Personal Finance

Damages of the short-term mindset

"Short-termism" refers to corporations focusing on short-term results to boost share prices in response to pressure from financial players, often at the expense of long-term interests

Yan Barcelo | 6 August, 2019 | 2:36AM

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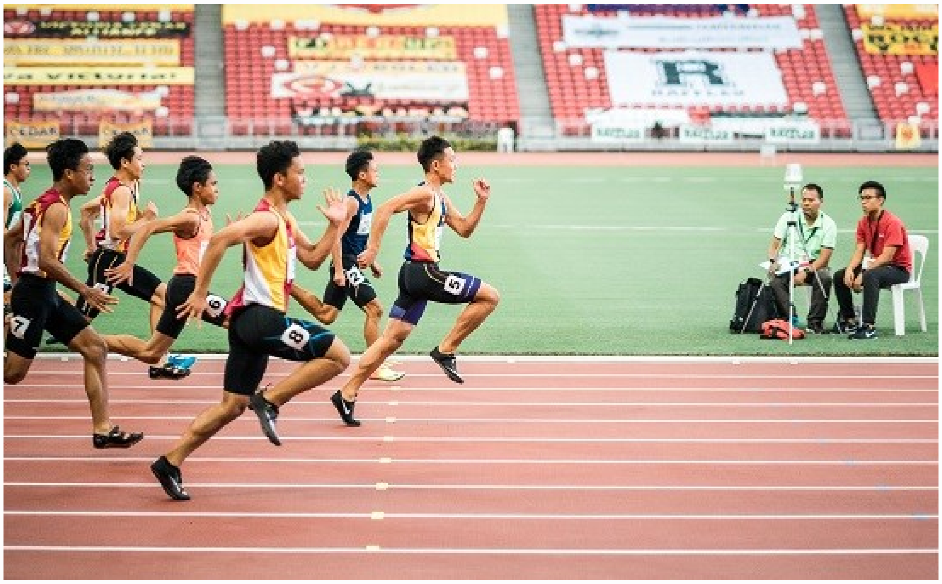

In March 2014, CEOs of many *Fortune 500* corporations received a letter that started with these words:

"We are preoccupied... that too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.

This was not written by a socialist economist, but by Larry Fink, president and CEO of BlackRock, arguably the largest investment firm in the world.

Fink is a powerful voice in the ongoing concern with the "tyranny of the short-term mindset" that, according to many commentators, plagues both Wall Street and Main Street. Another was Vanguard founder John Bogle, who said that "we have ceased to be investors and have become speculators", and even devoted his last book to the subject (*The Clash of the Cultures: Investment vs. Speculation, John Wiley & Sons, 2012*).

Yvan Allaire, president of the Institute for Governance of Private and Public Organizations, in Montreal, defines "short-termism" as "the conscious decision on the part of management to take measures that will have a positive effect on share price in a near future, even while knowing very well that such measures can eventually harm the long-term well-being of the corporation."

In financial markets, the most visible form of short-termism hinges on the average time investors hold on to shares, which has shrunk from 97 months, in 1950, to 7 months in 2010. However, that shortened holding period can be overly influenced by computer trading volumes, acknowledges Allaire.

Short-term damage

Short-termism affects several concrete outcomes. Asked in a 2005 survey what measure they would favour if they were to miss quarterly earnings targets, 80% of 300 CEOs interviewed said that they would first reduce discretionary expenses (R&D, publicity, maintenance, etc.) and 55% that they would postpone the beginning of a project even if it reduces the company's value.

Despite this, many commentators refute the notion of short-termism, saying that macro-economic metrics don't show any downward trend. For example, R&D investment holds well, and unemployment is at historic lows.

People who say that "are fast asleep", snaps Judy Samuelson, vice-president of the Aspen Institute, in Washington, also executive director of the Institute's Business and Society Program which has been one of the early framers of the short-termism debate.

R&D numbers may not appear to suffer, but what they don't tell us is the content and quality of the R&D, points out Allaire. Are companies fine-tuning a button on a smartphone – or inventing the next smartphone. As for low unemployment, a large part is mirage. "We have returned to populism. People are angry. Sure, there is 'full employment', but look at the numbers that are out of the workforce," says Samuelson.

"The big winners have been profits of corporations that were able to offshore production. We have kept services jobs, but with minimal salaries and no unions. It's among blue collar workers, who suffer reprehensible living conditions, that we find the highest rates of suicide," Allaire says.

Bringing back long-term capitalism

The way to repair such damage is to practice anew long-term capitalism, asserts the Aspen Institute. Concentrating on quarterly earnings "absorbs a lot of time that would be better spent thinking tactically and strategically for the long term. The failure to invest in workers and leaving them on the side while profits go to a small band of investors, that has big consequences," Samuelson warns.

Ironically, long-term investing is overwhelmingly profitable, finds a 2017 McKinsey report. From 2001 to 2014, companies adhering to five long-term evaluation criteria (higher investment, earnings reflecting cash flow and not accounting decisions, and sustainable margin growth) show 47% average higher revenue and with less volatility than short-term competitors, 36% higher earnings, almost 50% more R&D spending, 81% greater economic profit and a 7 billion US$ larger market capitalization.

Despite this, the short-term imperatives of financial markets still drive the show. How can the dial be moved back toward a long-term perspective?

Those with the most influence are institutional investors like pension fund and mutual fund managers. Long-term investors own 75% of US stocks, another McKinsey report finds, noting that "Executives have more room than they realize to stand together with sophisticated investors to maintain focus on long-term value creation."

Unexpected allies

Paradoxically, it is the smaller cohort of 25% of investors that call the shots with their constant pressure to meet short-term quarterly earnings targets, what is euphemistically labeled as "increasing shareholder value". And a major unspoken "occult" component turns executives into allies of these short-term players: pay structure. The increasing portion of share options in their paycheck pushes executives toward the short-term view, leading them into initiatives that only serve to boost share prices.

One extremely prevalent action is the systematic buying back of shares, which has totalled $US 3.5 trillion since 2010 and reached an all-time high of $US 800 billion in 2018. "Corporations have put more money in their own stocks ... than every other type of investor (individuals, mutual funds, pension funds, foreign investors) combined," comments a recent *Atlantic* article. Referring to an analysis carried out by the SEC, the *Atlantic* notes that "it revealed that in the eight days following a buyback announcement, executives on average sold five times as much stock as they had on an ordinary day."

"Corporations should get their capital from an IPO and then concentrate on their

About Author

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core business of product, market and human resources development," says Samuelson adding that linking executive pay to the stock price causes the separation line between two very distinct markets to blur. "Another unfortunate outcome of linking pay structure to shares is that "it tempts CEOs to sell their company, and profit from it," Allaire notes.

Apart from severing links between executive pay and share price evolution, Samuelson and Allaire put forward two measures that could help correct short-termism. a) Before having the right to vote, an investor should hold on to his shares for at least one year. The present state of things is the equivalent of allowing tourists and temporary visitors to vote for a country's government, highlights Allaire. b) The longer an investor holds onto his shares, the lower should the capital gains tax be.

Can individual investors play a role? Absolutely, Samuelson answers. "By choosing funds that have a long-term perspective and by asking questions that address long-term considerations when they participate in an earnings call."