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Modern Financial Theory, Corporate Strategy, and Public Policy: Another Perspective

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Modern financial theory (MFT) is not widely recognized beyond the confines of a relatively small segment of academia. An examination of the theory's main assertions reveals that MFT may be more compatible with corporate strategy and public policy than is commonly recognized. Disciplinary interaction is encouraged.

In a thought-provoking, interdisciplinary work on modern financial theory (MFT) and its implications to corporate strategy and public policy, Richard Bettis (1983) expresses concern about the reluctance of financial theorists to extend their research across disciplinary boundaries. All too frequently financial theorists have neglected to reply to such external challenges, claiming MFT to be a "pure science" that is capable of standing on its own merits. However, the possibility of any legitimate science being able to thrive in a vacuum is remote; accordingly, as a matter of sheer survival, financial theorists must eventually respond in a meaningful way to the call for interfield research and discussion. Such interdisciplinary activity in the long run can only serve to strengthen the understanding and application of MFT.

In a sense it is regretful that the quest for a universal application of a viable financial theory has to originate outside the financial community. In fact, the practice of research isolationism by some financial theorists has hampered the evolution of MFT for two primary reasons. First, the acceptability of MFT generally has not spread beyond the boundaries of a relatively small segment of academia. As a result, MFT remains a "foreign" science to many who otherwise might find it useful. The ability to increase the understanding of the theory should enhance acceptability. Second, sometimes MFT is maligned as being too theoretical, possessing little, if any, practical applicability. Although MFT still has some practical problems that must be resolved, it nonetheless extends a robust challenge to the active corporate manager—a challenge that cannot be dismissed lightly. It seems that in many instances the outside attack

is not aimed at the theory itself, but is directed toward one or more of the theory's underlying assumptions. If that is the case, then the theory may be more meritorious and thus more compatible with other disciplines than is commonly recognized.

Greater cooperation by financial theorists could, of course, mitigate these problems and thus facilitate the expansion of MFT beyond current confines. The author strongly endorses Bettis's conclusion:

Relevant results from modern financial theory should be incorporated into the strategic management literature, and conversely. There also is a need for strategic management researchers to establish closer working relationships with researchers in finance. Such cross-fertilization could help... foster a more parsimonious view of the general problem of strategic management (1983, p. 414).

Bettis raises three conundrums concerning MFT in an effort to stimulate disciplinary interaction. The purpose of this paper is to respond to the first two conundrums and in so doing demonstrate that MFT is more congruous with corporate strategy and public policy than is commonly believed.

Unsystematic Risk Management

In his first conundrum Bettis maintains:

Modern financial theory suggests that the equity markets will not reward unsystematic (i.e., firm specific) risk management, but unsystematic risk management lies at the heart of strategic management (1983, p. 406).

The essence of this conundrum is that MFT implies that the corporate manager should *not* manage firm specific risks. An example of unsystematic risk is drawn from a popular finance text by Van Horne (1980) to illustrate this problem: that of a competitor

who begins to produce a similar product. Bettis points out that to manage this risk would necessitate devising a strategy for deterring a new entrant, but he then posits that according to MFT “managers should not concern themselves with the management of entry barriers.” Obviously such managerial negligence would be contrary to the very foundation of corporate strategy. Is there really a void that substantial between corporate strategy and MFT? To respond to this query, one first must examine the main assertion of MFT concerning the treatment of unsystematic risks.

An individual stock is exposed to dual risk: systematic (market) and unsystematic (unique). Thus, either a market fluctuation or the occurrence of a firm-specific event can alter a given stock’s price. On the other hand, a properly diversified stock portfolio is susceptible only to market risk—unique risk is diversified away. (One should note that proper diversification depends far less on the number of stocks in the portfolio than on the selection of stocks whose risks are related to different business, financial, economic, and social factors.) The diversification concept may be portrayed by observance of the indexing technique. An investor who acquires a portfolio that exactly replicates a selected market indicator (the *Standard & Poor’s 500*, for example) obviously has pegged or “indexed” his portfolio’s performance to that of the market. Because the indexed portfolio *is* the market, unsystematic risk is non-existent.

MFT contends that a rational investor, desiring to achieve a given expected return level, should construct the unique portfolio that possesses the lowest degree of risk for that particular return objective. This unique portfolio is known as an “efficient” portfolio because no other combination of stocks can be devised that produces the desired expected return level for as small a degree of risk. The only way to create an efficient portfolio is via proper diversification so that unnecessary unsystematic risk is eliminated.

Thus, the main assertion of MFT is that an investor should diversify away all unsystematic risk to attain an efficient portfolio. But Bettis takes MFT a step farther by stating:

This leads naturally to the conclusion that managers should *not* manage unsystematic risks . . . because such behavior will not be rewarded by the stock market (1983, p. 408).

Yet MFT only holds that unsystematic risk should be eliminated through diversification; it does *not* claim that unsystematic risk should go unmanaged. Maybe the difference between “managing” and “diversifying” risks seems trivial; however, the distinction between these two actions is vital to the full comprehension of MFT.

An investor must observe two crucial elements of a stock, expected return and risk, in order to determine that stock’s suitability (unsuitability) as a component of an efficient portfolio. The stock’s expected return is dependent on the underlying company’s future cash flows; whereas the stock’s risk in a portfolio context is measured by beta. Mathematically, beta is expressed as follows:

$$\beta_i = cov_{im} / \sigma_m^2$$

where

β_i = beta coefficient for stock *i*,

cov_{im} = covariance of returns for stock *i* with those of the market (*m*), and

σ_m^2 = variance of the market’s returns.

Furthermore, the equation may be simplified by observing that the covariance term is calculated in the following way:

$$cov_{im} = \sigma_i \cdot \sigma_m \cdot \rho_{im}$$

where

σ_i = standard deviation of the returns of stock,

σ_m = standard deviation of the returns of the market, and

ρ_{im} = correlation coefficient between the stock’s and the market’s returns.

It is a well-known fact that beta measures *only* systematic risk; however, the calculation of an individual stock’s beta is dependent, among other things, on the standard deviation of that stock’s returns. But a stock’s standard deviation quantifies *total* risk (i.e., the sum of systematic and unsystematic risks). Thus, one can observe the emergence of a perplexing paradox. In a diversified portfolio context beta is the only relevant risk measure because it gauges only the nondiversifiable systematic risk. However, an individual stock’s beta is affected by the total risk of the stock’s return. For example, several researchers have determined that beta is affected by the fundamental business and financial features of the company (Beaver, 1972; Beaver, Kettler, & Scholes, 1970; Bowman, 1970;

Hamada, 1969; Haugen, 1979). Therefore, to an extent, nonsystematic risk affects beta.

Hence MFT does *not* submit that managers should neglect to manage unsystematic risks. Such extreme negligence ultimately would place the firm at a severe disadvantage to its actively managed competitors, causing investors to view the firm less favorably (more risky). This risk magnification eventually would lead to a corresponding hike in the stock's beta estimate. A large amount of research has been conducted about the problem of nonstationary betas (Blume, 1975; Sunder, 1980; Valentine, 1975).

The effect of an increased beta can be most devastating to a stock's price. Because the stock has proportionately higher risk (beta) without a greater expected return, it no longer will be as attractive to investors. In fact, many investors may conclude that the stock's new risk/return combination is undesirable for an efficient portfolio. Those investors already owning the stock in their portfolios most likely will elect to sell, creating an oversupply on the market, and thus drawing the stock's price downward—an action that any wealth-maximizing manager would strive to avert. And the way to avoid such an action is active management of individual corporate projects to prevent the increase in risk that inevitably will accompany inactive corporate management.

As for the example of the competitor attempting to market a similar product, financial theorists do *not* advocate that managers should ignore that specific risk. These theorists actually would suggest that managers attempt to thwart the competitor's entry—a suggestion compatible with the advice of corporate strategies. What financial theorists really contend is that such a risk be diversified. In the long run an investor possessing a properly diversified portfolio would observe that unique losses such as one caused by the unexpected successful entry of a competitor into the market would be offset by favorable happenings to other stocks (maybe, for example, another firm whose stock is in the portfolio succeeds in introducing a highly profitable new product). Such random unique occurrences should cancel out, signifying that unsystematic risk is eliminated—thus leaving the portfolio vulnerable only to market risk.

Fortunately, MFT and strategic management appear to be more harmonious in their attitudes toward unsystematic risk management than Bettis maintains. Although considerable interactive research is needed, this author believes that the current thoughts of the

two disciplines can coexist. Accordingly, Bettis's following conclusion seems to be overstated:

Either the conclusion of MFT about unsystematic risk management or the focus of much strategic planning and strategy research is misplaced (1983, p. 409).

Information Disclosure and Efficient Markets

Conundrum 2 focuses on the controversial efficient market hypothesis (EMH), one of MFT's main corollaries, and states the following:

Modern financial theory suggests that disclosing additional information about a project or strategy can positively affect the value of the firm, but strategic management has stressed only the value of such information to a firm's competitors (1983, p. 406).

The EMH maintains that all publicly available information that affects stock prices is known to and continuously analyzed by large numbers of investment professionals and that all incoming information is evaluated almost instantly. Thus, at any given moment, a stock is "efficiently" priced, which means that its price reflects all of the available facts, opinions, and expectations that have a bearing on its value. The EMH contends that there are no undiscovered values, simply because securities analysts strive so hard to discover them. And because stock prices at all times reflect what is knowable about values, no one can consistently outperform the market.

Most empirical studies by financial theorists deduce that the market is not so incredibly efficient that it exposes nonpublic information (Davies & Canes, 1978; Finnerty, 1976; Ken & Jen, 1979). These findings reinforce the notion that the market reacts only to information that is publicly disclosed. Indeed, a tremendous volume of research supports the contention that the market readily "possesses" all publicly-disclosed information (Fama, 1970).

A firm is required by legal mandates and accounting conventions to disclose some minimum amount of information. But a large body of additional information may exist that does not have to be revealed. Here management may have considerable discretion. If this information is withheld from the public, the company's stock price will not reflect the value of that data. However, if management elects to release all or part of this salient information, then the stock price will react immediately.

Bettis correctly contends that the release of nonobligatory information will fuel investors with a more comprehensive data set, thus enabling them to

forecast future cash flows with greater precision.

The more information that is available the better investors are able to forecast. Because investors are risk averse, they will pay a premium for the uncertainty reduction that increased information brings (1983, p. 410).

Any financial theorist would concur with the statement that greater cash flow predictability would reduce uncertainty and correspondingly lower the discount rate applied to projected future cash flows. Therefore, if expected cash flows remain the same, the lower discount rate will translate into a higher market value of the firm.

Focusing on MFT's purported claim of a higher potential market value as a result of more predictable future cash flows, Bettis raises a managerial dilemma.

Much of the information that would make cash flows more forecastable is the same information that is competitively valuable. . . . Therefore, the information that investors need to forecast cash flows with less uncertainty, and hence increase the value of the firm, is the same information that a competitor may be able to use to thwart the realization of those cash flows (1983, p. 410).

On the surface, it would appear to be highly counterproductive for management to disclose information that could impair the firm's competitive position. Can MFT be guilty of encouraging such disclosures merely for the sake of better cash flow forecastability? At this point the concepts of MFT diverge from those implied in the Bettis paper.

The EMH makes only one primary assertion: a stock's price reacts almost immediately to the release of pertinent information and, therefore, at any given time the stock's price fully reflects all publicly available information. In this instance, however, the EMH is criticized for recommending that management should reveal confidential information in order to enhance cash flow predictability and thus increase the firm's stock price. But this is *not* an accurate expression of the EMH. Only the release of information that enhances cash flow forecastability proportionately more than it reduces expected cash flows will cause a firm's stock price to appreciate. Indeed, the EMH recognizes that the release of essential corporate information may cause the firm's stock price to plummet because of investors' realization that such information in competitors' hands would reduce the firm's competitive position and thus pare future cash flows. The expectation of significantly lower cash flows, even if predictability is improved, would exert a strong downward pressure on the firm's stock price.

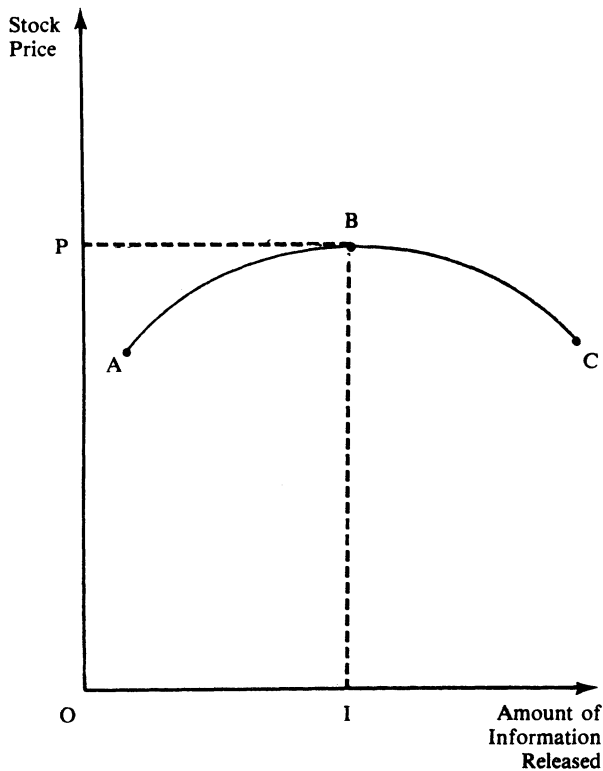
It appears to this author that strategic management and financial theory are gradually advancing toward the same conclusion: that the wealth-maximizing corporation should attempt to protect and conceal information that, if released, would damage its future cash flow streams, but should not be so protective as to retain information that could improve cash flow predictability (without damaging future cash flows) and thus contribute to a higher stock price.

Therefore, the real dilemma becomes the following: Does strategic management currently recommend the retention of too much information while MFT encourages the release of too much valuable data? The dichotomy is illustrated in Figure 1. The maximum stock price may be expressed as a function of the proportion of relevant information released. Points A and C are the extreme values, representing, respectively, the minimum amount of information that can be disclosed and the amount of information that would emerge if all corporate data were divulged. One can observe that in either instance the firm's stock price is low. As the firm releases information beyond the minimum requirement, the stock price responds positively because cash flow predictability is improved. This favorable stock reaction continues until point B is attained. Beyond that point the improvement in cash flow forecastability is more than offset by the decline in expected cash flows caused by the relinquishing of crucial competitive information. As more valuable information is revealed, the stock price will deteriorate further.

The goal of every corporate manager should be to achieve that unique level of information disclosure (denoted as I in Figure 1) that yields the maximum stock price (P). It is this author's viewpoint that strategic management theorists urge the importance of protecting the corporate competitive position (possibly resulting in too little information release, i.e., to the left of I in Figure 1), and financial theorists push for the dissemination of too much information under the guise of improving cash flow predictability (i.e., to the right of I).

But it also appears that each discipline recognizes the other's merits. Certainly MFT does not recommend the public release of all corporate information, nor does strategic management advocate the retention of all meaningful data. No doubt the two theories to a large extent are compatible and, as a matter of practicality, seem independently to be converging toward a common objective: to make available the optimum amount of information to contri-

Figure 1
Stock Price Response to
Information Released



bute to maximizing the stockholder's wealth.

Conclusion

The development of modern financial theory poses a real challenge to the active corporate manager. But financial theorists often have been criticized for being too theoretical and narrow-minded. Indeed, many of these theorists are reluctant to blend their research with that of other areas. Because of this kind of research isolationism, MFT has not contributed in a meaningful way to the resolution of strategic management problems.

Richard Bettis (1983) maintains that MFT poses some real threats to the current teachings of corporate strategy and public policy. He raises three conundrums or puzzles that he believes have emerged from the development of MFT. It is this author's viewpoint, however, that Bettis overstates the initial two conundrums. In particular, it seems that financial theorists and corporate strategists share more harmonious ideas about unsystematic risk management and information disclosure than Bettis implies. Nevertheless, there still remains a gap between the two schools of thought. Consequently, Bettis's overriding desire to establish a closer working relationship between strategic management and financial researchers is strongly endorsed by this author. Improved interaction is necessary to reap fully the benefits of the stream of research flowing from each area.

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