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Managing Investors: How Financial Markets Reshaped the American Firm

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Financial Markets and the Ideal Firm

What causes large numbers of firms to change strategy and structure in tandem? Organizational institutionalists find that managerial and professional groups that span organizations develop new models of organizational efficiency—models that are typically in the interest of the group pushing them (DiMaggio and Powell 1983; Baron, Jennings, and Dobbin 1988). These new models are often framed as responses to wider economic or political changes, and they serve to enhance the prestige and power of the groups behind them. The new models often diffuse before the jury is in on whether they are more efficient than the models they replace, suggesting that while changes are framed as efficiency-enhancing, they are not really based on rational learning.

We find that over the last three decades, experts promoted a new model of the firm. But in this case the experts were not part of a rising management specialty that hawked their new model from within the firm. They were outsiders. Institutional investors, financial analysts, and hostile takeover firms began to articulate a new ideal of the modern firm, an ideal that suited the professional interests of these three groups. Executives paid attention to this new ideal, in part, because firms were beginning to reward them differently. Executive pay had largely been tied to the size of the firm—the bigger the firm, the higher the chief executive officer (CEO) salary. Executives thus defined firm growth as job one. Agency theory (Jensen and Meckling 1976) led firms to compensate CEOs through stock options, tying CEO remuneration to stock price. Thus CEOs became more and more sensitive to how financial markets valued their firms, and paid more attention to institutional investors and securities analysts. We find that the new ideal of the firm that institutional investors, securities analysts, and takeover firms promoted led to a revolution in firm structure and strategy. The story offers important insights for organizational theorists. Early students of organizations traced practices to internal functional demands, such as size and technological complexity. Open-systems theorists (Scott 2002) traced practices to networks of specialists who spanned organizations, constructing management approaches. We show that emergent extra-organizational networks can successfully promote new management models. The power of those networks to discipline executives plays an important role. The availability of rhetorical devices, notably new theories of agency, core-competence, business process reengineering, and shareholder value, may matter as well.

We look at the effects of the new corporate ideal on the internal structure and strategy of over 400 large US firms for the period 1963–2000. Firms restructured their top management teams, installing chief financial officers (CFOs) to manage stock market valuation and eliminating the Chief Operating Officer (COO), a vestige of the diversification strategy. Firms also embraced the preference of institutional investors and securities analysts for focused firms, buying their competitors and suppliers rather than buying far-flung industries.

Institutional Theory and the External Control of Organizations

Institutionalists were among the first organizational scholars to argue that corporations follow their peers—that groups of firms behave like herds of cattle (Meyer and Rowan 1977; DiMaggio and Powell 1983). Early studies covered practices that symbolized a commitment to equality (Edelman 1990; Dobbin and Sutton 1998). Recent studies (Fligstein 1990; Abrahamson 1991; Davis 1991; Dobbin and Dowd 2000; Davis and Robbins, Chapter 14, this volume) have examined core business strategies, finding that the social environment shapes ideas about efficiency just as it shapes ideas about equality.

Management fads often strike at the heart of corporate practices, and they often involve competing visions of how to best manage the firm. Fligstein (1990) has shown this with considerable subtlety in his study of the corporate revolution that put the conglomerate ideal of the firm into practice. For Fligstein (1990), diversification was promoted between the 1950s and the 1970s by managers with backgrounds in finance, as a replacement for the sales/marketing model of corporate strategy. Fligstein's argument was revolutionary, for it challenged the received wisdom of America's preeminent business historian, Alfred DuPont Chandler (1977), who had argued that conglomeration represented the functional evolution of American business, rather than the outcome of a power struggle between management cliques.

We build on the work of Fligstein and Markowitz (1993), Fligstein (2001), and Davis, Diekmann, and Tinsley (1994), who show that when finance managers faced a wave of hostile takeovers that disassembled undervalued conglomerates, they installed the 'core-competence' model of the firm. We show that both the top management team and the core business strategy were revolutionized. We underscore the role of extra-organizational groups in constructing and diffusing the new model of management. In the institutional tradition, we find that a new management ideal arises among a network of experts, who see an opening to push a strategy that serves their interests, but which they frame as in the interest of investors and managers. Yet we find that the key networks constructing and diffusing this new ideal were exogenous to the firm—they were major financial market networks (Zuckerman 1999, 2000).

Our core argument is that three key groups in financial markets retheorized their own interests, and the interests of investors at large, as synonymous. The successful promulgation of a new theory of interest turned out to be key to restructuring the firm. This is an important insight from institutional theory (Dobbin et al. 1993; Strang and Meyer 1994). Three groups that were newly powerful in financial markets theorized their own interests, and the interests of others. First, hostile takeover firms broke conglomerates up, demonstrating that the component parts could sometimes be sold for more than the previous market valuation—that the parts were greater than the sum of the whole. They argued forcefully that such break-ups were in the interest of investors, who reaped higher share prices, and ultimately benefited the economy as a whole. In the end, they convinced the world that what they did for a living, which was at first construed as illicit, was in fact efficient. Second, institutional investors, who controlled ever larger shares of corporate stock, had difficulty placing a value on the huge conglomerate and saw it as their job—not the job of the CEO—to diversify risk by building balanced portfolios. Thus they defined it as in their professional interest to invest in focused firms. By shunning conglomerates, they lowered their value. They defined focused firms as better serving the interests of investors, because focused firms now had higher share prices and because investors should, following financial economics, balance their portfolios themselves. Third, securities analysts typically specialized by industry, forcing diversified firms eager to attract analyst coverage to sell-off businesses unrelated to their core (Zuckerman 2000). Analysts preferred to evaluate single-industry firms, and they translated this preference into a theory that single-industry firms were superior and into an incentive for firms to focus their activities.

Management specialists and economists sketched new theories of the firm that would help to both explain and propel these changes. 'Core-competence theory' was given its name in 1990 by C.K. Pralahad and Gary Hamel in a *Harvard Business Review* article titled 'The Core Competencies of the Firm'. But General Electric's Jack Welch had argued since the early 1980s for hands-on management. 'Agency theory' in economics (Jensen and Meckling 1976) encouraged firms to tie executive compensation to stock performance, through stock options that paid executives to focus on increasing share price. The field of financial economists favored firms that were more focused, and favored allowing investors to diversify their portfolios on their own. The 'business process reengineering' (downsizing) movement (Hammer and Champy 1993) suggested that firms should eliminate unnecessary layers of management, including the conglomerate's extra layer of finance experts who handled acquisition strategy.

The new core-competence/shareholder-value ideal suggested that the firm's main job was to focus on the core business and to manage stock price. This carried implications for the structure of the top management team, and for acquisition strategy. Now the top manager—the CEO—was supposed to spend his time managing the core business. A COO signaled that the firm was still following the antiquated strategy of portfolio diversification. Managing stock price was now supposed to be the firm's primary task, and so the treasurer was promoted to the position of CFO, as part of the top management duo or troika. Because portfolio diversification was now defined as the job of investors, diversifying acquisitions gave way to horizontal and vertical acquisitions.

We chart changes over time in the importance of hostile takeover firms, institutional investors, and securities analysts. We also chart changes in the preferences in these groups—in their articulation of what the ideal firm should look like. We tie these changes to shifts in the top management team structures and acquisition strategies of 429 large American corporations, for the period 1963–2000.

The Rising Importance of Financial Market Players

Over the past quarter century, firms have paid more and more attention to financial markets. We find that important actors in financial markets changed in character over time, as individual investors gave way to large institutional investors, stock analysts grew in number and in importance, and the activities of takeover firms, particularly in the 1980s, heated up the market for corporate control. While each group of actors articulated its own reasons for wanting firms that were less diversified and that catered more to investors, executives became increasingly attentive to share price. We present data from a sample of large public American corporations to document these trends.

Constructing a Sample to Study What Changed

We collected data from a stratified random sample of 429 public corporations for the years 1963–2000. We stratified the sample by industry, collecting information on firms in twenty-two industry categories. We sampled from annual Fortune 500 lists and Fortune 100 lists, which cover the largest firms in each industry. To avoid survivorship bias, the sample was drawn from all Fortune lists published during the observation period rather than from a single Fortune list. Consequently, the sample includes firms founded later than 1963 and firms that cease to exist sometime before the year 2000.

We gathered information on management structure and business strategy from Standard and Poor's Register of Corporations, Directors and Executives, Thomson Financial's CDA Spectrum database, Institutional Brokers Estimate System (I/B/E/S), Thomson Financial's FirstCall database and SDC Platinum.

New Financial Market Players: Takeover Firms, Institutional Investors, and Analysts

Important actors in financial markets changed in character over time, as individual investors gave way to large institutional investors, stock analysts grew in number and in importance, and the hostile takeover firms grew in number and in activity.

Davis, Diekmann, and Tinsley (1994) have linked the demise of the conglomerate to takeover specialists who bought firms only to break them up and sell off the parts. Their data from a Fortune 500 sample show that about 30% of large corporations received takeover bids between 1980 and 1990. Our sample is comparable. To track the rising importance of takeover firms, we examine not all takeover bids, but unsolicited (hostile) takeover bids. Figure 13.1 shows that between 1980 and 1990, slightly more than 11% of the firms received hostile takeover bids. This suggests that about one-third of

FIGURE 13.1. Firms Receiving Hostile Takeover Bid (Three-year Centered Moving Average)

Source: SDC Platinum.

the takeover bids that Davis et al. document were hostile. Every large American firm recognized the growing threat of hostile takeover. The phenomenon declined significantly toward the 1990s, as firms took precautions ranging from the poison pill (Davis 1991) to doing the job of takeover firms themselves, spinning off unrelated businesses.

Institutional investors and securities analysts were growing in importance at this time. Driven by both the explosion of pension plans that allowed individuals to direct their own investments and the democratization of stock market investment through mutual funds, institutional investors grew from minor players to major players. We document this in Figure 13.2, which displays the average percentage of shares controlled by institutional investors for the firms in our sample. From slightly more than 20% in 1980, the proportion grew almost threefold in twenty years time. Among large firms, in other words, institutional investors came to control the lion's share of stock. Institutional investors began to try to influence the internal workings of firms. Because they lost money when they sold stock in companies that were performing poorly, they found the strategy of voicing concerns rather than seeking exit more and more feasible. By sponsoring shareholder resolutions, they lobbied for changes in corporate governance and firm strategy. Davis and Robbins (Chapter 14, this volume) show how scrutiny by institutional investors and shareholder activism have led to changes in the board composition of large US corporations. We demonstrate the rise of this strategy in Figure 13.3, which presents data from the Shareholder Proposal Database

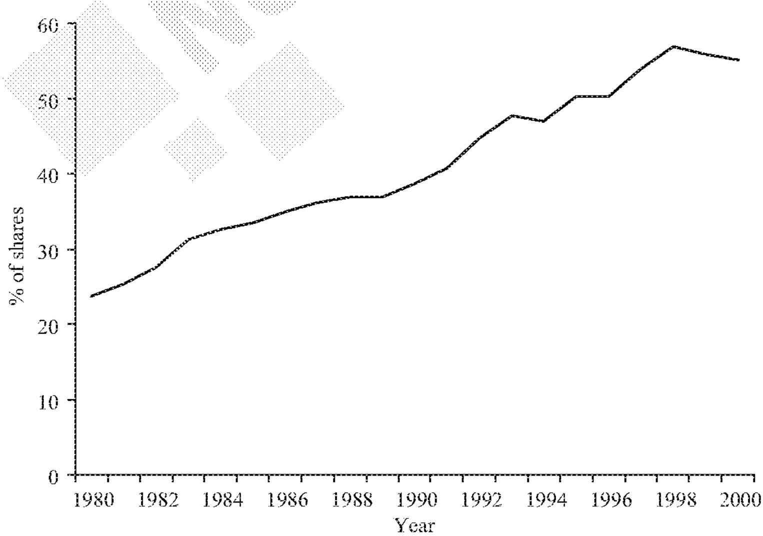

FIGURE 13.2. Shares Held by Institutional Investors

Source: CDA/Spectrum.

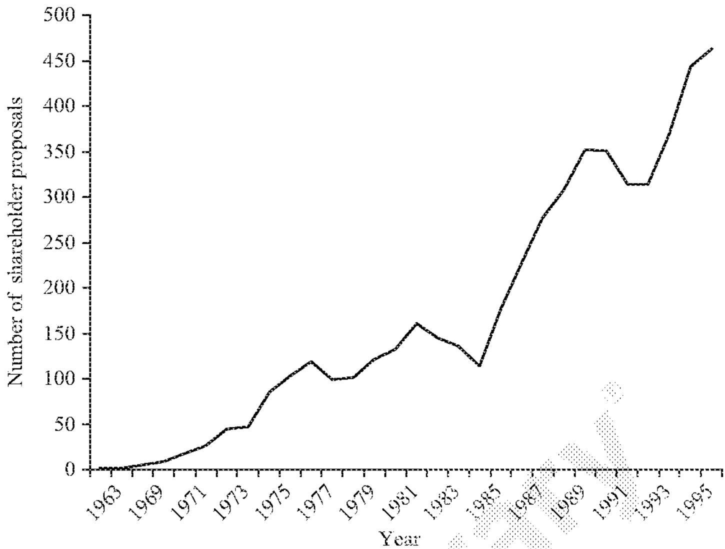

FIGURE 13.3. Number of Shareholder Proposals Sponsored by Institutional Investors (Three-Year Centered Moving Average)

Source: Shareholder Proposal Database (Proffitt 2001).

(Proffitt 2001) on institutionally sponsored proxy votes. Between the mid-1980s and the mid-1990s, the number of proposals supported by pension funds and other investment companies more than tripled.

The increasing role of stock analysts can be seen in Figure 13.4, which graphs the average number of stock analysts covering the firms in our sample over time. Between the late 1970s and the early 1990s, the average number of stock analysts following a firm rose from eight to eighteen. The importance of stock analysts to firms has been well documented in the studies of Ezra Zuckerman (1999, 2000). He shows that the conventional wisdom that firms were restructured in the 1980s as shareholders demanded the dismantling of diversified firms and their reconfiguration into more focused firms misses a key process. In the late 1980s and early 1990s, firms dediversified to please stock analysts, who had difficulty valuing diversified firms. He also shows that firms that were not covered by these industry specialists suffer, in terms of share price, relative to their peers. Their CEOs, now dependent on stock options for income, suffered as well.

The New Corporate Metric: Stock Price

These newly influential groups in financial markets began to define a new way to judge the firm. In the 1960s, investors believed that stock price would

FIGURE 13.4. Securities Analyst Coverage

Source: I/B/E/S.

reflect profitability and dividends, and so firms that paid attention to the bottom line would succeed on all fronts. Even before the bull market of the 1990s, however, profits began to look like a poor measure of a firm's value. As during the heady days of railway expansion in the nineteenth century, prospects for future profitability seemed more important than current accounts. This was particularly the case for high technology firms. Institutional investors and securities analysts turned their attention from current accounts to stock price, particularly in growth industries.

This change was fueled by accounting technologies that improved the quality of quarterly reports, and by rise of services that provided data on analysts' profit projections. Journalist Joseph Nocera (1998: 59–60) notes that at Fidelity, a major institutional investor, the focus shifted from actual performance to beating the consensus estimates among analysts:

> From time to time, young Fidelity hands would rush into Lynch's office to tell him some news about a company. They would say things like, 'Company X just reported a solid quarter-up 20%'. Eleven years later, as I review my old notes, I'm struck by the fact that no one said that Company X had 'exceeded expectations'. There was no mention of conference calls, pre-announcements or whisper numbers. Nor did I ever hear Lynch ask anyone—be it a company executive or a 'sell side' analyst on Wall Street—whether Company X was going to 'make the quarter'.

Whereas stock price used to rise and fall on the strength of the profits per se, now it rose and fell on the strength of profits vis-à-vis analysts' forecasts.

For many computer and Internet firms, after all, the bottom line was printed in red every quarter. Fortune magazine speculates that the emergence of firms making available consensus forecast data, based on the averages of these profit projections, has furthered managerial attention to analysts and to their forecasts:

> Executives of public companies have always strived to live up to investors' expectations, and keeping earnings rising smoothly and predictably has long been seen as the surest way to do that. But it's only in the past decade, with the rise to prominence of the consensus earnings estimates compiled first in the early 1970s by I/B/E/S (it stands for Institutional Brokers Estimate System) and now also by competitors Zacks, First Call, and Nelson's, that those expectations have become so explicit. Possibly as a result, companies are doing a better job of hitting their targets: For an unprecedented sixteen consecutive quarters, more S&P 500 companies have beat the consensus earnings estimates than missed them. (Fox 1997: 76)

It was not only that analysts and institutional investors developed preferences for corporate strategy, but also that executives paid more attention to their preferences. Firms were, by their own accounts, relatively insulated from investor preferences in the 1960s and 1970s. Individual investors rarely had time to scrutinize firms, but with the proliferation of institutional investors and stock analysts, large firms now had many scrupulous overseers (cf. Davis and Robbins, Chapter 14, this volume).

With this increase in attention came more volatility in stock price. Stock price began to move more frequently in tandem with quarterly earnings reports and with analysts' buy and sell recommendations. At the same time, executive compensation had become more closely tied to stock price. Meeting the profit targets of stock analysts thus became a preoccupation among corporate executives, for their capacity to benefit from stock option grants depended on their capacity to drive up stock price. As Justin Fox wrote in Fortune in 1997:

> This is what chief executives and chief financial officers dream of: quarter after quarter after blessed quarter of not disappointing Wall Street. Sure, they dream about other things too—megamergers, blockbuster new products, global domination. But the simplest, most visible, most merciless measure of corporate success in the 1990s has become this one: Did you make your earnings last quarter? (Fox 1997: 76)

Next, we turn to the implications the new corporate ideal carried for the structure and strategy of the large firm. We first explore the structure of the top management team and then take a look at acquisition strategy.

A New Sidekick: From COO to CFO

When the conglomerate ruled the world, managers from finance backgrounds were defined as the optimal CEOs, because a key job of the top management team was to manage the acquisition strategy of the firm. Training in finance, at the MBA level, meant training in diversification strategy and in strategies for funding acquisitions. After that approach to management had been well institutionalized, the idea of naming a COO to take over day-to-day operations and freeing the CEO to focus on acquisitions became popular. Thus the ideal conglomerate had a CEO focused on the big picture, and a COO handling the mundane business of making the widgets.

Institutional investors and securities analysts helped to frame a new, investor-oriented theory in which the firm should focus on lines of business where executives held expertise, leaving the job of diversification to investors. The COO now became a liability—a signal to markets that the firm had not let go of the old conglomerate model. Now that the CEO was supposed to oversee the making of widgets, he needed a sidekick to handle financial markets. The head finance person *c.*1950 had been an accountant. The head finance person *c.*1970 had the added tasks of planning financing for diversifying acquisitions. The new finance chief, the CFO, was to manage stock price and market expectations.

The Conglomerate Model and the Chief Operating Officer

When the conglomerate was king, the typical CEO was trained in finance and it mattered little whether he knew much about the main line of business (Fligstein 1987, 1990). For a sample of Fortune 500 firms in the early 1970s, Michel and Hambrick (1992) find that broad conglomerates are most likely to have top managers with finance backgrounds and without operational expertise in any of the business units. The early finance model of management suggested clear prescriptions for who should run the firm and for how it should be run. Beginning in the early 1970s, that prescription included a finance-trained CEO, to make long-term decisions about acquisitions, and a COO to manage daily operations. In the popular press, the COO was often described as the person who minds the store. Thus when David Rockefeller created the position at the Chase Manhattan Bank in 1975, *Business Week* (1975: 74) reported: 'a great deal more of the day-to-day job of checking the slide in Chase's return on assets, reducing its soaring loan losses, and fattening its capital base has fallen onto (the COOs) shoulders'. In a study of the rise of the COO (Dobbin, Dierkes, and Zorn 2003), we find that in the 1970s, firms that pursued conglomeration were most likely to install COOs. Profitable firms also created COO positions to allow their executives to focus on strategic decisions, evidently because they had the luxury of doing so. Hugh Hefner appointed a COO at Playboy Enterprises. From the end of the 1970s, however, COOs became associated with success because most high-growth firms had them. The single-industry firm now installed a COO as well, as an amulet to bring success.

The Shareholder Value Model and the Chief Financial Officer

From the early 1980s, the idea of having a COO became tarnished because it was associated with the broad conglomerate. The CEO–COO structure implied a top executive focused on diversification with a sidekick who was supposed to run the business. CEOs became more likely to name CFOs than to name COOs, for the CEO–CFO structure seemed to send the right signal to financial markets—that the CEO was minding the store.

Jack Welch at General Electric was among the first to eliminate the position of COO, in 1983, with the argument that he, as CEO, should be running the business. Welch went on to implement a new approach to managing the large conglomerate, by whittling down General Electric to a few broad domains. He spun off unrelated businesses and bought aggressively in the main lines of endeavor, pursuing both horizontal acquisitions of direct competitors and vertical acquisitions of suppliers. As General Electric's star rose, Welch became the poster boy for hands-on management.

We saw above that the number of securities analysts more than doubled in the first half of the 1980s, and that analysts successfully established their importance by making profit projections that investors took quite seriously. Firms paid closer attention to analysts and tried harder to meet their projections. To this end, firms implemented investor relations programs and promoted the corporate finance function to the level of chief. With the change in name came a profound change in the job of the top finance manager. For most of the twentieth century, the corporate finance function had been confined to bookkeeping, monitoring of debt and capital structures, and creating the budget—after strategic decisions had been made (Gerstner and Anderson 1976; Harlan 1986: xv–xvi; Whitley 1986: 181; Walther 1997: 3).

When the conglomerate came to prominence in the early 1960s, it paved the way for a more prominent role for financial tools that could relieve executives from the need for detailed operational knowledge in each of the firm's business segments. Now a small head office could monitor the financial performance of different units, and direct the flow of investment based on relative yields. Conglomerates were first to embrace the CFO title in the late 1960s. In 1970, Olin Corporation, with a product range that included books, chemicals, aluminum, and mobile homes, named James F. Towey vice president and CFO (*Wall Street Journal* 1970: 19). Sperry Rand Corporation, a large multiproduct firm, named Alfred J. Moccia CFO in September 1972 (Sperry Rand Corporation 1973), and Rockwell International Corp., a diversified aerospace and industrial manufacturer, recruited Robert M. Rice from CBS Inc. as its new CFO in 1974 (*Wall Street Journal* 1974: 19).

In those early firms, the CFO was to manage data flows for the top executives. But between 1980 and 1990, investor relations became a core function of the CFO (Useem 1993: 132). *The New York Times* reflected on the change in 2002:

Once upon a time, window-dressing was not in the job description. 'The CFO back 20, 30 years ago generally came out of the accounting profession', said Karl M. von der Heyden, former chief financial officer of both PepsiCo and RJR Nabisco. 'They were glorified controllers', he said, 'and strictly operated in the background'. Controllers generally report numbers and balance budgets, without arranging financing or offering strategic advice. Chief financial officers also served as treasurers, banking revenues, paying bills and investing reserves in new projects while ensuring that the company had enough cash to finance day-to-day operations. Yet in the 1980s, with the rise of junk bonds and more exotic ways to raise money cheaply, finance chiefs began to get involved in their companies' operations, deciding whether mergers were affordable and helping chief executives pick which parts of the business would deliver the best returns on investment. The role kept expanding in the next decade. 'In the 90's, the CFO more and more became the partner of the CEO in many good companies', Mr. von der Heyden said. 'At that point, the CFO became more visible in the public arena, because next to the CEO, he was the person that generally had the best grasp of the business as a whole'. As partners of chief executives, chief financial officers took on the task of growth, helping rapidly expanding companies capitalize on high stock prices with aggressive financing and by acquiring rivals. (Altman 2002: 10)

To track the effect of the corporate ideal on executive structures, we collect annual information on top management teams from Standard and Poor's Register of Corporations, Directors and Executives. Figure 13.5 shows the prevalence of each of the titles of CEO, COO, and CFO separately. Figure 13.6 shows changing combinations of these three titles. The rise and fall of the CEO–COO dyad and the steep rise of the CEO–CFO dyad are striking, while the CEO–COO–CFO triad is a model being phased out.

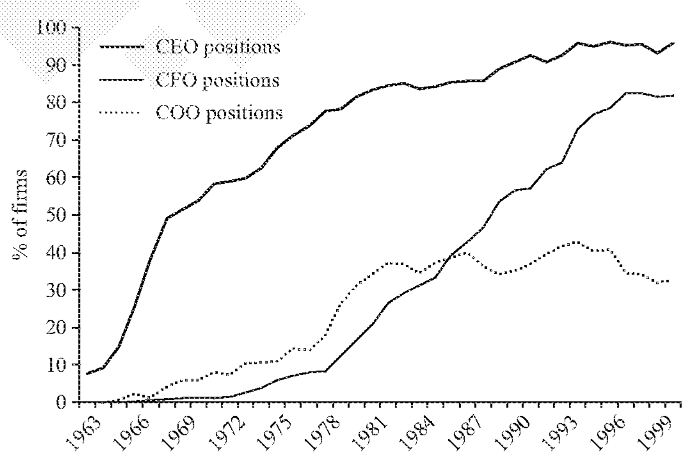

FIGURE 13.5. Firms with CEO, CFO, and COO Positions
Source: Standard and Poor's Register of Corporations, Directors and Executives.

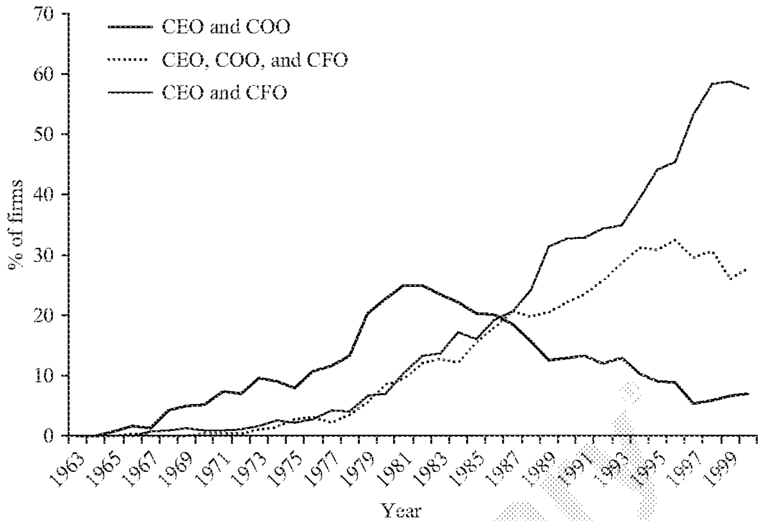

FIGURE 13.6. CEO, COO, CFO Combinations Over Time
Source: Standard and Poor's Register of Corporations, Directors and Executives.

Taken together, these two graphs show the rise of the COO toward the end of the conglomerate ideal of the firm, and then the stagnation of that position (in Figure 13.5) and its decline as one of the top two positions in the corporation (in Figure 13.6). Later in the period, few firms added new COOs, and firms were increasingly likely to eliminate the position when its incumbent moved on. We see clearly that the COO is no longer the preferred partner of the CEO. As we suggested, firms became reluctant to signal that the CEO was not minding the store. We also see that the CFO surpasses the COO quickly in prevalence (in Figure 13.5) and that the CEO–CFO duo becomes the dynamic duo of the 1990s.

The Shareholder Value Model and Stock Market Management

With increased scrutiny from institutional investors and securities analysts, firms began to try to manage and manipulate analysts' projections. CFOs held conference calls to update sales and cost information. They introduced 'earnings preannouncements', in the hope of bringing analysts' predictions into line with their own projections. These changes can be seen in Figure 13.7, which charts the practice of earnings preannouncements in our sample. The first firms issued preannouncements in the early 1990s, and by 2000 some 50% of firms were doing so. Figure 13.7 also shows that firms became increasingly successful at meeting analysts' forecasts. The share of firms that meet expectations rose from about half in the 1980s to nearly two-thirds by the late 1990s.

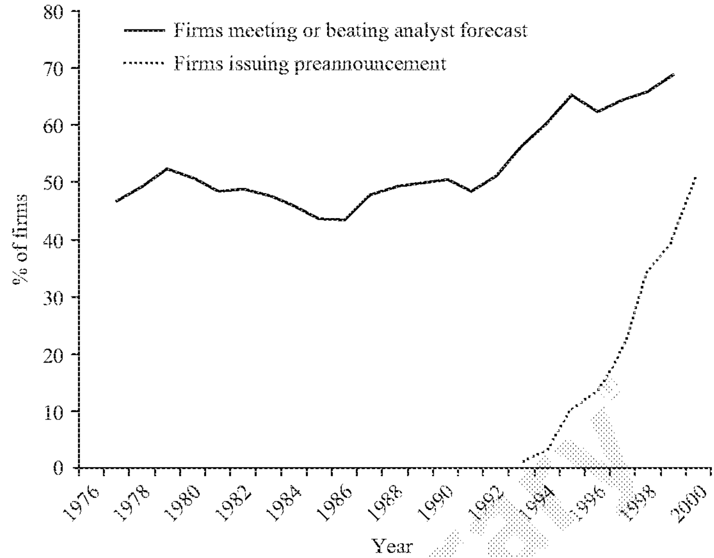

FIGURE 13.7. Firms Meeting or Beating Analysts' Consensus Forecast and Issuing Earnings Preannouncements

Source: I/B/E/S and FirstCall.

This change was the result of two processes, for CFOs both learned to manage analysts' projections and to manipulate earnings statements through accounting sleight-of-hand. The accounting specialist gave way to the spin doctor. As Daniel Altman wrote in the *New York Times* in April of 2002:

In the 1990's, men like Mr. Fastow (CFO at Enron) and Mr. Swartz (CFO at Tyco) were paragons of corporate ingenuity for meeting and beating ever-higher revenue forecasts, but those values have backfired. That model made it hard for investors to figure out how much companies are really worth. Now, even many scrupulous companies see earnings statements parsed for accounting gimmicks. In the last decade, as Wall Street demanded more frequent reports of results and more guidance about companies' prospects, chief financial officers became spokesmen and even salesmen, conducting conference calls with analysts and often delegating to others the mundane task of watching the numbers. Companies began recruiting lawyers, investment bankers, and consultants as chief financial officers, more for their deal-making talents than for technical expertise or fiduciary integrity. (Altman 2002: 10)

The New Acquisition Strategy

By 1980, the conglomerate had come to dominate the Fortune 500. By one common definition, the two-digit Standard Industrial Classification code, only 25% operated in a single industry. Half operated in three or more industries (Davis, Diekmann, and Tinsley 1994: 553). The level of diversification had increased dramatically since the Second World War, spurred in part by the Celler–Kefauver Act of 1950 which made vertical integration suspect under antitrust law and which thereby popularized diversifying acquisitions as an alternative growth strategy (Fligstein 1990).

Portfolio theory in economics reinforced the idea that the modern firm should be run as an internal capital market, investing in promising sectors and spreading risk across different sorts of industries. Oliver Williamson (1975) also reinforced this idea, arguing that conglomerates could acquire poorly performing firms and improve their profitability by managing them under financial accounting methods. Meanwhile, the major consulting firms—McKinsey, Arthur D. Little, The Boston Consulting Group—had developed technologies that simplified the management of diversified conglomerates. By the end of the 1970s, 45% of the Fortune 500 had adopted these portfolio planning techniques (Davis, Diekmann, and Tinsley 1994: 554).

This business model came crashing down in just a decade. It never made sense to financial and organizational economists, because it turned the firm into a diversified stockholder that could not easily sell off stocks that had turned into bad bets. Managers would have to turn around poorly performing units, which were often in industries they knew nothing about. Moreover, the Reagan administration helped to make a new model of the large firm possible. Reagan's antitrust officials relaxed restrictions against mergers among competitors and the courts relaxed controls of hostile takeovers, in the first place permitting firms to expand by moving toward monopoly and in the second allowing groups to acquire and break up conglomerates (Davis, Diekmann, and Tinsley 1994: 554).

As we saw in Figure 13.1, the hostile takeover became a popular solution to a new management problem, the relative undervaluation of conglomerates. Diversified conglomerates sometimes served the interest of their CEOs, who wanted to run huge firms, better than the interests of their investors, in whose interest stock price was paramount. Agency theorists cited this mismatch of interests as the reason for tying executive compensation to stock performance. The firm of Kohlberg, Kravis, and Roberts (KKR) showed how successful the strategy of buying up large conglomerates and selling off tangential businesses to raise the stock price could be. Beginning in 1976, they bought up over forty companies and restructured them, including such behemoths as Beatrice Companies and RJR Nabisco. They often played 'white knight', helping executives to fend off external suitors by taking firms private themselves, but the results were much the same: the diversified conglomerate was broken up and a streamlined firm emerged (Baker and Smith 1998).

The new theory of how the large firm should be managed was reinforced by four different theories of the firm, from different camps. The 'core-competence' movement among management consultants built on the classical theory of managerialism, which suggested that managers should stick to what they know best. Financial economics had long favored allowing investors to diversify their portfolios. 'Business process reengineering', a.k.a. downsizing, suggested that firms should eliminate the need that conglomerates produced for extra management layers. 'Shareholder value' theory defined the firm's first goal as pleasing shareholders by driving up stock price. 'Agency theory' in economics encouraged firms to tie executive compensation to stock price.

The Changing Pattern of Acquisitions

Davis, Diekmann, and Tinsley (1994) show two effects of the decline of the conglomerate ideal. First, in the 1980s, firms that were diversified were significantly more likely to be acquired (and presumably broken up) than firms that were not diversified but were otherwise similar. Second, the lion's share of the acquisitions in the late 1980s were horizontal and vertical acquisitions. We look at two related indicators. We examine acquisitions over a long period of time, to show the decline of diversifying acquisitions and the rise of horizontal and vertical acquisitions. We use the mergers and acquisition database (provided by SDC Platinum) to retrieve information on domestic acquisitions patterns among firms in our sample. We follow extant research in the field of mergers and acquisitions and distinguish between horizontal, vertical, and deals that are unrelated to a focal firm's major business lines (e.g. Blair, Lane, and Schary 1991; Haunschild 1993). To assign a particular acquisition or divestiture to any of these three groups, we follow Davis, Diekmann, and Tinsley (1994: 560).

Figure 13.8 charts the change in acquisition pattern from 1983 to 1998 among 328 of the 429 large firms in our sample. This figure shows the relative numbers of unrelated (diversifying) acquisitions, horizontal acquisitions (those in an industry the firm currently operates in), and vertical acquisitions (those in an industry that supplies, or buys from, an industry the firm currently operates in) over time. The number of diversifying acquisitions rises until the mid-1980s, but then it declines and remains low. Meanwhile, the number of horizontal acquisitions—acquisitions of firms that are in one of the businesses that the corporation already covers—rises sixfold, and the number of vertical acquisitions—typically of supplier firms—rises fourfold. The investor-centered finance model is clearly reflected in these changes, for firms become less likely to try to diversify and more likely to buy other firms that are in the existing areas of strength.

Figure 13.9 represents changes in the level of diversification in a different way. Here we show the level of diversification in over time, plotting the number of four-digit industries firms operate by quartiles from 1963 to 2000. The firm at the seventy-fifth percentile rises in the number of four-digit industries it covers from five to nine, and then decreases to six over the period.

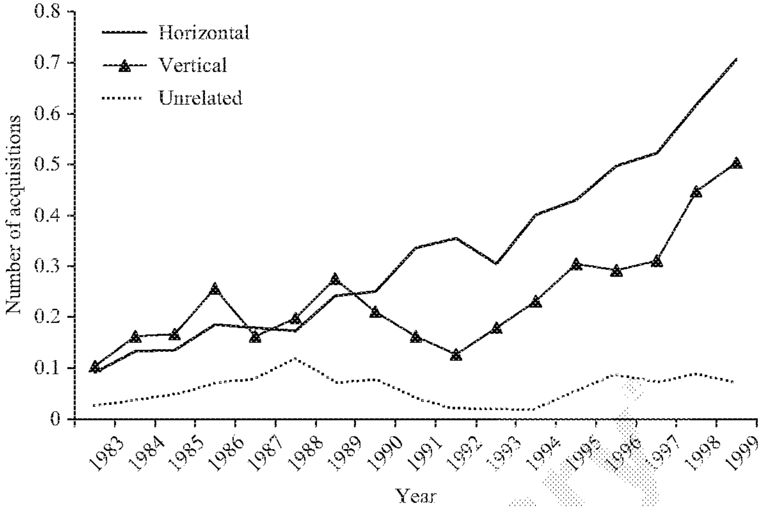

FIGURE 13.8. Horizontal, Vertical, and Unrelated Acquisitions
Source: SDC Platinum and Compustat.

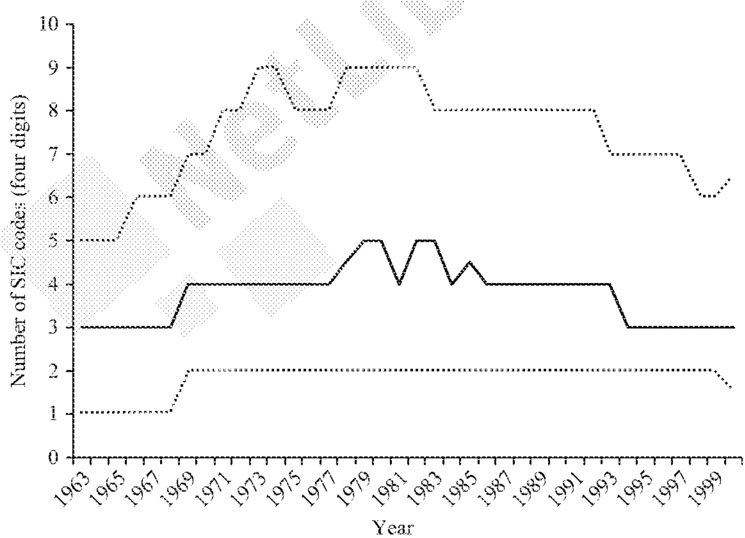

FIGURE 13.9. Distribution of Firm Diversification Levels (Twenty-Fifth, Median, and Seventy-Fifth, Percentile)

Diversification in the median firm rises from three to five and then declines to three. Diversification in the firm at the twenty-fifth percentile rises from one to two, and declines to one. The overall pattern suggests that the average firm in 2000 is no more diversified than the average firm was in 1963—despite the fact that the average firm is much larger in terms of sales and workforce. The conglomerate model is clearly on the wane. The data on diversification, then, show a pattern consistent with that found by Davis et al. The rise of the new corporate ideals of shareholder value and core competence, as promoted by institutional investors, securities analysts, and takeover firms, led to changes in core corporate strategy. These huge corporations shed unrelated industries, and when they went shopping, they bought competitors and suppliers rather than branching out.

Conclusion

In the last quarter of the twentieth century, key groups in financial markets came to play increasingly important roles in shaping structure and strategy among America's largest corporations. As investors evaluated firms in terms of how financial markets would value them in the future, firms became acutely aware of the norms for corporate governance that key players in financial markets were developing.

The diffusion of new models of how to manage the firm is anticipated by institutional theory in organizational sociology, but the mechanisms of diffusion we identified are not entirely anticipated. Institutionalists argue that new business models are developed and promoted in organizational fields, consisting of industry members and of people in important related industries. For the most part, the community of investors was exogenous in these models. The initial formulation, by Meyer and Rowan (1977), suggested that government agencies might promote new models of management, or that organizations and consultants might develop new models among themselves. In DiMaggio and Powell's (1983) version, executives could copy peer organizations, states could coerce firms to adopt new management techniques, or professional groups that spanned organizational boundaries could promote new management techniques. Many of the empirical studies (Edelman 1990; Dobbin and Sutton 1998) showed how these last two factors worked together—how professional groups actively interpreted public policy edicts and constructed compliance mechanisms that diffused among organizations.

The story of the rise of the shareholder value ideal of the firm does not quite conform to this theoretical model. Here the preferences of exogenous groups—emergent networks of hostile takeover firms, analysts, and institutional investors—became increasingly important to corporate executives. These groups expressed a new ideal of corporate structure and strategy, voting for this new ideal with their market power. They lowered the price of firms that did not abide by this new ideal (in the case of institutional investors), recommending against buying stock in them (in the case of stock analysts), or took them over and did the restructuring themselves (in the case of hostile takeover/white knight firms).

The result of these events was, to be sure, a new myth of the efficient firm. The myth of the ideal modern firm as an internal capital market, based in portfolio theory, gave way to the myth of the ideal firm as a focused single-industry oligopolist. Institutional theory describes the rise of successive myths of rationality in the modern firm, and to that extent we have provided evidence for the theory. But the agents of change in most institutional models are managers, not outsiders. And the mechanisms they use to change organizations are largely rhetorical. Our findings suggest that the agents of change can be professional groups in financial markets who have relatively little direct contact with the corporation, but who express their preferences for firm structure and strategy through their roles in markets. And the mechanism of change can be market power, which became salient to executives largely through agency theory's effect on compensation—from size-related-salaries to stock options. Our findings suggest that institutionalists should pay greater attention to the role of outside forces in constructing corporate strategies, and to the role of power in promoting new strategies.

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