

Comment



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I am delighted to have the opportunity to comment on this interesting article. Keane's paper attempts seriously to give an answer to an apparent fundamental contradiction in finance theory. The primary target for managers should be the share price maximization criteria. But if the rational expectations equilibria in efficient financial markets applies, this is a nonsensical objective. To solve this apparent paradox, Keane posits a *new financial objective* of corporate enterprise which is free of the above problem. The new criteria is the maximization of the long-term value of the firm subject to maximizing the share price. He argues that this is a more appropriate criteria both under perfect and imperfect product markets.

There are also other interesting ideas, relating *the importance of zero-NPV investments*, the role of *initial market valuation* as a reward to the founder shareholders and finally the relevance of *executive incentive schemes*.

I shall comment on the work from the perspective of what it has to say about the degree of informational efficiency of the financial markets and to what extent its results are sustainable. I find the paper stimulating, but I do not agree with all of his interpretations of the results of his model nor with the conclusions about the relevant financial objectives.

This *new financial objective* is the proposed maximization criteria as stated in section 2. The criteria is: $\text{Max } V_t P_t$, where V_t is the long term value of the firm and P_t is the share price. This is, under Keane's assumptions, basically a size criteria, i.e. the bigger the better, subject to nondecreasing prices.

This criteria is in contrast with the 'classical corporate finance' manager's goal, which can be summarized as follows. If capital markets are efficient, then the market value of the firm reflects the present value of the firm's expected future net cash flows, including expected cash flows from future investment opportunities. Therefore there is no ambiguity about the firm's objective function, that should be as follows: managers must maximize the current market value of the firm. For securityholders to prefer value maximization also requires that their consumption opportunities are altered by the firm's investment and financing decisions only through wealth changes. Thus, one important implication for corporate finance of the efficient market hypothesis is that security returns are meaningful measures of firm performance.

In his paper, Keane maintains that security returns are basically random numbers (under rational initial valuation) and then are useless. My main criticism on the paper starts here, because the essential point in his exposition is (Section 3) that either the market does an (instantaneous) unbiased valuation

of the firm's price or the market's temporary informational deficiency (if present) should disappear soon in order to guarantee an unbiased estimation of the firm's price. My view is that this information deficiency could last a long time if information is costly. The work by Grossman and Stiglitz (1980) suggests that with costly information, either markets will never be informationally efficient or markets are likely to be thin. It can be shown that when the efficient markets hypothesis is true and information is costly, competitive markets break down. Therefore, the initial unbiased estimation, essential for Keane's subsequent conclusions, may be a flawed starting point.

The *importance of zero-NPV investments* is based on one classical microeconomics idea. In the long-run (rational expectations) competitive equilibrium, all assets are expected to earn their opportunity cost of capital. Thus, economic rents are nonexistent and the NPV of any investment is zero. In this framework it is easy to understand Keane's comment (section 1) 'a zero-NPV project consists of the primary wealth creation process (...) a key assumption in the paper is that "wealth creation" (...) may in practice be the principal activity of many seasoned companies in mature industries'. But again, one may argue, the only reason to engage in this kind of investment is size increase (with no effect in prices). If we are considering quasi-equilibrium situations (seasoned companies in mature industries), this target (size) is as good as any other and I find it difficult to find any theoretical reasons that may give support to Keane's suggestions.

One interesting point related to the *initial market valuation* as defined by Keane, interpreting it as 'the reward to the founder shareholders for their entrepreneurship' is if we can identify that with the well-known mispricing observed in the Initial Public Offerings (IPO's) and with their information content as suggested by Gale and Stiglitz (1989). One may argue how could this be compatible with the market's initial unbiased estimation of the firm's value that Keane posits.

Keane's idea of relating *executive incentive schemes* to 'corporate size and growth subject to the market criterion' seems to me an attractive one. It would be interesting to know if this approach could solve in a better way the problems associated with asymmetric information in contracting (see Ricart (1989)) than the usual executive stock options plans as reviewed by Baker *et al.* (1988).

In summary, Keane is to be congratulated for an article that deals with potentially valuable ideas for treating the inconsistency between the traditional firm's maximization criteria and the rational expectations financial market equilibria in a relatively simple, intuitively appealing fashion. Unfortunately, he stops short of embracing the theoretical problems of informational efficiency of the financial markets fully, and more refined theory and empirical evidence is needed to understand the relevance of Keane's new financial objective.

References

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