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A Defense of Short-Termism

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ONCE upon a time, in a bygone era, a new creature began stalking Wall Street. He was called a "corporate raider," and he made strange utterances that executives had not heard before.

He growled that executives cared more about building empires than building shareholder value. He bought big stakes in bloated, inefficient companies and began demanding — demanding! — that chief executives cut loose money-losing units to become more competitive. He insisted that management be paid with stock and options so that they would start caring about the stock price, and would be rewarded as their shareholders were rewarded.

And how did executives respond to this alien threat? They resisted mightily, of course.

Among the major arguments they raised was that these new creatures didn't really care about the companies they were stalking. All they cared about was a short-term fix that would lift the stock price, even if that so-called fix ultimately hurt the company. The raiders, executives said, didn't just want to pare back unprofitable divisions; they wanted to slice into valuable research and development. They wanted to throw out the baby with the bath water. Why, executives asked, should they sacrifice the long-term health of the corporations they were running just because some rich financier wanted to get a little richer?

Yes, well, that was then.

AND this is now. The former Securities and Exchange commissioner William H. Donaldson is standing at a podium in a Manhattan hotel. It is this past Tuesday — smack dab in the middle of "quarterly earnings season"— and about 40 people, including a handful of reporters, have gathered to listen to Mr. Donaldson decry the rise of "short-termism" in American business.

Two groups — the Business Roundtable's Institute for Corporate Ethics, and the CFA Institute's Centre for Financial Market Integrity — have produced a report about the corrosive effect of short-term thinking in American business. Mr. Donaldson is helping them unveil the report at the luncheon.

In addition to laying out the problem of short-termism — which the report describes as "the excessive focus of some corporate leaders, investors, and analysts on short-term quarterly earnings and a lack of attention to the strategy, fundamentals and conventional approaches to long-term value creation" — it also proposes a handful of solutions. These include eliminating "earnings guidance," pegging executive compensation to "long-term strategic and value-creation goals" instead of short-term stock market goals, and communicating to Wall Street more frequently about long-term strategy and fundamentals.

“It’s a beginning,” says Mr. Donaldson, who then cedes the floor to people from the two organizations that produced the report.

“Seventy-six percent of our members say they don’t want earnings guidance,” says Jeffrey J. Diermeier, the president of the CFA Institute, which represents thousands of Wall Street analysts and professional investors. Kurt N. Schacht, the institute’s managing director, adds that it is critically important that Wall Street and corporations “get off the quarterly earnings treadmill.” In this room, at least, there are no dissenters.

And why would there be? Who, after all, can possibly be in favor of short-term thinking? In the space of 25 years, quarterly earnings have gone from being a requirement to an obsession that has seemingly warped the way American executives think and act. The Enron scandal, for one, was directly related to this obsession. But even putting scandal aside, it is pretty clear that too often, companies worry more about creating short-term financial results than long-term strategic results. Remember how Coca-Cola, under the late Roberto C. Goizueta, used to make its quarterly number, usually by a penny a share, like clockwork? Then, in 1997, Mr. Goizueta died, and eventually the truth came out: the company had played some financial games to smooth its earnings and achieve those results. I don’t think it’s a stretch to say that the company is still paying the price for some of the things it did back then.

“There’s a tyrant terrorizing nearly every public company in the United States,” wrote the Harvard Business Review in 2001. “It’s called the quarterly earnings report. It dominates and distorts the decisions of executives, analysts, investors, and auditors. Yet it says almost nothing about a business’s health.”

It wasn’t hard for me to find people to echo that line this week. “Stop worrying about the quarter,” said Robert Olstein, who runs the Olstein Financial Alert Fund. “It’s irrelevant.”

Peter L. Bernstein, the well-known economic historian, said, “There is evidence that companies will pass up profitable opportunities” if such an investment will have a short-term effect on coming earnings.

Peter M. Gilbert, chief investment officer for the Pennsylvania State Employees’ Retirement System, said, “Short-term focus takes the eye off creating long-term value for corporations and ultimately for the investor.”

And Candace Browning, Merrill Lynch’s global head of research, said, “It became a game.”

Ms. Browning was speaking in particular about earnings guidance, which companies began doling out in the 1990’s. That’s the now-common practice of a company estimating, within a small range, what its earnings-per-share are likely to be both quarterly and annually. Practically speaking, it means that companies get to set the bar — and then jump over it.

To Mr. Olstein, this is a classic example of “the tail wagging the dog instead of the dog wagging the tail.” It’s also a prime example of short-termism — companies that were really focused on long-term strategy wouldn’t bother trying to do the analysts’ job for them, nor would they be particularly worried about the short-term hit the stock might take if it “missed” the consensus earnings number ginned up by the analyst community.

In any case, companies that are managed well for the long-term will likely see their stock price rise accordingly — even if it is more volatile over the short term. Google doesn’t give guidance, and it hasn’t exactly hurt the company.

The most shocking thing I heard this week about the bad effects of short-term thinking came from a 2005 study conducted by three economists for the National Bureau of Economic Research. They asked a series of questions about the importance of quarterly earnings to more than 400 executives and discovered that almost 80 percent of them said they “would decrease discretionary spending” in such critical areas as research and development, advertising and maintenance if they needed to do so to make the quarterly numbers.

Campbell R. Harvey, a Duke University economist and one of the authors of the study, still sounded a little stunned by the results when I spoke to him. “You would think they wouldn’t want to admit this,” he said. As he saw it, in the wake of the accounting scandals, companies were less willing to use “accounting shenanigans,” as he called it, to meet earnings projections. So instead, “they are doing things that effect the real operations of the company, like postponing R.& D. This is the stuff that creates real value in the long term.”

So why, even after hearing the horror stories, is there still a part of me that says, “Not so fast?” Partly it’s because for all the anecdotal evidence of short-termism and its effects, there is not a lot of empirical data to back it up. Corporations, for instance, still do a great deal of research and development — $250 billion worth each year, according to Baruch Lev, the well-known accounting professor at New York University.

Mr. Lev scoffs at the notion that short-termism is even a problem. “It would be ludicrous to tell managers, ‘we’re going to leave you alone for five years and then come back and monitor your performance,’ ” he said. “Even if you are long-term oriented, you are going to look at how they are doing every quarter.”

The second reason, though, is that as I listened to Mr. Donaldson and the others, I couldn’t help thinking back to the early 1980’s, when the executives themselves made the exact same arguments Mr. Donaldson was making from the podium.

Let’s be honest here: for many of the executives back then, the argument that they were managing for the long-term was bogus. There was too much lethargy in too many companies, and a desire by too many executives to avoid making tough decisions — cutting loose unprofitable divisions, for example. Having sailed through the post-war era without much in the way of global competition, there were plenty of American industries that desperately needed to be shaken up in a tougher, more competitive era. Whatever their flaws, the raiders helped spur that process — in no small part by forcing executives to pay more attention to the stock price.

Ms. Browning of Merrill Lynch told me that she thought "the pendulum has swung too far in terms of focusing on the quarter." I agree with her. That's what often happens on Wall Street — and, indeed, in business. We swing from one extreme to the other.

So yes, by all means: let's get rid of earnings guidance, and start paying executives for achieving important long-term strategic goals that will help the company grow and prosper into infinity. Those are worthy suggestions. But let's not swing the pendulum back too far.

Surely we've learned by now that long-termism can be just as much a problem as short-termism.