Distortions in the investment system driven by financial markets

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SUMMARY: Over the past few decades, the financial sector in advanced economies has undergone profound changes, and this is particularly true for the US financial economy. This paper focuses on aspects of this evolution that are closely related to distortions in the investment system. The line of thought starts from the maximisation of shareholder value, which was the ideological basis for the split between the real economy and the financial sector. The paper provides a multifaceted analysis of the impact of financial markets on investment behaviour, the decline in real capital investment, the adverse consequences of value extraction, and the adverse effects of share buybacks. As long as the gap between the cost of capital and the minimum expected rate of return is not narrowed, the position of real capital investment will not improve.
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Introduction

In the past and emerging capitalist economies, profound changes have taken place over the last more than three decades. The most important structural change has resulted in the separation of the financial economy from the real economy, and the former has gradually come to dominate the latter. This new phase of capitalist economic development has been termed money managerial capitalism by critical analysts such as Minsky (1992, 1996); Wray (2009); Sweezy (1994). This profound structural transformation has been accompanied by doubts and criticisms, and a flood of questions has been raised in recent decades.

The dominant role of the financial economy has been attributed to the relative marginalisation of productive investment, the growing propensity of economies to crisis, and their increasing fragility. In the new stage of development, the objective

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of the investor was not to create new value, but to maximise the rate of return on the investment portfolio. As a consequence, resource allocation was dictated by the minimum expected rate of return rather than the cost of capital (Sen, 2020; Ehret, 2014; Bernstein, 1998).

The decline in the relative importance of productive investment has led to a decline in the importance of value creation in the real economy, and of casflow generation as a means of value creation, and to a shift towards value extraction and value absorption.

The dominance of the financial economy was reinforced by the financialisation of financial markets, securitisation, the buy-back of own shares and the rise of widespread speculation. The corporate orientation towards short-term returns, the exaggeration of the liquidity myth, led to the creation of bubbles, price manipulation, the questioning of the credibility of the financial market price, the distortion of markets, creative accounting. Krein (2018, 2021) has rightly concluded that value-creating economies *have become value-extracting economies* with the active participation of rent-seekers.

There is certainly an explanation for why the financial sector of economies has been the victim of real capital investment. Globalisation of the international economy has been a possible cause of the decline in real investment. Even investments with average resource requirements, but also megaprojects, carry a high long-term risk, and the fear of failure of productive investment is often very high. *Globalisation has increased the challenge for the internal cost levels and productivity of economies.* Techno-technological progress has led to a restructuring of sectoral investment needs, with today's leading sectors not requiring megaprojects and high-tech industries not requiring investment. Even with these arguments, real investment projects are destined to be outsourced and offshored, with a decreasing share of resources being invested in productive investments.

Stages in the development of capitalism by the weight of the financial sector

Minsky (1986, 1990, 1993) has dealt with the phasing of the development of capitalism in several works. He describes the development of capitalism in the United States as a process, which can be divided into four phases: commercial, financial, managerial, money managerial.

The *first* phase was commercial capitalism, in which commercial banks provided working capital (production financing) to firms. To acquire capital assets, firms usually used their own resources, but later production equipment became increasingly expensive, requiring external financing of investment. External funds were the primary drain on future profits and could also foreshadow the possibility of failure and bankruptcy, for financial reasons, leading to the separation of ownership and management.

The second phase is financial (or fincancial) capitalism, whose rise served to establish large industrial corporations and productive megaprojects. This required access to financial markets, which presupposed the existence of market forces. It

was during this phase that investment banks acquired a dominant position in the ownership of companies. The world crisis of 1929-1933 marked the end of an early form of financial capitalism. It fundamentally changed the nature of capitalism by making it more unstable than before.

The third phase is managerial capitalism, which came into being in response to the Great Depression... it required the creation of new economic institutions that limited uncertainty. According to Minsky (1993: 111-112), the Great Depression represented the failure of the 'small government/laissez faire' economic model, while the New Deal promoted the successful 'big government/big bank' model of financial capitalism. To consolidate the capitalism that emerged from the Great Depression, a series of institutions were put in place to make it stronger than ever. As Minsky (1993: 19) writes:

> *"Capitalism took off in a big way after the Second World War, with big government intervention and central banks that were less constrained than between the two world wars".*

The *fourth* phase is money manager capitalism, which was created by analogy with the success of managerial capitalism. According to Minsky (1996), capitalism in the United States has entered a new phase, called 'money manager capitalism', in which the vast majority of financial instruments are directly owned by reinvestment and pension funds and asset management holding companies. The total return on the portfolio held is the main criterion by which the performance of the managers of these funds is judged. Asset managers – the actors of institutional investors – are the new leaders of the economy, and the funds they manage are the new cornerstone of finance.

Asset managers have less interest in monitoring the economic performance of the individual companies they own than the employees and managers of those companies. All in all, their job security and wage growth depend on the success of their employers. In contrast, the profits of senior asset managers rarely depend on the relative success of the company.

Asset managerial capitalism *has led to a proliferation of uncertainty at* both the corporate and the shop floor level; this is a specific problem – in the corporate context – for middle management. There is an almost chronic need to reduce overheads and to achieve the lowest possible variable costs. Significant reductions in transport and communication costs have pushed down the barriers protecting local production and increased the pressure to bring current operating costs "in line" with those of advanced foreign companies. Even as the natural barriers to trade are falling, management lacks the ability and willingness to accept lower profit margins in order to maintain domestic production. These factors have reduced the financial security – in the broad sense – of employees. Although the aggregate performance of the economy may improve, individual security is reduced (Minsky, 1996).

According to Wray (2009), the financial crisis of 2008-2009 was a convincing representation of the failure of the 'big government/neoliberal model', which promoted deregulation, reduced control and supervision, advocated privatisation and the consolidation of market forces. In his view, this experiment has replaced

New Deal-style reforms with "self-policing of markets" and *promotes greater reticence about personal responsibility.*

As Keynes (1936) famously wrote: the separation of nominal ownership (holding shares) and corporate management means that share prices can be influenced by a whirlwind of "optimism and pessimism".

The objective of asset managers – the only criterion by which they are judged – is to maximise the value of the funds entrusted to them. As a corollary, corporate managers have become increasingly sensitive to *short-term profits and the valuation of companies in the stock market.* This is how Minsky (1993: 111-112) formulates his view of Keynes's conception of speculation:

> *"Keynes's famous remark about speculation and the corporation is particularly valid for money manager capitalism: speculators cannot be as harmful to the continued operation of the corporation as bubbles. But the position becomes serious when the corporation is transformed into a bubble in the whirlwind of speculation. When the capital development of a country becomes a by-product of casino activity, the activity is likely to be distorted".*

According to Minsky (1987), modern capitalism is characterised by an unrestrained speculative boom. As an ex-post confirmation, the 2008-2009 financial crisis was preceded by a speculative boom. The result was an explosion in unsustainable house prices. There has also been a price boom in mortgage and leveraged positions and in covered securities. Minsky (1987) argued that securitisation reflected two additional developments. One was that it was part of the globalisation of finance, as securitisation creates assets irrespective of national borders. The other development is the relative decline in the importance of banks in favour of financial markets.[3]

Wray (2009) gave a comprehensive analysis of the rise and incipient decline of money manager capitalism. The author gave a detailed account of how financial sector innovators and policy makers have exposed the global economy as a whole to increased risk. Particular attention has been paid to the role of money managers in securitisation, credit default swaps and futures contracts on exchange traded assets.

Shareholder value maximisation

Stout (2013) notes that in the second half of the 20th century, a broad consensus emerged in the Anglo-American corporate world that the corporation should be governed according to a philosophy of shareholder primacy. The theory of *shareholder primacy teaches* that companies *are owned by their shareholders*; directors and decision-makers should do what the company's owners want them to do; shareholders want managers to maximise *shareholder value* as measured by share price.

3 The share of total financial assets held by banks in the United States fell from 50% in 1950 to 25% in 1990 (Krein, 2021).

The profit maximisation of the underlying company has been replaced by the maximisation of total shareholder return (dividend and share price growth) as the sole corporate objective. Where does the idea that the maximisation of shareholder value is the sole objective of corporations come from? The idea comes from a widely cited article by Friedman (1970), which it is worth recalling before referring to Friedman's (1962) earlier views on the subject. In his book Capitalism and Freedom he writes:

> *"a company has one and only one social responsibility – the efficient use of its resources – and a commitment to actions that aim to increase its own profits as long as it stays within the rules of the game, committed to open and free competition, without fraud or crime".*

For a long time, economists thought that corporate profit was the most persistent surviving indicator, at the heart of all theories of corporate purpose. And then came Friedman's (1970) article, which would shape the thinking of managers for decades.

"The goal of the corporation is to increase its own profits and maximize the return to shareholders.(Friedman argues that) shareholders decide for themselves which social initiatives to participate in, rather than having a corporate manager to whom shareholders explicitly indicate the circumstances under which such issues can be decided in their favor. According to the shareholder primacy approach, shareholders are the movers of the corporate organization, the only group to which the corporation has a social responsibility" (Friedman, 1970).

A similar influential platform to what became known as the Friedman Doctrine was Jensen-Meckling's (1976) study on the critique of managerialism. In Stout's (2013) view, the theory of shareholder primacy led many to conclude that managerialism was no longer an effective enough way to manage, and that it was necessary to 'reform' companies from the outside through shareholder activism. Stout (2013) also points out that shareholder primacy – in the 1970s – rose from a mysterious academic theory to a dominant corporate practice. This has occurred despite the fact that traditionally, the rights of shareowners to corporate ownership in a publicly traded company are limited and indirect; these rights primarily include the *right to vote on* who should be on the board of directors and the right to sue for breach of fiduciary duty.

Stout (2013) first questioned the relevance of the shareholder value myth from a legal perspective. He challenged the truth of Friedman's belief that shareholders 'own' corporations. Although the layman sometimes has difficulty understanding that corporations are legal entities that own themselves just as human entities own themselves. The share holder *owns the share securities*; this is a contract between the share holder and the legal entity, *giving the share holder limited rights.* In this respect, share holders are on the same platform as the company's creditors, suppliers and employees, all those who enter into a contractual relationship with the company that gives them limited rights.

Jensen-Meckling's (1976) article shares Friedman's (1970) view that shareholders are regarded as the real owners of the company. However, Jensen-Meckling (1976) reveals that managers do not have the same interest as shareholders, as they often

have access to information that shareholders do not know and often make decisions that redistribute wealth away from shareholders. Jensen-Meckling (1976) presented a corporate theory that revolved around reducing the cost of agency, the risk that managers would not act in the best interests of shareholders in the absence of adequate compensation. The article presented a detailed case study of how to provide an incentive compensation scheme for managers, giving them stock options, giving them a claim on the distribution.

Denning (2014) points out that the Jensen-Meckling (1976) article focused on individual decisions and the short-term effects of compensating decision-makers for their participation. The long-term effects of tracking shareholder value were not addressed. The authors did not foresee the risk that collusion between managers and shareholders would turn the firm against its stakeholders and society. Directors may collude with shareholders on the basis that both sides have an interest in short-term profits and in extracting value from the company at the expense of customers, employees and the organisation, at the expense of the community in which the organisation operates and ultimately at the expense of society as a whole.

Jensen-Meckling (1976) was not concerned about the risk that *corporate managers might manipulate share prices through share buybacks.* At the time of writing, such practices were not permitted. These authors did not anticipate that if legal barriers were removed, corporate executives might engage in this self-serving behaviour, involving billions of dollars, and in effect engage in wholesale stock price manipulation.

Laux (2010) argues that the separation between ownership and management creates potential conflicts of interest, where managers may be tempted to put their own welfare before that of shareholders. The agency conflict arises from the separation of ownership and control, adding to the conflict of interest that manifests itself in the clash between the goals of owners and managers, and information asymmetry (Fama-Jensen, 1983; Coase, 1937).

Moving away from maximising shareholder value

Stout (2013) concludes that a strategy of increasing shareholder value may be profitable for a particular shareholder over a period of time, but may be a bad deal for shareholders collectively over a longer period. Some shareholders may plan to hold shares for a long time and hold on to them permanently, while others may speculate and want to make a quick profit by selling shares. Some shareholders expect the corporation to make a long-term commitment to constant renewal that will win the loyalty of customers, employees and suppliers; others may want to profit from the occasional exploitation of shareholder commitments. There may be conflicts between shareholders' interests: some shareholders adapt strategies in a way that harms the interests of other shareholders.

As an example, consider the conflict between short-term and long-term investors. Theoretical economists believed that the market value of a company's

stock perfectly captures the best estimate of the company's long-term value. It is now widely recognised that *certain corporate strategies can temporarily raise the share price while potentially damaging the long-term interests of the company.* Examples include cutting marketing and/or R&D costs… withdrawing cash from the company that could otherwise be invested in the future; paying massive dividends or buying back their own shares; making a risky reallocation; possibly selling off part or all of the company.

More than half a century earlier, Simon (1955) argued that a company need not maximise-optimise a single objective. Instead, firms may pursue multiple objectives and attempt to perform at least satisfactorily well on all of them rather than maximizing one. Simon (1955) called this "satisficing"[4], which means satisfactory enough. When managers are allowed to perform satisfactorily, they can invest retained profits in marketing, research and development, human capital, and contribute to future growth through investment. Beyond this, they can increase the financial leverage to the point where it may threaten the stability of the company. Corporate leaders can also fulfil their duty by building customer and employee loyalty.

Since the emergence of the Friedman Doctrine, many have believed that a single-purpose focus that maximizes shareholder value is an unhealthy practice and counterproductive for companies. Stout (2013) argues that the consensus in the last third of the 20th century is fading and that the theory of shareholder primacy is suffering from a crisis of confidence. This is why Stout (2013) concludes that shareholder value-based thinking, as an abstract theory, *cannot be justified on the basis of practical experience, legal reasoning or shareholder interest.* In the following, it is worth reviewing the many critiques of the limits of shareholder value maximization that have developed in recent decades.

A critique of shareholder value maximisation

In 2016, The Economist wrote that a focus on short-term shareholder value allows for flawed corporate governance practices, including cutting back on investments, huge salaries, high leverage, pointless acquisitions, tricky accounting, share buyback frenzy. There is a widespread belief that *shareholder value or wealth as a fundamental objective has triggered the advance of finance at the expense of value creation.*

Shleifer-Vishny (1997) provides a comprehensive overview of corporate governance and lists the set of shareholder powers that are inevitable in controlling managers' self-interested actions: Long-term incentive contracts; indicator-dependent compensation (allocating share ownership, gaining stock options, threat of realization in case of low earnings); institutional ownership (large investors who control managers based on their substantial ownership stakes); cumulative voting rights; protection gained through contracts; threat of corporate takeover; large

4 Satisfying is derived from combining "satisfy" and "suffice".

creditors protect themselves with substantial debt bailouts and rights in case of failure of the borrowed company. All these mechanisms can erode shareholder value at a cost. Nevertheless, as economic theory teaches, firms will invest in the above objectives to the point where the marginal benefits are balanced by the marginal costs. The challenge often concerns determining whether effective control of benefits and costs is guaranteed in the firm's immediate environment. In the relevant literature, *doubts have been raised about the effectiveness of shareholder value maximisation, both in terms of the controlling role of financial management and* whether the principle is ethically realistic.

A remarkable change in Jensen's (2002) opinion, a quarter of a century after Jensen-Meckling's (1976) influential article, is noteworthy. Jensen (2002) writes in a later article:

"if illuminated value maximisation is specified as long-term value maximisation ... then it is also specified as a corporate objective" (Jensen, 2002: 235).

In Jensen's (2002) new concept, the value of *the whole firm is* maximised, including equity, debt, preferred shares, guarantees, and this requires that good relationships are established between all the components, but that no single component is guaranteed to

"preferably complete satisfaction if the company is to prosper and survive" (Jensen, 2002: 246).

Jensen's (2002) perspective represents a move away from shareholder wealth maximisation and towards a broader vision of *stakeholder* maximisation.

Jensen's (2002) new approach was more nuanced than the Friedman doctrine. Jensen (2002) understood shareholder primacy as a more precise notion of "maximizing total firm value". Jensen (2002) equates corporate value with the long-run market value of the corporate profit stream, largely ignoring the implications of the fact that markets value some profit streams more highly than others.

Donaldson-Preston (1995), in his often cited article, distinguished between the theory of interest holders and the shareholder value theory. They concluded the following about the relationship between the two theories:

"... the simple truth is that the most prominent alternative to the stakeholder theory (assuming that management performs its service on the basis of the shareholder theory of value) is morally untenable" (Donaldson-Preston, 1995: 88).

Other conceptual works also question the ethicality of shareholder value. The work of Chambers-Lacey (1996) argues the following:

"A corporation that embraces shareholder value maximization does not create a moral or ethical position, it merely serves as a guiding principle for ethical beliefs and the desires of market participants" (Chambers-Lacey, 1996: 93).

Dobson (1999) asks whether the maximisation of shareholder value is amoral, immoral or moral? He disagrees with Chambers-Lacey's view that managers

"make decisions on the basis of the signals they receive from others through the market mechanism" (Dobson, 1999: 71).

Rather than adapting the maximisation of shareholder value as a goal, managers adopt a certain moral context – the utilitarian principle (as many goods as possible for the benefit of shareholders), and their actions

"are based on the interests of those who have the greatest influence on the price of the company's shares" (Dobson, 1999: 71).

From the last decades of the 20th century, an *alternative incentive target* to shareholder value can be seen *in the form of the theory of interest-bearing.*

Freeman (1984) has already suggested the consideration of stakeholder value as an alternative.

"A stakeholder is any group or individual who can influence or be influenced by organisational outcomes (Freeman, 1984: 53).

Stakeholders include customers, suppliers, employees, creditors, directors, communities, the environment and government officials. In a company that pursues a stakeholder goal, then, corporate managers make decisions based on the interests of all stakeholders.

It is worth quoting Jensen's (2002) critical view on the evaluation of the theory of interest:

"In fact, the vested interest theory does not hold managers and directors accountable for the extent to which they care for the resources of the corporation ... giving them free rein to pursue their interests at the expense of the corporation's financial claims and largely at the expense of society. This allows managers to use company resources according to their preferred intentions – to spend on the environment, art, cities, medical research – without being held accountable; not surprisingly, they give considerable support to the theory of interest-holding' (Jensen, 2002: 239).

Bower-Paine (2017), on the other hand, is critical of the consequences of following the Friedman doctrine:

" ... distracts companies and their managers from innovation, strategic renewal and future-oriented investments that demand attention, exposes companies to activist shareholder attack and ... puts managers under pressure to achieve the fastest and most predictable returns possible, curtailing riskier investments that address future needs" (Bower-Paine, 2017: 52).

Rappaport (2005), while supporting the wealth maximization guiding principle of stock ownership, deplores the use of short-term stock performance as a measure of wealth, criticizing the practice of stock analysts *basing* stock selection *on short-term returns rather than long-term growth in cash flow*:

"The biggest obstacle to achieving allocative efficiency is the persistent use of non-DCF models in equity analysis" (Rappaport, 2005: 67).

He argued that if managers adopted a long-term view, profit manipulation would become unnecessary, more profitable projects would be adopted, and resources would be better spent on R&D, advertising, maintenance, and filling skilled human

resources positions to achieve the highest long-term value for the company. While shareholder wealth can be a driver of managerial decisions, risk-adjusted long-term cash flows are an important determinant of value (Rappaport, 2005: 72).

The above illustrates that there are different considerations with regard to the incentive principle, in the context of whether the company should pursue the maximisation of shareholder value or whether the preference for the interests of stakeholders should be the governing objective of the company. The choice is difficult because even today Friedman's basic premise is widely invoked as the reason why shareholder value maximisation is blamed for the increase in the activity and crisis propensity of the economy through the distortions of money manager capitalism. Another quotation from Friedman's (1970) article is taken as an argument for the importance of shareholder value:

> *"In a free enterprise, private ownership system, the corporate decision-maker is an employee of the owner of the company. He has direct responsibility to the employees. This responsibility is to run the firm in accordance with the wishes of the owners, which usually means producing as many resources as possible while conforming to the basic rules of society" (Friedman, 1970).*

Sen (2020), in line with Minsky (1986) and Wray (2011), criticises the link between the capitalist model of money management and the predominant weight of the money economy . He argues that the constant stock market repricing and intensive market trading of financial assets *led to increasing returns that often exceeded the returns on real investments.* Sen (2020) writes:

> *'the problem is that money manager capitalism, as a highly leveraged economic system, encourages actors to maximise total return in an environment where the system grossly undervalues risk' (Sen, 2020: 277).*

We can add that, in the meantime, they aim to achieve returns through higher yields and capital value.

Investment strategy distortions

Ehret (2014) notes that securitisation has played an important role in the boom of the subprime mortgage market. Securities formed the basis of the shadow banking system, including hedge funds and special investment vehicles, which served the same purpose: to help remove illiquid assets from the balance sheets of mortgage lenders. All this could be an attractive way to increase mortgage leverage in an environment of evolving conditions. However, in the event of uncertain market growth, *system participants will be unable to identify the risk of failure.*

Konczal-Abernathy (2015) sees financialisation as

> *"the growth of the financial sector, its increasing power over the real economy, the explosion of the power of wealth, the reduction of the (influence of) society in relation to the realm of finance" (Konczal_Abernathy, 2015: 4).*

According to Palladino (2018: 4), what is at stake – in this context – is corporate financialisation. According to this

"an increasing share of profits is derived from financial activity and shareholders benefit from the increasing flow of profits".

By corporate financialisation, the author means a mechanism for capturing such (opportunity), specifically by increasing financial activity within the corporation. Carney (2014) has sympathetically judged the motives for the emergence of money manager capitalism when he wrote:

"financial capitalism was not an end in itself, but a means to promote investment, innovation, growth and prosperity" (*Carney, 2015: 840).*

Contrary to Carney (2014), the most obvious aspect of financialisation is the dramatic change in the dominant banking business. Tabb (2021), discussing the social structure of accumulation, notes that *banks become part of the speculative network, financing* risk-taking. Banks are themselves borrowers, borrowing funds from non-deposit sources. Rather than providing funds to the economy (by oiling the economy's processes by establishing a link between savers and companies that want to finance productive investment and need funds to do so), they have become involved in securitisation, by guaranteeing mortgage obligations. The proliferation of new derivative products, often financed by borrowing, increased *asset price speculation, causing financial fragility*, shifting risk to others and over-inflating debt.

Since securitisation of debt allows for immediate sale for future income claims, the short term will dominate as too many "investments" involve speculative trading. The result of securitisation is repackaged units of debt that contain perceived risk, sold to buyers who are presumably aware of the real risk of the financial products they are buying. There is also a price to pay for loss protection insurance, but in a market downturn these guarantees cannot be without the occasional bail-out of these guarantors by the government.

Krein (2018) highlights the alarming fact that corporations own an increasing share of the financial assets of the economy and are realising an increasing share of their total profits on such assets (as opposed to the profits they earn from their normal business activities of producing and selling goods). They are increasingly using their profits to buy back shares and lend money rather than spending it on labour and real capital. *Companies borrow large sums of money to* buy *back their own shares.*[5]

In the subprime crisis, the valuation of securities has worsened market performance in two ways. On the one hand, securities helped to disconnect valuations from the fundamental value of investments . *Securities prices undermined investors' ability to estimate the value in use of the underlying assets.* On the other hand,

5 Between 2007 and 2016, 93% of the total profits of Fortune 500 companies were spent on share buybacks and dividend payments (Coy, 2019). When a buyback is announced, corporate decision-makers and directors cash in their stock options as soon as the market price starts to rise on news of the announcement.

securities have impeded market transparency by removing critical assets from the balance sheet.

Lazonick-Shin (2020: 618) has detailed what is known as *parasitic value extraction.* The authors argue that investment opportunities are needed to create prosperity, because without them, firms will not reinvest capital because, without promising projects, they will not be able to operate capital productively. Sweezy (1994) previously explained the phenomenon in this way:

> *"Money capital, once detached from its original function as a balanced facilitator of the real economy based on production to satisfy human needs, becomes clearly speculative capital, driven solely by the desire for its own expansion" Sweezy, 1994: 2).*

Sweezy makes another observation in the same place:

> *"In the old days, many dreamed that speculative capital – a phenomenon that is as old as capitalism – would grow to the point where it would dominate the national economy, or the world alone. Well, it has" (Sweezy, 1994: ....).*

The reason for this phenomenon is not simply a dramatic increase in the size and importance of finance, but a change in the character of its role in the contemporary economy. A decade after Sweezy's (1994) recognition, there has been a sharp escalation in debt-financed acquisitions and a significant increase in the role of hedge funds here. The intensive use of financial leverage has led to an increase in corporate indebtedness, as Fatoussi-Saraceno (2014: 14) has described:

> *"the net economy becomes overvalued and high asset prices create the false impression that high debt levels are sustainable. The crisis will unmask itself when the bubble bursts".*

The authors also identified the following crises as a consequence of speculation:

> *"although the (2008-2009) crisis developed directly in the financial sector, its roots go much deeper and are rooted in structural changes in the distribution of income over the last twenty-five years" (ibid.).*

Following the financial crisis of 2008-2009, governments devoted considerable resources to maintaining liquidity in US and international financial markets. Jomo (2017), like others, argues that the new money created by quantitative easing

> *"did not have a significant impact, as investment in new productive activities did not increase, but instead flowed into stock markets and property sales, inflating the price of shares and other financial products without generating jobs or prosperity".*

Quantitative easing has enriched asset holders but has not guaranteed widespread investment activity. Tobb (2021) argues that this 'help' within the institutions and norms of *the social structure of accumulation* only leads to much more leveraged (highly leveraged) economies.

The crown virus epidemic has shaken the continued sustainability of the financialisation-based redistributive growth model. Tett (2020), a Financial Times columnist, wrote the following at the time of the financial market crash:

> *"This decade in the US stock market has been like a drug addiction. Until 2008,*

investors were hooked on monetary heroin (the private sector credit bubble). Then, when the bubble burst, investors turned to monetary morphine (thousands of billions of dollars in Federal Reserve bailouts). The historic stock market crisis of March 2020 was bound to confront the tantalising question of whether monetary morphine had lost its impact" (Financial Times, 13 March).

According to basic economic principles, companies should invest in real capital projects whenever *the expected return exceeds the cost of capital for the company*. However, in practice, companies keep the 'minimum expected' rate of return well above the cost of capital. The experience of real investment by investors and companies suggests that the minimum expected rate of return is generally higher than the cost of capital, by almost 7.5 percentage points. Moreover, the minimum expected rate of return has remained almost unchanged for decades, hovering around 15%, despite some declines in interest rates. From the point of view of economic theory, this is a seemingly irrational questioning of profit maximisation. However, in terms of maximising equity value, it can also be a rational strategy. An arbitrary lowering of the minimum expected rate of return could mean investing in projects that would increase profits but at the same time degrade the quality of returns. In other words, measures such as return on assets would deteriorate and valuation multiples would likely fall.

Krein (2021) raises the question of what shareholders actually do with these cash returns. Economic theory argues that they allocate it to companies that are about to undertake promising real investment projects. According to Krein (2021), because the economy is organised along principles that *separate profit from capital and labour costs*, any viable capital-intensive company will have low returns and slow growth, and will be highly exposed to business cycles and unlikely to be able to attract capital. Hence Krein (2021) concludes that the dominance of the financial sector has the effect of using these resources to drive up the value of superstar firms or the price of other financial assets in financial markets.

Value stocks have traditionally been considered (Graham-Dodd, 1934) to offer a "safety margin" because low prices promise high returns and free cash flow income (and/or strong asset backing). In contrast, growth stock prices embody optimistic assumptions about the ability of such companies to increase earnings and returns. If an economic downturn or some other adverse event threatens the realisation of these assumptions, growth stocks suddenly revalue, moving away from the high multiples of aggressive earnings forecasts (P/E ratio) and towards the low multiples of pessimistic forecasts.

The fundamental problem for value investors is that the economic incentive system is organised around maximising asset values, regardless of operating cash flows, which essentially amounts to a systematic elimination of the safety margin through low valuation . A company whose shares are now traded at a low valuation (i.e., a company that is attractive to value investors) should not merely be "outdated" or with limited growth potential, and its remaining capacity should not be available for value-expanding financial speculation (for example, by adding leverage,

increasing share buybacks, or divesting high-multiplier high-quality business units) (Sen, 2020).

A typical example of destabilising expectations in the context of fundamental uncertainty was the crisis in secondary securities trading in the United States, which spread around the world in late 2008. Asset-backed securitisation and the use of credit default swaps played a major role in the proliferation of the crisis, along with other derivative instruments such as options. Acknowledging the role of institutions in the process, *speculative flows* and the associated damage have been implicated.

After 2008-2009, the movement to curb speculation soon came to a halt, in line with the interests of dominant financial institutions and annuity hunters (Shull, 2012; Sen, 2014). These destabilising transformations of institutions have not only created instability in developed countries, but also in emerging economies. These countries have faced relatively free flows of investment resources, accepting the dominance of the financial sector. The constraints of the adopted mainstream doctrines were influenced by powerful financial institutions, which often collaborated with the rent-seeking class, which was also able to control state policy (Bagchi-Dymski, 2007).

The impact of financial markets on investor behaviour

From what has been described so far, we can conclude that the principle of shareholder value maximisation, the emergence of money manager capitalism, the dominance of the financial economy, the deregulation of financial markets, the mass speculation – *have profoundly transformed investor behaviour in the financial sector as well as in the world of real capital investment over the* last three to four decades. To assess this, it is necessary to identify the principles that guide the investment decisions of actors in financial markets and in the real economy. Sen (2003: 30-31) concludes that the deregulation of financial markets has played a major role in the significant increase in the rate of return on financial assets compared to the return on the underlying real assets.

Bernstein (1998) reminds us of what Keynes criticised in his call for liquidity. The push for liquid markets leads to the separation of irreversible real investment decisions in the firm from reversible financial investment decisions to buy equity. For the investor, the only exit strategy is entirely dependent on the average perception of financial markets. In other words*, the valuation of productive real assets can easily become a victim of mass psychosis.*

According to Keynes, *the liquidity fetish* allows investors to change their minds at low cost. According to Keynes, the goal of liquidity primacy

> *"investment is very difficult to base on real long-term expectations ... and is seldom practical" (Keynes, 1936: 157).*

Keynes placed great emphasis on the role of real capital investment in the development of the economy as a whole, so valuation errors in productive real assets can have serious consequences: misallocated real capital, a volatile stock market

climate adversely affecting risky decisions; equity ownership adversely affected by household decisions. Keynes reminds us that

> *"(the majority of our decisions) have some positive result ... and can only be regarded as the result of animal spirits ... and not as a weighted average of quantitative advantages with quantitative probabilities" (Keynes, 1936: 164).*

In the valuation system criticised by Keynes, the market value is the value of the company derived from the current share price, which rarely reflects the current value of the company. This is because the market value still reflects the supply and demand of the investment market and the extent to which investors are (or are not) actively involved in shaping the future of the company. If investor demand is strong, the market value is usually higher than the intrinsic value. The opposite is true if there is weak investor demand, which may lead to an undervaluation of the company.

Bernstein (1998) suggests that in an allocatively efficient market, stock prices reflect an unbiased estimate of the present value of future cash flows, thus allocating scarce resources to the most promising prospects. Optimistically, intense competition among sophisticated professional investors ensures allocative efficiency. On the other hand, sceptics argue that *recurrent market excesses provide evidence that share prices are generally not sufficiently credible indicators of value.* Allocative efficiency depends on competitive estimates by well-informed sellers and buyers based on the present value of future cash flows implied by stock prices. *Allocation efficiency* is important because it affects not only investors but also the real economy. When stock prices deviate from information-based estimates of discounted cash flow values, arbitrageurs will buy and sell to bring the price back to equilibrium.

The emergence of the dominance of the financial sector went hand in hand with a radical transformation of the theoretical foundations, and the changing ideology of financial economics played a major role in this. Ehret (2014) starts from the premise that financial economics replaces value-based investments with (financial) theory-based rules for anonymous markets. Financial economics seeks to make investment more robust by applying economic theory and stochastic models to the valuation and trading of securities.

Financial economics assumes a world in which entrepreneurs are "redundant" because financial markets have superior knowledge about consumption needs and resource potential. According to financial economists, an individual investor cannot defeat the market: in rational markets, individual investors can, at best, only hope to achieve equilibrium prices resulting from a bargain between buyers and sellers. Financial economics assumes that the traditional value-based approach to investment is wrong. Under the value-based approach, investors estimate the present value of the expected future income streams from a given investment. Because future returns are uncertain, traditional investors use their experience, information network and intuition to evaluate an investment. Under the assumption that the price of a stock, bond or other financial product will move towards equilibrium – a basic tenet of financial economics – conventional investors are certain to lose because even their best estimates will deviate from the equilibrium price. For this reason, *speculative strategies based on*

financial markets are thought to *override value-based strategies* (Fox, 2009). Ehret (2014) points out that financial economics offers investors a whole system of models: these almost exclusively use financial markets to estimate the future price of an asset. As a consequence, financial economics elevates the traditional value-based investment valuation practice to a science, guided by economic theory and statistical calculus. Financial economics assumes that market-based speculation will outperform value-based investors and that financial markets will force the economy towards equilibrium.

In contrast, financial economics has obscured investor risk, causing market participants to overprice assets to an extent that has had an unprecedented destructive effect on advanced economies*. Under the financial economics approach to market-based valuation, financial institutions have decoupled asset values from the associated cash flows.* One of the important lessons of the subprime crisis is precisely that value-in-exchange cannot be completely separated from value-in-use.

The financial crisis of 2008-2009 has shown that the use of financial economics as an organizing force undermines the foundations of equilibrium theory, especially with respect to the knowledge of economic agents (Lawson, 2003; O'Driscoll-Rizzo, 1996). In neoclassical economics, financial economists assume that market agents have sufficient knowledge to make rational decisions.[6] If one accepts Hayek's (1945) critique (footnote), then in its light, the valuation dominance of financial markets may also undermine the conditions for financial markets' own performance. If financial markets begin to send confusing signals about consumer value or resource capacities, they can no longer allocate resources efficiently. Financial economics systematically replaces entrepreneurs with a system of economic equilibrium models.

Share buybacks and shrinking productive investment

Over the last three decades, deregulation of financial markets, liberalisation of trade in financial products and the dominance of the financial sector have resulted in massive increases in expected profits, but these profits *have not been reinvested in* productive business activity or, despite promises, in the workforce. Krein (2021) finds that these resources flowed into financial markets and stayed there. An old lesson is that without sufficient investment in productivity-enhancing technologies, equipment and facilities, productivity will stagnate and the economic prospects for future generations will deteriorate. Lazonick-Jacobson (2018) argues that under-investment despite the abundance of resources:

"an economy that extracts value has been replaced by an economy that rewards value creation".

6 Hayek (1945) challenged this assumption and argued that prices are relevant in the presence of disequilibria, where consumers can effectively signal their unmet needs or producers can signal their unused resources. Once prices are either formed in a different way or for a different reason, they cannot be used as meaningful instruments of economic communication.

In other words, financial markets reward corporate behaviour that *extracts value from capital assets to convert them into liquid financial assets, rather than encouraging the diversion of financial resources into investment in the real economy*. If the disinvestment in the real economy continues over a number of years, the adverse effects are cumulative. We cannot believe that share buybacks will automatically lead to a more efficient allocation of capital. If companies simply return more funds to shareholders – in all cases where they hold more cash and buy shares at unusually high valuations – there is no reason to believe that increased share buybacks will have any effect on the set of investment opportunities for a given company.

The increasing return of resources from corporations to equity holders may be explained by the decline of capital-intensive sectors and the rise of intellectual property-oriented businesses and less capital-intensive service sectors. But this argument does not answer the fundamental question about investment, it simply restates it.

Companies have distributed too much cash to shareholders, and this is certainly limiting their ability to invest in the future. *The money spent on share buybacks has not created assets and has not created any future income cash flow*.[7]

Krein (2021) argues that it would be a broad explanation to say that the US economy is organised around the maximisation of asset value, with the aim of maximising returns to capital that are independent of corporate growth. The disconnect that has emerged between the return on US financial assets and underlying economic performance – or indeed corporate profits – over the last few decades raises deeper questions about the underlying economic policy assumptions and their theoretical underpinnings.[8]

The corporate sector is dominated by institutional asset managers and decision-makers whose compensation is based on short-term stock returns, which gives them a strong incentive to commit to valuation expansion even if it has no impact or a negative impact on earnings.[9]

Over the last few decades, the US economy (and many other advanced economies) has been moving away from capital-intensive productive activities (e.g. manufacturing) towards less capital-intensive sectors (software and other forms of

7 Goldman Sachs estimated that it spent $1,000 billion on share buybacks in 2018, an amount that the corporate sector could not invest profitably. The question arises that the corporate sector may then be at fault: it may be that there are more investment opportunities but capital is misallocated due to misaligned incentives; on the other hand, it may be that there are indeed no promising investment projects and the corporate sector simply does not deploy the huge amount of capital (Krein, 2021).

8 Between 1989 and 2017, the US corporate sector accumulated $34,000 billion (2017: Q4) in real equity capital. It is estimated that 44% of this increase was attributable to resources allocated to equity holders in a slowing economy, primarily at the expense of labour compensation (Krein, 2021).

9 For Apple, the largest US company by market capitalisation, operating income barely changed (2011-2017), while the company's share price quadrupled, largely thanks to a $337 billion share buyback.

intellectual property). Less capital-intensive firms achieve high valuations even when cash flows are not growing, as they avoid the high capital expenditures required to maintain real assets and therefore often achieve expansion without significant additional investment.

Companies seek to maximise shareholder returns (which in practice means maximising the company's share capital) and to increase profits – at best – as a means of achieving this. Capital is used to increase income and profit, but *without taking the risk of expanding operations, modernising production or developing new products*. It is often easier for companies to reposition themselves or restructure financially to achieve higher value.[10]

In the asset management money manager capitalist system, the high minimum required rate of return requirement on capital indicators is strongly held, discouraging risky real investments. The requirement for a minimum required rate of return that is significantly higher than the cost of capital for a company *provides a* clear *incentive to favour financial investment and to marginalise real capital investment*. The choice of financial capital through offshoring (offshoring of entire sectors) makes securities investment the main investment, and thus the emergence of asset price bubbles has become chronic. On the one hand, there has been the pursuit of growth and productivity through real investment, and on the other, the pursuit of financial asset returns by all means. *Growth and return as conflicting objectives, the gap between the minimum required rate of return and the cost of capital for a company cannot be closed easily, it is* precluded by a return-centric investor attitude backed by a huge cost of capital. Each is interconnected with others through a network of markets, some of them structured and regulated, others informal.

Finish

Driven by the doctrine of maximising shareholder value, the development of asset-management money manager capitalism in recent decades has resulted in a financial superstructure dominated by the financial sector, independent of the economy of individual states, and consisting of central banks, commercial and investment banks, institutional investors, dealers and a wide variety of capital funds in inter-relationship with each other. This far-reaching change has led to *a disconnect between financial expansion and real economic prosperity.* By the end of the 20th century, financial expansion was not fuelling a healthy growth economy, but rather a stagnant or moderately growing one. Sweezy (1994) argues that an understanding of the inverse relationship between the financial and the real economy is necessary to understand the new trend in the world. ■

10 IBM's operating income and net profit in 2021 were lower than in 1998. At the same time, the company's share price and P/E ratio are higher, meaning that the company spent much more on share buybacks than it invested in its core profile during this period.

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