



SHORT-TERMISM AND U.S. CAPITAL MARKETS: A Compelling Case for Change

Beginning in 2007, prominent individuals including Warren Buffett and former SEC Commissioner Bill Donaldson publicly expressed deep concern about what they viewed as an intensifying short-term focus in corporate and investment decision making. In September 2009, over two dozen individuals representing all aspects of business, investment, labor and politics including John Bogle, Lou Gerstner, Peter Peterson, John Whitehead and Mr. Buffett, again, reinforced this concern in a public policy statement released by the Aspen Institute entitled, “Overcoming Short-Termism: a Call for a More Responsible Approach to Investment and Business Management.” A host of organizations including the Aspen Institute, Business Roundtable, CFA Institute, Committee for Economic Development, The Conference Board, and the U.S. Chamber of Commerce have committed time and resources to this issue over the past few years.

Amidst this upswing in concern and activity, the Aspen Institute’s Business and Society Program prepared this document in 2007 and further revised it in 2010, posing the following two questions:

1. What evidence supports the hypothesis that U.S. companies and capital markets are increasingly focused on short-term results?
2. If an overly short-term market focus dominates, how are firms, investors, and the economy impacted?

EVIDENCE OF SHORT-TERMISM What conditions indicate increased short-termism in U.S. markets?

For Example:

1. Research by JP Morgan indicates less investing by U.S. corporations. According to a *New York Times* article, one main reason for this is a focus on quarterly earnings in many U.S. companies. To show short-term profits, public companies increasingly defer investments in marketing research, product design, or prototype development.¹
2. Shrinking public company CEO tenure² is both an indicator of short-term thinking (impatience for results by boards and markets) and a driver of more short-termism: CEOs, fearing quick dismissal, have a strong incentive to pursue short-term gains and stock price increases at the expense of long-term strategies and investments.
3. There have been fundamental changes in the nature of shareholders. The rise of hedge funds and private equity firms adds a heightened short-term focus into markets and pressures on companies to be responsive to these holders. The proliferation of high frequency trading introduces a nanosecond

¹ “Are profits hurting capitalism?”. *The New York Times*, July 2010.

² Speech by Indra Nooyi in April 2010 at the Economic Club of Chicago. Further see Kaplan/Minton (NBER Working Paper 12465). According to Weber Shandwick’s latest study of CEO turnover (March 2008), CEO tenure in the US is on the decline, falling from 8.5 years in 2006 to 6.7 years in 2007, while more than 1/3 of American CEOs who stepped down were ousted against their will.

focus. Meanwhile, fewer retail investors invest directly in corporate equities and choose financial intermediaries, such as mutual funds, instead³.

4. There have been fundamental changes in *who*⁴ manages an individual's stock holdings and *for how long*. The current average term of stock-holding is less than one year⁵. This decline in average stock holding periods together with increasing misalignments between time horizons of beneficiaries and investment decisions of money managers lead to an increased short-term focus in U.S. capital markets.⁶
5. The corporate practice of providing quarterly earnings guidance has gained tremendous importance over the last decades. From 1994 to 2001, the number of firms providing guidance rose from 92 to 1200. Over the last 2 years, data suggest that a growing number of companies see the frequent provision of guidance as ineffective or increasingly difficult and have discontinued it or shifted toward more long-term oriented reporting.⁷ Nevertheless, approximately 60 percent of all companies continue to provide short-term guidance and generally view the practice of providing earnings guidance either positively or as a market necessity.⁸ The intensity of this discussion indicates that it remains an important topic within a large number of U.S. firms and worldwide.

EFFECTS OF SHORT-TERMISM

If an overly short-term market focus dominates, how are firms, investors, and the economy affected?

Effects on Firm Performance and Management

1. A significant stream of academic literature and market research cite deferred or cancelled R&D and Net Present Value (NPV) positive projects, as well as a managerial preference for higher short-term earnings/lower long-term cash flows over the converse. The studies connect these decisions to corporate managers' excessive focus on Earnings Per Share (EPS) as the most important metric for firm performance, and/or a response to a large block of short-term holders in a firm's shareholder base⁹. For example, one survey of 400 CFOs suggests that 80 percent will cut discretionary spending – for R&D, maintenance, advertising, et cetera – to avoid missing a quarterly forecast¹⁰.
2. The cases of Enron, Worldcom and Nortel show how unrealistically high expectations from the stock market and analysts can lead to short-term thinking and behavior by the firm's management in order to fulfill these expectations. A broad-based shift in executive compensation towards stock

³ According to a 2009 Investment Company Institute (ICI) report, assets held in mutual funds have increased from US \$899 billion in 1989 to 10 trillion in 2009. The number of households owning mutual funds rose from 23.4 to 50.4 million over this same 20 year period (or 43% of US households owned mutual funds in 2009).

⁴ "...Direct holdings of stocks by individual investors have plummeted from 92 percent of all stocks in 1950 to only 32 percent today, as corporate control fell into the hands of giant financial institutions—largely pension funds and mutual funds—whose share soared commensurately, from 8 percent to 68 percent, a virtual revolution in ownership." (Remarks by John C. Bogle, University of Virginia, Charlottesville, VA, February 8, 2006.)

⁵ Ben Heineman, "Shareholders – Part of the Solution of Part of the Problem?" *The Atlantic*. October 28, 2009.

⁶ The Aspen Institute Business & Society Program (2009). "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management."

⁷ McKinsey & Co. (2006). "The Misguided Practice of Earnings Guidance." *McKinsey Quarterly Report*. See also the National Investor Relations Institute (NIRI) results of its 2007 Earnings Guidance Practices Survey.

⁸ According to a 2009 survey by NIRI, there was a relatively modest 4% decrease in the number of companies that provide earnings-per-share guidance (60% in 2009 versus 64% percent in 2008). The number of companies providing other financial guidance showed a similar decrease (from 86% to 82%). See also "Earnings Guidance: The Current State of Play," a June 2009 report by Deloitte and FERF, for further information.

⁹ See the work of Graham, Harvey & Rajgopal; Subramanyan, Chen & Zhang; Bushée; and Bhora & Libby. For example: Subramanyan, Cheng and Zhang (2007). "Earnings Guidance and Managerial Myopia."

¹⁰ Graham, Harvey and Rajgopal (2005). "The Economic Implications of Corporate Financial Reporting."

options as an increasing part of compensation has further aggravated this problem¹¹. In these cases, the result was unstable growth of the firm in the long run and the destruction of value.¹²

3. Taking the provision of quarterly guidance as a proxy for short-term focus, research compares long-term earnings growth of “occasional” and “dedicated” providers of quarterly guidance. Findings indicate that the earnings of dedicated guiders grow more slowly over the long-term than companies that provide only “occasional” guidance.¹³ A McKinsey report indicates that provision of guidance appears to have no significant relationship with a firm’s marketplace valuations—regardless of the year, industry, or size of the company. Similarly, a company’s liquidity is not affected by the provision of earnings guidance.¹⁴
4. The more frequently a firm provides earnings guidance, the higher the cost of providing it in valuable management time.¹⁵ A majority of managers say that guidance is costly in the time they, as managers, have to spend on the effort, with no concomitant benefits accrued to their organization.

Effects on Investor Returns

1. Financial intermediaries show increasing short-term interests according to recent studies; the people whose money they manage, however, often require a long-term view (to use the money for college tuition or retirement, for example). As a result of this misalignment of interests between the two groups, significant losses for retail investors arise.¹⁶ Transaction costs aggravate this problem: as a short-term outlook drives high portfolio turnover, this can lead to high transaction costs, reducing returns to investors.
2. Short-termism does not yield higher shareholder returns over the long-term (as outlined above) and can, if further accelerated by unrealistically high expectations from the stock market and money managers, even lead to a firm’s downfall. Accordingly, the long-term net effect of short-term thinking on investor returns is often negative.
3. New research on family-owned firms demonstrates that these firms – arguably those with the longest time frames and sense of legacy – yield higher returns for shareholders over a ten year period (1999-2009) and show lower levels of financial leverage and have lower costs of debt.¹⁷
4. Some research indicates that as a short-term focus intensifies, the use of (legitimate) accounting techniques to “manage earnings” becomes more frequent. This dynamic might further lead to accounting abuses, which can destroy value if taken to an extreme.¹⁸ In addition, there are costs of controls implemented to prevent abuses in reporting.
5. Another approach to documenting costs of short-termism to investors is tied to theoretical work on the “universal shareholder.” According to this body of work, value creation at one firm may result in value destruction at another – in an M&A transaction, for example. Given the high degrees of

¹¹ According to research by the Harvard Business School (especially Fuller and Jensen, see Footnote 12), this encourages executives to focus predominantly on short-term returns in an attempt to boost stock options and fulfill (often also adversely incentivized) analysts’ expectations.

¹² Fuller and Jensen (2002). “Just Say No to Wall Street: Putting A Stop to the Earnings Game,” *Harvard Business School*. Reprinted in 2010.

¹³ Subramanyam, Cheng and Zhang (2007). “Earnings Guidance and Managerial Myopia.”

¹⁴ McKinsey & Co. (2006). “The Misguided Practice of Earnings Guidance.” *McKinsey Quarterly Report*.

¹⁵ McKinsey & Co. (2009). “Weighting the Pros and Cons of Providing Earnings Guidance.” *McKinsey Quarterly Report*.

¹⁶ The Aspen Institute Business & Society Program (2009). “Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management.”

¹⁷ “The Five Attributes of Enduring Family Businesses.” *McKinsey Quarterly Report*, 2009. Even though it is difficult to statistically prove that the family influence was the main driver, the results are surprisingly stable across geographies and industries, and are further supported by academic research.

¹⁸ Michael Jensen (2005). “Agency Costs of Overvalued Equity.” *Journal of Finance*.

portfolio diversification and market indexing, this will hurt investors if the loss is greater than the gain.¹⁹

Effects on National Competitiveness, Economic Growth, and Society as a Whole

1. Taken to a national level, a potential systemic underinvestment in R&D will lead to long-term challenges to U.S. competitiveness. The U.S. ranked only 22nd in global R&D spending in 2006²⁰, if we look at non-military R&D expenditures as a share of the overall economy. As the importance of innovation for America's future economic growth and prosperity is widely agreed-upon, overall societal costs of deferment of R&D spending due to short-term pressures are significant²¹.
2. Short-termism may have deleterious effects on efficient markets, such as a mispricing and misallocation of assets due to a lack of reliable information about long-term prospects. This might lead to fewer listings on U.S. markets. For example, Wharton research demonstrates that when market incumbents introduce promising new technologies with significant long-term, positive implications for the firm, market reaction is negligible.²² Further, research suggests that markets trading on short-term information tend to undervalue or ignore important long-term structural risks and opportunities. If so, this would create significant losses for both investors and society at large over the long-term²³.
3. The decline in public trust in U.S. business, tied in part to this new short-term outlook, has been widely discussed since our most recent wave of corporate scandals and the economic crisis of 2007-2008. The economic implications are myriad.
4. In a 2007 survey, 31 of 34 corporate board directors, each of whom served on an average of six *Fortune* 200 boards, said they would "cut down a mature forest or release a dangerous, unregulated toxin into the environment in order to increase profits. Whatever they could legally do to maximize shareholder wealth, they believed it was their duty to do."²⁴

¹⁹ On zero-sum games and rent extraction, see Greenfield (2009). "The Origins and Costs of Short-Term Management." In Corporation 20/20's Paper Series on Restoring the Primacy of the Real Economy.

²⁰ "The State of Research isn't all that grand." *The New York Times*, September 2006.

²¹ As highlighted by the US Chamber of Commerce in their 2010 publication "The Impact of Innovation and the Role of IP Rights on US Productivity, Competitiveness, Jobs, Wages, and Exports."

²² Brenner (2007). "The incumbent discount: stock market categories and response to radical theological change." *Academy of Management Review*.

²³ Michael Jensen (2005). "Agency Costs of Overvalued Equity." *Journal of Finance*.

²⁴ Jacob Rose, "Corporate Directors and Social Responsibility: Ethics versus Shareholder Value," *Journal of Business Ethics*, 2007, vol. 73, issue 3.