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# Asset Manager Capitalism, Stakeholder Management and Share Buybacks

Demir Bektić<sup>1,2</sup> · Patrick Jahnke<sup>3</sup>

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## Abstract

We assess what the prevalence of share buybacks can tell us about the relationship between the firm and its stakeholders in an environment in which ownership is increasingly concentrated in the hands of a small number of large asset managers. While the finance literature has put forward several reasons for the current prevalence of buybacks, we posit that without the significant institutional changes outlined in this paper, namely the rise of index investing, these triggers by themselves cannot explain their popularity. We present a game theory model in which three players vie for the cash flow of the company: managers, shareholders, and other stakeholders. We show how in a constellation in which all three players have equal power the expected outcome would be to invest the company's surplus cash in growth opportunities. This contradicts what is observable in practice: the prevalence of buybacks. We identify 'asset manager capitalism' as the cause and conclude that changes in the shareholder ownership structure are partly responsible for this. Shareholders have used their increased influence to supervise managers and to shape corporate policy in their favour. This paper adds to the literature on stakeholder theory an understanding of how the relative power of stakeholder groups has changed under asset manager capitalism. We do not, however, seek to take sides in the debate as to whether share buybacks are desirable or not.

**Keywords** Game theory · Stakeholder theory · Share buybacks · Mutual funds · ETFs

**JEL** G23 · G32 · G34 · L22 · P16

## Introduction

This paper contributes to the literature on stakeholder cooperation (Bundy et al. 2017; Tantalo and Priem 2016; Harrison and Wicks 2013) a model of the relationship between institutional shareholders and corporate management. As Bridoux and Vishwanathan (2020) point out, the fact that managerial discretion may be limited by powerful

stakeholders (including shareholders) has received little academic attention as managers are generally considered as central to any explanation of firm's stakeholder strategy.

With the help of game theory we illustrate how the power of institutional investors relative to other stakeholders has increased. Based on the conceptual understanding of stakeholder theory (Freeman 1984), we make the case that executive compensation has been constructed in such a way that managers today are no longer the impartial referees of stakeholder interests (Aoki 1984) that they once were. Through 'value appropriation behavior' powerful stakeholders can use their large bargaining power to constrain managers' choices (Bridoux and Vishwanathan 2020). Increases in the amount of compensation and changes to the structure of compensation (Edmans et al. 2017) have been accompanied by a shortening in CEO tenures (Marcec 2018), which together have had the impact of shortening the investment time horizons of CEOs. CEOs, faced with shorter tenures, are less likely to make longer-term investments as they may

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not be in office when such investments come to fruition (Lee et al. 2017).

Any discussion of firm objectives typically involves multiple fundamental debates including profit maximization, stakeholder theory (Freeman 1984), principal-agent theory (Jensen and Meckling 1976) and the ownership of the firm (Jensen and Meckling 1976; Hansmann 1988; Easterbrook and Fischel 1989). Central to all these discussions is the question in whose interest companies should be run and by what means a company's productivity can be optimized. In this regard there are two primary schools of thought. Proponents of 'shareholder value' such as Jensen (2000) argue that focusing on shareholder interests and maximizing firm profits provides the best course to maximizing overall societal wealth. Proponents of 'stakeholder theory' such as Freeman (1984) suggest that a better result is achieved if companies consider the concerns of all their stakeholders. Stakeholder theory is based on the understanding that to be successful, managers must simultaneously address the interests of several groups of 'stakeholders' such as shareholders, employees, suppliers, and customers.

Both the shareholder approach and the stakeholder approach seek to maximize the value created by the firm. However, they disagree in how such value creation is best achieved. The shareholder primacy approach typically builds on a principal-agent understanding of the firm that sees the shareholder as the owner (principal) of the company into which she invests.<sup>1</sup> Furthermore shareholders are cast in the role of 'residual claimants' (Jensen and Meckling 1976) on the company's assets, getting paid only after all other stakeholders have already been paid. This, shareholder primacy advocates argue, makes them most incentivized to ensure that companies operate at maximum efficiency. In doing so they will not only maximize their wealth but that of society at large. The stakeholder approach differs in that it does not believe that the best means of maximizing the value of a firm is to focus on short-term payments to shareholders but in a longer-term value maximization to all stakeholders. In doing so it also differs in how wealth is distributed. Shareholder proponents such as Friedman (1970) believe the social responsibility of the business is to make profits for its shareholders. Regulation and taxes can then take care of any needed redistribution.

The rise in executive remuneration and the use of share buybacks has occurred against a backdrop of rising institutional share ownership. Up until the 1950s it was individual 'retail' investors that controlled most shares in US listed companies. Today it is institutional investors that control most share capital (Arjaliès et al. 2017). Davies (2015) describes a 'portfolio society' in which financial markets

have shaped the society to the point where "the investment idiom becomes a dominant way of understanding the individual's place in society" (p. 6). The rise in institutional capitalism has been referred to by several terms, including 'investor capitalism' and 'finance capitalism' (Useem 1996), 'mutual fund capitalism' (Hawley and Williams 1997), 'pension fund capitalism' (Clark 2000), 'fiduciary capitalism' (Hawley and Williams 2001) and 'asset manager capitalism' (Braun 2015). With the rise of passive fund management, the reference to mutual funds and pension funds to describe the current framework seems less appropriate. While fiduciary capitalism has the quality that it references the nature of the relationship that guides institutional investors in their decision-making, we will make use of the term asset manager capitalism throughout this paper as it is asset managers that have grown to become the largest investors (see Braun 2022).

This asset manager capitalism, discussed in detail in Section "[Asset Manager Capitalism](#)", has fundamentally changed the shareholder ownership structure of listed companies and the role played by investors. By reducing the collective action problem previously faced by shareholders, asset manager capitalism has increased the influence of institutional investors enabling them to take a seat alongside management in an increasing number of issues (Jahnke 2019).

This shared interest, our model suggests, may provide a partial explanation for the prevalence of share buybacks. Rather than being singularly responsible for share buybacks we suggest that this reasoning should be considered alongside others that have suggested interest rates (Elgouacem and Zago, 2018), a lack of profitable investment opportunities (Edmans 2017 and Asness et al. 2018), and tax cuts (Otani et al. 2018) as reasons for the current popularity of share buybacks.

The remainder of this paper is structured as follows. Section "[Stakeholder Theory](#)" reviews the literature on stakeholder theory, explaining why we have chosen to follow this approach. Section "[Asset Manager Capitalism](#)" outlines the concept of asset manager capitalism and explains how it has helped to empower shareholders by reducing the collective action problem previously restricting them. Sections "[Outlining the Conceptual Framework: Changes at the shareholder level](#)" and "[The Conceptual Framework: Changes at the company level](#)" set out the conceptual framework that provides the base for the game theory approach applied in Section "[Constructing the Game](#)". Section "[Discussion](#)" is the Discussion and Section "[Conclusion](#)" concludes.

<sup>1</sup> See Stout (2012) for the case against regarding shareholders as owners.



## Stakeholder Theory

The traditional business management literature defines stakeholder as “those groups on which the organization is dependent for its continued survival” (Freeman and Reed 1983, p. 91). This definition was subsequently expanded by Freeman (1984) to include anyone that “can affect or is affected by the achievement of the organization’s objectives” (p. 46), thereby also including the wider society as stakeholders. We choose to employ the latter, broader, definition of Freeman as we believe that all corporations are today in need of maintaining a ‘social license’ to operate, the granting of which is at the discretion of the society at large. In today’s highly globalized and digitalized world, news travels instantly. Through social media, virtually anyone can initiate a campaign with the potential to benefit or harm a company’s prospects. In the information age stakeholders are increasingly interconnected (Crane et al. 2018).

Drawing on the stakeholder groups identified by Freeman and Reed (1983) and Carroll (1991) we select the following six groups as stakeholders for our game theory approach: Shareholders, Local Community, Customers, Employees, Suppliers, Public at Large. The challenge facing corporate managers is how to simultaneously address the legitimate interests of all these identified groups (Donaldson and Preston 1995). Aoki (1984) therefore compares the role of corporate managers to that of a referee.

Jensen (2000) argues against stakeholder theory on the grounds that “it is logically impossible to maximize in more than one dimension, purposeful behavior requires a single valued objective function.” He further argues that “by refusing to specify how to make the necessary tradeoffs among these competing interests they leave managers with a theory that makes it impossible for them to make purposeful decisions.” Taking these two points together, Jensen’s criticism is that a stakeholder approach requires a balancing of interests to achieve a single valued objective function. And with no way to “keep score” he argues that stakeholder value leaves corporate managers unaccountable. Jensen is right to emphasize the need for keeping score, but data analysis is rapidly expanding what can be measured and the fund management industry is setting up an increasing number of funds incorporating environmental, social and governance (ESG) factors into their investment process.<sup>2</sup> Over the longer-term it is to be expected that through the strategies employed initially by quantitative investment funds, and subsequently by all funds, such ESG criteria will be reflected in company valuations. At that point we will be one step closer to keeping score. Further financial analysis may then over time suggest an optimal balance of different

factors to provide management with a singular objective. Such measurement and balancing will have its shortcomings but there is no reason to suggest that these will be worse than the current system under which executives’ pay is balanced between earnings per share, share price, sales growth, margins, and free cash flow, to name just a couple of measures commonly employed.

We believe that the two approaches of stakeholder and shareholder value are not mutually exclusive. The challenge with maximizing anything is that maximization is an extreme condition. And to measure the success of an extreme condition a specific timeframe has to be set. It is here where in practice the stakeholder and shareholder approaches diverge. Companies operate within societies with regulation and taxation, which provide society at large with control functions. These control functions enable stakeholder over the long term to force a company to internalize many negative externalities it produces. It also changes the bargaining power of the various stakeholders. While companies can adjust profit targets in the very short term, taking decisions such as to cut on staff or their benefits, negative effects resulting from these actions may take longer to materialize. An employer may have monopsony power over the local labor market and abuse this by paying low wages. It may take years for the local workforce to respond to insufficient wages in this scenario, but over time, possibly generations, new entrants to the workforce may seek employment in other states or skills suitable for other industries. Similarly, consumers may seek socially responsible alternative products and over time this demand may create powerful competitors. Similarly, a company whose production or products pollute the environment may find that society votes to enact new regulation internalizing externalities such as in the case of CO<sub>2</sub> emissions certificates or the ban of internal combustion engine cars in major cities. Over an appropriately long timeframe the maximization of company value may therefore satisfy both shareholder value and stakeholder value proponents. The primary challenge to this approach is the shortsightedness of financial markets.

In fact, Jensen (2000) himself acknowledges the need for consideration of stakeholder concerns in his concept of ‘enlightened value maximization’. What makes value maximization ‘enlightened’, he argues, is that it considers stakeholder concerns but retains the long run value maximization of the firm as its goal.<sup>3</sup> This approach seeks to take from stakeholder theory certain parts of business strategy while shedding from it the ethical considerations inherent in the longer-term distribution of the created firm value. Such an approach runs afoul of the ‘separation fallacy’ (Freeman 1994). It can only succeed if it were possible to alter the

<sup>2</sup> For an example of this see work of the Sustainability Accounting Standards Board (SASB): <https://www.sasb.org/>.

<sup>3</sup> In fact Jensen (2000) explicitly states “A firm cannot maximize value if it ignores the interest of its stakeholders”.



economic value created for shareholders without simultaneously impacting society at large. However, the fact-value dichotomy, the attempt to distinguish between facts (“business” considerations) and values (“ethical” considerations), dictates that pursuit is an impossible task as values are “embedded in social contexts from which they cannot be removed” (Sandberg 2008, p. 230). What companies and their shareholders must realize is that they are not operating in a vacuum but within a society and that this realization will help guide their longer-term success. The approach of Jensen (2000) in this regard is like that taken by Porter and Kramer (2011) in their ‘shared value’ approach. Crane et al. (2018) point out in reference to the latter’s work “it is unoriginal; it ignores the tensions inherent to responsible business activity; it is naïve about business compliance; and it is based on a shallow conception of the corporation’s role in society” (p. 130).

We therefore disagree with Jensen’s criticism of stakeholder theory, and believe that purposeful behavior does not preclude the incorporation of multiple stakeholder concerns. While the balancing of such concerns will require greater managerial skill, seeking to complete this balancing act provides the possibility of greater value creation than maximizing purposeful behavior in only one dimension.

## Asset Manager Capitalism

Asset manager capitalism has brought about three specific changes that impact institutional shareholders’ relationship with other stakeholders. Firstly, a significant portion of the rise in institutional assets has been down to the success of Exchange Traded Funds (ETFs).<sup>4</sup> These index funds do not have the ability to follow the ‘Wall Street walk’ and simply sell a stock if they are unhappy with a firm’s performance. Instead, they are forced to remain invested in the stock for as long as it remains in the benchmark indices they track. This means passive investors are ‘along for the ride’ and the only option they have is to engage with the management.<sup>5</sup>

Secondly, the holdings of many of the largest asset managers are today so broad that they have been referred to as

‘universal owners’ (UNEP, 2011) and ‘universal investors’ (Lydenberg 2007).<sup>6</sup> Due to their board ownership they are said to have greater concern for negative externalities such as pollution, as any environmental cost saved by one portfolio company is borne by another portfolio company (UNEP, 2011).

Finally, along with the asset managers, their customers, the ‘ultimate owners’ of the assets they manage, have also transformed over the last decades. Financial innovation, such as the creation of ETFs, has significantly decreased the cost of holding equities and made stock market investments more accessible. Supporting this have been global pension reforms such as the shift from defined benefit (DB) to defined contribution (DC) pensions, which has the result of shifting investment risk from the corporate sector to the household (Broadbent et al. 2006). As a result of both trends a much larger proportion of households today own shares directly or indirectly and an individual today may take on the personality of a number of stakeholder groups. Individuals may, for example, confront a company as an employee, a local resident or in the form of a shareholder. Institutional investors must also consider that their ultimate investors may be both their customers as well as employees in one of their portfolio companies. Consumers have discovered that besides their purchasing preference, they can also employ their pension and stock brokerage accounts as means with which to signal discontent.<sup>7</sup>

The game theory approach employed in Section “**Constructing the Game**” consists of three players. Player 1 is the company’s management, Player 2 represents the shareholders, today dominated by the large index funds, and Player 3, representing all other stakeholders.

## Outlining the Conceptual Framework: Changes at the shareholder level

Clearly there are differences between shareholder types with each having their own interest as the literature on blockholders has taught us.<sup>89</sup> This is especially true when it comes to activist investors as well as founder shareholders. Nevertheless, in the age of asset manager capitalism,

<sup>4</sup> ETFs are investment funds that are listed on exchanges, giving investors the opportunity to sell them on an intra-day basis. This contrasts with conventional mutual funds that typically have at least a one-day delay between the ordering of the fund and the investment in the fund. To enable ‘market makers’ to set prices and provide liquidity in ETFs they need to know the constituents of the funds, which is why the strategies they follow are passive in nature. ETFs have taken significant market share from active mutual funds due to the lower fees they charge and the ease with which they can be bought and sold. For more information on ETFs see Braun (2015).

<sup>5</sup> For a list of further reasons why passive investors may choose to engage see Jahnke (2019).

<sup>6</sup> In a study conducted by Bew and Fields (2012) amongst 19 leading North American asset management firms and their affiliates approximately half the participants reported holding shares in between 4,500 to 10,000 individual companies.

<sup>7</sup> For a practical example see the “Pension Power” campaign organized by ShareAction in the UK. Further details at: <https://shareaction.org/category/campaign/pension-power/> accessed 23rd of June 2018.

<sup>8</sup> See Edmans and Holderness (2016) for a comprehensive discussion of the blockholder literature.

<sup>9</sup> See the Appendix for a three player version of our model that separates out shareholders into activists and non-activists investors.



the largest investors mostly vote in support of buybacks as shown by their proxy voting data and outlined in their proxy voting guidelines. In this regard, Fichtner and Heemskerck (2020) analyze 8,125 shareholder resolutions on share buybacks between 2012 and 2017 in the United States, the United Kingdom, France, Germany, and Japan and find that in the vast majority cases the Big Three have voted with management in support of buybacks. Similarly, Baines and Hager (2023) in their study of index funds' voting behavior at US oil and gas firms found that in the years between 2014 to 2020 index funds consistently voted in support of buybacks, backing between 90% and 97% of relevant proposals in each of the years studied (and not voting against a single buyback).

Furthermore, ownership concentration has reduced the collective action problem previously faced by shareholders and consequently increased investors' influence over corporate managers (Jahnke 2021). Fichtner et al. (2017) highlight that just three U.S. investors (Blackrock, Vanguard and State Street, the "Big Three") together constitute the largest shareholder in 88% of the firms that make up the S&P 500 index. They further show that in the 1,662 US companies in which the Big Three make up the largest shareholder, they represent a mean ownership of 17.6%. What makes this voting block even more powerful is that in most proxy votes the fund management companies display internal agreement on their votes.<sup>10</sup> On average the Big Three vote approximately 90% of the time with management.<sup>11</sup> Furthermore, Voss (2024) shows that shareholder value constitutes the main guiding principle of the Big Three and that they reinforce their large block holdings by forging interest coalitions with activist investors when it suits their ends.

Besides growing ownership co-ordination, there are two further, partially related, reasons why we choose to treat shareholders as one homogenous group for the purpose of our game-theory approach. Firstly, there is the presence of proxy advisors. These advisors help institutional investors complete proxy ballots in any or all the following ways: by recommending how to vote, helping to process large numbers of votes through "custom proxy policies" or by supplying the needed "plumbing" to facilitate the processing of the actual votes. The industry is highly concentrated with the two largest proxy advisors, ISS, and Glass Lewis, holding an estimated market share of 97% (ESMA 2012). Proxy advisors through their annual proxy policy update framework help to aggregate and in some cases shape investor

opinion. Though proxy advisors likely also have some influence over the Big Three, it is appropriate to consider ISS and Glass Lewis as two further voting blocks, as proxy voting has great economies of scale making smaller fund managers more likely to follow proxy advisor recommendations (Choi et al. 2013). The actual level of influence proxy advisors have is highly disputed and estimates range from as low as 6 percent to 25 percent.<sup>12</sup>

IBM in a comment letter to the U.S. Securities and Exchange Commission (SEC) complained that the voting block controlled by ISS had more influence than IBM's largest shareholder. The estimation of their influence is complicated by the need to differentiate between correlation and causation when it comes to comparing asset managers' votes with proxy advisor recommendations. The findings of Ertimur et al. (2013) suggest "that, rather than identifying and promoting superior compensation practices, PA's key economic role is processing a substantial amount of executive pay information on behalf of institutional investors, hence reducing their cost of making informed voting decisions" (p. 5). The issue being voted on is also of significance and with say-on-pay votes particularly technical in nature proxy advisors appear to have a particularly high impact on these votes (Larcker et al. 2013).

The role of investor coordination is closely related to ownership concentration and the work of proxy advisors. Davies (2015), shows that for any level of ownership concentration, there is a greater reduction in shareholders' agency costs in countries that allow for the co-ordination of shareholders. Similarly, Edmans and Holderness (2016) show that the degree of the "free-rider" problem is dependent on factors including the ability to coordinate. Such investor coordination was greatly simplified in 1992 when the SEC instituted expansive reforms (Choi 2000). Today institutional investors regularly meet at industry network conferences such as the Council of Institutional investors, the United Nations Principles for Responsible Investment (PRI) and the International Corporate Governance Network (ICGN) Jahnke (2021). They also meet at events of issue-related networks such as the Institutional Investors Group on Climate Change (IIGCC). At these networks, as at roundtable meetings organized by proxy advisors, institutional investors can exchange views and discuss on best practice policies. Crane et al. (2014) find that "for the purposes of

<sup>10</sup> Fichtner et al. (2017) show that only in 0.018% of cases Blackrock's funds do not vote in unison, for Vanguard the figure is 0.006% and for State Street 0.195%.

<sup>11</sup> "The voting behavior of BlackRock, Vanguard, and State Street is similar to that of most active mutual funds: They side with management in more than 90 percent of votes" (see Fichtner et al. 2017).

<sup>12</sup> Bethel and Gillian (2002) find that a negative ISS recommendation can sway between 13.6 percent and 20.6% of the vote and Cai et al. (2009) find that a negative recommendation can influence 19% of the vote. Malenko and Shen (2016) find that a negative ISS recommendation on say-on-pay proposals leads to a 25-percentage point reduction in support. However, Choi et al. (2010) estimate that ISS recommendations only shift 6 percent to 10 percent of the vote and conclude that "popular accounts substantially overstate the influence of ISS".



governance, such coordinated groups can effectively act as single blocks of ownership” (p. 2).

Together the rise of institutional share ownership, the presence of proxy advisors, and the establishment of investor networks, mean that companies today face a shareholder group that is both more powerful and better coordinated than in the past.

### The Conceptual Framework: Changes at the company level

From 1978 to 2016 CEO pay has increased by 936.7% and the CEO-worker ratio has expanded from approximately 20 times to 240 times.<sup>13</sup> In order to reign in this high pay and better align it with shareholder interests, investors’ focus more recently has been on the structure of payments, with the aim of reducing the perceived agency costs that occur under dispersed ownership.

Edmans et al. (2017) review the theoretical and empirical literature on CEO pay and identify three distinct transformations. Firstly, starting in the 1980s they find a large increase in the use of stock options. Following the financial downturn of 2001–2002 stock options were increasingly replaced with restricted stock grants until in 2006 the restricted stock grants made up the majority. Finally, the authors observe that the structure of restricted stock awards themselves have changed from time-vesting stock to performance-based equity awards that only vest if certain goals are fulfilled.

This increasing complexity reflects the increasing importance investors place on executive compensation. It also explains why Malenko and Shen (2016) and Larcker et al. (2014) show a much higher investor dependency on proxy advisors in their studies on say-on-pay than other studies such as Choi et al. (2010) that look at, for example, director elections. The changing structure of executive pay documented by Edmans et al. (2017) is likely a reflection of the emancipation of institutional investors.

While the first attempt at incentivizing executives was in the form of options, following the collapse of the Internet bubble, investors realized that the asymmetry inherent in option payouts—unlimited upside with limited downside—did not match their own economic exposure to company share prices. The shift to restricted stock awards realigned the payout profile but lacked the ability to provide detailed incentives. The introduction of performance-based stock awards, which enable investors to link pay to one or several strategic goals, such as sales growth or free cash flow generation, provided this detail. As a result, investors today can

fine tune executive pay according to the desired corporate strategy. For example, HSBC (2018) shows that depending on the maturity and composition of the company’s industry, investors may choose to have a greater focus on organic sales growth (for growth companies) or on cash returns (for companies operating in mature industries).

The move to performance-based restricted stock awards together with other corporate governance reforms such as the introduction of “proxy access” mandates has solidified investors’ control over management teams.<sup>14</sup> This in turn has resulted in a shortening of CEO tenure. Data compiled by the consulting company Marcec (2018) shows that median CEO tenure has decreased from 6.0 years in 2013 to 5.0 years in 2017. Similarly, Kaplan and Minton (2012) report a coincidence of shorter CEO tenures and higher CEO pay. Dikolli et al. (2014) find that CEO tenure is highly correlated to the quarterly earnings misses with each negative quarterly report increasing CEO-turnover probability by between 18 and 36 percent. CEOs cognizant of this development are likely to increase their focus on short-term results and the interest of shareholders. The consequence is a management that is aligned with shareholders both because of their pay structure as well as their time horizons due to the shortening CEO tenures.<sup>15</sup>

### Constructing the Game

We start with three players and then progress to a simplified game with two players. Prior to asset manager capitalism we would construct the game with three players: Managers (Player 1), shareholders (Player 2) and all other stakeholders (Player 3). The decision that our players must make is whether to invest a fixed amount into either a share buyback or capital expenditure.<sup>16</sup> We choose this example as we expect to favor capital expenditure over share buybacks. This is because capital expenditure has the potential to lead to growth and to create jobs and better products, thereby supporting the local labor force, community, customers and suppliers.<sup>17</sup> In a constellation in which all three players have

<sup>14</sup> Proxy access is a bylaw that allows shareholders that fulfill certain conditions (typically a minimum holding size, held for a minimum duration) to propose director candidates at the annual general meeting of a company.

<sup>15</sup> See Davies et al. (2014) for a discussion of investor short-termism.

<sup>16</sup> For simplicity we ignore other uses such as dividends or acquisitions. Though it is assumed that shareholders would prefer dividends and corporate managers acquisitions. The history books are full of “empire building” CEOs.

<sup>17</sup> In theory share buybacks have the potential to create growth in other companies as investors allocate the capital to new startups. However, for the purpose of this game these competitors are assumed to be in another community leading stakeholders to prefer capital expenditure.

<sup>13</sup> Based on data from the Economic Policy Institute quoted on CNBC: <https://www.cnbc.com/2018/01/22/heres-how-much-ceo-pay-has-increased-compared-to-yours-over-the-years.html> accessed 17th of July 2018.



equal power the expected outcome would be to invest the company's surplus cash in growth opportunities (as stakeholders want jobs and managers want to oversee a larger company).

In the game that follows, we will, however, only construct a game with two players. As explained in the preceding sections, it is today appropriate to consider managers to be largely aligned with their more concentrated shareholder base. This therefore means that the game we present below will consist of only two players; Management and Shareholders (Player 1) and all other stakeholders (Player 2).

Having defined the various players to our game and their respective interest, the next step is to define what goal it is they are playing for. At the heart of the stakeholder versus shareholder debate lies the question over the allocation of the cash a company generates. All stakeholders, including shareholders, want to maximize value. The definition as well as the time horizon of achieving this value may, however, differ between stakeholder groups. In the case of shareholders, it is assumed to be purely financial.

Assuming investors have control over how company executives are paid, then executives have the remaining options of investing in capacity expansions, research and development, market-ing, increasing employee wages, mergers and acquisitions, deleveraging of the balance sheet (buying back debt), share buybacks or dividends.<sup>18</sup> Each of these uses of capital will have different impacts on different stakeholder groups. While management may employ dividends and share buybacks to cater for shareholders, they could increase production facilities or research expenditure to advance organic growth options or simply increase employee pay to improve employee satisfaction with the aim of increasing productivity and loyalty.

If management chooses to pay out surplus cash to shareholders in the form of dividends or a share buyback, they in fact forgo the opportunity to goodwill with their stakeholders. This is not to say, however, that returning cash to shareholders is necessarily a bad thing. There are several considerations that may warrant cash returns to investors. Management may not see investment opportunities at the time, may wish to maintain an efficient balance sheet, or may want to ensure that it retains the right type of shareholders.<sup>19</sup> Similarly, employing capital to reduce the

leverage of a highly indebted company is likely to increase stakeholder trust, especially that of suppliers and employees. The desirability of share buybacks is a hotly contested issue that some have referred to as a "buyback derangement syndrom" (Asness et al. 2018) and we do not seek to enter this debate here.

## Game Theory Approach to the Stakeholder Question

Game theoretical problems usually involve multiple criteria as well as multiple decision makers. To solve such problems by conventional optimization methods, the problem is usually converted to a single-decision-maker problem with a single composite objective for the whole system such as an overall economic or social welfare function or a weighted constrained multi-objective function. In game theory each decision maker plays the game to optimize the decision maker's own objective, knowing that other players' decisions affect the decision maker's objective value and that the decision maker's decision affects others' pay-offs and decisions. The self-optimizing attitude of players, represented in game theory, often results in non-cooperative stakeholder behaviors even when cooperative behavior is more beneficial to all parties. The fundamental elements of carrying out a non-cooperative<sup>20</sup> game-theoretic analysis are (I) framing the situation as a function in terms of the available actions as well as their payoffs to players, and (II) employing various equilibrium notions to make either descriptive or prescriptive predictions. Game theory can help to provide some planning, policy, and design insights that would be unavailable from other traditional methods. Another advantage of game theory over traditional quantitative simulation and optimization methods is its ability to simulate different aspects of the conflict, incorporate various characteristics of the problem, and predict the possible resolutions in the absence of quantitative payoff information. Often non-cooperative game theory methods can help to resolve the conflict based on the qualitative knowledge about the players' payoffs [i.e., how the players order (rank) different outcomes (payoffs)]. This enables handling of the socioeconomic aspects of conflicts and planning, design, and policy problems when quantitative information is not readily available. In general, game theory results are closer to practice because this method better reflects the behaviors of the involved parties, something often neglected by conventional optimization methods for solving multi-criteria, multiplayer decision-making problems.

Competitors pose a challenge to the game's construction. They would likely prefer share buybacks rather than capital expenditure by their competitor.

<sup>18</sup> Ignoring many smaller uses such as political contributions or philanthropy.

<sup>19</sup> There are several reasons why companies may want to maintain a certain balance of equity to debt such as the ability to offset debt interest from profits. The company may want to ensure it pays a dividend yield above a certain level to attract 'income investors' as these investors are typically more longer-term than growth-oriented investors.

<sup>20</sup> The term "noncooperative game theory" describes models where players are assumed to behave selfishly and their behaviors are directly modeled. The contrary, "cooperative game theory", refers to more abstract analyses of bargains or behaviors of players, without explicitly modeling the processes.



Finally, game theory is applicable for the analysis of problems where the decisions of agents affect each other’s costs and benefits (Brams 1992), the potential for the existence of multiple strategies that yield best benefits, dependent on the actions of other agents (Dixit and Skeath 1999), and a manageable number of agents who interact strategically in a system (Gibbons 2001).

The divergent interests between shareholders and stakeholders are parallel to the classic example of the Prisoner’s Dilemma in game theory, where two separate prisoners must decide separately whether to confess to a crime: if a prisoner confesses, she will get a lighter sentence and her accomplice will get a heavier one, but if neither confesses, sentences will be lighter than if both confess. For instance, shareholders will compete in an attempt to further maximize their own private interests e.g. short-term vs. long-term interests. Such competition will lead to a decrease in overall value, given that some private interests conflict with the interests of share-/stakeholders in general. In other words, even though the two are better off collectively by cooperating with each other, their self-interest will deal them to compete, disregarding the negative effects that such competition may have.

Some would probably argue that the difficulty with using the Prisoner’s dilemma to model the share-/stakeholder situation could be the number of players involved. In a classic prisoner’s dilemma, the dilemma arises where the game is played a single time. Where the game is played in multiple iterations, however, a tit-for-tat strategy has been shown to induce the players to reach the collective best outcome. Although the shareholder-stakeholder interaction is a repeated game with no finite terminus, which should be ideal for tit-for-tat strategies, the number of players involved would seem to preclude that solution. However, as we will show, the prisoner’s dilemma as an example of shareholder vs. stakeholder interactions can provide valuable insights. It’s true that this dilemma is typically used for a game of two players where the game is only played once. But if we follow the assumptions outlined above, that shareholders as well as the company’s management represent Player 1, and the remaining stakeholders are fragmented in a way that altogether can be categorized as Player 2, and the game is repeated infinitely, then we may end up with Nash equilibrium where Player 1 would pursue its own self-interests

given what Player 2 does, and vice versa.<sup>21</sup> Player 1’s actions would likely be designed to benefit its own private interests, while Player 2’s actions may be designed to benefit stakeholders overall. Or Player 1 may just engage in a dominant strategy where she will pursue its own interests, no matter what Player 2 does over time.

### Analytical Arguments

Let us begin with a standard representation of a game, which is known as a normal form game, or a game in strategic form:

- The set of players is  $N= 1, \dots, n$
- Player  $i$  has a set of actions,  $a_i$ , available. This set might be finite or infinite.
- Let  $a = a_1 \times \dots \times a_n$  be the set of all profiles of actions, with a generic element denoted by  $a = (a_1, \dots, a_n)$ .
- Player  $i$ ’s payoff as a function of the vector of actions taken is described by a function  $u_i: A \rightarrow \mathbb{R}$ , where  $u_i(a)$  is  $i$ ’s payoff if the  $a$  is the profile of actions chosen in the society.

As discussed above, the most famous normal form game is the prisoners’ dilemma. Similarly, if we assume that all shareholders as well as the company’s management of a major corporation represent Player 1, and the remaining stakeholders are fragmented in a way that altogether can be categorized as Player 2, and the game is repeated infinitely, then we may end up with Nash equilibrium where Player 1 would pursue its own self-interests given what Player 2 does, and vice versa. Player 1’s actions would likely be designed to benefit its own private interests, while player 2’s actions may be designed to benefit stakeholders overall. Normal-form games are often represented with the use of tables. Let’s assume that two players 1 and 2 have their own rights and power. They each have two options to express their rights and power: positive (cooperation) or negative (defect). If they decide to act positively, they would create value added, while at different standpoints they would create less value. If they cooperate, the value is high and they each make a contribution of let’s say 2 units of value. If they each decide to act negatively (defect), value would drop significantly and lower their overall value to 1 units of value each. If one defects and the other cooperates, then the value is in a middle range. The player that cooperates creates a higher value of 3 units, while the player that defects is flat in

**Table 1** Two Player Game

		Player 2	
		C	D
Player 1	C	2, 2	0, 3
	D	3, 0	1, 1

<sup>21</sup> Due to the aforementioned arguments (management and shareholders today mostly aligned) as well as simplicity reasons, we consider here a two player game. However, for interested readers, we provide a three player game theory approach in the appendix.



value creation and just generates a value of 0 as represented in Table 1.

Now let’s extend this to the stakeholder question. A company has shareholders (including management) and stakeholders, which will be denoted as Player 1 and 2, respectively. The goal that Player 1 and Player 2 play for is long-term value maximization and the decision they have to make is whether to support the use of the company’s free cash flow for either (A) a share buyback program, or (B) an investment in the company. There is also a third option (C), which is to decline both. Player 1 ranks the three choices, from the most to least preferred, as follows: accept A, accept B, and accept neither of them (C). Player 2’s ranking is B, then C, then A. The rankings are summarized in Table 2.

Assume that a Player gets a payoff of 2 if her most preferred choice is implemented, a payoff of 1 for her second choice, and a payoff of 0 for her third choice. The two players act simultaneously and are required to choose all of their 100% preference for A, B, or C; she cannot divvy them up among the three alternatives. The strategy set for a player is then composed of A, B, and C. Plurality voting is used, which means that the alternative with the most votes is implemented.

To derive the payoff matrix, let us first determine how votes translate into a plurality winner. For example, if Players 1 and 2 vote for alternative B, then B is the winner. Table 3 shows the plurality winner for each of the 9 different ways in which the two players can vote. The next step is to substitute the associated payoff vector for each alternative in a cell in Table 3. For example, if B is the winner, then Player 1’s payoff is 1 (since B is his second choice) and Player 2’s payoff is 2 (since B is his first choice).

Substitution, then, gives us Table 4.

In making statements about how these players might vote, a natural possibility to consider is what political scientists call ‘sincere voting’. The term is used when a voter casts his vote for his first choice. In this case, it would mean that Player 1 casts her votes for A and Player 2 casts her votes for B. But is sincere voting a Nash equilibrium? Is it optimal for players to vote sincerely? Actually, no. Note that player 1 prefers choice B over C. Given that player 2 is voting sincerely, player 1 can instead engage in ‘devious voting’ and vote for choice B rather than A. Doing so means that B ends up supported by both Players 1 and 2, and thus is approved. Shifting her votes from her most preferred alternative, A, to her next most preferred alternative, B, raises Player 1’s payoff from 0 to 1. Hence, sincere voting is not a Nash equilibrium for this game.

**Table 2** Player Preferences

1st Choice	2nd Choice	3rd Choice
Player 1 A	B	C
Player 2 B	C	A

Although it can be shown that it is always optimal to vote sincerely when there are only two alternatives on the ballot, it can be preferable to vote for something other than the most preferred option when there are three or more options, as we just observed. The intuition behind this assertion is that the most preferred option may not be viable, that is, it will not win, regardless of how you vote. In the event that your first choice cannot win, it is reasonable to start thinking about which remaining choices could prevail, depending on various voting scenarios, and, among those choices, vote for the one that is most preferred. In the case we have just examined, with Player 2 voting for B, Player 1 can cause B to win (by casting her votes for B) or cause C to win (by casting her votes for either A or C). The issue, then, is whether she prefers B or C. Since she prefers B, she ought to use her votes strategically to make that option the winner.

What our model has shown is that management and shareholders as well as stakeholders would vote in favor of investments in organic growth over share buybacks. This conclusion appears at odds with what is currently observable in the financial markets. The prevalence of share buybacks and the apparent lack of capital expenditure that has been reported in the press suggest an issue with our model. There are three possible explanations. The first is that Player 1 would not in fact prefer capital expenditure over no action, and would thus always vote for no action if a share buyback cannot be achieved. The second explanation is that capital expenditure is in fact not as low as it appears, as suggested by Asness et al. (2018), accompanied by the possibility that there are not enough sufficiently profitable investment projects available. The other explanation is that our model neglects the corporate governance realities of asset manager capitalism. Corporate managers are the ones that ultimately get to make the decisions. Shareholders have the opportunity to influence or attempt to replace management. The other stakeholders have very limited powers such as calling for a strike or government intervention. The fact that under asset manager capitalism the interests of institutional investors and corporate managers are so closely aligned further reduces the power of other stakeholders.

## Discussion

We acknowledge that our research raises potential concerns, a fact further substantiated during the review process.

On the one hand, the paper’s topical contribution was recognized: we link the concentration of ownership among large asset managers to corporate payout choices through a transparent game-theoretic framework and a stakeholder-power lens. Furthermore, our approach of framing the paper as an explanation of how ownership structure can shape



**Table 3** Plurality winners

	2 votes for A		2 votes for B		2 votes for C	
	2	2	2	2	2	2
A	A	B	C	A	B	C
A	A	A	A	A	B	C
B	A	B	A	B	B	C
I				I	I	B

the marginal trade-off among reinvestment, deleveraging, mergers and acquisitions, and cash distributions, rather than as a normative judgment about the desirability of buybacks was appreciated.

On the other hand, three main critiques have proven especially valuable in helping us refine the manuscript. First, we were cautioned against a normative drift and a logical misstatement to associate share repurchases with lower earnings and taxable income; it was further noted that our discussion sometimes treated dividends and buybacks asymmetrically when describing payout versus reinvestment. Second, it was pointed out that we cannot prescribe that firms should reinvest free cash flow by default, emphasizing that macro growth arithmetic and the existence of mature or sunset industries can make cash distribution the efficient choice. Finally, we were asked to reconcile a tension between our baseline model—which under equal stakeholder power tilts toward organic investment—and the prevalence of buybacks in practice.

We responded with several targeted revisions. We removed the logical error and eliminated language that could be read as anti-buyback; we now present dividends and repurchases in parallel as alternative payout mechanisms alongside investment, deleveraging, and M&A. We re-stated the paper's scope in the Abstract and Introduction to make clear that our contribution is explanatory: we analyze how ownership concentration and index-fund governance can alter stakeholder power and hence payout policy, without prescribing a universal optimum. We added explicit discussion of circumstances in which returning cash is warranted, including target capital structure, investor clienteles, limited opportunity sets, and the dynamics of mature industries. To address model–practice tensions, we clarified how real-world governance features—such as concentrated ownership, compensation design that aligns managers with shareholder preferences, and proxy coordination—can shift marginal decisions toward buybacks even when a frictionless benchmark would not. We also expanded the institutional context (ownership concentration, voting patterns, and coordination mechanisms) and updated the literature to situate our mechanism more firmly in current debates.

There remain points of agreement and a principled difference. We agree that payouts do not mechanically reduce earnings and that executive incentives can be structured to mitigate price-based distortions in repurchase decisions. At the same time, we maintain our central claim: once governance frictions and power asymmetries characteristic of asset-manager capitalism are acknowledged, ownership concentration and index-fund governance help explain why, at the margin, buybacks can prevail over investment more often than a naive “equal-power” baseline would predict. Overall, we believe, that this discussion strengthened the



**Table 4** Strategic form of the voting game

2 votes for A		2 votes for B						2 votes for C						
		2		2		2		2		2		2		
A	B	A	B	A	B	A	B	A	B	A	B	A	B	C
A	2,0,0	2,0,0	2,0,0	2,0,0	1,2,1	2,0,0	1,2,1	1,2,1	1,2,1	1,2,1	1,2,1	2,0,0	0,1,2	0,1,2
B	2,0,0	1,2,1	2,0,0	2,0,0	1,2,1	1,2,1	1,2,1	1,2,1	1,2,1	1,2,1	1,2,1	0,1,2	1,2,1	0,1,2
I					I							I		

paper’s neutrality and clarified both its mechanism and its empirical motivation.

### Conclusion

In this paper we have sought to explain that the prevalence of buybacks cannot solely be explained by financial considerations such as leverage or tax rates but must be understood in part as the product of a changing shareholder structure. The rising share ownership of index funds and the resulting increased ownership concentration amongst institutional investors has grown to the point where shareholders are able to substantially influence executive remuneration and call for, as well as vote for, share buybacks. With the political spotlight the Big Three find themselves under, particularly in the United States, they are increasingly focusing on governance issues over environmental and social issues. Furthermore, the almost blanket support of managerial proxy voting recommendations by index funds has served to partially insulate managers from social issues being raised by other shareholder groups. As the market share of index funds in Europe is lower than in the US, this insulation is not present to the same extent in Europe. The different political, regulatory environment in Europe has also contributed to a far greater support by the regions’ asset managers’ for ESG issues.<sup>22</sup> Together this may therefore also help explain the comparatively lower prevalence of share buybacks in Europe when compared to the United States.

After an initial swing of the pendulum in favor of environmental and social issues, peaking with BlackRock backing ESG issues at Exxon Mobil in 2021, it has now swung back with index funds behaving more in line with the traditional shareholder primacy notion of capitalism. Whether asset manager capitalism will in the future embrace stakeholder theory and consider stakeholder concerns from a long-term value maximizing perspective remains highly uncertain. But whatever the future of asset manager capitalism, what is certain is that index funds will continue to play a significant role in shaping the way it impacts on corporations and society as whole.

### Appendix

We include here an expanded three-player version of our model. One possibility is to split shareholders into two groups: activist and non-activists. The same approach could be used to separate out managers from investors, which would be particularly useful in instances where the managers

<sup>22</sup> For data see Jahnke (2021).



were also controlling shareholders such as in cases where a company's founders are both controlling shareholders and make up the management team. The three-dimensional payoff matrix represents the possible outcomes:

Assume a player acts on his own (maximum of 1.5 units of value per player):

	W	M	B
W	1.5, 1.5, 1.5	1.5, 0, 1.5	1.5, 0, 1.5
M	1.5, 1.5, 0	1.5, 2, 2	1.5, 0, 0
B	1.5, 1.5, 0	1.5, 0, 0	1.5, 0, 0

Assume a player acts with one of the other two players (maximum of 2 units of value per player):

	W	M	B
W	0, 1.5, 1.5	2, 2, 1.5	0, 0, 1.5
M	2, 1.5, 2	1.33, 1.33, 1.33	2, 2, 0
B	0, 1.5, 0	2, 2, 0	0, 0, 0

Assume a player acts with both other players (maximum of 3 units of value per player):

	W	M	B
W	0, 1.5, 1.5	0, 0, 1.5	0, 0, 1.5
M	0, 1.5, 0	0, 2, 2	0, 0, 0
B	0, 0, 0	0, 0, 0	3, 3, 3

Now there are three equilibrium strategies for the players:

- Nobody trusts anybody so they all get 1.5 units of value
- Someone expects at least one person but not the other to be trustworthy so they get 2 units of value
- Total trust results in the maximum possible value of 3 units per player

In this example Player 3 represents an activist investor in the company. Player 1 represents all other shareholders as well as management, and Player 2 represents all other stakeholders. The three players have the following choices to create value: A best-case scenario ("B", worth 9 units of value), a medium-case scenario ("M", worth 4 units of value) and a worst-case scenario ("W" worth 1.5 units of value). In the worst-case scenario the players decide not to co-operate and each follows their own strategy. In this case there can be only one winner, and that winner will receive value equal to 1.5 units. In the medium scenario, two of the player will cooperate. The result will be that the two players that cooperate will generate 2 units each of value, for a combined value generation of 4, while the third player will receive nothing. In the best-case scenario all players cooperate to generate a value of 3 units each for a combined value of 9 units.

Returning to our example: Player 3 represents an activist investor seeking to restructure the firm by selling-off non-core assets while focusing on cutting costs in the remainder of its businesses. Should the three players decide to follow the worst-case example in our model and each try to maximize their own value, two players will walk away

empty-handed while one of them will earn 1.5 units of value. One can imagine scenarios in which any of the three players win. Stakeholders may have secured government backing to rebuff the activists. As a result they may have strengthened their job security while the management and shareholders as well as the activists walk away empty handed. The management and shareholders for their part may have succeeded in their attempt to rebuff the activist by strengthening their grip over the company and paying out more of the free cash flow in the form of share buybacks and dividends. Finally, the activist's campaign, while failed, may still raise the equity markets' awareness of the undervaluation of the company and lead to a small short-lived re-rating of the stock that the activist can then use to sell out of their holding.<sup>23</sup> Such a re-rating, followed by the activists exit, without any corresponding policy changes is unlikely to result in a persistent revaluation so that the other shareholders do not get to benefit from any short-term rally in the company's share price.

Continuing with our example, in Scenario M, there is cooperation between two players. In this scenario each of the cooperating players captures 2 points of value while one player walks away empty handed. When the company's management and shareholders (Player 1) close ranks with the other stakeholders (Player 2) against the activist investor, each of them will receive 2 units of value for a combined value of 4 units. In such an example one can imagine the case where, after the activists exits, the stakeholders and management agree to a partial restructuring of the business that reduces costs while increasing job security. Such actions are likely to result in a moderate medium-term share price appreciation benefitting management and shareholders as well as other stakeholders through the promise of continued local employment. In an alternative scenario Player 3 and Player 1 agree to a far-reaching restructuring of the business that results in a higher share price and executive pay while leading to significant job losses affecting Player 2.

However, the M-scenario also allows for the possibility that players agree to several bi-lateral cooperation agreements. In such a case Player 1 may cooperate with Player 2, Player 2 cooperates with Player 3, while Player 3 also cooperates with Player 1. In this scenario, likely characterized by low trust, the resulting value created is lower than that created when only two co-operate and even lower than

<sup>23</sup> The "market" is the sum of all investors, as well as other stock market participants such as research analysts at banks as well as their traders. In a multiples approach, the value of a company's stock is compared to other companies' shares. Two popular ratios are the price/earnings (P/E) multiple and the EV/EBITDA multiple. In the case of the P/E multiple a company's share price is divided by the company's earnings per share (EPS), while in the case of the EV/EBITDA approach the company's Enterprise Value (EV) is divided by its Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). A re-rating occurs when investors accord a higher confidence in a company's future earnings prospects.



that created when just one player seeks to maximize his or her value.<sup>24</sup>

In such a scenario management agrees something with the activist while also agreeing terms with stakeholders. But the stakeholders are not privy to the agreement between management and the activist. The resulting scenario once each player becomes aware of the others' actions leads to a loss of trust and the value achieved is reduced by the negative influence this loss in trust will have to future cooperation.

In the best-case scenario, all three players agree to work together. In such an example the activist would present a restructuring plan to which managers and shareholders as well as the other stakeholders agree. The share-price would appreciate delivering 3 units of value each to Player 1 and Player 3 while Player 2 would benefit from an equal amount of value due to the concessions they secured for their cooperation. This is the scenario under which overall value would be maximized (9 units). The model suggests that, in the case of an activist campaign, management and the shareholder base should always seek cooperation with the other stakeholders first. Assuming a bilateral cooperation can be agreed they can then engage with the activists in unity. If they fail to agree with stakeholders it is in their interest to next try to come to an agreement with the activists. In either case the value generated (2 units) would exceed that which could gain without cooperation. In practice, the risk that management agrees with stakeholders while stakeholders go behind their back and also cooperate with the activist is limited (and thus the risk of a payout of only 1.3) as stakeholders likely have a greater mistrust of activist investors and the time frame they follow.

One can imagine that in practice this three-player game would be preceded by an additional game that first seeks to confirm the cohesion of management with their core institutional shareholder base. Only if there is cohesion between managers and their shareholder base will they be in a position to confront the activists. Otherwise there is the risk that the activists succeed in convincing the remaining shareholders to replace the management before proceeding with their restructuring plans.<sup>25</sup>

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<sup>24</sup> See Crane (2018) for a model of stakeholder connectedness that relies on trust.

<sup>25</sup> In this regard Jahnke (2021) reports a company as saying that “if an activist were trying to drive a wedge between the company’s management and its shareholders, the best move would be to target index funds.”

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