

Tracking Stocks Are Likely to Derail

General Motors announced earlier this month that it plans to restructure its economic interest in its Hughes Electronics "tracking stock," focusing renewed attention on the exploding use of trackers over the past few years.

A tracking stock is a class of common stock whose value is tied to the performance of a particular segment of the company's business. It is designed to give investors a "pure play" on an especially at-

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tractive part of a company's business. The first tracker, also from GM, was issued the mid-1980s when GM acquired Ross Perot's Electronic Data Systems, and Mr. Perot insisted on receiving consideration in shares of a stock that would track the success of his former business rather than tying his fortunes to the sale of Chevys. GM has since spun EDS off as a wholly independent company.

Supporters of trackers argue that the technique allows a company's management to retain control over all of its businesses while creating new, more efficient ways to enhance and reward employee performance through options on the unit being tracked. If tracking stock maintains its premium, it is a more valuable currency to use in acquiring other companies. Most importantly, trackers are designed to "unlock," in a tax-efficient manner, the "hidden value" of a separate business to whose earnings the stock market assigns higher multiples than the parent.

Bumper Crop

The day after the GM announcement, AT&T filed with the Securities and Exchange Commission to raise as much as \$10 billion in an initial public offering for a tracking stock to represent its thriving wireless business. Last week MCI WorldCom said it may issue a tracking stock for its data and Internet businesses. Sprint already has a wireless tracker, Sprint PCS, which more than quadrupled in one year of trading. We can expect to see a bumper crop of trackers come to market later this year.

But do tracking stocks make sense? For an economist—particularly one who believes that markets are usually quite efficient—trackers present a conundrum. We know a pie does not grow through its slicing. Why should trackers, or, for that matter, actual spinoffs, increase shareholder value? Does the performance of the separate units change dramatically? Or is corporate finance a kind of con game in which investors are misled into thinking that the parts are worth a good deal more than the whole?

Some financial history is illuminating. In the mid-1960s Wall Street engineered a wave of conglomerate mergers with the hope that they would produce important synergies. The mergers, investors believed, would allow the conglomerate to achieve greater financial strength and thus greater borrowing capabilities at

lower rates, enhance market capabilities through the distribution of complementary product lines, give greater scope to superior managerial talents, and produce savings by consolidating operating services such as human resources and accounting. Thus it was plausible to suggest that two separate companies with earning power of \$2 million apiece might produce combined earnings of \$5 million if consolidated.

The major impetus for the conglomerate wave of the '60s, however, was that the acquisition process itself could produce growth in earnings per share. By an easy bit of legerdemain, groups of companies with no basic potential earning growth at all could appear to show steadily rising earnings per share as long as the price-earnings multiple of the acquiring company exceeded the multiples of the companies being acquired. Companies such as Automatic Sprinkler Corp. (later called A-T-O, then Figgy International) that literally manufactured earnings-per-share

Tracking stocks, growing in popularity, create unresolvable conflicts of interests for boards that must serve two different sets of shareholders.

growth through mergers were the darlings of Wall Street during the period.

These matches generally proved not to have been made in heaven. It turned out that conglomerate managers, who were usually financial wizards rather than operating people, were not able to control their far-flung empires. Investors became disenchanted with the conglomerates' new math. Two plus two didn't equal five. Often it equaled less than four. By the 1980s deconglomeration had come into fashion, and most of the old conglomerates began to shed their unrelated acquisitions.

This was the precursor of the current wave of spinoffs and tracking stocks. Investors view separation rather than consolidation as the way to increase value, particularly if the unit to be separated could be associated with a sexy stock group in particular favor with investors, like Internet stocks today.

We see then that the consolidation and breaking apart of companies has been influenced more by the fads and fashions of Wall Street than by real economic performance. Yet it's hard to deny that in today's market temporary increases in total market value can be created by spinoffs and trackers and other such feats of financial engineering.

This is due to the unusual structure of the current stock market. Growth stocks—especially those associated with the information revolution—have soared to dizzying heights, while the stocks of companies associated with the older economy have tended to languish. As long as such a two-tier market exists and "pure play" companies associated with communications and information technology can command ex-

traordinary valuations, creation of tracking stocks for Internet or communications divisions could well create value. But that may not always hold true. History suggests that popular financial techniques to enhance market values tend to get undone in saner times.

The tracking-stock phenomenon carries with it several dangers. Owners of tracking stocks may be getting less than they think for their investment. Trackers involve an elaborate and complex corporate structure that only a lawyer could love. Shareholders of the tracker actually own shares of the parent company, not of the unit being tracked. They have limited voting rights, and since the parent keeps control, the tracker loses the potential takeover premium for the shares that other trendy stocks in independent companies enjoy.

The price of tracking shares will still be influenced by developments affecting the parent. The parent and tracker unit are like Siamese twins—if one group becomes financially distressed, the other group is affected. Shareholders have no direct claim on the assets of the unit to which their fortunes are linked, and a nasty free-for-all could ensue if either tracker or parent finds itself in financial trouble. Creditors do not have to respect internal divisions of assets or earnings.

Perhaps most important, the parent/tracker structure creates the potential for unresolvable conflicts of interest. The board of directors must serve two different sets of shareholders with different interests and objectives. Conflicts can arise over the allocation of expenses, intergroup transactions and especially the allocation of resources. Suppose a business opportunity arises that could be undertaken both either by the parent or the tracking unit. How should the board decide which one gets to exploit the opportunity? How should one business group that develops some new technology be compensated for sharing its discovery with other business units? The jockeying for resources could become particularly troublesome in harder economic times, making many trackers derail and unleashing shareholder lawsuits.

Late-Stage Bull Market

Ingenious financial engineering is often the sign of a late-stage bull market. It takes the form of carving out and separately pricing different attributes of a company in order to capitalize on the attributes that are particularly popular in the market at a given time. But such innovations created during euphoric periods typically settle back to discounts from underlying values, as the drawbacks of complexity and conflicts of interest become more apparent.

Even the supposed advantages of trackers in providing unique management incentives are likely to dissipate in less ebullient stock markets. As Wall Street is willing to give infant companies multibillion-dollar valuations, these stocks will remain on the express track. But the future may see them derail and crash.

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