Does finance lead to short-termism?

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Agenda

How short is short?

Time horizons of investors

Institutionalizing expectations about the (short-term) future

Conclusion

What is Short-termism?

Narayanan (1985)

- Manager chooses project with lower net present value and earlier positive cash flows.

Laverty (1996)

- Action that is best for the short term but suboptimal in the long term.

Marginson and McAulay (2008)

- Actions in the near term that have detrimental consequences for the long term.

Kay (2012)

- Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business.

Standard Definition

Short-termism is the choice of a demonstrably suboptimal investment strategy that adds less value than other alternatives but has a faster payoff.

Why is it bad?

Loss of long-term value creation (e.g. R&D investment, intangible assets, employee skills)

Unsustainable business strategies (e.g. depletion of organizational capabilities)

Creation of externalities (e.g. ecology, pensions, etc.)

Short time horizon leads to zero-sum conflicts (e.g. distribution of wealth rather than creation of wealth)

Difficult to break the cycle of short-term focus!

Alternative Frameworks

Short-termism as...	... Optimization problem
Time preference	Single discount rate
Time horizon	Consistent preferences across time horizon
Decision model	Correct valuation model defined by observer
Actor orientations to reduce uncertainty	Myopia Risk Aversion

... Ecological rationality
Situational motivations towards time
Inconsistent preferences across time horizon
Various decision heuristics used by actors
Commitment Trust Habit Governance

How to “Measure” Short-termism

Empirical studies have used various proxies

R&D investment (Hansen and Hill 1991; Bange and DeBondt 1998; Cheng et al. 2005)

Earnings management / restatements (Liu 2005)

Investment portfolio turnover (Bushee 1998, 2001; Wahal and McConnel 2000)

Surveys (Demirag 1998; Grinyer et al. 1998; Graham et al. 2005)

Limits of Conventional Approaches

Discount rate

Time horizon

Model project valuation

Myopia and risk aversion

What is short-termism?

Intertemporal choice

Stakeholders decide in favor of less valuable strategies that have earlier payoffs

Clock time versus cyclical time

- Time as linear and finite to be measured and manager
- Time as embedded in relations, recurring with nested horizons

While myopic decisions can happen, short-termism refers to a systematic and institutionalized form of decision bias

Problem of corporate governance

Inter-temporal Agency Conflict

		Managers' orientation Short	Long
Shareholders' orientation	Short	**Short-termism**	Agency conflict – Long-term managers pressured by short-term investors
	Long	Agency conflict – Long-term investors undermined by short-term opportunism of managers	The Sustainable company

Short-termism is self-reinforcing

Double contingency

"since the outcome of ego's action (e.g. success in the attainment of a goal) is contingent on alter's reaction to what ego does, ego becomes oriented not only to alter's probable overt behavior but also to what ego interprets to be alter's expectations relative to ego's behavior, since ego expects that alter's expectations will influence alter's behavior" (Parsons and Shils 1951, p.105)

Temporal calibration (Noyes 1980)

- Easier for ego to adjust to 'short' time horizon of alter than convince alter to look at a 'long' horizon

Interactions among shareholders and managers may be self-reinforcing

- Managers expect that shareholders will be short-term, so adjust their behaviour and vice-versa
- Mechanism for overcoming uncertainty

A systematic rather than piecemeal approach is needed!

Shareholders

Organizational orientation

- Owners vs. traders
- Capacity to evaluate and monitor firms
- Conflicts of interest

Investment incentives

- Agency problems along investment chain
  - (e.g. individual → institutional investor → fund manager → company)
- Risk and “other people’s money”

Shareholder Time Horizons

Figure 3: Shareholder Time Horizons

Organizational Orientation		*Incentives* Short	Long
	Short	- "Impatient capital" Hedge funds	*Role conflict* Pension funds
	Long	*Role conflict* Private equity, some hedge funds	+ "Patient capital" Family owners, commercial banks

Financialization

Growth of financial markets

Market valuation is about the expected future value of a company

Institutionalization of higher market values relative to the „real economy“ creates pressure on companies

It may lead to shortening of time horizons

Table 2 Corporate Performance, Selected Averages 2000

	Germany	United Kingdom
Real returns to capital		
Price-earnings ratio	17.8	21.5
Dividend yield	2.7%	2.6%
Return on equity	18.2%	20.4%
Market valuation		
Market value (mill. euros)	20,754	42,337
Ratio of market value to turnover	0.51	2.14
Market value per employee (mill. euros)	0.14	0.97
Price-book ratio	2.5	4.6
Sales, profits, employment		
Turnover (mill. euros)	38,122	22,015
Return on sales (EBIT to sales)	9.4%	19.2%
Employees	138,072	60,676

Source: Handelsblatt Europa 500, Handelsblatt June 11, 2001. Averages are calculated from the 19 largest British and 20 largest German industrial firms belonging to the "Europa 500." For computational purposes, negative values or price-earnings ratios exceeding 50 were dropped.

Investment Chain

Ultimate ownership is often meaningless

Investment is managed by organizations trading with „other peoples' money"

A key problem is the agency chain

- Delegation of investment decisions to traders
- Traders must demonstrate their performance
- Leads to short-term incentivization
- Herding behavior around „events" like restructuring, M&A, etc

Income redistribution

- Bankers bonuses, traders, executives
- But redistribution across time….

Need to better understand investment models…

Gatekeepers

Reputational intermediaries

- Normative regulation by professional groups
- But often powerful conflicts of interest

Securities analysts

- Focus on quarterly earnings

Auditors

- Non-audit services

Conclusion and next steps

Short-termism arises from interactions among actors in the context of corporate governance

Challenges to study intertemporal choices empirically due to inherent counterfactual of long-term future

Time is a neglected dimension of social scientific study