Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?

CEO STRATEGIC IMPLICATIONS

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Managers of public companies are under constant pressure to meet quarterly guidance and maximize profits, often at the expense of future profitability. Those pressures, driven by a number of factors, are likely to increase in the next 10 to 15 years as corporate profits decline and labor costs rise. Public companies are dying faster than ever, and these contracting corporate life spans are, on average, diminishing long-term value creation, making it more important than ever that business leaders act to ensure that the drive for short-term performance doesn't come at the expense of sustainable value creation. Along with board members and investors, business leaders should review their companies' governance structures and consider whether any changes could better serve their long-term prospects.

What is driving short-term behavior?

Activist hedge funds Activist investors are gaining ground in the governance of public companies. In 2014, activists gained board seats at 107 companies, an all-time record that is likely to be broken this year.[1] And, when companies resisted putting activists on their boards, the activists won proxy contests 73 percent of the time last year.

Increasing payouts to shareholders is one of the most frequent demands of activist hedge funds, after obtaining board seats and M&A campaigns such as sale of the company or a spin-off, and these demands drive some short-term behavior. From October 2008 through August 15, 2015, hedge fund activists led more than 220 public campaigns against US companies to increase payouts to shareholders.[2]

1 David Benoit and Kirsten Grind, "Activist Investors' Secret Ally: Big Mutual Funds," *Wall Street Journal*, August 9, 2015.

2 Data from Activist Insight, retrieved August 15, 2015.

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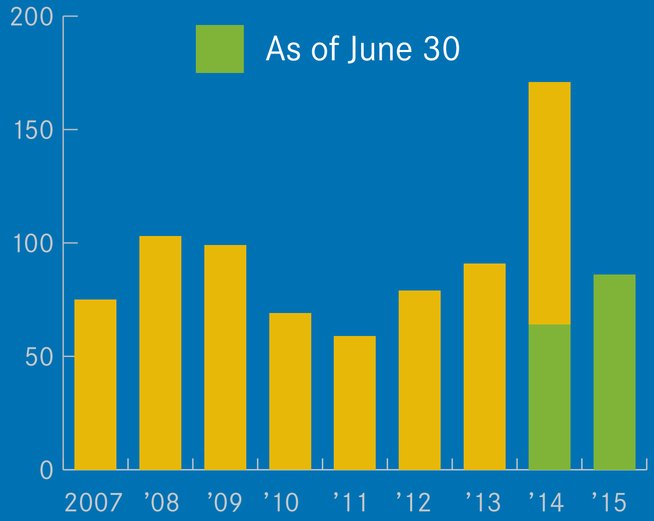
What is driving short-term behavior?

Activist hedge funds

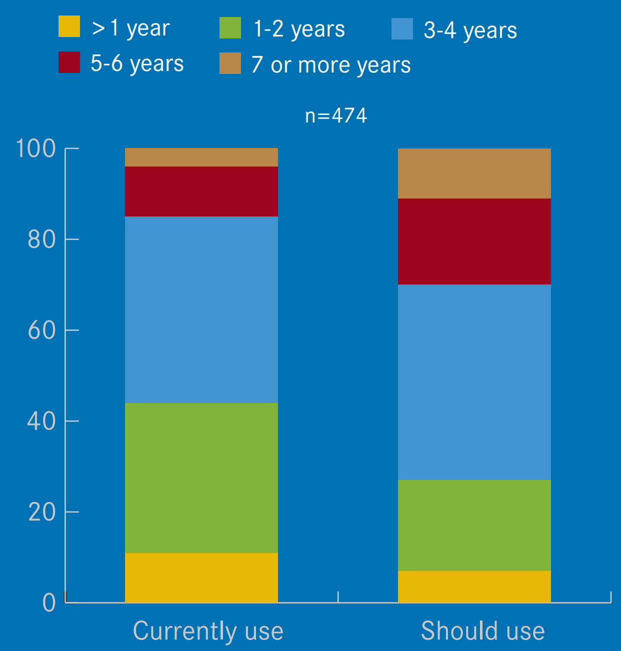
Number of activist campaigns resulting in board seats won



Source: FactSet

Quarterly capitalism

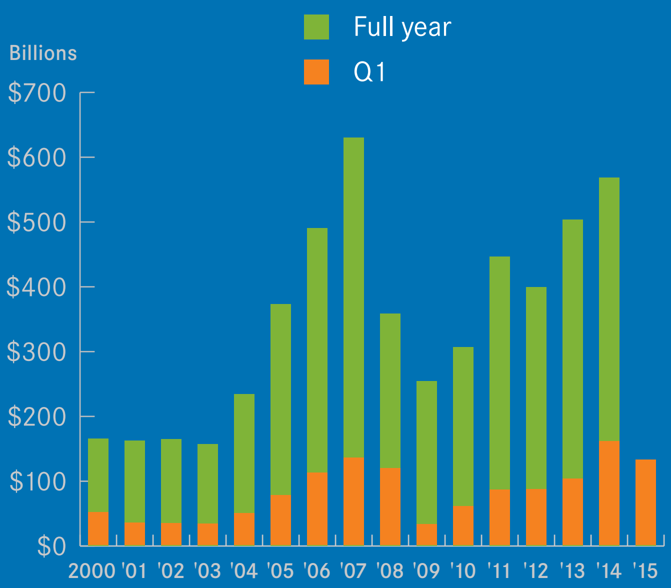
Primary time horizons management teams use in future strategic planning



"Don't know" responses are not shown.
Source: McKinsey

Executive compensation design

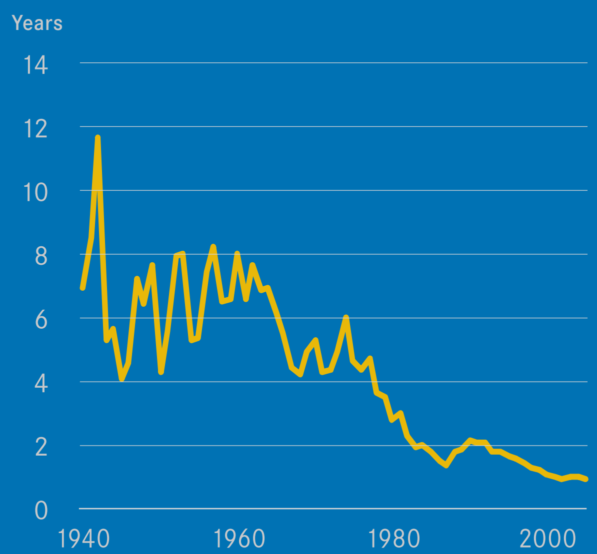
Value of buybacks for S&P 500 companies has increased significantly



Source: Bloomberg

Changes in capital markets: from investing to trading

NYSE average holding period declined from 7 years to 1 year



Source: New York Stock Exchange

Executive compensation design The design of stock compensation, the main component of executive pay, may exacerbate that focus on short-term results. Performance triggers for stock compensation that are tied to near-term indicators, such as earnings per share or one-year share price increases, encourage executives to focus more on short-term share price and accounting measures than on long-term performance.[3] Stock compensation is also linked to increasing stock buyback programs at companies that seek to offset dilution to shareholders when options are exercised or share grants vest. Whether buybacks add or destroy value depends upon the price paid relative to intrinsic value. If a company pays less than intrinsic value (i.e., shares are cheap), a buyback will add value. If the company pays more than intrinsic value (i.e., shares are expensive) a buyback will destroy value, since wealth is transferred from those who hold to those who sold.

Quarterly capitalism Pressure on managers of public companies to meet quarterly earnings is one of the most often-cited drivers of corporate behavior focused on short-term value extraction, which often comes at the expense of long-term value creation—reduced investing to meet earnings targets. When asked how much of their companies' quarterly earnings or revenue targets could be put at risk to pursue an investment with a positive net present value that would boost profits by 10 percent over the next three years, a majority of more than 1,000 C-level executives and directors surveyed by McKinsey & Company and Canada Pension Plan Investment Board responded that their companies would not be willing to accept significantly lower quarterly earnings for this kind of investment, and nearly half said short-term pressures reduce their companies' willingness to pursue investments with less certain returns. The vast majority felt the most pressure to deliver financial results in two years or less, despite the fact that 86 percent said using a longer time horizon to make business decisions would positively affect financial returns and innovation.[4]

Changes in capital markets: from investing to trading Changes in the stock market itself contribute to short-termism. Technological and regulatory changes have reduced the costs of trading stocks, giving rise to high-frequency traders and more frequent trading by many other market participants.[5] Trading does not provide capital for investment in the business; it simply flows capital between shareholders. Stock markets have largely become trading platforms in which capital is directed not to business but to traders.

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3 *Built to Last, Focusing Corporations on Long-Term Performance*, Committee for Economic Development, 2007, p. 13.

4 Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term," *Harvard Business Review*, January–February 2014, p. 4.

5 Matthew O'Brien, "Everything You Need to Know About High-Frequency Trading," *The Atlantic*, April 2014.

What Can Be Done?

Leaders and stakeholders should discuss these recommendations in the context of their company's particular circumstances as they determine how best to move forward to achieve their long-term strategy.

Governance changes public companies, with support of their investors, can make

Abandon quarterly bottom-line earnings guidance and replace it with longer-term guidance and information that is material to the company's longer-term prospects.

Investors can encourage the companies they own to shift away from issuing quarterly guidance to focus on communicating metrics that are material to long-term value creation—for example, 10-year economic value added, R&D efficiency, patent pipelines, multiyear return on capital investments, and energy intensity of production. A balanced scorecard approach can help boards communicate nonfinancial metrics to help guide strategy when income statements don't capture the emerging story.

Revamp executive compensation to reward longer-term thinking.

Companies should review the design of their executive pay to ensure that it effectively incentivizes thinking beyond the current stock price movements. In particular, companies should consider stock ownership guidelines or retention policies and should ensure that their long-term incentive plan design measures performance in a way that is consistent with company strategy.

Stock ownership guidelines obligate executives to act as "buy and hold" investors by requiring them to purchase and hold a substantial number of shares according to policies tailored to the company's circumstances.[6] Another variation on this theme is to require executives to retain most of their shares awarded under compensation plans for several years or until they retire (with an allowance to sell a limited number of shares to cover taxes due on vesting of stock awards or exercise of options).

Incentive plan metrics should measure performance consistent with company strategy. Long-term incentive plan design can be improved by applying value-based performance metrics such as return on invested capital relative to their weighted average cost of capital and/or economic profit in performance measurement design and a move away from a dominant use of total shareholder return or earnings per share. Future value improvement drivers (i.e., innovation, customer loyalty) can be added to the performance metrics mix, and the long-term investment plan design and the performance period for named executive officers can be extended beyond three years.[7]

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6 *Built to Last, Focusing Corporations on Long-Term Performance*, Committee for Economic Development, 2007, p. 13.

7 Mark Van Clieaf, Karel Leeflang, and Stephen O'Byrne, "The Alignment Gap Between Creating Value, Performance Measurement, and Long-term Incentive Design," Investor Responsibility Research Center Institute and Organizational Capital Partners, November 2014.

Consider the benefits of offering extra dividends or enhanced voting rights to reward longer-term investors

Most institutional investors in the United States oppose any deviation from the "one-share-one-vote" model, so any adoption of a plan that departs from this model would need to be carefully designed with input from shareholders. Nevertheless, the growing trend to offer market incentives for patient capital in the form of enhanced shareholder participation rights with minimum holding periods or time-based vesting is worth noting.

Among those increasingly espousing this trend are The Aspen Institute, which endorsed the concept with the support of a number of prominent business leaders and leaders of major institutional investors; France, which mandates double voting rights to investors who have held shares for at least two years unless shareholders vote to amend the bylaws to opt out of the rule; and the European Parliament Legal Affairs Committee, which has backed proposals that aim to reward long-term shareholders in the form of additional voting rights, tax incentives, loyalty dividends, or loyalty shares.[8] A number of companies are already experimenting with some form of loyalty shares or additional voting rights. Any concerns that L-shares could be used to further entrench management or may be interpreted as a potential negative signal by the market should be addressed through careful design and communication.[9]

Adopt capital allocation policies to ensure the long-term interests of the company are not sacrificed to the pressures of daily business activity

A capital allocation policy should be part of the board's strategic overview so the two are aligned and the decision to allocate capital to stock buybacks is not made before the decision to allocate capital for investing in projects, people, and facilities. Development of a capital allocation policy should take into account the growing concern about excessive stock buybacks and timing of stock buyback purchases to enhance capital efficiency. While most companies have investment hurdle rates for investment in the business, few have such metrics for stock buybacks. Such metrics may help boards evaluate how best to allocate capital among competing proposals.

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8 Aspen Institute, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management*, September 9, 2009, p. 4; ISS, "Impact of Florange Act (France)" (www.issgovernance.com/file/publications/impact-of-florange-act-france.pdf; "Give Shareholders More Say on Directors' Pay, Urge Legal Affairs Committee MEPs," The European Parliament Legal Affairs Committee press release, May 7, 2015.

9 Patrick Bolton and Frédéric Samama, "Loyalty Shares: Rewarding Long-term Investors," *Journal of Applied Corporate Finance*, 25, no. 3, Summer 2013, pp. 86-97.

Governance changes investors can make

Move away from quarterly portfolio manager compensation and evaluation

Many compensation arrangements for portfolio managers are structured with incentives based on time periods that encourage trading rather than stewardship (i.e., compensation linked to outperforming peer competition or outperforming indices within short time frames, usually quarterly).[10] Compensating portfolio managers based on the amount of assets they have under management could be problematic if they seek to boost investment returns with short-term unsustainable strategies solely in order to increase their pay. According to the CFA Institute and the Business Roundtable Institute for Corporate Ethics, "when asset managers are evaluated and compensated primarily on the basis of quarterly metrics, they may pressure companies into the same short-term thinking or increase volatility by regularly trading in and out of company securities in an effort to capture short-term profit." They recommend that a significant portion of asset managers' incentive pay be measured by long-term metrics (three to five years), similar to those used at the companies in which they invest.[11]

Do not overly discount longer-term corporate investments

A recent empirical study confirmed anecdotal and survey evidence that public company management prefers investment projects with shorter time horizons based on the belief that investors fail to properly value long-term projects.[12] McKinsey calculates that investors penalize long-term corporate investments by using discount rates that are 5 percent to 10 percent higher than risk and actual returns justify.[13] Survey evidence indicates that investors typically expected full payback on a corporate investment within three to five years, although the average life of assets was often 10 times that.[14] Another study found that, in the United Kingdom and United States, "cash-flows 5 years ahead are discounted at rates more appropriate 8 or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead; and cash-flows more than 30 years ahead are scarcely valued at all."[15] The consequence of overdiscounting is that projects with positive returns may be misperceived as having a negative return or too lengthy a payback period.

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10 Ben W. Heineman, Jr. and Stephen Davis, *Are Institutional Investors Part of the Problem or Part of the Solution?* October 2011

11 *Breaking the Short-term Cycle*, CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics, 2006.

12 John Asker, Joan Farre-Mensa, and Alexander Ljungqvist, "Corporate Investment and Stock Market Listing: A Puzzle?" *Review of Financial Studies* 28, no. 2, February 2015, pp. 342–390.

13 Jonathan Bailey, "Focusing Capital on the Long Term," presentation to The Conference Board Institute for Sustainable Value Creation, September 29, 2014.

14 Andrew G. Haldane and Richard Davies, "The Short Long," speech to Société Universitaire Européenne de Recherches Financières Colloquium: New Paradigms in Money and Finance?, Brussels, May 2011 (www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2011/speech495.pdf).

15 Haldane and Davies, "The Short Long."

Tax changes the government can make

Adjust the capital gains tax rate to reward longer-term investments

Favorable tax treatment in the United States currently kicks in at a one-year holding period. A longer-term holding period for favorable tax treatment, reducing the tax on investments to zero after a significant commitment, would incentivize greater stewardship.

Impose a transaction tax on frequent trading

While high-speed trading is not likely to result in pressure on corporations to engage in short-term thinking, a number of business leaders support implementation of an excise tax "to discourage excessive share trading and encourage longer-term share owning."[16] Supporters of a financial transaction tax (FTT) believe that capital markets should allocate capital to businesses to invest in R&D, to produce products and services, and to enable businesses to grow and create jobs. They doubt that trading every millisecond serves the purpose of allowing companies to raise capital for investments, despite proponents' claims that high-speed trading creates liquidity in the market. Discussion of an FTT imposed on the purchase and/or sale of financial securities has reemerged since the financial crisis. Adoption of an FTT by 11 EU countries is scheduled to go into effect in 2016. In the United States, proposals for a new FTT have been introduced in Congress. One report estimated that such a tax could raise about $50 billion per year in the United States, with about 75 percent of the burden falling on taxpayers in the highest income quintile, and more than 40 percent falling on the top 1 percent.[17]

Conclusion

Public corporations have been the engine of growth and prosperity in the United States since the beginning of the twentieth century, leading to an unprecedented increase in the standard of living and the development of extraordinarily innovative products and services. Yet at the turn of the twenty-first century, the future prosperity of this engine of growth is being jeopardized by the short-term focus of many public companies on extracting value today instead of investing for the creation of value in the future. The recommendations made in this report are a starting point for public companies, their shareholders, and policy makers to begin to right the balance from quarterly capitalism to a longer-term focus.

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16 Aspen Institute, "Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management," September 2009, p. 4.

17 Leonard E. Burman et al., *Financial Transaction Taxes in Theory and Practice*, Urban-Brookings Tax Policy Center, June 2015, p. 4.

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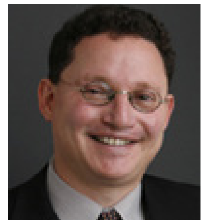

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