

Stocks and Strategy

The Rise of Conglomerates

- **Large, diversified companies** with many subsidiaries
- Examples: widgets, financial services, food business, jet engines, etc.
- **Managers compensated by:**
- **Sales growth**
- **Asset growth**
- **Issue:** High sales, low profits
- No focus on **profitability**
- CEOs and managers doing well, but **shareholders** frustrated

The Problem with Conglomerates

- **Difficult to manage** multiple unrelated businesses
- **Extraordinary skill** required to excel in all sectors
- **Managers** reduce risk but:
- **Lack of focus** on profitability
- Low performance despite growth
- **Risk-averse CEOs:**
- Focus on **sales** and **asset growth**, not profits
- **Managers** focused on **risk minimization**, not long-term performance

The 1980s Solution: The Breakup of Conglomerates

- **Shift:** Breakup of conglomerates for more focus and profitability
- **Why?:** Companies were worth more **broken up** than as a whole
- **Objective:** Improve **efficiency** and **profitability**
- **Hostile takeovers:**
- **Buy companies**, break them apart, sell pieces for more
- **Motivated by:** Profits for **shareholders**

- CEO's **comfort** was the barrier

Hostile Takeovers and Regulatory Impact

- **1968 Law:** Limits on **hostile takeovers**
- **Requirement:** Inform public once you own **10%** of a company
- **Public Tender:** Once a company's stake reaches a threshold, offer a public price to buy the company
- **Corporate defense tactics:**
- **Poison pills**, legal strategies to avoid takeovers
- **Resistance** from current CEOs who were comfortable
- **1980s Corporate Battles:** Managers vs. takeover artists

Key Figures in the Takeover Era

- **Michael Milken:**
- **Junk bonds** (high-risk, high-return) funded many takeovers
- Created massive capital for the restructuring of **American industry**
- Instrumental in the development of **fiber optics** and **cellular networks**
- **Carl Icahn:**
- **Takeover artist:** Bought companies, broke them apart
- Focused on **improving efficiency** and **productivity** of companies

The Role of Stock Markets

- **Stock Market Function:** Provides a way for businesses to **raise capital** and **change control**
- **Hostile Takeovers:**
- Ability to **replace bad managers** with **better ones**
- Companies get **more focused** and efficient under new leadership
- **Regulatory Impact:**
- **Laws** make it harder to execute hostile takeovers today
- **Efficiency loss:** Some large companies remain inefficient due to **regulatory**

barriers

Stock Market's Role in Efficiency

- **Managers & Shareholders:**
- The **best way** to maximize shareholder wealth: **Make managers shareholders**
- Align the **interests of managers** with the **owners**
- **Board of Directors:**
- **Problem today:** Boards are often filled with **outsiders** (e.g., politicians, academics)
- **Best practice:** Boards should consist of **shareholders** who are incentivized to **maximize wealth**

Regulations and Their Effect on Capital Markets

- **Stock Market Regulations:**
- Regulations have distorted incentives and **created inefficiencies**
- **Stock buybacks:** Companies return capital to shareholders when they can't find better investments
- **Stock options:** Managers incentivized with stock ownership to align their interests with shareholders
- **Insider Trading:**
- **Controversial topic:** Should insiders be allowed to trade based on private info?
- **Argument:** Let markets decide through **contracts**, not **government regulation**

Conclusion: The Role of Stock Markets in the Economy

- **Stock Markets:**
- Provide a **mechanism** for businesses to raise capital
- Offer a way to change **control** and replace poor management
- **Efficient markets:** Price reflects **available information**
- **Market Efficiency:**
- **Speculators:** Crucial for making markets efficient by embedding **information** in

stock prices

- **Bubbles:** Caused by **cheap money** and **easy credit**
 - **Stock prices reflect the future**, not just short-term gains
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