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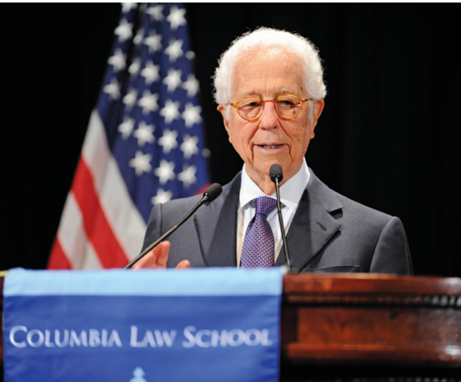

10th Year Anniversary Essay

"Short-Termism"

COLUMBIA LAW SCHOOL

About the Essay

This essay is part of a series written for the Millstein Center's 10-year anniversary. Each of the essays explores a topic or issue that the Center has addressed over its past decade of work. The essays' authors have all been on the front lines of the changes addressed and were often directly engaged in the Center's activities.

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The Millstein Center would like to thank the article's author, Douglas Chia, for his time and contribution. The Millstein Center would also like to thank Robert Kueppers for serving as editor for this essay series.

Short-Termism

By Douglas K. Chia

Perhaps no topic in corporate governance has garnered more and stronger reactions than the debate over whether short-termism is an issue for public corporations, the public markets, or the economy.

From the explosion in recent years of buybacks and dividends, to the declines in investment in research and development and capital expenditures, and unprecedented corporate profits and cash holdings, some argue that capitalism has focused in on the wrong outcomes, or worse, been coopted by the few at the expense of the many.

This essay will lay out the data and arguments over short-termism and what structural changes may be needed to foster long-termism in public companies and to encourage the long term growth of the economy needed to build wealth in a durable manner.

Sustainable capitalism calls for using the capital available to a business in a way that creates value and profit today while preserving value for the future. In short, it calls for a balance of short-term and long-term focus. The trends putting sustainable capitalism at public companies under pressure make it clear that the current state of business is out of balance, resulting in a focus that is too short term. The pressures to maximize profits at the expense of future profitability are likely to be stronger in the future as downward pressures on corporate profitability increase. Public companies can engage in longer-term behavior in the current environment, bringing back a more balanced focus, but only if companies and their stakeholders take affirmative steps to move in that direction.

Why Is Short-Termism a Concern Now?

Business investment has declined substantially in the last decade as measured by the 10-year moving average in the financing gap as a share of gross value added in the non-financial corporate sector.[1] Typically, investment has been around 1.5 to 3 percentage points of gross value added larger than internal funds, but in the past 10 years it has steeply declined into negative territory.

Public companies have been spending on stock buybacks and dividends. From 2003 to 2012, the 449 companies in the S&P 500 index that were publicly listed during that time used 54 percent of their earnings to buy back their own stock, almost all through purchases on the open market, and dividends absorbed an additional 37 percent of earnings, leaving just 9 percent for reinvestment in the business.[2] Noting that companies were on track to spend over 100 percent of their corporate earnings in 2015 on total payouts to shareholders, Commissioner Kara Stein of the U.S. Securities and Exchange Commission stated, "It's worth thinking about what effect this uptick in stock buybacks may be having on innovation and capital formation."[3]

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[1] The financing gap is equal to capital expenditures less the sum of the internal funds in the nonfinancial sector.

[2] William Lazonick, "Profits Without Prosperity," *Harvard Business Review*, September 2014.

[3] Commissioner Kara M. Stein, "Toward Healthy Companies and a Stronger Economy: Remarks to the U.S. Treasury Department's Corporate Women in Finance Symposium," April 30, 2015. Echoing Stein's concern, Andy Haldane, the chief economist for the Bank of England, said shareholder power is leading to slower growth due to the high proportion of corporate profits being paid out to shareholders rather than invested in the company. Interview of Andrew Haldane, British Broadcasting Corporation, July 24, 2015 (www.bbc.com/news/business-33660426).

A Look at the Macroeconomic Impact of Short-Termism

Short-term behaviors of companies and investors may be contributing to recent adverse economic and societal trends. A growing number of commentators have blamed the slowdown in the economy since the financial crisis on short-termism.[4] While a review of the data on macroeconomic effects shows that economists differ on whether short-termism is a significant factor in the economic slowdown, a number of economists have concluded that short-term focus is taking a toll on the overall economy: William Lazonick argues that the rise in stock buybacks affects income inequality, with implications for the economy,[5] Andrew Smithers shows how the decline in business investment affects trend growth of GDP,[6] and Andrew Haldane, chief economist of the Bank of England, who was recently quoted as saying shareholder power is "holding back economic growth."[7]

While data on macroeconomic effects clearly support a conclusion that short-termism is one factor in the economic slowdown, these data are not sufficient to conclude that it is a major factor.

Short-Term Pressures Are Likely to Increase in the Near Future

Short-termism is likely to grow in importance in the coming years as performance pressures mount. Corporate profits as a share of GDP in the past decade were unusually high, mostly due to very low labor costs during and after the Great Recession, leaving businesses with an unusually large amount of spare cash. But higher labor costs triggered by a growing shortage of workers are likely to lead to stagnating or even declining corporate profits in the next decade. In fact, corporate profits may have already reached a peak in this business cycle. In the United States and elsewhere, unemployment has already or soon will reach its "natural rate," meaning labor costs have already begun to rise and will continue to do so over the next 15 to 20 years as baby boomers exit the workforce in record numbers.[8] As labor costs rise, there will likely be increasing pressure to cut costs in other areas such as longer-term investments.

Moving Toward a Balanced Focus

The future strength of business rests on a return to a more balanced approach between long-term and short-term horizons and arresting the overrep-

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4 Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term," *Harvard Business Review*, January-February 2014, p. 4, state that, "the ongoing short-termism in the business world is undermining corporate investment, holding back economic growth." See also: "The Profits Prophet," *The Economist*, October 5, 2013 (www.economist.com/news/finance-and-economics/21587213-new-book-explains-why-business-investment-has-been-low-profits-prophet), and Robin Harding, "Corporate Investment: A Mysterious Divergence," *Financial Times*, July 24, 2013.

5 William Lazonick is codirector of the University of Massachusetts Center for Industrial Competitiveness, president of the Academic-Industry Research Network, and author of "Profits Without Prosperity," *Harvard Business Review*, September 2014.

6 Andrew Smithers established the economics consultancy Smithers & Co. in 1989. He writes for the *Financial Times* blog on economics and markets. See "Productivity and the Decline in Capital Efficiency," *Financial Times*, June 24, 2015 (http://blogs.ft.com/andrew-smithers/2015/06/productivity-and-the-decline-in-capital-efficiency/).

7 Duncan Weldon, "Shareholder Power 'Holding Back Economic Growth,'" *BBC News*, July 24, 2015 (www.bbc.com/news/business-33660426).

8 Gad Levanon, Bert Colijn, Ben Cheng, and Michael Paterra, *From Not Enough Jobs to Not Enough Workers: What Retiring Baby Boomers and the Coming Labor Shortage Mean for Your Company*, The Conference Board, Research Report 1558, September 2014.

resentation of short-term interests today. Corporate executives, board members and investors must review their governance structures and practices to determine whether they adequately promote long-term thinking and to consider whether any changes could better serve their long-term interests as they move forward in the current environment:

Proposals abound for how to "solve" or at least influence corporate short-termism. Some of these proposals have recently played a role on the national political stage, suggesting that the national sentiment on these issues is reaching a tipping point. With that as the backdrop, we can expect to see a continued focus on these issues. Roughly outlined, these "solutions" fall into three buckets.

Governance changes that public companies might consider

The proposal that is perhaps gaining the most traction is the suggestion that companies abandon quarterly bottom-line earnings guidance and replace it with longer-term guidance and information that is material to the company's long-term prospects. For many, this proposal holds great potential as a way to focus managers, and the market, on the longer term goals and strategy of the company. And it's important to note that quarterly reporting would still exist, as required by law, building in the ongoing accountability that many investors feel strongly about.

Board's should also consider a revamp of executive compensation to reward long-term thinking. For example, boards might require executives to hold shares for a longer term, say 5 to 10 years. And metrics in compensation plans should be revised and/or established that measure longer-term performance, again, over a period defined by the industry's business cycle.

Already underway in some European and Asian markets, we'll see companies and boards consider the benefits of offering extra dividends or enhanced voting rights to reward long-term investors. The intent here is that by encouraging these long-term investors, boards and management can build trust based relationships with key institutional holders and focus on their long-term strategy while maintaining some stability in the stock.

Finally, Boards will increasingly adopt capital allocation policies with respect to share buybacks to ensure that the long-term interests of the company are not sacrificed to the pressures of daily business activity.

With respect to governance changes that investors can consider, there are two principle considerations that have risen to the fore. First, investors will increasingly come under pressure to move away from quarterly portfolio manager compensation and evaluation.

And secondly, investors should be cautions not overly discount longer-term corporate investments, which arguably has encouraged shorter-term decisions at the expense of long-term growth.

And lastly, we'll see the government, and politicians in particular, revisit tax policy. In this regard, there are two key provisions that will come under scrutiny. The first is an adjustment to the capital gains tax rate to reward longer-term investments. And the second will be the imposition of a transaction tax on frequent trading.

Conclusion

Public corporations have been the engine of growth and prosperity in the United States since the beginning of the twentieth century, leading to an unprecedented increase in the standard of living and the development of extraordinarily innovative products and services. Yet at the turn of the twenty-first century, the future prosperity of this engine of growth is being jeopardized by the short-term focus of many public companies on extracting value today instead of investing for the creation of value in the future. This focus has been driven by

those managers and boards who believe that maximizing stock price every quarter is their fiduciary obligation to shareholders and by those shareholders who share this belief. That there is no such legal fiduciary duty is irrelevant. This belief has been exacerbated by the rapid rise of hedge fund activists whose success depends largely on increasing stock price performance of target companies over the short term.

The results are clear and evidence of short-termism is all around us. Public companies are investing less in their businesses and paying out earnings to shareholders more than in the past, to the point that earnings are not retained for the business. The capital markets have changed from being primarily the providers of capital to businesses to being primarily platforms for shareholders to trade with each other. These trends, if they continue, will inevitably result in a loss of competitiveness. Public companies, their shareholders, and policy makers must take affirmative steps to begin to right the balance from quarterly capitalism to a longer-term focus. Many of the possibilities being discussed in the marketplace are not new, but the need for a renewed effort to address the problems of short-termism is urgent.

For these unhealthy trends to be reversed, it will be critical for all stakeholders to look inward on how their own respective practices and behaviors may be contributing to the problem. For too long, one stakeholder group has placed the responsibility for reform on other stakeholder groups, resulting in maintaining the status quo. At this point, all stakeholders must join the discussion to consider constructive solutions. Some of the more innovative proposed solutions may potentially be disruptive to certain interest groups, necessitating careful thought about unintended consequences. However key decision-makers cannot allow the specter of unintended consequences to result in inaction. Some may propose resurrecting practices that were long ago dismissed or abandoned. These must be given a fresh look, regardless of the current conventional wisdom. Most of all, reversing the trend of succumbing to short-term pressures will require real leadership from all stakeholder groups. The leaders who emerge must be willing to convene, make concessions, take calculated risks, and at times sacrifice their own commercial interests to create a business environment that positions our society to prosper over the long-term.

About the Author

Douglas Chia: Douglas K. Chia is executive director of The Conference Board Governance Center. He joined The Conference Board in February 2016.

Mr. Chia previously served as assistant general counsel and corporate secretary of Johnson & Johnson. Before joining Johnson & Johnson in 2005, he served as assistant general counsel, corporate of Tyco International, and practiced law at the global firms Simpson Thacher & Bartlett and Clifford Chance, both in New York and Hong Kong.

Mr. Chia has held a number of central leadership positions in the corporate governance field, including chair of the board of directors of the Society of Corporate Secretaries and Governance Professionals, president of the Stockholder Relations Society of New York, member of the Corporate Laws Committee of the American Bar Association, and member of the New York Stock Exchange Corporate Governance Commission. He is also a member of the National Asian Pacific American Bar Association.

Among other recognitions, Mr. Chia has been named Corporate Governance Professional of the Year by Corporate Secretary magazine, Distinguished Corporate Secretary by Corporate Board Member magazine, one of the 100 Most Influential People in Finance by Treasury & Risk magazine, and one of the 100 Most Influential People in Corporate Governance and the Boardroom by NACD Directorship magazine.

Mr. Chia is a graduate of Dartmouth College and the Georgetown University Law Center. He currently lives in Princeton, New Jersey with his wife and their four children.

About the Millstein Center for Global Markets and Corporate Ownership

The mission of the Millstein Center for Global Markets and Corporate Ownership is to bring world class scholarship, research and academic rigor to the vital task of restoring and strengthening long-term financing of innovative and durable public corporations, which are the underpinning of economic growth.

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