Corporate Short-Termism in the Fiscal Cliff’s Shadow

By Mark Roe

CAMBRIDGE – Economic trends are sometimes more closely related to one another than news reports make them seem. For example, one regularly encounters reports of governments’ financial troubles, like the “fiscal cliff” in the United States and the debt crisis in Europe. And much attention has been devoted, often in nearby opinion pieces, to the view that hyperactive equities markets, particularly in the US and the United Kingdom, push large corporations to focus disproportionately on short-term financial results at the expense of long-term investments in their countries’ economies.

The two are not unconnected. And examining that connection provides a good opportunity to assess the weaknesses and ambiguities of the longstanding argument that furiously high-volume stock-market trading shortens corporate time horizons.

The conventional thinking is that as traders buy and sell corporate stocks more often, they induce corporate managers to plan for shorter and shorter horizons. If institutional investors refuse to hold stocks for more than a few months, the thinking goes, CEOs’ time horizons for corporate planning must shrink to roughly the same timeframe.

Policymakers in Europe and the US are urged to act on this conventional thinking: Something must be done to insulate CEOs, boards, and managers from the financial markets’ ever-shortening time horizons. The UK’s official Kay Review from last July and the European Union’s Green Paper on corporate governance, adopted by the European Parliament earlier this year, diagnose corporate short-termism as a serious problem and point policymakers toward solutions. American commentators – and, increasingly, US judges – want to insulate CEOs and boards further from their firms’ trading shareholders.

But highlighting short-term trading in stock markets obscures other powerful sources of short-termism in corporate time horizons, such as uncertainty about long-term government fiscal policies on both sides of the Atlantic. More important, some corporate short-termism may not be as strong as it is thought to be.

Consider, first, the lofty market capitalization of Apple and other tech companies, which belies the depiction of US financial markets as hopelessly short-term-oriented. The ability to appreciate the long-term earnings potential of Silicon Valley and firms like Apple, Amazon, and Facebook suggests that more is going on in the US stock market than a relentless focus on short-term financial performance.

Indeed, the intermittent over-valuation of entire economic sectors – recall the dot-com bubble from a decade ago – indicates that financial markets are often excessively focused on the long term. Many firms during the bubble had no hope of making enough money in the short run to justify their sky-high stock prices.
Moreover, there are ambiguities in the trend lines for stock-holding periods. While the overall average length of time for holding a stock has declined, the impact on senior managers is unclear, because the holding period for core institutional investors, like Vanguard and Fidelity, has not changed in the past decade or two from its two- or three-year baseline. Fast program trading pulls the overall holding period average down. But it’s not as clear as many believe that the holding period for traditional shareholders has shortened greatly – or at all. The declining average is partly due to a furiously trading fringe.

Excessive short-termism can come from the executive suite as much as from financial markets, especially from CEOs, who in the US have an average tenure of 6-7 years. It is fully understandable – and largely supported by empirical evidence – that these CEOs would want good results to occur on their watch, rather than after their successor takes over. Insulating CEOs and boards further from financial markets may perversely free them to focus even more narrowly on short-term results.

In any case, while concern with corporate short-termism has arrived on the US judicial agenda, judges in America (or elsewhere, for that matter) are not well positioned to weigh economic evidence that is far from clear regarding the sources, extent, and even the direction of short-term thinking in large corporations. Other political and administrative institutions are better positioned to determine whether corporate short-termism is a serious problem and what the best solution would be. For example, a so-called Tobin tax on financial transactions is a frequently proposed solution, but it is not a policy solution that could be implemented by corporate-law judges.

Finally, firms that become more oriented toward short-term performance may be reacting to their real environment, not to their financial environment. They may well be adapting to new economic, political, and technological realities, not hiding from the future. Critics of short-term thinking, like the authors of the Kay Review and the EU Green Paper, ought to consider that economic life has, in fact, become more short term.

That brings us to the link between corporate short-termism and weak public finances. Companies on both sides of the Atlantic could be thrown off course by the US fiscal cliff and the EU sovereign-debt crisis. If economy-defining government and regulatory policies have become unstable in the short and long term, companies must adjust to that reality.

Similarly, if technological innovation can now transform major industries in a matter of a few years, or even months, long-term investment makes less sense than it did before. Amazon’s lofty price/earnings multiple indicates that investors are not shy about financing its long-term future. But does Amazon’s success mean that traditional brick-and-mortar retailers are slackers for not upgrading their stores, or for not building new stores in better locations?

If investors understand that online distribution is revolutionizing the retail sector, isolating the sector’s CEOs from financial markets would just push more resources into a deteriorating, shrinking business model. In this sense (and only this sense), short-term thinking that induces change and movement away from obsolete technology – here and throughout the economy – may well facilitate long-term prosperity.