Today’s readings continue our look at the design of the US public corporation, this time the way that corporate management tends to focus on the short term. This “short-termism” reflects the ways in which financial markets (primarily institutional shareholders) demand that corporate management seek to maximize short-term returns, as reflected in short-term pricing.

We begin with a reading from the student book (which you have seen before) that lays out the role of shareholders in the corporation. Specifically, you’ll read about the matters on which shareholders in US corporations have voting rights and how they’ve exercised their voting rights over time. You’ll see how the “rationally apathetic” shareholder has been replaced by a more “activist institutional” shareholder. But voting remains the exception, rather than the rule, for how shareholders express their preferences.

Next you’ll read an essay offering a definition of short-termism. The author of the essay argues that short-termism actually hurts shareholder by creating short-term returns at the expense of long-term returns and solvency. Why do shareholders tolerate this? What can be done about this paradox? The author suggests that shareholders can do a better job of understanding what’s in their best interests. For institutional shareholders, this is a particularly tricky problem – they are investing other people’s money.

Finally, you’ll read from an article that explains how short-termism dominates both the thinking and actions of financial firms (such as the banks at the epicenter of the 2008 financial crisis) and non-financial firms that depend on financing through financial firms. The article gives you a sense for how short-termism led to risky lending and investments, driven by the expectations of short-term investors. This short-termism, you’ll read, also has led executives in non-financial firms to “manage earnings” (that is, engage in deceit about company profits). Finally, you’ll read about how financial firms – particularly, hedge funds – have used shareholder voting to force even more short-term activities in non-financial firms, whose executives are subject to “herd behavior.”

Readings:
- E&E 6 (Shareholders’ Role in Corporate Governance)
- Greenfield, The Puzzle of Short-Termism (2011)
- Dallas, Short-Termism and Corporate Governance (2012)
CHAPTER 6

Shareholders’ Role in Corporate Governance

More than 200 years ago Blackstone described the corporation as a “little republic.” Conceptually, this description is still apt. The statutory model for the corporation prescribes a republican form of governance—

- **The shareholders (the corporation’s electorate)** elect directors annually and vote on fundamental corporate transactions. Although they are nominal “owners” of the corporation, shareholders do not participate in managing the corporation's business or affairs. The shareholders, even a majority, cannot act on behalf of the corporation—this is left to the board of directors.

- **The board of directors (the corporation’s legislative organ)** is the locus of corporate authority. “All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors.” MBCA §8.01(b); see also Del. GCL §141(a). The board is not an agent for the shareholders, but has independent status. Directors have fiduciary duties to the corporation and the body of shareholders (see Chapter 11).

- **The officers (the corporation’s bureaucracy)** are delegated the day-to-day management of the corporation and are answerable to the board. All authority to act for (and to bind) the corporation originates in the board of directors (see Chapter 30).

Corporate law protects shareholders’ financial position through three principal mechanisms: voting rights, litigation rights to enforce management accountability, and liquidity rights to sell their shares. This part considers voting rights and the shareholders’ role in corporate governance:

- the purposes of shareholder voting (§6.1) and its use in publicly traded corporations (§6.2) and closely held U.S. corporations (§6.3)
- the matters on which shareholders vote, the voting process, and the methods for electing directors (Chapter 7)
- judicial supervision of the voting process (Chapter 8)
- federal regulation of proxy voting in public corporations (Chapter 9)
- the liability for proxy fraud regime (Chapter 10)

Shareholder voting is a study in U.S. corporate federalism, as well as the division of labor between the legislative and judicial branches. State corporate statutes establish the structure of shareholder voting, including compulsory annual elections of directors and shareholder voting on fundamental corporate changes. State courts supervise the fairness of the voting process through judicially created fiduciary duties. Federal regulations, authorized by federal statute, fill a perceived gap in the state-enabled voting structure by mandating disclosure in connection with proxy voting in public corporations. Federal and state courts ensure the fairness of transactions on which public
shareholders vote under judicial antifraud standards that assume voting by reasonable shareholders.

**Note on Shareholders as "Owners"
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Sometimes it is said (metaphorically) that shareholders “own” the corporation. But, as you study the role of shareholders in the corporation, you will notice the many things shareholders cannot do under the traditional model. They cannot act on the ordinary business and affairs of the corporation. Thus, they cannot bind the corporation contractually (see Chapter 30); they cannot select and remove officers (even for cause); they cannot fix employees’ compensation; and they cannot have the corporation pay dividends (see §31.1). Furthermore, shareholders cannot compel or overturn particular board decisions, unless the board failed to comply with the corporate statute or the corporation’s constitutive documents (see §3.3.3) or the directors breached their fiduciary duties (see Chapter 11).

**§6.1 PURPOSES OF SHAREHOLDER VOTING**

Shareholder voting has many functions. It gives self-help remedies to the shareholder majority: to elect directors to the board, to pass on fundamental corporate changes, and to initiate limited changes to the governance structure. Voting gives shareholders the power to protect their position as last-in-line claimants of the corporation’s profits. Majority voting prevents a minority from holding up useful change or extorting concessions from the majority. Although other corporate constituencies (such as employees, creditors, or bondholders) could in theory have voting rights, shareholders value these rights more highly than other constituents and pay for them when they invest.

Shareholder voting operates in tandem with shareholder litigation rights. The power of shareholders to replace lax or inept directors justifies deferential judicial review of directors’ judgment in making business decisions. Likewise, shareholder approval of transactions involving managerial self-dealing or other conflicts of interest reduces the judicial scrutiny that would otherwise apply. When shareholders are prevented from exercising their voting right—as when the board changes the voting rules to thwart a shareholder insurgency to replace the board—judicial review is heightened.

Shareholder voting is critical to shareholder liquidity rights and the “market in corporate control.” Since shares are sold with voting rights, buyers of a majority of shares acquire the power to install their own board and thus replace incumbent management. The availability in public trading markets of sufficient shares to constitute a voting majority creates strong incentives for managers to act consistently with shareholder interests.

**§6.2 SHAREHOLDER VOTING IN PUBLIC CORPORATIONS**

The reality of shareholder voting in modern public corporations diverges from the theoretical model. In public corporations, shareholders typically participate in the election of directors less fully than the model assumes. Historically, public shareholders have been mostly passive. They generally vote their proxies for the slate of directors and the transactions proposed by incumbent management. It is unusual for an insurgent to offer an alternative slate of candidates or for a management initiative to be defeated. Nonetheless, with the rise of institutional shareholders over
the last two decades, shareholder initiatives in the form of nonbinding resolutions have become a prominent feature of U.S. corporate governance (see §9.4.2).

§6.2.1 Proxy Process

In the United States equity shares typically carry voting rights. In a public corporation, given the logistical difficulties and expense of assembling all of the corporation’s shareholders, voting is mostly by proxy—in effect, absentee ballot. As a result, the process of soliciting and voting proxies effectively takes the place of the shareholders’ meeting. The actual meeting is often a sparsely attended public relations event.

Proxy voting is usually an annual rite of spring that takes place after the company's management and its auditors have prepared financial statements for the previous year. (For the legal mechanics of shareholders’ meetings, see §7.2.) The board of directors sets the date of the annual shareholders' meeting and then selects a “record date” used to identify which shareholders will be entitled to notice and to vote at the meeting. Under state law, only record shareholders vote. Beneficial owners must give their voting instructions to those who hold their shares in the company’s records. The board (often by a nominating committee) then proposes director candidates, and the board decides which matters to submit for shareholder approval.

To solicit proxies, management sends to shareholders at corporate expense a voting package containing an annual report, a proxy disclosure document, a proxy card, and a return envelope. Since 2007, the SEC allows companies to send shareholders a notice that these materials are available online. Exchange Act Rel. No. 55,146 (2007) (permitting shareholders to always request printed materials). After receiving the notice by regular mail or email, shareholders can go online and vote their proxies electronically. This “notice and access” method reduces the costs of voting, which ultimately are borne by shareholders.

Dissemination of proxy materials is complicated by the situation that most public shareholders are beneficial owners, not record owners. This means shares are owned on the corporate books by a nominee, typically a brokerage firm, for the benefit of its investor-customers. Under SEC rules, the corporation must send proxy materials or notice of online access either (1) to the record owner for distribution to beneficial owners or (2) to beneficial owners who do not object to having their nominees furnish their names and addresses (“non-objecting beneficial owners” or “NOBOs”). Depending on brokerage firm practice, beneficial owners either complete the proxy card themselves or instruct the firm (the record holder) on how to complete it. A prior practice in which brokerage firms decided how to vote shares for which they had not received voting instructions is now prohibited under stock exchange rules mandated by the Dodd-Frank Act. See §11.5.2.

Shareholders receive their voting packages (whether by mail or online access) a few weeks before the scheduled meeting. The cover letter from the board chair invariably asks shareholders to vote promptly to avoid the expense of a second mailing. Few individual shareholders read the proxy materials, though many complete the proxy card or vote online as recommended by management. Institutional shareholders, which now hold more than 70 percent of voting shares in public corporations and often rely on proxy advisory firms, have become increasingly independent and activist.

The shareholders’ meeting typically follows a script. Directors are nominated and other voting matters proposed. Votes, cast mostly by proxy holders, are taken. With the important business done, the company’s senior executives describe company results and plans, and respond to polite shareholder questions. If shareholders get unruly, the meeting chair can end the meeting.
Although state law permits any shareholder to nominate her own slate of directors or to propose a proper shareholder resolution, the effort would be futile unless the shareholder has already solicited and obtained proxies. Many corporate bylaws also prohibit shareholder nominations or proposals if not submitted well in advance of the meeting. In the end, the shareholders’ meeting is largely a formality, for the votes have already been “cast” in the proxy cards. In fact, to avoid surprises, the votes will often have been tabulated before the meeting.

§6.2.2 History of Public Shareholder Voting

Separation of Ownership and Control

In 1932 a Columbia law professor and an economics professor combined to write an influential book that systematically identified the separation of corporate ownership and management in U.S. public corporations. Berle & Means, The Modern Corporation and Private Property. The authors pointed out that when stock ownership is widely distributed and no group of shareholders has a sufficient interest to control the company’s affairs, management becomes “a self-perpetuating body even though its share in the ownership is negligible.” They found that 44 percent of the country’s largest 200 companies were under “management control.”

Central to the Berle and Means thesis of management control was the ineffectiveness of shareholder voting as a control device in public corporations. They found that when shareholders hand over their votes to individuals selected by existing management, the proxy mechanism leaves control in the hands of the board of directors, who “virtually dictate their own successors.” Although shareholders can replace incumbent directors by soliciting proxies for an insurgent slate of candidates, they found proxy contests to be rare.

In reaction to the gloomy Berle and Means story of the separation of management and ownership in public corporations, Congress created the Securities and Exchange Commission in 1934 to (among other things) promulgate a federal regulatory regime for proxy voting. Despite SEC rules that mandate disclosure by management when soliciting proxies and compel shareholder access to the proxy machinery, shareholders in publicly traded corporations did not leap at the invitation to participate in corporate governance. During the 1950s and 1960s, proxy contests for board control were no more frequent than before the SEC rules. Management’s candidates and initiatives won and insurgent’s candidates and initiatives lost, each by wide margins. By the 1970s, many academics had come to accept shareholder apathy as insoluble, indeed “rational.” Any shareholder dissatisfied with management had little choice but to exercise the “Wall Street rule” and sell his shares.

Institutional Shareholders

In the 1980s public shareholders began to use their powerful, latent control over managers despite the practical weaknesses in shareholder voting. Shareholders’ power first arose not from voicing their views through voting, but from their ability to exit and sell their shares. During the takeover boom of the 1980s, the voting power that shares carry served as the linchpin for hostile stock acquisitions and takeovers. Public shareholders could sell to an acquirer, who consolidated the voting power of dispersed shareholders to replace the board and acquire control of the company. Takeovers—and their threat—provided the discipline that atomistic voting had not.

But as the era of hostile takeovers came to an end in the late 1980s, a new era in U.S. corporate governance began. In the 1990s institutional investors emerged as a powerful new corporate actor. As Berle and Means had noticed 60 years ago, large shareholders have relatively
more incentives to become informed about management and proxy contests, and they are more likely to vote than other shareholders. The collectivization obstacles that discouraged any one shareholder from taking the initiative—since any gains would have to be shared among all shareholders—are overcome when a group of institutional investors organize against management.

Who are institutional investors? They take many forms, but are essentially financial intermediaries that hold large pools of investments for beneficiaries: pension funds (private and public), mutual funds, insurance companies, bank trust departments, hedge funds, endowments. As of 2009, institutional investors controlled 73 percent of the outstanding stock of the largest 1,000 U.S. public companies—up from 16 percent in 1965, 38 percent in 1980, 49 percent in 1990, and 61 percent in 2000. Institutional ownership is also increasingly concentrated. The ten largest institutional owners of each of the top 25 U.S. companies hold together on average 28.9 percent of the company's voting stock.

These trends are due to a combination of factors. Tax rules encourage employers and workers to contribute to retirement plans, which are invested in pension funds and mutual funds. And individual investors seeking diversification have moved from holding individual stocks to investing in mutual funds. As of 2006, mutual funds held 26.9 percent, and pension funds (both private and government) held 23.1 percent of U.S. public equities.

**Institutional Activism**

Institutional investors have fiduciary obligations to manage and vote their shares for the exclusive benefit of their beneficiaries. Although institutional investors have traditionally voted with management, often because they rely on management for investment business, this culture of acquiescence is changing. Pressure from regulators, such as the Department of Labor, which oversees private pension funds under ERISA, has led institutional investors to take their voting responsibilities more seriously. Disclosure of voting policies and actual votes, required by rule in 2003 for mutual funds, has exposed voting by institutional investors to greater scrutiny. Greater “indexation” (the diversification of investment portfolios to track the performance of whole markets) makes it difficult for institutional investors to follow the “Wall Street rule.” An indexed institutional investor that disapproves of a company's management cannot simply sell its stock without defeating indexation—and so must become active in monitoring and voting.

Institutional investors have in some dramatic instances been successful in asserting their new power. For example, in the 1990s under pressure from institutional investors, corporate boards of prominent corporations (such as General Motors, Sears, American Express) ousted management, divested businesses, made structural governance changes, and revised dividend policies. Nonetheless, the corporate financial scandals of the early 2000s and the collapse of the largest U.S. investment banks in 2008 have led many to question the effectiveness of institutional investors in monitoring and disciplining wayward management. Moreover, diversification requirements (often imposed by law) prevent many institutional investors from holding a meaningful percentage of stock in a given company, thus diluting their effectiveness as monitors.

The story of institutional activism is still evolving. In the late 1980s and early 1990s, institutional investors used a strategy of confrontation. Insurgents in record numbers proposed alternative board slates and initiated proposals for structural reforms to enhance shareholder control. During the late 1990s, institutional investors turned to nonvoting strategies. Some larger institutions adopted policies of “relationship investing” to establish ongoing communications with company management. In the 2000s, many institutional investors have followed the voting
recommendations of proxy advisory firms (such as Institutional Shareholder Services), which have assumed significant influence in the design of executive compensation packages and the terms of contested mergers. In addition, shareholder proposals on such governance matters as majority voting for directors and shareholder nomination of directors have received majority support, increasingly leading management to undertake reforms.

Lately hedge funds, which often buy positions in companies planning to sell after the company undertakes structural or governance changes, are becoming the most prominent shareholder activists. For some observers, hedge funds (with other institutional investors as their natural allies) realize the decades-old hope that institutional investors would be able to collectivize and serve as a disciplinary force for the benefit of all shareholders. Hedge funds seem particularly suited to their activist role for a couple reasons. First, hedge fund managers are highly compensated for making successful investments and thus have incentives to undertake short-term turnarounds of portfolio companies. Second, hedge funds are expected to focus on achieving high absolute returns rather than returns pegged to a benchmark.

§6.2.3 Voting Incentives for Public Shareholders

The greater activism of institutional investors in the governance of public corporations derives from the voting incentives large shareholders have compared to small shareholders. For a smaller shareholder who identifies value-producing reforms, there is little incentive to try to collectivize other shareholders. The insurgent must be prepared to commit significant time, money, and effort to overcome shareholder apathy. Expenses for an insurgent in a contested board election, for example, have been estimated to range between $5 million and $10 million.

If an insurgent loses, she absorbs the full costs of the contest; she cannot seek contribution from other shareholders or the corporation. If she wins, she may be able to obtain reimbursement from the firm, but any gains she creates will be shared with all other shareholders. Her portion of the gains is limited to her pro rata shareholding in the firm—usually quite small. In short, she must risk substantial amounts to create gains in which other shareholders will share even though they risked nothing. This “free rider” phenomenon leads rational small shareholders to do nothing to overcome voting “collective action” obstacles.

An insurgent's problems are compounded by the “rational apathy” of most small shareholders confronted with competing proxy solicitations. If an individual shareholder holds a small stake in a firm as part of a diversified portfolio, he has little incentive to spend time educating himself about the merits of any given proxy contest. Is management doing poorly? Will the insurgents improve the company’s performance? Small investors will perceive (rationally) that the time spent becoming familiar with the contestants and the issues will not be worth any potential gains to his portfolio. It is not surprising, given the informational position of most small shareholders, they follow a general rule of thumb: Vote for the incumbents. Small shareholders, it is said, awaken from their apathy only when presented with a premium bid in a takeover.

For larger investors, voting incentives are very different. Institutional shareholders have much larger stakes in individual companies, and there are fewer of them. It is not unusual in larger U.S. companies for the company's top ten institutional shareholders to hold 15-25 percent of its voting shares. Collective action by institutions is also easier under SEC rules that since 1992 have facilitated shareholder communications. In addition, for institutional shareholders it is not rational to be apathetic about the corporation’s management and reform possibilities. Even though an institutional activist must share any gains it produces with all other shareholders, the institution's
larger shareholding (and the greater ease in forming shareholder coalitions) may make its activism worth the effort. Finally, institutional investors (indexed or not) cannot easily exercise the "Wall Street rule" and sell their stock when they become dissatisfied with management. The very selling of a large block of stock drags down the stock’s market price.

Hedge funds (largely unregulated investment pools for wealthy individual and institutional investors) have also changed the U.S. corporate governance landscape. Activist hedge funds make money for their investors by identifying under-performing public companies and then seeking, through proxy fights or litigation, to oust the company’s incumbent management or change its business strategies. Hedge funds have enlisted the support of institutional investors, both through their voting and the lending of voting shares to the hedge funds. Activism by hedge funds has been controversial, with some asserting that they impose a useful discipline on management and others worrying that they force companies to focus on short-term results and not long-term value.

In addition to activism by hedge funds, voting recommendations by proxy advisory firms (particularly Institutional Shareholder Services) have been influential in how shareholders, especially institutional shareholders, vote on such matters as contested mergers, shareholder proposals on governance topics, "just say no" campaigns against individual directors, and lately "say on pay" proposals in which shareholders indicate their support (or opposition) to the company’s executive pay practices. The ISS posts voting guidelines for how it will advise shareholders to vote—and corporate boards will often tailor their actions to conform to the guidelines.

§6.3 SHAREHOLDER VOTING IN CLOSE CORPORATIONS

In closely held corporations (those with few shareholders and no ready market for their shares), things are quite different. (See Chapter 25.) Shareholders who own a majority of the shares can exercise their voting power to elect the board, giving these owners virtually unfettered control of the business. Controlling shareholders, who often rely on the corporation as a source of livelihood, assume a far more active role in the corporation’s governance than the statutory model contemplates.

For minority shareholders in a close corporation, voting rights are usually not a meaningful protection. Nor can these shareholders sell their shares in a public market if they become displeased with the majority's management. Instead, minority shareholders must negotiate for special voting rights (such as supermajority voting, see §26.1.1; cumulative voting, see §26.1.2; or class voting, see §26.2.2) or negotiate limits on the majority's discretion, specifying by agreement how the corporation is to be run (see §26.4). They may require that, as in a partnership, important decisions be made by unanimous consent (see §26.4), or they may negotiate for contractual withdrawal rights comparable to those of partners on dissolution (see §26.3).
INTRODUCTION

The financial crisis of 2007–2009 was preceded by a period when financial firms sought short-term profit regardless of long-term consequences. This short-termism or myopia -- defined as the excessive focus of corporate managers, asset managers, investors, and analysts on short-term results, and a repudiation of concern for long-term value creation and the fundamental value of firms -- was a major contributor to the crisis.

Short-Termism in Nonfinancial and Financial Firms

For a nonfinancial firm, short-termism manifests itself when managers seek to increase the firm’s current stock price or profits by inflating current earnings at the expense of the long-term health of the firm. This behavior may include decreasing discretionary expenses, under-investing in long-term assets, or taking on excessive risk to maximize short-term earnings. When firms use short-termism to bolster their current stock price or profits it is referred to as “earnings management.”

For a financial firm, short-termism also involves seeking to increase the firm’s current stock price or profits. It may include investing in assets with hidden risks and taking on excessive debt to bolster short-term firm profits or portfolio returns. It may also include short-term trading strategies that ignore the fundamental value of portfolio firms, resulting in losses. Additionally, short-termism may include using nonfinancial firms as short-term arbitrage opportunities -- that is, using voting rights to pressure firms to provide immediate payback to owners, such as through dividend payouts, stock repurchases, or selling off assets or a division.

Identification of Short-Termism as Problem

The business community has identified short-termism as a serious problem prior to the financial crisis, and has since denounced it more emphatically. Short-termism is the subject of important research reports, policy statements, and recommendations from the business community. Common to all of these is the belief that short-termism is pervasive in business decision making and is deleterious to the U.S. and world economy. Scholars have also joined business leaders in their concern about short-termism. Research has demonstrated the pernicious effects of short-termism on the well-being of corporate America. Relevant to the financial crisis, one report concluded that “short-term visions are the cause for market volatility and the instability of financial institutions.”

This Article describes how financial and nonfinancial firms engage in short-termism and how to mitigate it. It explains how market and internal firm dynamics contribute to short-termism by considering various problems operating within firms and in markets. Structural explanations
include consideration of how biases in financial firms cause them to incur ever-increasing debt levels during periods when the economy is strong and interest rates low, leading such firms to a state of financial fragility. This Article also includes consideration of the advantages to asset managers in investing their assets under management in short-term assets.

WHY SHORT-TERMISM?

Informational asymmetries facilitate short-termism as managers take advantage of their control over information to fool markets through signaling and signal jamming behavior. Informational problems also create competitive pressure for managers to behave in ways that are inimical to the long-term health of their firms. These competitive pressures may cause managers to invest their firm’s assets in short-term projects and may present firm managers with a prisoner’s dilemma in which the dominant strategy is participating in an irrational market because of the inadequacy of market signals to coordinate properly the actions of market participants.

The failure of market prices to reflect the long-term values of nonfinancial firms also provides the grounds for financial firms to use nonfinancial firms as short-term arbitrage opportunities through takeovers or shareholder activism. Myopic behavior may also occur, however, in efficient informational markets if managers believe they can fool the markets or shareholders prefer short-term results and focus on short-term information. Behavioral biases also play a role in encouraging short-termism. There is hyperbolic discounting, which refers to the priority of the present or the tendency of individuals to heavily discount the future.

Behavioral concepts, such as the availability hypothesis and threshold heuristic, explain how individuals tend to discount or disregard low-frequency events in their analysis, a case of disaster myopia. Another behavioral concept, the over-optimism bias, causes market participants in a prisoner’s dilemma situation to believe that they, unlike others, will find a seat when the dance ends. Over-optimism also encourages banks to continue to increase debt levels as asset values inflate. In addition, the more optimistic beliefs of some investors, often referred to as “dumb money,” cause other investors “to pay more than what they believe to be the stock’s long-run fundamental value because they think they will be able to sell their shares in the short run” to the more optimistic investors. Herding behavior also accentuates short-termism and causes prices to move away from fundamentals as market participants see more and more participants embracing short-term strategies and assume that these participants must have information that they do not and thus follow the herd. Group dynamics in decision making on boards of directors may also play a role as the group polarization phenomenon causes homogeneous groups to gravitate to more extreme, risky positions.

Incentives certainly exist for short-term behavior and seeking short-term profits. Inadequate market signals and structural factors motivate managers to engage in earnings management. Business motivations that are stock-driven exist for firms to meet earnings targets, such as to build the firm’s credibility with capital markets, maintain or increase their stock prices, convey future growth prospects, and achieve desired credit ratings. Achieving these goals may assist the firm in acquiring financing through stock issuances or debt financing on favorable terms and may assist the
asset manager in acquiring more assets to manage. Business motivations relating to stakeholders also exist for a firm to meet earnings targets, that is, to assure stakeholders, such as customers, suppliers, and investors, that the business is stable. When meeting earnings targets involves earnings management, attaining these objectives may enable firms to achieve short-term benefits, but for many firms it will result in negative long-term consequences, including the bankruptcies of firms, which were experienced in the aftermath of the recent financial crisis.

In addition, personal managerial motivations to some degree influenced by a firm’s culture explain the desire to meet earnings targets. Managers may lose their jobs, fail to be promoted, or find their opportunities to move to other firms impeded by their failure to meet earnings targets. In addition, managers may suffer a decrease in compensation. To increase their compensation, managers may seek short-term performance to enhance their bonuses (based on accounting-earnings performance), stock compensation (based on stock-price performance), or compensation based on the amount of assets under management that is enhanced by short-term profits that draw additional assets to their funds. Moreover, asset managers may follow the herd because those managers who invest in a conventional manner are less likely to lose their jobs than managers who invest in a nonconventional manner, regardless of the performance of the funds that they manage. In addition, corporate managers may act shortsightedly for business or personal reasons to ward off hostile tender offers.

Considerable attention has been given to short-termism in financial firms in order to understand the recent collapse of the financial system. Attention has also been given to the impact that the behavior of financial firms has on internal decision making in nonfinancial firms. Concerning the latter issue, financial firms have an impact on nonfinancial firms for two reasons. First, the stock trading strategies of financial firms affect securities prices and in this manner give managers of nonfinancial firms information on short-term behavior that will impact securities prices. Market reactions to failures of nonfinancial firms to meet earnings expectations, for example, cause their managers to engage in earnings management to meet market expectations. Second, financial firms’ use or potential use of shareholder voting rights impacts managerial decision making in nonfinancial firms. It may influence managers of nonfinancial firms to shift cash flow to the present by having their firms issue dividends or sell a division to avoid the use of their firm as a short-term arbitrage opportunity by a financial firm in a hostile takeover or through shareholder activism. Unlike the well-known agency cost theory, which holds that agency costs are minimized when managers are disciplined by market pressures, such as through hostile takeovers or managerial compensation tied to stock prices, managerial myopia theories explain why managers “caring too much” about current stock prices leads to myopic decision making. The more managers care about current stock prices, the more incentive they will have to engage in myopic behavior.

**WHAT CAN BE DONE ABOUT SHORT-TERMISM?**

The problem of short-termism is not attributed to one source but requires attention to a number of facets. Informational responses to short-termism regarding the financial crisis would include the adoptions of additional disclosures and due diligence obligations for underwriters, issuers, and credit rating agencies to increase the accuracy of market signals. Additionally, improved disclosure to investors about derivatives would include disclosures on such matters as the risks associated
with derivative transactions, the financial ability of firms to meet their obligations in these transactions, and the financial exposure of firms to such transactions. Finally, the losses that sophisticated investors suffered as a result of the financial crisis require a rethinking of exemptions from disclosures based on supposed investor sophistication.

Structural changes exist that counter short-termism in general. Short-term trading has an impact on prices and earnings management as well as on the norms of the marketplace in placing emphasis on short-term profits. It is desirable for the economy as a whole to encourage long-term investments. For example, an excise tax on securities transactions, including debt and derivatives, would create incentives for long-term investments and would also provide resources for a fund used to address the negative consequences of short-term trading. In addition, modifying capital gain and loss taxation as well as repealing mutual fund rules that require quick redemptions would be steps toward discouraging short-term trading.

Another structural response to short-termism in general concerns the use, or threatened use, of voting rights by short-term traders to pressure firms to engage in short-termism. Corporate recapitalizations and state corporation law should empower long-term shareholders. The determination of which shareholders are long-term shareholders may take into account the portfolio characteristics of shareholders as well as the duration of their share ownership in the firm. To further buttress the long-term orientation of long-term shareholders, governments should also consider rules encouraging the unwinding of share ownership over a period of years, such as tax incentives for doing so. In addition, they should exclude from voting those shares that are hedged through equity swaps or borrowing arrangements, to prevent voting inimical to the best interests of the firm.

**SHORT-TERMISM IN FINANCIAL FIRMS**

This Part explores the contributions of financial firms to short-termism. It discusses the tendency of financial firms to become highly leveraged, the competition among asset managers for short-term investment returns, the impact of short-term trading on earnings management, and the use of nonfinancial firms as short-term arbitrage opportunities for financial firms.

**Structural Reasons for Increasing Debt and Risky Loans**

The financial press referred to the financial crisis as a “Minsky” moment, the point when market participants scramble to cover obligations in an economy spiraling out of control after an extended period of euphoric speculative investments. Minsky’s financial instability theory explains how structural biases in financial firms lead them to ever-increasing levels of leverage during periods when the economy is strong and interest rates low, and how this leverage leads them to a state of financial fragility. At the heart of his analysis is excessive leverage and the kinds of debt that signal this excess. Minsky explained that financial firms such as banks (today also shadow banks) which carry assets on their balance sheets are able to borrow money, using as security the ever-increasing value of their assets. This increase in asset value results in increased borrowing. The increased borrowing allows firms to either maintain a targeted leverage level or increase it. The financial
firms use this borrowing to acquire increasingly-valued assets and will continue to do so in a state of euphoric expectation that asset values will continue to rise—or that competitors and clients will expect this increase to occur. For example, the leverage ratios of investment banks preceding the financial crisis increased from 30:1 to 41:1, a 30% increase. From 2000 to 2007 financial sector debt increased from $8.4 trillion to $15.8 trillion.

In addition, Minsky explained that the kinds of debt financial firms take on become more speculative as firms finance increasingly problematic assets, which creates greater financial instability. The progression is from “hedged” to “speculative” to “Ponzi” debt. Hedged debt is used to finance assets which are expected to generate income to pay the interest and principal on the debt. Assets financed by speculative debt are expected to pay the interest, but not the principal on the debt. Speculative debt is generally short-term debt and the purchaser of this debt is not expected to pay back the principal, but to refinance or roll over the debt. Assets financed by Ponzi debt are not expected to generate income to cover either the interest or the principal on the debt which results in higher debt levels owed due to negative amortization of the debt. Profits on Ponzi debt are expected from financing transaction fees and increased asset values.

Investments banks, hedge funds, and structured investment vehicles financed many private pools of CDOs using short-term debt they expected to refinance or roll over. When the short-term credit markets unexpectedly dried up, assets had to be sold, and the government stepped in to prevent a fire sale of these assets. The defaulting mortgages in mortgage pools consisted of many mortgages representing speculative or Ponzi debt. Some debt was interest-only, and other debt required refinancing and could only be paid if housing prices continued to climb. Thus, short-termism resulted in firms and individuals taking on excessive debt levels. Mortgages were based on speculation that asset prices would continue to rise and an expectation of the availability of refinancing opportunities.

**Competition among Asset Managers for Short-Term Investment Returns**

In addition to structural problems in financial firms, competition for investment funds among asset managers also leads to short-termism. Investment banks, mutual funds, hedge funds, and other firms compete for assets from investors -- including other institutional investors (such as pension funds), sovereign wealth funds, and retail customers. The problem is that these clients do not have perfect information about the ability of asset managers to invest their money. Consequently, investors who place their money with asset managers charge a higher cost of capital (demand higher short-term returns) than if information on long-term returns were readily available. Investors thus often place their funds in financial firms (with notable exceptions) on a short-term basis.

The demand for short-term returns, combined with the investors’ ability to readily change asset managers, make trading in short-term assets more attractive to asset managers than long-term assets. Why is this so? Asset managers make their money by identifying instances of mispricing. They assume dual risks: the risk that the fundamental value of the asset they purchase may fall before the market eliminates the mispricing (fundamental risk) and the risk that the mispricing may get worse before the market eliminates it at a point when the trade must be liquidated (noise trader risk). These risks
are greater for long-term asset arbitrage because “there is more time for bad news or a wave of pessimism to hit.” It is therefore less risky and less costly for asset managers to arbitrage a short-term asset for which mispricing will disappear in the short term than a long-term asset for which mispricing will not disappear for some time, particularly in the presence of noise trading.

There is another benefit to short-term trading for the asset manager. It is less risky for him to create a track record of performance to investors with a record of multiple short-term trades than a few long-term ones. Such a record allows the asset manager to attract more funds from investors and may decrease his cost of capital and credit constraints.

While the short-termism caused by the competition for funds by asset managers is rational for asset managers, this competition results in short-term investments and asset managers’ continual pressure on investors to switch their assets to their funds. But switching funds is problematic. Studies show that investors move their money from one fund to another based on past performance, but past performance is in most cases not a good predictor of future performance. The movement of money from one fund to others in search of higher profits is for the most part illusory and often a losing proposition.

**Short-Term Trading's Impact on Earnings Management**

A burgeoning literature about institutional shareholders has categorized shareholders by the characteristics of their stock portfolios. Shareholders are categorized as transient, dedicated, or quasi-indexer institutional investors. These studies have shown that the transient institutional shareholders are responsible for pressuring managers toward short-termism.

The classes of institutional investors are categorized by stability (the continuity of share ownership within the portfolio) and the size of the stakes taken in portfolio companies. The transient institutional shareholders have a short-term time horizon which is reflected in high portfolio turnover, high use of momentum trading, and highly diversified portfolios. While these firms may hold a quarter of their portfolio for two years, they pursue aggressive trading strategies with often over 70% of their portfolios turning over each quarter. The second category of institutions, dedicated institutions, have portfolios characterized by a low quarterly stock turnover (often less than 1%) and a much higher percentage of their shares held for two years (often over 75%). They are stable shareholders who, on average, have substantial investments in portfolio firms and therefore invest in fewer companies. Lastly, the quasi-indexer institutions fall between the other two categories. Their portfolios are characterized by high diversification but also a high degree of ownership stability. Thus, quasi-indexers trade infrequently but own small stakes in a large number of companies. For the period 1983 to 2002, 61% of institutional shareholders were quasi-indexer institutions, 8% were dedicated institutions, and 31% were transient institutions.

The institutional shareholders that pressure managers of nonfinancial firms toward short-termism are transient institutional shareholders. Research shows that a high level of transient institutional ownership is associated with an overweighing of near-term earnings which “also translates into significant misvaluations” of shares. In addition, transient institutional shareholders, unlike dedicated and quasi-indexer institutional shareholders, are more likely, when there is a break in a
string of consecutive firm earnings, to buy heavily when earnings increase and to sell heavily when earnings decrease. Dedicated and quasi-indexer institutional shareholders are more likely to hold the stock regardless of the break in earnings. Firms with higher transient institutional ownership also experience a sharper drop in stock price on the release of disappointing earnings news.

Transient institutional ownership affects managerial decision making and negatively impacts corporate governance. Nonfinancial firms with an ownership base dominated by transient institutional shareholders are more likely to cut research and development expenses to meet short-term earnings targets than firms dominated by dedicated and quasi-indexer institutional shareholders. Such firms seek to increase current earnings to support stock prices through myopic investment decisions. Moreover, firms with higher transient institutional ownership are more likely to have positive abnormal accruals (earnings management). These firms are also “more likely to have accruals that cannot be mapped into cash flow realizations” and therefore have lower accruals quality. In addition, transient ownership in firms is positively associated with the likelihood and magnitude of financial restatements (misreporting). Thus, the predominance of transient shareholders can lead to a negative impact on the quality of financial information, which may have an adverse impact on a firm’s access to capital and the future performance of the firm. In contrast, ownership by dedicated long-term shareholders is not associated with misreporting. Additionally, a higher percentage of transient institutional ownership in firms is positively associated with the existence of internal control material weakness, weaknesses which are negatively associated with future operating performance and stock returns.

In addition, holdings of independent, long-term institutional shareholders with large stakes are positively associated with post-merger performance. Firms with such holdings are also more likely to withdraw announcements of the worst deals. Moreover, the significant presence of transient shareholders is associated with an increased likelihood of takeovers but also with overbidding and value reducing acquisitions.

Research on misreporting, internal control weaknesses, and institutional ownership demonstrates the importance of differentiating among institutional shareholders. One study states that, “By aggregating different classes of institutional holdings, the prior research fails to identify the adverse influence of transient institutions’ trading strategy that places excessive focus on current earnings.” For example, another study found a positive relationship between aggregate institutional ownership and misreporting primarily driven by transient institutional shareholders, not dedicated long-term shareholders. A different study found a positive relationship between aggregate institutional ownership in firms and internal control weaknesses, mainly attributed to transient institutional ownership in firms. The study found that that the existence of internal control weaknesses was not associated with the level of dedicated or quasi-indexer institutions.

**Short-Term Traders Encourage Earnings Management**

Besides institutional ownership patterns affecting firm short-termism, high stock turnover indicates heterogeneous beliefs concerning stock value. When heterogeneous beliefs exist and there are limitations on short selling, the price of stock is driven up to the value placed on the stock by the most optimistic investors. The overvalued equity causes managers who are unable to meet the
performance requirements indicated by the overvalued equity to create an “illusion of growth” by
overinvesting in inefficient projects that ultimately lead to the long-term destruction of the value of
their firms. This incentive to engage in inefficient projects (earnings management) is greater in
firms with higher turnover. A study found firm investments to be more sensitive to the mispricing
of stock prices, on average, the higher the turnover of the firm’s shares.

This myopic firm behavior reflects a conflict between current short-term shareholders and future
shareholders of the corporation. Current short-term shareholders benefit from speculative
episodes in the market with the expectation of reselling their shares to more optimistic investors.
As the bubble lures dumb money into the market and more sophisticated traders ride the bubble,
current short-term shareholders value managers who engage in earnings management that
provides positive signals to the market. It increases the likelihood of current short-term
shareholders selling their shares to more optimistic investors. As one study reports: “When it is
possible for future investors to overvalue the firm due to their optimism, it is in the interest of
current [short-term] shareholders to cater to such potential sentiment at the expense of firm long-
term fundamental value.” Thus, in this manner short-term traders have an adverse effect on
decision making in nonfinancial firms by encouraging managers of such firms to engage in earnings
management.

Financial Firms’ Use of Voting Rights to Engage in Short-Term Arbitrage

In addition to market pressures on managers of nonfinancial firms from stock trading by financial
firms, financial firms may affect nonfinancial firms by their use, or threatened use, of their
shareholder voting power. Financial firms, because of their ownership of voting stock in
nonfinancial firms, are in a unique position to use nonfinancial firms as short-term arbitrage
opportunities. By reducing the duration of assets of nonfinancial firms, financial firms, through
shareholder activism (the use of shareholder voting rights), can shift the nonfinancial firm’s “cash
flow toward the present by cutting investments, raising dividends, and selling some of the
divisions.”

Predominant in a list of recent shareholder proposals made by financial firms at nonfinancial firms
are the following proposals: liquidation, selling (or buyout) of the firm or one of its divisions, large
one-time dividend payouts, and stock repurchases. Some of these transactions are beneficial to
nonfinancial firms but others are not. Short-term strategies that seek to squeeze as much value as
possible from a nonfinancial firm are bound up in exit strategies (not long-term investment) and
may leave the nonfinancial firm in a weaker financial position. Dividends encouraged by
shareholders that are financed by debt are referred to as “leveraged” dividends, a term which
recognizes that the payout comes at the cost of increased leverage levels for nonfinancial firms.
When dividends are financed by floating rate debt, they are called “drive-by dividends,” which
indicates a short-term strategy of financial firms in influencing dividend payouts by nonfinancial
firms.

Financial firms may also engage in hostile takeovers or leveraged buyouts of nonfinancial firms
with the aim of changing the investment policies of nonfinancial firms to short-term plans that the
stock market may value more highly than long-term plans. Leveraged-buyout financiers who
facilitate these transactions are often referred to as “capital turnover” banks (as distinct from “portfolio” banks), which seek to divest themselves quickly of debt issued to finance the buyout. Leveraged buyouts leave nonfinancial firms with heavier debt loads, which increase their risks of difficulties during market downturns.

**SHORT-TERMISM IN NON-FINANCIAL FIRMS**

As the previous discussion indicates, managers of non-financial firms may engage in short-termism because of competitive pressures from informationally imperfect markets. Additionally, they may do so to take advantage opportunistically of informational inefficiencies in markets. This may also lead them to engage in herd behavior and to ignore or underestimate the risks of low-frequency economic shocks.

**Prisoner’s Dilemma: The Difficulty of Coordinating**

In the situation where markets cannot fully observe managerial behavior, managers face a situation similar to the prisoner’s dilemma: a two-person situation where both parties are better off not confessing their participation in a crime, but they cannot be sure that the other person will not confess and in doing so implicate the other.

In the context of the recent financial crisis a similar situation presented itself. Consider competing firms A and B. The two firms are better off not engaging in myopic behavior (cooperating), but they can't be sure that the other firm will not engage in such behavior (defect), such as engaging in excessive leverage and purchasing nonprime mortgage-backed securities. If A engages in the myopic behavior and B does not, A will benefit in the short-term marketplace and may get out in time to avoid serious long-term consequences (a lower sentence) and B will certainly lose profits in the short term or go out of business (a very long sentence). If A and B both engage in myopic behavior (defect), they will maintain their market shares in the short-term and possibly get out in time to avoid serious long-term consequences (a moderate sentence). Thus, the dominant strategy is for the firms to engage in myopic decision making even though the firms would be better off not engaging in this behavior if they cooperated.

**Neglect of Private Information and Herd Behavior**

Short-termism may also occur when managers neglect private information about an investment or course of action if they cannot effectively communicate this positive information to the markets. They may behave myopically by forgoing a better investment for the firm in favor of an investment that the market perceives as more valuable and thus engage in herd behavior. In addition, herd behavior may occur when managers infer information from the behavior of others. Managers may ignore their own private information on the suspicion that executives of other firms are more knowledgeable. The more they see other executives taking a particular course of action, the more credibility that course of action acquires and the more likely they will ignore their own private information. The informational neglect theory explains why managers who suspected the risks associated with RMBSs ignored this private information and nevertheless invested in them.
Suboptimal information collection may also occur when managers decide to forgo collecting their own information in favor of waiting and mimicking the choices made by other managers. Markets also absorb less diverse information when unsophisticated investors rely on certain public information, such as quarterly earnings, and the sophisticated investors follow this uninformed herd.

CONCLUSION

Underlying structural, informational, behavioral, and incentive problems contribute to short-termism. In financial firms, structural biases cause them to incur excessive short-term debt during periods when the economy is strong and interest rates are low, leading to a state of financial fragility. The advantages to asset managers of investing their assets under management in short-term assets to discourage their clients from switching funds based on short-term fund performance also causes short-termism. Additionally, informational and technological changes in markets have led professional and day traders to use short-term trading strategies, creating what has correctly been labeled a casino mentality on Wall Street. Evidence shows that short-term trading by transient institutional investors leads to earnings management and that short-termism is pervasive in the business community, causing long-term damage to both financial and nonfinancial firms. Short-term traders may also use firms as short-term arbitrage opportunities through the use of voting rights, or their threatened use, to cause firms to decrease the duration of their assets in order to shift cash flow to the present.
THE PUZZLE OF SHORT-TERMISM

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Introduction

When pondering the question of the “sustainable corporation,” one of the intractable problems is the nature of the corporation to produce externalities. By noting this characteristic, I am not making a moral point but an economic one. The nature of the firm is to create financial wealth by producing goods and services for profit; without regulatory or contractual limits, the firm has every incentive to externalize costs onto those whose interests are not included in the firm’s current financial calculus. In fact, because of the corporation’s tendency to create benefits for itself by pushing costs onto others, the corporation could aptly be called an “externality machine.”

The obvious, routine kind of externality is the one that happens in the same time frame as the benefits gained. These current externalities take a number of forms and are subject to some push-back from stakeholders and regulators. A company might refuse to provide health benefits to its employees, leaving Medicare or Medicaid to pick up the tab. The company might save on production costs by skirting environmental laws, thereby forcing communities, neighbors, or employees to suffer risks of harm that do not need to be accounted for on the company’s financial statements. Alternatively, the company could sell shoddy products to one-time purchasers, produce goods in sweatshops, or underfund employees’ pension funds.

The more difficult kind of externality to address—especially if our focus is on the sustainability of the corporation—is the future externality. What I mean here is the kind of cost that a corporation’s management can externalize to the future. From management’s perspective, the future is a much more attractive place to push off costs. Stakeholders who must bear such future costs will be less aware of those costs than current costs, and even if they do learn of such future costs, they will be less able to gain the attention of regulators.

The aim of this Essay is to ask about one particular kind of future externality: future costs to shareholders. I recognize that shareholders are not usually the focus in a discussion of externalities. In the present, their interests are sufficiently (even if not perfectly) aligned with those of management that we need not concern ourselves with externalities borne by shareholders other than through the usual corporate governance tools. But in the case of future externalities, the analysis is more complex. Current shareholders may prioritize present returns over future returns, and current shareholders may not expect to be future shareholders at all. This means that corporate managers have incentives not only to externalize costs to current and future stakeholders whose interests they can ignore but also to future shareholders as well. This means that corporations will, by their very natures, be fixated on the short term.

If one is worried about the sustainability of corporations from an environmental, social, or political perspective, the problem of “short-termism” has to be a central worry. This is because in
the long run the interests of corporations conflate with those of society as a whole. Short-termism is a problem whether we focus our attention on the sustainability of the corporation or the ethics of its management.

Short-termism is also costly economically, since the economy as a whole benefits when companies have a long-term strategy. The economy is a summation of the fortunes of the millions of companies and individuals that make it up; if most companies make decisions that prioritize the short-term at the expense of the long-term, we all suffer. A nation's wealth grows more over time when companies invest for the future and maintain their viability as a going concern.

Despite some naysayers, the problem of short-termism is very real. Shareholders hold their stocks, on average, for less than a year, and even less for small companies. Institutional investors have been said to be particularly bad on this front, acting “more as traders, seeking short-term gain.” Managers admit that they make decisions that harm the company in the long-term in order to meet short-term earnings expectations. In 2006, both the Conference Board and the Business Roundtable, two of the nation’s most prominent business organizations, issued reports “decrying the short-term focus of the stock market and its dominance over American business behavior.” And, let’s remember, that was two years before the collapse.

But there is a puzzle. In contrast to the others who suffer the costs of future externalities, future shareholders have a way to communicate with present-day managers and shareholders. They “communicate” with the present by way of the market. What I mean is that in a well-functioning, efficient market, present-day decisions that exact a future cost will affect present-day stock price. Current stock price will be affected by future losses because current stock price is a function (in part) of future profitability of the firm. With that truth in mind, why do managers focus on the short term? Why would a company benefit from short-term management? If short-termism is a problem because it falsely inflates the company's stock price, how does that occur? That is, why would share prices be inflated rather than depressed for such a company?

I. The Short-term Puzzle

Consider that any shareholder who sells her stock in order to profit in the short-term is selling to someone else, who by definition believes that the stock is selling for less than it is worth. Share turnover is not by definition a problem, then, since for every seller there is a buyer. Moreover, it ought to be irrational for Wall Street analysts to require--and company management to make--decisions that hurt the company in the long run but allow the company to meet short-term earnings projections. In such situations the share price should fall rather than increase or stay steady. The reason is that in an efficient market, share price is a reflection of the company's value. If decisions are being made to decrease the true value of the firm then the share price should reflect that.

Indeed, if the company is in fact being managed for the short-term at the expense of the long-term, the share price should fall dramatically and consistently. If managers intentionally manage a company to accelerate all profit and earnings into the next five-year period and then go bankrupt, no informed shareholder should purchase shares of that company at the current price. The shares will be worthless in five years, and fall dramatically in value between now and then.
In figuring out this puzzle, allow me to make an assumption that will simplify the analysis as we go. Allow me to assume that there are two kinds of companies: one that manages for the short-term and one for the long-term. The short-term company seeks to maximize profits and earnings in the near future and disregards the long-term. If decisions can be made to transfer value from the future into the present day, the management will do so—even if it will decrease the total value of the firm aggregated over time. (I’ll set aside for the moment why management would do this.) Long-term-oriented companies will make decisions that seek to maximize the value of the company over time. If decisions can be made in the short-term that cost the company money but will pay returns in the future, then the company will do so—even if in so doing the company will be unable to recognize profits in the near future.

In a company whose management team is oriented toward the long-term, one would expect to see a greater-than-usual dedication to sustaining the company as a going concern over time; a larger commitment to maintaining the loyalty of those who have made investments in the company, whether by way of capital, infrastructure, or work; a dedication to the development of products or services that will pay off in the future; a diversification of firm endeavors and investments to guard against short-term shocks in the financial or consumer markets; and so on.

On the other hand, a company focusing on the short-term will also have a number of strategies at its disposal, each of which will likely impose long-term costs onto the firm but have short-term benefits to the company, the management, or certain shareholders. There may be situations in which such long-term costs are worth the short-term gain—for example, when the company needs to satisfy some short-term financial obligation (to pay a legal judgment, say) and can only do so if R&D expenditures are put off.

This is not to say that a company that refuses to engage in such short-term decisions will necessarily succeed. Managers make mistakes, and some mistakes are quite costly. Moreover, to the extent that a company’s time horizon is long, it may be more difficult to know whether a long-term strategy pays off more than a short-term strategy. Also, a long-term strategy is more difficult: not only must a company’s management make decisions that are focused on success five, ten, or twenty years out, it must also make short-term, tactical decisions that work as well. A part of a company’s long-term strategy must always be to survive in the short term.

So here we get to the nub of the problem: if by definition short-termism is costly to companies in the long run and to the economy as a whole—because the economy is a summation of the well-being of everyone—then why do we see the short-term management tactics described above?

**II. Puzzling Out the Puzzle**

One possible answer lies in the nature of management. To state the obvious, companies are controlled by managers, and some managers intend to be at the company for a long period of time and therefore look toward the long-term. Other managers want to make their money and get out. This would explain why some managers would want to manage their companies for the short term. But it does not explain why the market does not consistently punish such behavior. If managers
make decisions that will hurt the company in the long-term for selfish reasons, why does the share price not fall?

Another answer might be that that some investors, too, focus on the short-term, so that they buy stock of companies so oriented. But even that does not fully answer the question, since short-term-oriented shareholders should not be able to realize any benefit from owning shares in a short-term-oriented company. If dividends are inflated in the short-term at the cost of the long-term fortunes of the company, whatever benefit realized from the short-term dividends will be more than set-off by the decline in the stock price brought about by the decline in the real value of the company. No benefit should be gained from such a strategy if indeed it is known to the investing public. As the costs of the short-term strategy become clearer, the stock price will plummet, and those holding the shares of such a company will find fewer willing buyers.

As for companies with long-term strategies, the future earnings will be reflected in current prices as well, so the stock price will be trading at a fairly high price-to-earnings ratio. (The value of the future earnings will not be fully captured by the current share price, however, since investors will discount future earnings in relation to the time value of money and will also likely impose a “risk discount” in connection with the probability that the company will not actually realize the benefits of its long-term strategy.) All in all, in a perfectly informed market, the value of long-term-oriented companies will tend to be recognized as such, and their share values will so reflect.

III. The Information Fallacy

Of course this argument depends on an unreasonable and simplistic assumption—that the market is perfectly informed. In fact, investors are not perfectly informed, and it is often costly or impossible to determine whether companies are being managed for the long- or short-term. That is, it is often costly or impossible to determine whether an increase in quarterly earnings is evidence of a short-term orientation that will be costly to the company in the long-term, or if the increase is due to the realization of returns from a successful long-term strategy.

This fact poses a significant difficulty for public policy. Profits and earnings for a long-term-oriented company may be indistinguishable from profits and earnings for a short-term-oriented company. It is easy to show the numbers; it is rather difficult for most investors to determine the reason for such numbers. In fact, a company that is utilizing short-term managerial strategies may show profits and earnings that are greater than companies with a long-term focus. And capital markets may not “punish” such short-term management if it is not clear that the inflated earnings are based on strategies that are costly in the long-term.

When a company’s management strategy is not known, or is not widely known, a company that is being managed for the short-term may have a share price that is inflated, only for the price to fall along with earnings when the strategy becomes clear. As for long-term-oriented companies, the depressed short-term earnings brought about by the long-term strategy will not be easy to distinguish from depressed earnings caused by bad management or a short-term strategy that has run its course. The stock price will also be discounted because it will be unclear to investors what the true strategy really is. This in turn makes the company ripe for takeovers.
So in a world in which (1) short-term management can result in short-term bumps in profits and earnings and (2) such earnings and profits are indistinguishable (or costly to distinguish) from those coming from long-term-oriented companies, then (3) the market will be slow in punishing short-term-oriented management. That is, there will be a lag between the implementation of a short-term management strategy and when the capital market prices shares correctly.

The other side of the story should be told as well: it will often be difficult and costly to distinguish between a company that is showing a low level of short-term profits and earnings because of the costs of implementing a long-term strategy and a company that is showing a low level of profits and earnings because of poor management or a failure of strategy. So the share price of the company that is actually being managed for the long-term—but showing no signs of success as of yet—will trade deceivingly low.

The existence and extent of this lag time between the establishment of a long- or short-time horizon and the recognition of the costs or benefits thereof in the stock price will depend on a number of factors. The most prominent of these will be how obvious the strategy is to investors in the market. The more obvious the strategy, the more efficient the capital markets will be in "pricing" the securities issued by the company. If a company that is pursuing a short-term strategy is able to camouflage it as a long-term strategy, the stock price will be falsely inflated until the strategy becomes sufficiently clear to the investing public that they recognize that it is overpriced. Only then will the share price fall to a level that correctly reflects the company's value.

Most investors will not invest the time to distinguish between the long-term companies that are not yet making money and the companies that are simply floundering. Instead, they will look toward companies that are showing profits and earnings. The problem here is that some of these companies are realizing the benefits of successful long-term strategies, while others are simply exchanging long-term benefits for short-term profits at the cost of the company's long-term prospects.

**IV. Sophisticated Investors in an Uninformed Market**

Note that nothing I have said so far will be unknown to sophisticated investors. They know that earnings and profits in the short-term do not necessarily translate into long-term success. They know that a failure to show short-term earnings does not necessarily mean that the company is destined to fail. But they also know that it is costly to figure out which is which, and that what counts to them is the value of their portfolio as a whole over time, not the profits from a single investment.

So in maximizing the value of their portfolio, sophisticated investors face a variety of choices. If such investors have a short-term focus, perhaps because their own time horizons are short because of imminent retirement or the like, then they have no incentive to try to pick the long-term successes and hold for the long-term. These investors will instead look for companies whose stocks will pay off in the short-term, whether such payoff comes as a result of short-term strategies with long-term consequences or as a result of companies that are realizing the payoffs of long-term
strategies.

As for long-term investors—individuals planning for retirement years in the future or investment funds that hold accounts for such people—one might expect that they would tend to “buy and hold” investments in companies that appear to be strong for the long-term, even if short-term earnings are disappointing or foregone. That is true for some long-term investors, but certainly not all. Such long-term investors, whether individuals or institutions, face a choice: they can (1) try to identify companies that have successful long-term strategies but whose stock is undervalued at present; or (2) identify companies with high earnings and profits in the short-term. Some of the latter group will be truly successful companies; some will be companies that are utilizing strategies to emphasize short-term gain at the expense of long-term gain.

Most investors cannot control the timing of the investment’s withdrawal. They can only try to stay ahead of the curve by trading often and quickly, usually on the slightest sign of downturn in a stock. This makes the market as a whole more volatile, since small upticks in stock price will attract a host of short-termers looking for a place to put short-term money, and small downturns will cause many short-termers to flee in fear that the small downturn is the beginning of something worse. But such a strategy is highly risky, and unlikely to maximize gains over time (witness that very few mutual funds outperform index funds over time).

V. Making a Short-term Strategy Work in an Uninformed Market

What if an investor could time their investments? The gains from the short-term strategy could be immense. The long-term value of their portfolios would be the summation of a series of above-market, short-term gains. And the strategy could be maintained as long as there are enough investment opportunities available so that the money investors pull out of one company can find a place to land elsewhere. But how could such timing be accomplished? How would they do that? The answer is by taking over management of the company or by buying enough stock in a company that the management is forced to listen to you.

Obviously, such a tactic would be available only to investors with significant capital to invest. But if investors are successful in doing so then the company can be made to do the things that shift future company value to the present. For example, the company can buy back stock, increasing immediate returns to investors; pay management exorbitant compensation, in effect taking present and future earnings of the company as individual compensation; sell off portions of the company for cash, distributing the cash as a dividend; or leverage the company highly, multiplying the return on equity at the cost of increased risk for the firm in the long-term. Moreover, while the investors themselves are managing the company in such a way, they need not make the true implications of their decisions clear to the investing public.

VI. What to Expect in a Short-Term Market

So that’s the story of how short-term-oriented investors could collude with, or become, short-term-oriented management to cause businesses to manage for the short-term without being punished by the market in the short term. Such a strategy will hurt the company in the long term
and impose external costs onto company shareholders and stakeholders with long-term interests -- as well as society and the economy in general. But such costs will not be borne in the short term by the investors or managers. As long as they "get out" in time, they will be able to enjoy above-market returns. And as long as they can continue to find companies that are susceptible to the same strategy, they can maintain above-market returns for the duration. But of course such returns are not truly a reflection of anything other than being a winner in a zero-sum game. The returns are not a reflection of excellent management, or product innovation, or the creation of value. They are only, in economists’ terminology, the "extraction of rents," the shifting of financial gain from someone who is losing at least as much. The fact that those who are losing exist mostly in the future does not make the losses any less real.

There is one last thing to recognize: in a market where companies are being increasingly managed for the short term, the typical "Main Street" investor will not stay in the dark forever. Investors who do not have the access or capital of the hedge funds and private equity funds will eventually recognize what is happening. So they, too, will start investing with a view toward the short term, and be extremely sensitive to downturns in stock price that might be signs of a more serious downturn. This will in turn make the market as a whole more volatile. And as volatility increases, the entire market will become less secure. More and more investors will either lose their shirts or simply leave the market and put their money elsewhere. And eventually, the costs of short-term management will be such that the entire economy will suffer.