The long-term benefits of short-term investing

Globe and Mail
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August 27, 2013

Are markets really myopic? Do managers of publicly traded companies spend too much time focusing on the quarterly earnings report?

The usual storyline is that the daily grind of the stock market – pressure from hedge fund investors, the threat of takeover by giant private equity funds, selective attack by short sellers – discourages long-term planning and investment. And corporate management's compensation packages, which are sometimes tied to hitting short-term profit or share-price targets, shorten managers' focus, inhibiting strategic thinking.

The cost of myopia, according to this view, is forgone long-term investment, lack of innovation, and missed productivity growth.

Corporate governance gurus have many solutions to these perceived problems: independent directors, corporate-social-responsibility mission statements, say-on-pay shareholder initiatives, and ending quarterly conference calls with analysts, to name a few. Then there are the bigger ideas, like requiring firms to issue stock that pays high dividends to buyers who commit to lengthy holding periods.

Emerging research suggests that these may be solutions in search of a problem.

Let's look at hedge funds, a favoured target, first. Lucian Bebchuk of Harvard University and his co-authors looked at 2,000 hedge fund interventions over 14 years, and analyzed the results over the five years that followed. Their striking takeaway? "We find no evidence that interventions are followed by declines in operating performance in the long term."

In fact, they found that hedgies' interventions are followed by improved operating performance. Even when they load up firms with debt, even when they boost shareholder payouts, reduce investment, or pursue hostile tactics – performance goes up, not down. There's no pump and dump, and firms are not left more vulnerable than before.

Private equity, which acts through a slightly different channel, has the same positive result. Professor Lars Persson and his colleagues at Sweden's Institute Of Industrial Economics examined the incentives driving these clearly short-term investors, and the impact on target companies and their competitors.

Private equity firms beef up governance structures, and do more restructuring than long-term buyers. They overinvest in their targets, and have an incentive to overpay – because they want to block rivals from acquiring the assets. This overinvestment is good for consumers and, because it drives down margins, makes life harder for the target's competitors – they are forced to pick up their game.

In this sense, short-term investors offer a great example of how markets are supposed to work. And this understanding explains the fact that the share price of rivals typically goes down when a firm in their sector is targeted and why, even if leverage goes up after a buyout, so too does productivity.

Short sellers usually get the worst rap – they sell shares without taking the trouble to buy them first, and naked short sellers do not even trouble to locate shares to borrow. Pressure from heavy short interests deeply unsettles managers of target companies, and they sometimes go on the offensive, with complaints to regulators.

The theoretical and empirical evidence of short sellers' impact is truly voluminous, and uniformly positive.

Writing almost a decade ago, Harvard's Owen Lamont looked at 327 short-selling disputes, and found that stocks of the targeted companies subsequently underperformed, to the tune of minus 25 per cent, relative to the market. And an uncomfortable number of the targets, it turned out, had misstated earnings or were otherwise fraudulent. Among companies where the U.S. Securities and Exchange Commission investigated complaints from targets, this underperformance was about minus 28 per cent.

But the best recent example was an unusual breakout of regulatory contagion in the fall of 2008 when, as the financial crisis began to unfold, many countries' regulators either prohibited short sales or, as in the United States, imposed a temporary ban on short selling of financial stocks.

The New York Fed recently had a look at the impact of the U.S. short-sales ban, which affected financial stocks from Sept. 18 to Oct. 8, 2008. To the surprise of almost no one, the affected share prices continued to decline sharply after the ban was in force – the market felt that declines were warranted, even without the shorts in it. Nor should it surprise that when the ban was lifted, financial shares rose.

And the SEC's non-accomplishment was costly. During the short-sales ban, liquidity dried up, the convertible bond market evaporated – because it depends on shorting for hedging – and bid-ask spreads rocketed up for affected stocks.

Markets, in the near term or long, work in the interests of shareholders – so long as they are unfettered by overseers who bet otherwise.