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The Capitalist Manifesto:

Managing the Rise of Citizen Investors

By Stephen Davis, Jon Lukomnik and David Pitt-Watson

It is time to re-imagine the corporation. It is time to establish a new set of rules to guide corporate behavior. Why? Because executives who fail to re-imagine their companies will shortly discover that their firms get re-imagined out from under them.

What has changed? And why is the situation urgent?

Here is the new starting point. Businesses around the world are no longer owned by the wealth few, but by a burgeoning class of citizen investors who, like it or not, are demanding fresh and often unfamiliar skills from corporate leaders. We call what these owners want a “Capitalist Manifesto.”

You won’t find the owner revolution named in any headlines, because it is occurring below radar screens, in seemingly disconnected events, and over time rather than in a sudden big bang. Think of it like the movement of a tectonic plate. Slow and powerful, now and then creating a volcanic eruption. Just ask Bob Nardelli, chairman and CEO of Home Depot, if it isn’t happening.

Last May he inadvertently became a poster child for executives caught flat-footed by the new realities. Nardelli stood confidently—and conspicuously alone—in a Wilmington hall facing hundreds of shareowners gathered for the company’s annual 2006 meeting. Despite fiery advance protests over performance and pay, the chief executive had advised his board of directors not to show. Only troublemakers would care, he reckoned. Directors inexplicably agreed, and stayed away en masse.

Nardelli frogmarched the crowd through his agenda, answering no questions and ignoring rising outrage both in the room and among investors around the country listening in through Home Depot's website. At the stroke of 30 minutes, Nardelli gaveled the meeting to a close and bolted for the airport.

It took just hours before shareowners re-imagined Home Depot. A company that had long cultivated a brand identity of caring for customers found itself morphed in the press and blogs into an arrogant, despot-driven evildoer. At first, the company justified Nardelli's shotgun annual meeting. But executives soon saw catastrophe looming and beat a hasty retreat. Within days, Home Depot opened a round of serial apologies and rushed fresh, shareowner-friendly practices into place. Nardelli himself paid penance with repeated admissions of misjudgment in media interviews.

The Impact of Citizen Investors

What happened in Wilmington was more than a mere miscalculation of tactics, however—and will require much more than a few weeks of groveling to fix. Home Depot's board had missed the consequences of a vast new reality facing public companies. In North America, Europe, Japan and, increasingly, on a global scale, the owners of multinational corporations are the tens of millions of working people who have their pensions and other life savings invested through funds in shares. Each pensioner owns a tiny sliver of vast numbers of companies. From IT pacesetters in Silicon Valley to the oil wells of Nigeria, from breweries in Mexico to the hardware retailers of America, citizens collectively are now the ultimate owners.

Chairmen and CEOs ignore these investors at their peril. Poor corporate performance now can ravage the accounts and future dreams of millions of middle and working class savers. Through their agents—pension funds and money managers—these citizen investors are learning to make their protests heard like never before.

Indeed, way behind the scenes, complex pressures are building to turn what were once passive, faceless fund managers into market activists attentive to grassroots savers. Funds not only own corporate America on paper; the largest one hundred money managers alone control 52% of US equity. More of them are actually starting to behave like owners. Each day brings evidence, from Nelson Peltz' insurgent election to the board of Heinz to word that such mainstream superstar managers as Legg Mason's Bill Miller are increasingly taking governance into account.

Moreover, the marketplace is handing citizen investor funds tools to assume the powers of ownership. Proxy voting advisory services and corporate governance rating agencies analyze everything from who is on a corporate board to whether executive pay aligns with long-term shareowner interests. Forensic accounting firms scour corporate filings in search of financial sleight of hand that aims to goose up stock prices in the short term, while costing owners in the longer term. Citizen investors now have information sources on everything from the sustainability and quality of a company's earnings, to perquisites the board awards its CEO, to the shape and size of a firm's carbon emission footprint. Increasingly, activist funds stand ready to oust CEOs who fail long-term performance expectations.

The bottom line: the owner revolution forces directors and executives to navigate a fresh path to shareowner confidence.

Management for New Owners

What do citizen investors want of companies that CEOs didn't have to worry about in the past? Here is the central difference. A lone owner defines what he or she wants from the enterprise and when. If such an owner is sensitive to social duties, he may well make the company behave in a highly responsible fashion. Alternatively, the owner may happily retire to Palm Springs and encourage its manager to generate the greatest possible private profit without any concern about the consequences for society at large.

But citizen investors *are* society at large. Yes, individuals own equity to make money. They save for their long-term future, such as retirement. However, it makes no sense for these owners to encourage a corporation to make a great profit if they will have to pay for it through another means.

Citizen investors are re-imagining the corporation as a vehicle pursuing financial success through accountability and responsible social behavior.

For example, environmental destruction may create a short-term benefit for a particular company (assuming it doesn't break the law and pay fines, doesn't suffer environmental damage, and can keep its workforce healthy amongst environmental dangers). For that lone owner living far away in Palm Springs, perhaps that was acceptable. But with dispersed citizen ownership, it is inevitable that the company's investors will have to pay for that short-termism through, for instance, higher taxes for environmental remediation and higher health insurance costs. In other words, for a company to act that way means it is simply stealing from one pocket of its owners to put it in another. The same is true for any corporate activity that freeloards costs onto society at large.

Effects once thought to be no business of the corporation turn out to be very much the business of its citizen investors.

Oh oh. The mantra of enterprise up to now has been that corporations worry determinedly about making products while all those bureaucrats and politicians manage the messy challenge of taking care of society. Now, the new owners of companies are blurring that line. Citizen investors are re-imagining the corporation as a vehicle pursuing financial success through accountability and responsible social behavior.

Visionary companies understand this.

Need evidence? Look at Starbucks, which is advertising daily in newspapers how attentive a corporate citizen it is. Or BP, which re-branded itself 'Beyond Petroleum' and is sinking millions into renewable energy research. Or General Electric, which touted its 'ecomagination' initiative as earning the company green credentials. If you think each of these firms is on nothing more than a public relations binge, you'd be wrong. Sure, there are PR benefits. But these companies changed course because these are precisely the kinds of strategic shifts citizen investors demand of boardrooms as the new route to making money.

Along the way, those corporate executives learned they had to truly communicate with their owners so as to understand the new realities. It has proven a valuable dialogue. GE's ecomagination program, for instance, stemmed from an unlikely source: a coalition of Catholic nuns who owned shares in the gigantic company. The nuns requested a report on GE's greenhouse gas emissions. The company, looking into the issue, realized that making energy efficiency a core competency could add \$10 billion in revenue in five years.

Of course, not every shareowner communication portends such a corporate payoff. But if you shut down that communication, none do. That's another reason why Mr. Nardelli's actions struck such a discordant note.

The Capitalist Manifesto

So what are executives to do? The Capitalist Manifesto is a set of guideposts we've culled from vanguard boards. It forms the lesson plan for a new school of corporate leadership; its 10 points chart ways to success by treating citizen investors not as the enemy, but as an asset.

These lessons are not some random selection of "good things to do". They are the inevitable demands of the citizen investor owners to whom executives have promised to deliver value.

1. Be profitable—create value
2. Only grow where you can create value
3. Pay people fairly to do the right things
4. Do not waste capital
5. Focus where your skills are strongest
6. Renew the organization
7. Treat customers, suppliers, workers and communities fairly
8. Seek regulations which ensure your operations do not cause collateral damage and your competitors do not gain unfair advantage
9. Stay clear of partisan politics
10. Communicate what you are doing and be accountable for it.

Sure, the commandments may at first glance seem simple, motherhood-and-apple-pie statements. But take a closer look. You'll find that they match the revolution in corporate ownership with a revolution in corporate management.

1. **Be profitable and create value.** Sound familiar? Yet many executives in conventional business spend money on ventures that have little prospect of creating value. Maybe you recognize the phenomenon: enthusiasm for a business gets translated into excessive optimism about prospects. Then, through the magic of the spreadsheet, optimism is turned into a complex financial schedule, where scores of untested assumptions create a plan built on sand. So schemes look brilliant on paper, but don't deliver real value.
2. **Only grow where you can create value.** If companies do not have good investment opportunities, they should return the surplus cash, so that owners can invest it elsewhere. Too often, a CEO will repeat that his aim is to deliver shareowner value, only to wind up doing the exact opposite. He will base an acquisition, for instance, on optimistic earnings projections, or on how much cash the company has in its reserve pool, rather than the true merits of the case. Study after study has shown that the majority of acquisitions fail to make a proper return for the acquiring company, losing their investors billions of dollars in this way. CEOs seek what they perceive as the excitement of running a new business rather than sticking to their knitting, exploring more creative routes for expansion of their existing one.
3. **Pay people fairly to do the right things.** No business controversy has received more headlines than the payments received by chief executives and other senior managers of large companies. But it is not just the quantum of these salaries that fails the interest of citizen investors. It is that wage scales are often unrelated to the individual executive's performance, or to his or her success in creating long-term value for the company's owners. Further, salaries may be massively higher than average workforce pay. That is a potential staff morale-killer in good times. It can be poisonous to a company when CEO wages, bonuses and perks rise even as shopfloor jobs and benefits are cut. Pay is not the only significant contributor to value creation. But it is a barometer above all else of the degree to which companies have become the plaything of their managers rather than a service to their civil investors. What is true for all company employees should also be true for the CEO. The aim

should be to compensate them fairly, and in a way which will encourage them to behave in the interests of their citizen investors. At the end of the day, this isn't just about how companies calculate pay. It is about the culture of a workplace.

4. Do not waste capital. Citizen investors want their savings to generate the greatest possible surplus. Yet many corporations raise far more money than they need, and keep a large store of cash for their company's own use. This tends to make life easier for managers. They have a cushion against poor performance. But in featherbedding themselves in this way, managers are denying their owners the opportunity to invest in other profitable ventures. By contrast, some companies borrow too much. If things go well, this might generate higher returns, and perhaps high value for the CEO's stock options. But if they go badly, the shareowner (and, in cases of insolvency, the lender) picks up all the losses. Citizen investors are willing to accept significant risks when they invest in a company, provided they are proportionate to the expected return. But they spend more time today scrutinizing whether executives are aiming at reasonable targets or building empires. Managers facing the owner revolution must focus on capital efficiency as one key element in the pursuit of profit.

5. Focus where your skills are strongest. You are unlikely to be successful if someone else can do the job better. So treat with skepticism any business plan that purports to show a profitable business without giving a credible reason why that business will be the best. Start the planning process by looking at the skills of your organization and linking them to market opportunity, rather than the other way round. And leave financial modeling to the end of the process, after you have established the competitive strengths of the business. With this approach, you as a manager will rarely have to find an entirely different field of business where the grass is supposedly greener. You'll be able to focus on how to develop and hone your organization's skills to meet customer needs better.

6. Renew the organization. It is difficult to think of any company that would still be in business if it were using the same systems, with the same products and the same levels of efficiency, that it had even ten years ago. What is new, however, is that today corporate regeneration must come to terms with the owner revolution. Companies need to respond, and rapidly. They need to be on a perpetual search for renewal, constantly finding ways to meet customer needs better or at lower costs. If they fail to do so, they will be overtaken by competitors and their owner's capital will be destroyed. Such renewal is not just about spending more on research and development. It should pervade the whole organization. Starting at the top, the company board of directors should be thinking about how they could do the job better. As the world shifts around them, companies should be planning how best to ride these dynamics to add value. That is good management, which is also in keeping with the demands of citizen investors.

7. Treat customers, suppliers, workers and communities fairly. Well-managed companies cannot ignore their impact on the wider society. Insensitive actions are likely to encourage government regulation and create tensions between the company's culture and that of the wider world within which it exists. But citizen investor funds, because they speak for a broad public, need CEOs to go much deeper than this. New capitalists need the entire economic system, not just a single company in which they are invested, to be successful over the long run. They can take no advantage when private profit comes at the expense of social cost, since they suffer from the latter just as they benefit from the former. Citizen investors want companies to treat customers, suppliers, workers, and communities fairly because those customers, suppliers, workers, and communities are also the company's shareowners.

8. Seek regulations which ensure your operations do not cause collateral damage and your competitors do not gain unfair advantage. Companies should support measures meant to prevent unfair and opaque competition. After all, companies struggle when they have to compete against those who illegitimately pass costs onto society. Citizen investors say they do not want companies to pollute, for instance. But what do you do if your competitors take

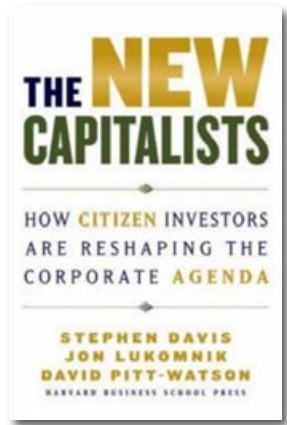
advantage of your socially conscious behavior to push you out of business? If competitors engage in anti-social behavior, companies should, on behalf of their citizen investor owners, seek regulations or incentives that will modify competitive rules to ensure rivals don't create collateral damage. Ideally, such rules should be voluntary and as flexible as possible. But where this is impractical, it is appropriate to encourage statutory regulation.

9. Stay clear of partisan politics. Companies are creations of the law. Citizen investors do not want them to use economic muscle for partisan political advantage to change the law in their favor. If a company seeks to influence the regulator for private gain, without reference to public costs, it undermines not only the demands of its new capitalist owners, but also the superstructure of democratic civil society. It can rarely make sense for companies to finance partisan politics. Should they propose to do so, it should only be done with the explicit permission of their citizen shareowners in an annual meeting resolution.

10. Communicate what you are doing and be accountable for it. Citizen investors require companies to be transparent for a simple reason. If companies are to be accountable to savers, such owners need the information necessary to make accountability work. Accountability, indeed, is the biggest consequence of the owner revolution. Companies should seek an open and honest dialogue with their shareowners and others affected by their plans. They should be clearly accountable for their actions. Like all other institutions, it must be possible to call companies to account for their actions, good or bad. Markets, regulators and society may all constrain companies, but only the owner can create a comprehensive framework of accountability.

Companies behaving according to the Capitalist Manifesto are building a new model for free enterprise among publicly listed corporations. Citizen investors are compelling the corporation to operate for social as well as private value. Executives that get this right early on will earn investor trust, which translates into a lower cost of capital. Others will find their companies re-imagined by their new owners—and possibly ejected from their jobs.

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For more details or to buy a copy of Stephen Davis, Jon Lukomnik and David Pitt-Watson's, *The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda* [click here](#).

ABOUT THE AUTHORS

Stephen Davis is president of Davis Global Advisors, Inc., the world's leading consultancy on international corporate governance. **Jon Lukomnik** is the managing partner of Sinclair Capital LLC, a strategic consultancy to corporations, institutional investors, and the investment management industry. **David Pitt-Watson** is former Chief Executive of Hermes Focus Asset Management, Europe's leading shareholder activist fund manager. They are the co-authors of *The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda*; Harvard Business School Press; November 1, 2006.

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