With Hillary Clinton’s tax proposals to encourage longer-term investing, the debate over whether American business is too fixated on the short term has moved from the dimly lit offices of earnest policy wonks into the klieg lights of U.S. primary season. Lots of commentators have jumped into the fray to declare that there is—or isn’t—a problem with short-termism, waving research studies of varying age and relevance.
Somewhat ironically, many engaging in the discussion seem to think that the issue itself has a short history. But that is far from true. Thirty years ago, no less a business guru than Peter Drucker weighed in, skewering short-termism in a *Wall Street Journal* editorial. “Everyone who has worked with American management can testify that the need to satisfy the pension fund manager’s quest for higher earnings next quarter, together with the panicky fear of the raider, constantly pushes top managements toward decisions they know to be costly, if not suicidal, mistakes,” he wrote.

One reason the question of short-termism still hasn’t been settled is that the answer is fundamentally unknowable. There is no control group; we can’t compare the performance of America with short-termism to that of America devoid of short-termism — or even prove beyond a doubt that short-termism exists in the first place.

That hasn’t stopped lots of people from studying the issue and offering their opinions—myself included. But the studies’ findings are ambiguous, and they have been for some time: In 1996 professor Kevin Laverty wrote a widely cited piece saying the evidence was inconclusive. I come out on the side believing that short-termism is a problem, but I can’t even view my own position as definitive.

There are, not surprisingly, voices confidently positioned on both sides of the debate. Those in Clinton’s camp include the venerable Aspen Institute, which produced a 2009 call to arms arguing that corporations’ short-term objectives corrode the “foundation of the American free enterprise system.”

On the other side, noted economist and hedge fund adviser Larry Summers cautions that reforming “quarterly capitalism” would risk driving us toward “Japan’s *keiretsu* system, which insulated corporate management from share price pressure by tying large companies together.” *Keiretsu* “was widely seen as a great Japanese strength,” Summers notes, “yet even apart from Japan’s manifest macroeconomic difficulties, Japanese companies lacking market discipline have squandered leads in sectors ranging from electronics to automobiles to information technology.”
A Review of Relevant Studies

With most contentious issues, it behooves us to take a deep breath and see what the accumulated body of research shows. Unfortunately, serious studies have come out with conflicting assessments about both the existence of short-termism and its consequences.

The data is often contradictory. For instance, one measure of short-termism is the level of corporate capital investment. Expenses considered short-term flow entirely through yearly income statements, while longer-horizon investments are capitalized and amortized on the books over many years.

R&D spending falls into the long-term bucket. For much of the period since 2000, its growth was fairly weak in the United States, but 2014 saw a big increase in R&D. And 2015 is looking even better, with R&D investment at the highest level (as a percentage of GDP) in the history of America. However, the Brookings Institute has shown that a broader measure of business investment — nonresidential capital investment — is trending steadily downward. One way to look at it is that R&D intensity is the ultimate measure of long-term investment, so things have never been more focused on the future. But you could argue that R&D is only one component of investment. And because it’s under closer scrutiny, corporations are careful to classify as much as possible as ”R&D” to avoid accusations of short-termism when they lower their overall investment.

Another prominent argument is that briefer CEO tenures lead to more short-term thinking. Some studies show that long CEO tenures produce better performance (though that appears to be limited to more stable industries) and lead to better product-safety results. However, there is also a study showing that the longer CEOs hold their jobs, the higher their pay, and the more likely they are to take risks that hurt shareholders. And another study found that relationships with customers, and thereafter performance, weaken as CEOs’ terms lengthen. Clouding the picture, it is not at all clear that CEOs’ time in office is in fact consistently
shrinking. Recently, the Conference Board noted that the average tenure of S&P 500 CEOs had declined from 11.3 years in 2002 to 7.2 years in 2009. However, since then it has lengthened, to 9.9 years in 2014.

Bank of England economists Andrew Haldane and Richard Davies argue reasonably convincingly that corporate impatience is increasing. While it is clear that both infinite patience and utter impatience undermine corporate performance and that something in between is better, it’s not clear where the optimal point on the spectrum is — or where we actually are on it today.

Over the years, investors have become more impatient, as revealed in shorter holding periods of stocks. However, those periods have not shortened meaningfully of late. That combination may mean that shorter holding periods are simply not a problem. Or it could be that there has been a time delay and it took a while for the earlier steep fall in holding periods to cause negative outcomes. Either explanation is plausible.

Hedge fund activists loom large in the discussion of short-termism. Harvard Law professor Lucian Bebchuk argues that they catalyze improved corporate performance, not just short-term stock price increases. Martin Lipton says that Bebchuk is lying with statistics and that, properly measured, corporate performance suffers when activists throw their weight around. And Yvan Allaire looks at the entire universe of hedge fund investments and performance indicators and argues that activist hedge funds do drive short-termism along multiple dimensions. Personally, I find Allaire more compelling than Bebchuk, but it’s hard to argue that the effect of activist hedge funds is unambiguous.

**A Big Red Herring**

A big red herring in this debate is the performance of short-term traders. Much is made of the fact that they get better returns than long-term investors do. That leads to a logical implication that if we create rules that lock individuals into their investments, we would hurt the overall performance of the capital markets.
The great irony is that the very shortest-term traders – the hedge funds, including the program-trading hedge funds that hold stocks for minutes or even seconds – often lock their limited-partner investors into their holdings for longer periods than Clinton’s proposed legislation encourages. Withdrawal waiting periods can range from six months to the entire duration of the fund – say, five years. Hedge funds like, and therefore enforce, a regime of stable investment capital more than the corporations that they jerk around on a daily basis do.

In any event, hedge funds’ performance is simply not the issue. The performance of companies delivering real products and services is. Since their investors can make as great a profit shorting stocks as investing long term, the shortest-term of them could do fantastically well while driving the economy to hell in a handbasket.

So I utterly reject any argument that suggests short-termism can’t be a problem if short-term investors are doing well. I would be more inclined to believe that their success is evidence that short-termism is a problem.

**The Lens I Take**

In total, the literature that purports to show that corporate short-termism does or does not produce a bad outcome is ambiguous and has been for at least 20 years. To me, this isn’t a surprise. The performance of the corporate sector in America is the product of a complex adaptive system, in which it’s really difficult to say that $x$ causes $y$. It is much more likely that a whole lot of $x$’s combine to cause $y$ and a bunch of other stuff.

In complex contexts generally, and certainly in this one, I tend to swim upstream from the output and look at the behaviors of actors in the system to infer their likeliest impact. Which behaviors give us pause for genuine concern? Outcomes produced by businesses will be a function of the decisions made by executives, and if those decisions are made with little regard for the long term, it is fair to expect that long-term performance of business will suffer.
On this front, three studies have had considerable influence on my thinking.

The first is a study in which John Graham, Campbell Harvey, and Shiva Rajgopal interviewed 400 CFOs of large U.S. public companies. Almost 80% of them said that they would sacrifice economic value for the firm in order to meet that quarter’s earnings expectations. To me this was a stunner. I was not surprised that 80% would do so – in fact, I suspect that the reality is closer to 100% – but that 80% would actually admit it. I would have expected executives to avoid any answer that would identify them with a socially frowned upon behavior: earnings manipulation.

The second and third studies are linked. Bill Lazonick’s research into the extraordinary rise of corporate buybacks in America demonstrates that firms are devoting a disproportionate share of their earnings to repurchasing their own stock rather than investing them in future growth. Of course, buyback proponents argue that this is in fact optimal behavior; a reflection of the fact that in today’s environment, American corporations don’t have promising investment opportunities, so returning the cash to shareholders is the right thing to do.

However, a University of Illinois study shows that a large share of buybacks occur when a corporation would miss its earnings per share target if not for the lift provided by a buyback. And the research in general demonstrates that buybacks do boost share price in the short term. So buybacks, plain and simple, are a tool for boosting short-term performance, regardless of their impact over the long haul.

I worry a lot about these managerial behaviors. And one reason is that they completely align with what I see in my work advising CEOs of very large public companies on strategy.

The executives I work with speak openly about the market pressures for short-term performance. Though my perspective might be colored my empathy toward them, I would say that to a person, they want to ensure that their companies do as well as possible in the long run. But they believe the capital markets place unrealistic and unproductive constraints on them. Their eternal question is, How much can we invest in the long term before Wall
Street starts agitating and making our lives so miserable that it threatens our ability to manage productively at all? For the better positioned of them, the answer is that they can invest nearly all that we would wish them to. But the CEOs who are already under threat or pressure, especially from activists, can invest almost nothing at all.

The current hue and cry from stock markets about organic growth is a product of this dynamic. The markets relentlessly demand profit growth this quarter. Executives respond by underinvesting in long-term growth and buying back stock. For many, buybacks are an explicit, ongoing part of their EPS growth formula (for example, 5% from organic growth, plus 3% from acquisitions, plus 2% from stock buybacks equals the desired double-digit EPS number). Then the markets hammer their companies for low top-line growth, telling executives that they won’t be able to maintain profit growth without revenue growth. Duh! Of course! You reap what you sow — except for the hedge funds, which will just swarm like locusts onto the next company to destroy it, too.

This argument isn’t going to get resolved any time soon. As Malcolm Gladwell pointed out in his piece about concussions and chronic traumatic encephalopathy (CTE) in football, when clever interested parties employ lack of definitive scientific evidence as their defense, they can keep the gravy train going for a long, long time. Coal-mining companies did this to stave off concerns about black lung for half a century. Tobacco companies did it to ignore concerns about lung cancer for decades.

Now hedge funds and their friends are doing it — really successfully. I agree that the scientific evidence isn’t definitive. But if you were a coal miner’s wife or the husband of a two-pack-a-day smoker, you didn’t need definitive scientific evidence. You saw it with your own eyes. That is how I feel. I see it with my own eyes, and I am not waiting with bated breath for the study that proves that short-termism is here and it is a problem.

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3 COMMENTS

Steinar Valade-Amland mDD 12 hours ago

Thank you, Mr. Martin - I have argued my concerns for capital fund owned ventures for many years - however mostly in a sustainability and CSR context. As much as you now support the scepticism against short-termism from a performance point of view, I also think that it is unrealistic to expect short-term ownership of companies to promote investments in footprint reduction or in better work conditions - both long-term by nature. I appreciate that I now will have hard-core financial arguments to back up my worries.

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