



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

Recently, prominent individuals including Warren Buffet, Bill Donaldson, and Bill McDonough have publicly expressed deep concern about what they view as an intensifying short-term focus in corporate and investment decision making. A host of organizations including The Aspen Institute, The Conference Board, The Business Roundtable, The Committee for Economic Development, and Boston College's Institute for Responsible Investment are committing time and resources to this issue.

Amidst this upswing in concern and activity, the Aspen Institute's Business and Society Program prepared this document, posing the following two questions:

1. What evidence supports the hypothesis that U.S. capital markets are increasingly focused on short-term results?
2. If a short-term focus exists, is it good or bad – and for whom?

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

For Example:

1. McKinsey data tracks the dramatic upswing in earnings guidance – “the number of firms telling the market what to expect rose from 92 in 1994 to about 1,200 in 2001.”¹ This increasing focus on short term metrics is a proxy for a short-term focus.
2. Shrinking 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, need to show dramatic short-term improvements).
3. There have been fundamental changes in *who*³ manages an individual's stock holdings and *for how long*. The current average term of stock-holding is less than one year. (See the work of John Bogle, Marjorie Kelly, and others.) The argument is that as agency problems between stock holders and money managers intensify, and as average stock holding periods decline, short-term focus increases.
4. There have been fundamental changes in the nature of shareholders. The rise of hedge funds and private equity firms introduce more short-term focus into markets.

¹ The Sound of Silence, *The Economist*, April 29, 2006.

² The World's Most Prominent Temp Workers, *Strategy + Business*, Issue 39, Spring 2005.

³ “...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 @ The University of Virginia, Charlottesville, VA, February 8, 2006.)

EFFECTS OF SHORT-TERMISM: Is short-termism good or bad – and for whom?

Possible harmful effects of increased short-termism include:

Effects on Firm Performance

1. A significant stream of academic literature documents evidence of deferred or cancelled R&D and NPV positive projects within firms – tying these decisions to an excessive focus on 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 base. (See the work of Graham, Harvey and Rajgopal; Subramanyan, Chen and Zhang; and Bushee.)
2. Taking the provision of quarterly guidance as a proxy for short-term focus, McKinsey 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.⁴
3. New research is emerging in studies of family-owned firms, which demonstrates that family-owned firms – arguably those with the longest time frames and sense of legacy – significantly outperform their peers.

Effects on National Competitiveness and Economic Growth

1. Taken to a national level, a systemic underinvestment in R&D will lead to long-term challenges to U.S. competitiveness. A recent *New York Times* article posits that the U.S. ranks only 22nd in global R&D spending, if we look at non-military R&D expenditures as a share of the overall economy.
2. Short-termism may have deleterious effects on efficient markets, such as a mis-pricing and misallocation of equity in our markets because of lack of good information about long-term prospects. This might lead to fewer listings on U.S. markets. For example, new research out of Wharton demonstrates that when market incumbents introduce promising new technologies with significant long-term (positive) implications for the firm, market reaction is negligible.⁵ Further, research at Boston College 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-term.
3. Some argue that the practice of providing quarterly guidance leads to an increase in market volatility and a reduction in overall economic growth – while others argue the exact opposite.
4. 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. The economic implications are myriad.

⁴ The Sound of Silence, *The Economist*, April 29, 2006.

⁵ Personal conversation with the author

Effects on Investor Returns

1. Some research indicates that as 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. (See Jensen, “Agency Costs of Overvalued Equity” and others.) In addition, there are costs of controls implemented to prevent abuses in reporting.
2. As a short-term outlook drives high portfolio turnover, this can lead to high transaction costs, reducing returns to investors. Initial academic research exists (See Barber and Odean, 1998) that suggests that investors who trade more frequently indeed sacrifice value.
3. 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 value destruction at another – in an M&A transaction, for example. Given the high degrees of portfolio diversification, this will hurt investors if the loss is greater than the gain. (See Robert Monks and others).