more shares for sale than does a lower price. Financial theory explains that the price of a share of a single firm is determined by discounting the firm’s expected stream of future dividend payments to the present, called its “present value.” A share’s present value changes when expectations about the value of the firm’s future dividend stream changes, or when the rate of discount used to calculate the share’s discounted present value changes.

Moreover, the CAPM model is not concerned with share prices as such, but rather with share returns, comparing them with overall market returns. Here, the return is the difference in price between the start and the end of a time period.² Further, the model makes a number of assumptions, such as buyers and sellers having homogeneous expectations about the distribution of those returns. At one point, Silver (2019: 36) expresses concern that share prices might not reflect the “intrinsic value” of a share due to “reckless investor behavior or artificially inflated expectations.” Although CAPM does not reference the “intrinsic value” of a share, it does assume that share returns result from a stationary normal distribution, i.e., while a particular share return might be high or low, the mean and variance of the share returns are constant. Thus, the risk of holding a share is not affected by the share price, but rather by the volatility of the share return when

² More precisely, it is the difference between the logarithm of the prices.

compared to the market volatility. The value of particular shares, indeed of the market as a whole, might fail to reflect some “intrinsic value” without affecting the calculation of relative risk.

In a crucial passage, Silver (2019: 36, emphasis in the original) claims that the cost of equity (or discount rate) is the “price demanded by investors,” but that “what is demanded by investors does not mean that it is what investors *deserve*.” The CAPM crucial risk measure, beta, is not, however, a “price demanded by investors” in the sense of a price theory demand curve. Rather, beta measures the return that an investor should require to hold that stock, given its risk relative to the market. For a given level of risk, investors are powerless to “demand” more return than stocks at that level provide; a greater return is simply not justified, while a lower return would be irrational to demand. The “demanding” of a higher return can be done only if the stock has a higher level of risk.

With this in mind, consider Silver’s payday loan example. We are given that the contracted interest rate charged is “far above what is necessary to compensate for default risk.” Silver (2019: 36) goes on to claim that this is unfair, and so “not deserved.” The notion of fairness is superfluous here; desert by itself is sufficient.³ To say that the interest rate is higher than that required to compensate for the risk is simply to say, on our view, that the contracted interest rate is undeserved. Here we make no claims about the return that payday loan companies in fact deserve, but simply follow the assumption about return and risk that are in Silver’s example. In our approach, publicly traded payday loan companies could be assessed to determine if, in fact, their shares provide returns that are more than those of other shares of equivalent risk.

Turning from payday loans to stocks, Silver (2019: 36) is concerned that “reckless behavior” could lead to investors getting more return than they deserve. Indeed, some stocks might return more than the CAPM model predicts, and for a variety of reasons. If a stock in fact returns more than is required by its beta, however, that is pre-

³ Silver seems to equate fairness and deserving. We do not explore the connection here, but rely in paper on the pluralistic theory of desert presented in Sher (1987). In this approach, various desert claims are justified by reference to different external values (McLeod 2013). The desert claim in the SDP is justified by the external values created by the corporate form, and the risk taken to obtain value.

cisely what we mean by an undeserved return: a return greater than that required for the risk taken.

Our view is that risk and return should be proportional according to CAPM, and that, when this is so, the return is deserved. Paradigm cases of risk and reward, such as “Lee deserves a reward; he risked his life” (Sher 1987: 7), recognize that a reward may be deserved when something is put at risk, although they typically do not attempt to quantify the risk. In our domain of interest, we can use CAPM⁴ to provide the quantification for risk, and, hence, of return.

Of course, CAPM, like any model, is open to challenge. Perhaps we should have likened our use of CAPM to the use of an “original position” or “state of nature” in our paper. And, although any model can be attacked, shareholder wealth maximization must also rely upon a discount rate determined in some way, since firms select among possible projects by the comparison of present values. Any proper measure for the cost of capital will be a function of risk, or so we claim. Our Shareholder Desert Principle (SDP) simply states that the shareholder deserves a return proportional to the risk, and, as such, can be used with any risk measure the wealth maximizer prefers. As far as we can tell, Silver does not challenge the SDP itself in any way.

Agency Theory

Silver (2019: 39) points to agency theory as a “promising motivation” for shareholder primacy. In agency theory, in particular, as explicated by Jensen and Meckling (1976), the shareholders are said to “hire” management, as a principal hires an agent.⁵ Space does not allow for a full treatment of Silver’s claim. We must let it suffice to say that Jensen and Meckling do not attempt to ground their notion of agency in any moral theory, and that the legal status of managers as agents is highly contested among legal theorists.

In our paper, we tried for simplicity to omit the difference between corporate directors and corporate officers, referring simply to “corporate management,” since both have the same fiduciary duties.

⁴ Other models could be used. As we explain in our paper, we chose CAPM because of its wide acceptance.

⁵ Further, Silver adds that managers “are taken to be the agents of shareholders.” How managers should be “taken,” however, is at the heart of the dispute between advocates of shareholder primacy and their opponents.

Unfortunately, this simplicity cannot be maintained once the notion of shareholders “hiring” management is invoked. The claim that shareholders hire corporate officers is simply false; officers are hired by the corporate directors. Regarding directors, while they are elected by shareholder vote, Clark (1985) argues that they are not agents, since they are not subject to direct control or supervision. Moreover, the *Restatement (Second) of Agency*, §14C (1958) states, “Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members.”

Corporate directors are, however, fiduciaries for the shareholders. A paradigm case of a fiduciary that is not an agent is the trustee, and we analogize directors to trustees in our paper. Although Silver (2019: 38) objects to this analogy, stating that the “point” of trusts and corporations is different, any bald claim about the “point” or “purpose” of the corporation is going to be considered question begging by opponents of shareholder primacy.

In any event, the purpose of our paper was to provide managers with a criterion for determining what shareholders deserve. The very theory of desert on which we base our analysis grants that desert and entitlement are two different regions of the moral realm. Perhaps shareholders, via some as yet to be articulated theory, are entitled to returns that they do not deserve. We grant that this could be the case, if, for example, an entitlement to all residual returns was specified in a corporation’s articles or bylaws. The problem, however, is that although such language could easily be provided at the time of incorporation, we are unaware of any corporation that has done so.

Received 9 March 2020 / Posted 8 April 2020

REFERENCES

- Clark, Robert C. 1985. “Agency Costs versus Fiduciary Duties.” In *Principals and Agents: The Structure of Business*, eds. John W. Pratt and Richard J. Zeckhauser, 55–80. Boston: Harvard Business School Press.
- Jensen, Michael, and William Meckling. 1976. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *J Finan Econ* 3: 305–360,
[https://doi.org/10.1016/0304-405X\(76\)90026-X](https://doi.org/10.1016/0304-405X(76)90026-X)

- McLeod, Owen. 2013. "Desert." *The Stanford Encyclopedia of Philosophy* (Winter 2013 Edition), ed. Edward N. Zalta, <http://plato.stanford.edu/archives/win2013/entries/desert/>
- Sher, George. 1987. *Desert*. Princeton: Princeton University Press.
- Silver, Kenneth. 2019. "Modern Portfolio Theory and Shareholder Primacy." *Bus Ethics J Rev* 7(6): 34–39, <https://doi.org/10.12747/bejr2019.07.06>
- Sollars, Gordon G., and Sorin A. Tuluca. 2018. "Fiduciary Duty, Risk, and Shareholder Desert." *Bus Ethics Q* 28(2): 203–218, <https://doi.org/10.1017/beq.2017.47>