



CAUSES OF SHORT-TERMISM IN THE FINANCE SECTOR

Discussion paper

Final

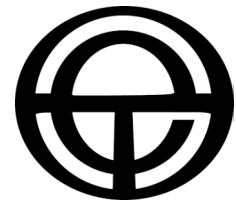
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For

Total Environment Centre

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Abbreviations

AGM	Annual General Meeting
ASX	Australian Stock Exchange
CAMAC	Corporations and Markets Advisory Committee
CEO	Chief Executive Officer
CFA Institute	Chartered Financial Analyst Institute
CFO	Chief Financial Officer
CSR	Corporate Social Responsibility
IMA	Investment Management Association
ISF	Institute for Sustainable Futures
NAPF	National Association of Pension Funds
NGO	Non-government Organisation
TEC	Total Environment Centre
TUC	Trades Union Congress
UNEPFI	United Nations Environment Program Finance Initiative
UTS	University of Technology, Sydney
WBCSD	World Business Council for Sustainable Development

1 Introduction

Short-termism has been identified as a significant barrier to achieving corporate sustainability, both in Australia and globally. The Total Environment Centre's (TEC) Green Capital Program has instigated a project to consider the problem of short-termism with the following objectives:

- To raise the issue of short-termism as a barrier to corporate sustainability
- To identify causes and solutions to short-termism
- To promote the uptake of solutions in Australian business

Green Capital has commissioned The Institute for Sustainable Futures (ISF) to research causes of, and solutions to, short-termism in the finance sector. The research involves desktop review of literature and two focus groups with Australian investment community stakeholders. ISF has not undertaken original empirical or theoretical research. The literature review includes consideration of relevant theoretical and empirical evidence, but is not a comprehensive theoretical review.

In undertaking this research, we have accepted the underlying premise of the project as set; that short-termism has a causal relationship to unsustainability. It should be noted, however, that this view could itself be a question for research. For example, short-termism could alternatively be a symptom rather than a cause of unsustainability. In our view, the causal relationship premise is supported by the fact that corporate sustainability¹[1], is generally associated with investments that have a relatively long payoff period and may not have a positive impact on company market valuation in the immediate future (and indeed could have a negative impact in the short-term). If the investment sector has a short-term outlook, therefore, initiatives to improve sustainability are less likely to get off the ground. Companies seeking to improve the sustainability of their business have expressed frustration at the constraints imposed by short-termism in the market. As we shall see, empirical research provides evidence of the operation of such constraints (whether real or perceived).

The outputs from this research project are: two discussion papers - one covering causes of short-termism and the other covering solutions to short-termism; and an Action Plan. The purpose of the discussion papers and Action Plan is to stimulate debate about short-termism and to lay the foundations for addressing short-termism in the Australian finance sector.

This paper discusses causes of short-termism in the finance sector. It should be read in conjunction with the second discussion paper *Solutions to Short-termism in the Finance Sector* and the Action Plan *Paradigm Shift to Long-termism*. Comments from the first of the two project focus groups are incorporated in this paper. The focus group is referred to hereafter in this paper as "the first project focus group".

In July 2005, The Conference Board Global Corporate Governance Research Center held a Corporate/Investor Summit in London that convened some of the most distinguished representatives from the corporate and investment worlds, to explore the debate on market

¹ Corporate sustainability is defined by the Australian Government as follows: "Corporate sustainability encompasses strategies and practices that aim to meet the needs of stakeholders today while seeking to protect, support and enhance the human and natural resources that will be needed in the future."

short-termism. The report from the Summit identifies three major 'links' in the investment short-termism 'chain' [2]:

- The investor link
- The analyst link
- The corporate link

The analysis of causes of short-termism that follows covers both systemic factors and factors impacting on the key links in the investment short-termism chain (as identified by the Conference Board Summit delegates). Firstly, we look at what is meant by short-termism and why short-termism is a problem.

2 What is short-termism?

In an adaptation of Marginson and McAulay's definition, we define short-termism as a preference for actions in the near-term without due consideration of the long-term consequences [3].

Determining what is short- and long-term is subjective. Sustainability practitioners tend to think of long-term as many years into the future. The International Panel on Climate Change, for example, reports on scenarios to 2100. By contrast, in financial markets, where decisions are made minute-by-minute, the time horizon of participants can be incredibly short – less than a day even. From this perspective therefore, anything from 3 to 10 years can seem long-term. In the UK, a consultation by the Marathon Club discussed long-term mandates and described the following timescales,

By short-term we mean periods of between three months...and three years...By long-term...we mean for periods of longer than three years, typically between five and ten years, or the length of the business and market cycles [4].

As this research centres on financial markets, we have accepted the Marathon Club premise of less than 3 years as short-term. The following analysis is undertaken in this context.

3 Why is short-termism a problem?

There are numerous analyses that explain why short-termism is problematic. We have identified the following consequences of short-termism:

- Depression of economic development and destruction of long-term value through:
 - undermining confidence in the soundness of the underlying economy [2]; and
 - lack of long-term outlook and investment within companies - building long term market share has become a secondary objective to maintaining short-term share prices [5].
- Failure to adequately account for and invest in long-term environmental, social and economic sustainability. Short-termism favours immediate financial returns. The long-term costs of unsustainability therefore tend to be ignored in favour of minimising short-term costs and maximising short-term profits. In the long-term, this could lead to society- and economy-wide destruction of value. For example:
 - The economic logic of the 'tragedy of the commons' suggests that, in the absence of a regulating authority, self-interested independent agents will seek

short-term personal gain at the expense of the long-term welfare of all. Over-exploitation can destroy long-term value. An example of this is the collapse of commercial cod fisheries. The pressure to maximise short-term profit by increasing supply and reducing costs has led to over-fishing and subsequent collapse of cod stocks. Conversely, a long-term approach that factored in sustainable fishing practices could have sustained the long-term economic, environmental and social value of the resource. Long-term economic prosperity depends on maintenance of environmental and social capital, but short-termism is undermining these forms of capital;

- Economic theory recognises that externalities (costs that are not paid for by participants in a transaction) are a sign of market failure. The cost of externalities may be temporally and spatially distant from the market transactions that give rise to them. This distance means that externalities do not factor in decision-making. Regulation, such as 'polluter pays', attempts to address externalities. However, companies that voluntarily go beyond compliance in incorporating externalities may be punished by the market if their costs increase in the short-term relative to other companies. Climate change is an example of an externality. *The Stern Review on the Economics of Climate Change* demonstrates that action now to prevent climate change is significantly less costly than meeting the future costs of the consequences of climate change. However, short-termism does not promote preventive action as there may be an increase in near-term business costs. Externalities can therefore result in economy-wide resource inefficiency; and
 - Despite evidence that investment in triple bottom line sustainability can lead to long-term economic benefits for individual companies (for example by reducing operating costs and insurance premiums, strengthening brand equity, reputation, human capital and alliances [6]) the upfront costs of implementing initiatives can be a deterrent to investment. At an economy-wide level, short-term pressure to minimise costs can also result in failure to invest in necessary long-term measures, such as infrastructure maintenance and replacement. As with externalities, the long-term costs of failure to invest are likely to be greater than the immediate costs of investment.
- Reduced investment returns [7]:
 - Firing fund managers due to poor relative short-term performance can destroy value [8], as performance is cyclical. Evidence suggests that trustees tend to replace poorly performing fund managers at the point at which performance improves and appoint new managers that are doing well at the point at which their performance declines [8]. Costs associated with hiring and firing managers – such as loss of knowledge and intellectual capital - are poorly understood; and
 - There are costs associated with the trading system itself. So the more frequent the trading, the more costs offset returns [8].
 - Damage to market credibility [2];
 - Lack of long-term relationships between investors and companies (*The State We're In*, Will Hutton, 1995 cited in [8]);
 - Marginalisation of the interests of stakeholders other than shareholders;
 - Market inefficiency [7];

- Impediments to efforts to strengthen corporate governance [7]. Corporate executives may behave irresponsibly to achieve immediate gains for which they are rewarded;
- Macro-incentives for companies to move to private markets to avoid earnings guidance pressure [7] thereby reducing accountability. However, reduction of agency costs can also lead to economic improvements;
- Growth through mergers and acquisitions rather than long-term organic growth. A report by the Trades Union Congress (TUC) in the UK argues that shareholders in target firms gain in the short-term, but at the expense of other stakeholders, especially employees, rather than as a result of greater efficiency. The TUC states that research shows that takeovers seldom improve long-term value [8]. However, not everyone agrees with this view and many see a positive role for mergers and acquisitions in the economic system; and
- Greater market instability, due in part to the rise of speculative short-term investors, assisted by technological developments such as automatic program selling.

Not everyone agrees that capital markets are biased against long-term investment. Herde argues that although the market does require short-term results it is also interested in knowing a company's long-term growth [9]. Marginson and McAulay question whether capital markets are myopic. They cite evidence that "positive returns have been found to be associated with the announcement of research and development projects" [3], thereby suggesting that "markets reward management decisions that are consistent with long-term value creation" [3]. The market for environmentally and socially responsible investment is now expanding rapidly and business consideration of sustainability factors appears to be on the rise, perhaps indicating a growing acknowledgement of the importance of long-term performance. Marginson and McAulay represent the contradictions as a dialectic debate in which one view is that capital markets are myopic and the other is that markets are interested in long-term value but are confronted by managerial short-termism [3].

Nonetheless, the bulk of the literature suggests that short-termism is a characteristic of financial markets, not just a feature of managerial behaviour, albeit greatly contributed to by the behaviour of, and pressures exerted on, individual market participants.

The first project focus group discussed short-termism as the dominant paradigm in the finance sector. However, it was suggested that there may be rational reasons for this and a short-term outlook itself is not necessarily a problem. Indeed a degree of short-termism is needed for market liquidity and actions are needed in the short-term to resolve problems. Good decisions can be made from a short-term perspective and not all decisions made from a long-term perspective are good decisions. In fact, some long-term investments in products and services, such as coal-fired power stations, may contribute to unsustainability. Likewise, certain sectors may be supported on the basis of presumed inherent environmental or social value, even though they may be poorly managed and have inadequate long-term business propositions and models. Apparently myopic decisions may therefore be justifiable as being in the best judicial long-term interests of the ultimate owner.

The possibility was also raised that some decisions that appear short-termist may not be due to an inherently short-term outlook, but instead may arise purely because of inadequate assessment of the future. The group discussed the need for the market to cater for both short-term traders and long-term investors. The problem with the short-termism paradigm is that it restricts the ability of long-term investors and corporates to take decisions based on principles of long-term value creation rather than short-term performance expectations. Perhaps the appropriate framing, therefore, is not so much short-termism versus long-termism. Maybe it is instead about quality of decision-making, which is largely dependent on quality of information flow, and creating space in the market for different investor types.

The focus group also discussed the possibility that the market may be vulnerable to a specific type of short-termism linked to social and environmental factors. The market has trouble incorporating factors that are difficult to price and around which there are major confidence intervals on potential outcomes, such as climate change.

In summary, fixation with the short-term can undermine creation and maintenance of long-term value and growth at an individual company level and at a societal level. Short-termism undermines sustainable development, as sustainability requires consideration of long-term impacts. The Conference Board concludes that short-termism “encourages opportunistic behaviours by a few to the detriment of the many” [2]. Short-termism is a problem for financial markets because it restricts long-term investment. In seeking to create a paradigm shift, however, the finance sector needs ensure that poor short-term decisions are not simply replaced with poor long-term decisions.

The remainder of the paper examines causes of short-termism in the finance sector.

4 Systemic causes of short-termism

4.1 *Reporting and communications*

Reporting and disclosure have been identified as key factors contributing to short-termism in financial markets. The problems with reporting can be roughly categorised as:

- The nature, or content, of reporting / disclosure; and
- Market reaction to reporting / disclosure.

4.1.1 Disclosure content

Annual reports

Mandatory annual reporting focuses on providing narrow financial information, largely ignoring extra-financial indicators such as human resources management, the environment, corporate ethics and stakeholder relations. Assuming that what gets measured gets managed, current disclosure requirements reinforce a narrow business focus on short-term financial capital only, at the expense of other forms of capital. As discussed above, consideration of extra-financial factors is important for the long-term value and growth of individual businesses, the economy and society-wide sustainability.

Financial reporting is therefore criticized for providing insufficient information to investors and other stakeholders to enable them to make decisions about a company's true long-term value drivers. The Conference Board reports that 75% of a company's market value consists of intangible assets and expectations of future growth that are not captured in its accounting book value, so annual reports are unlikely to adequately disclose the major value drivers of performance [2]. The CFA Institute criticises reporting for being legalistic and providing only 'boilerplate' analysis, rather than providing helpful information to investors about a company's long-term prospects.

Companies and analysts are comfortable with the tangible and familiar reporting of financials. By contrast, reporting of non-financial indicators can be complex - it is often difficult to value and account for intangibles. In the absence of regulation, this has led to an ad-hoc approach and inconsistent reporting of long-term risks and value. Nonetheless, attempts are being made on both a voluntary level and through regulation to address the deficiencies of traditional financial reporting. A 2005 KPMG survey found, for example, that 24% of Australia's top 500 companies now produce sustainability reports [10].

Earnings

In addition to annual reporting, ASX listed companies are required to announce earnings for the past period every 6 months. Companies also provide guidance on future earnings. In the US and UK, earnings are disclosed and guidance given quarterly. Under 'continuous disclosure' rules, Australian listed companies are also required to immediately announce to the market any events that are likely to have a material effect on their share price. Graham et al suggest that earnings per share is the predominant measure of success because it is a simple metric that summarises corporate performance, is easy to understand and relatively comparable. It enjoys wide media coverage and provides a single number for analysts and investors to use to predict the future [5].

As with annual reporting, however, the nature of earnings reporting is criticised for being too narrow and not providing adequate information to investors and analysts to assess long-term value. The nature of earnings reporting reinforces a short-term market focus by encouraging investors and analysts to concentrate their assessments on short-term measures rather than long-term drivers. Alfred Rappaport, of Northwestern University Kellogg Graduate School of Management, who has developed alternative performance metrics (such as the Corporate Performance Statement), believes that "neither last year's earnings nor next year's earnings provide much help in gauging the magnitude, timing and uncertainty of future cash flows...By combining yesterday's accomplishments and tomorrow's uncertainties, accountants produce a bottom line that doesn't tell investors what they need know" [11].

The first project focus group discussed the concern that analysts, working on the best available information, have nonetheless left out half the picture by focusing only on financial measures. Concerns were also expressed about what is measurable and what isn't and the inherent uncertainty in predicting the future. One participant suggested that too much faith is placed in the accuracy of short-term measurements, "all the assumptions that are used, even in very short-term modelling, they're immense and actually not that measurable". Therefore, it is perhaps a fallacy to believe that analysis of the short-term achieves greater measurability than analysis that also incorporates long-term measures.

4.1.2 Reaction to missed earnings targets

Marginson and McAulay contend that the nature of accounting measurement itself is of less significance than the importance attached to it [3]. Recent research suggests that the importance the market attaches to reported earnings has a profound effect on the actions of corporate managers.

Graham et al surveyed more than 400 executives to determine the factors that drive reported earnings and disclosure decisions. The results reveal that corporate managers fear retribution from the stock market for failing to meet earnings targets because the market uses short-term performance to gauge certainty about future prospects of the firm. Missed targets and earnings volatility can lead to a dip in stock price because the market regards these as indicative of higher risk. As a result, CFOs are pressured to manage earnings at the expense of longer-term objectives [5]. The study finds strong evidence that "managers take real economic actions to meet or beat earnings in preference to accounting actions." [5]. Long-term value creation is often sacrificed. 80% of managers interviewed claimed that they would, for example, "decrease discretionary expenditure on R&D, advertising and maintenance". CFOs see meeting market expectations as a necessary evil [5].

The first project focus group discussed the role of disclosure as a driver of short-termism. Some see the requirements for companies to disclose earnings and super funds to disclose performance, as a cause of short-termism. Participants noted that rating agencies add to the pressure on super funds. However, information flow was seen as important for market

efficiency. Less frequent information may contribute to greater market shocks and over-reactions.

It was suggested that market reactions to earnings announcements are perhaps more rational than implied – a short-term announcement can be a good predictor of a long-term valuation change. Market reactivity can lead to better operation of the market. However, it was agreed that the “culture of hyperactivity” in the market is unhelpful. The role of investor relations is to smooth market anxiety and curb waves of over-optimism and over-insecurity.

As discussed here and below, the adverse reaction of the market to missed earnings targets impacts the entire investment chain - fund managers, analysts and companies. The TUC report concludes that unless there is a fundamental change in the manner in which the stock markets perceive small misses from earnings benchmarks, the pressure that CFOs feel to manage earnings is unlikely to go away. “Business leaders feel unable to make long-term decisions because shareholders are looking for short-term relative performance” [8].

4.2 Regulation

Regulation can either encourage or discourage short-termism:

The Conference Board reports on legislative changes in the US in the 1970s that changed the landscape of capital markets in the US and elsewhere. These included regulatory changes that enabled wealth accumulation in pension funds and taxation policies that encouraged short-term investment strategies [2].

In Australia, the introduction of super fund member choice has heightened short-term performance pressure for institutional investors. Funds are now in competition for members seeking high returns in the short-term. The general shift from individual to institutional investors has given rise to disconnection between ownership and control. Individuals invested through a super fund are removed from shareholder ownership responsibilities – ownership is exercised (or not exercised) on their behalf by institutional investors. So even if an individual shareholder is interested in issues other than short-term profit maximisation, it is difficult for them to exercise their ownership rights. Short-termism in the finance sector has generally not been a focus of campaigning and awareness-raising by the NGO sector. There has therefore been little community pressure for change either at the regulatory level or through shareholder activism. This is likely to have contributed to decreased corporate accountability. The effects of a decrease (or perceived decrease) in accountability is evidenced in corporate scandals.

The Conference Board report refers to the recent corporate scandals in the US as evidence of corporate culture contributing to short-termism – a culture that encouraged corporate executives to look after their own personal, and largely short-term interest, rather than to “generate sustainable benefits to all stakeholders”. Such excesses are now being addressed through more stringent regulation on corporate governance, such as the Sarbanes-Oxley Act of 2002 and similar legislation in Europe. The study by Graham et al notes however that the current focus on corporate governance may be ineffective in addressing short-termism in corporate executives. The recent attention on improving corporate governance centres on manipulative accounting, but research indicates that the focus needs to be expanded to “the real business decisions of managers” [5]. It should also be noted that the whole question of governance and internal power relations is a widely debated field, subject to considerable academic and corporate discussion, which is beyond the scope of this paper.

The first project focus group discussed corporate governance mechanisms. It was acknowledged that there has been a degree of “clubbiness” between corporate managers and fund managers on governance issues. A comment was also made about the quality of

voting mechanisms; many AGM votes are lost or misdirected, indicating that there are operational issues to be addressed.

As noted above, reporting regulations in Australia have not, to date, required reporting of extra-financial factors, and the focus on narrow financial measures rather than long-term value and sustainability has encouraged a short-term outlook. There is also no regulated requirement for company directors to take account of the interests of stakeholders other than shareholders. The Corporations and Markets Advisory Committee's (CAMAC) December 2006 report on corporate social responsibility (CSR) in Australia concluded that there is no need to change the Companies Act to require directors to do so because:

...the established formulation of directors duties allows directors sufficient flexibility to take relevant interests and broader community considerations into account" [12].

Allowing flexibility, however, does not guarantee that other stakeholder interests will be considered. Creation and maintenance of long-term environmental, social and economic value is important, not just for business itself, but for the welfare of society.

Some regulation already exists to protect the interests of other stakeholders and to address externalities. Increasing environmental pressures suggest however, that current regulation is insufficient to address externalities such as climate change and over-exploitation of common resources, such as oceans. In the absence of adequate regulation, incentives to maximise short-term profit continue to override broader, long-term interests.

4.3 Speculation

A number of reports have drawn attention to the contribution of speculation to short-termism, particularly hedge funds. According to a report by The Evening Standard in London cited by the TUC, there is widespread concern that hedge funds are:

...turning the place into a casino where genuine long-term investors and companies are overwhelmed by their superior financial resources... Meanwhile they simply devastate the morale of managements who see share price movements that bear no connection to the work they are actually putting into a business[8].

However, studies have also shown that "many investee companies valued the business acumen of hedge funds, their contribution to market liquidity and their influence on complacent management" [8].

The Conference Board notes that speculation is not found only in hedge funds and derivatives trading, but also "in a large proportion of high-turnover portfolio managers ready to jump in and out of the market" [2]. The rise of speculative investors has been boosted by the availability of online trading, real-time stock price information, analysis and news. Speculative investors are not prepared to wait for long-term growth but instead make buy/sell decisions in minutes or seconds. Summit delegates were "unanimous in their belief that stock investment speculation is a major cause of market short-termism" [2].

4.4 Education and experience

There is a perception that the average participant in financial markets today is young and inexperienced [13]. Young analysts and fund managers who have not experienced a full business cycle may tend to over-react when a company misses an earnings target [5], contributing to pressure on companies to meet short-term targets.

The Conference Board report cites evidence from a study sponsored by the UN Environment Programme Finance Initiative (UNEP FI) and the World Business Council for Sustainable

Development which found that young analysts are typically uninformed about non-financial issues and long-term sustainability concepts [8]. Financial educators such as business schools and professional bodies, do little to improve the situation, by focusing only on short-term and narrow financial performance metrics. The UNEP FI study concluded that “Young finance professionals are reluctant to learn of new methodologies to differentiate their analytical skills” (cited in [2]). In addition, training provided by financial services firms to analysts and fund managers is costly and highly specialised, with a focus on achieving short-term returns. This, coupled with short-term incentive structures means that the majority of finance professionals have neither the expertise nor the inclination to work to longer-term horizons [13].

The CFA Institute also highlights the issue of a lack of appropriate financial education, noting that overall financial education levels around the world are low. This is likely to mean that super fund beneficiaries are not fully aware of the consequences of short-termism in management of their funds. Lack of relevant training is a particular problem among pension fund trustees [7]. Investors may have inadequate knowledge and experience to properly assess long-term business and investment strategy and are increasingly influenced by information provided by the mainstream media. Trustees exert pressure for change and improved performance at short notice [14]. The CFA Institute report also comments that corporate managers may misinterpret how the market values their company and therefore place undue emphasis on short-term valuation measures such as earnings.

4.5 Societal and behavioural factors

Human behavioural and societal factors both influence, and provide insight into, short-termism in the finance sector. Economic and political systems and institutions are locked into accepted behaviours and norms that are difficult to change as they require changes in deep-seated views and attitudes shared by a large number of people. This institutional inertia, along with social and technological developments over the last thirty years, has exacerbated the issue of short-termism. Governments working on short-term political cycles and focussing on re-election, tend to have a myopic view of issues and set short-term objectives rather than more visionary policies [15]. This applies to government regulation of the finance industry. The Australian cycle is more compressed than most. In 2000, Prime Minister John Howard acknowledged that “short-termism (is) forced on national politics by the maximum parliamentary term of three years.” [16].

At a cultural level, an increasingly materialistic society demands immediate returns and satisfaction. “...The increased pace of the world, the shortened time-frames within which we live longer, the shorter life-cycles of such things as markets, technology, products and employment tenure - the collapsing of time” [17] may have a causal link to the over-riding short-term mentality within society. The emergence of 24-hour news and channels dedicated to financial markets has increased scrutiny of the stock market, increasing performance pressure. In an increasingly globalised economy and society, the impacts of short-term stock market reactivity in one country can be experienced around the world.

The first project focus group commented on short-termism not only in investment but in “everything we do”. A further issue identified by the focus group is the lack of investment in commercialisation of new technologies in Australia. Although there is excellent research, for example in medical technologies, environmental technology and through the university sector, it is perceived that there is inadequate public investment in commercialisation funds, and a lack of venture capital compared to overseas. Therefore there is insufficient structural support for long-term economic development.

Human behavioural aspects also contribute to short-termism. Time affects an individual’s propensity to make appropriate and successful decisions – the longer the time horizon, “the

greater is the uncertainty and information is more likely to be deficient" [3]. Short term decision-making, therefore, feels more informed. Role ambiguity (the difference between the information a person needs to fulfil a role and the information available) also plays a part. Working to the short term can be a coping behaviour which can provide decision-makers with more clarity and structure [3].

Individual market participants are also influenced by peer pressure from their inter- and intra-firm colleagues. "Short-termism, as the accepted way of doing things, can become legitimised as an accepted form of institutional behaviour" (Lavery, 1996 cited in [3]). Within organisations, there are pressures to conform to the existing system. Social interaction and communication within the firm can lead to a convergence of views and beliefs and this serves to perpetuate the focus on the short-term. Behaviour is reinforced by positive reactions to individuals acting according to generally accepted norms [3]. However, the outcome of peer pressure is highly dependent on the culture of the individual firm. Companies such as Fuji Xerox, for example, are heavily influenced by corporate values that are a fusion of short- and long-term. Further, as internal organisational boundaries diminish, inter-organisational influences may either increase or decrease short-term pressures [18].

Fund managers in particular are influenced by the relative performance of their rivals and by the expectations of their clients. Fund managers tend to function according to a 'herd instinct' due to the perceived (or actual) emphasis on relative performance. For example, investment behaviour during the technology, media and communications boom led to fund managers second-guessing their competitors rather than accurately analysing stocks. This compounded existing distortions and poor decision-making [8].

4.6 Performance assessment and incentives

Throughout the investment chain, market participants are assessed and rewarded on the basis of short-term performance. This applies to fund managers, analysts and corporate executives. Assessment and rewards are key causative factors in short-termism, as discussed below.

5 Causes of short-termism at the level of links in the chain

5.1 The investor link

5.1.1 Individual and institutional investors

The predominant US/Anglo model of capitalism has contributed to the short-term outlook of the investment chain. The over-arching features of this business model are: "single-tiered boards focused on shareholder interests; dominant financial markets; weak role for banks; and little industrial/government policy." (Reed, 2002 in [19]). Since maximising shareholder value became the key objective for most companies in the 1980s, organisations have been judged on a very short-term (often daily) basis. Investors seeking to maximise returns on their investments evaluate success or otherwise on the short term performance of funds. Short-term performance is seen as a less risky way to earn returns and investors churn their portfolios regularly to take advantage of minor adjustments in stock prices. Recent loss of trust in corporate leaders is likely to be a contributory factor to investor risk aversion, and technological development has assisted speculative investors, as discussed above.

Individual investors closely monitor the performance of their super funds and are likely to switch if they are under-performing. The limited timeframe they have in which to earn a return for retirement means that there is a perception that they cannot afford to wait and persevere with a less successful fund [8]. This puts short-term performance pressure on institutional investors.

The first project focus group participants discussed the impact of a move from defined benefits to accumulation super funds and member choice. Retail investors are considered to be less reactive to poor performance than institutional investors. Nonetheless, super funds are concerned about losing members if short-term performance is poor. Accumulation funds have shifted risk, or at least made it more obvious who are the ultimate risk-bearers – fund beneficiaries. This was identified as a factor in increasing short-term performance pressure on superfunds. Individual fund beneficiaries may not be in a position to adopt a long-term view, specifically those approaching retirement age. It was suggested that younger investors may be more willing to ride out market fluctuations. There was also discussion about education of customers. It was noted that there have been significant advances in public understanding of market operations since the advent of super provision in the early '90s. The next stage of understanding – the benefits of long-term investment -may take some time to achieve.

Pension fund trustees make decisions based on short-term performance figures. TUC research found that “trustees...overwhelmingly supported the proposition that they should be able to terminate fund managers’ mandates early” [8]. This, despite many disagreeing that they put too much pressure on fund managers to deliver short-term results. The most important factor to the pension fund is whether the fund manager is meeting trustees’ expectations and helping to fund the pension scheme. If returns are unsatisfactory, there is a tendency to change fund manager, rather than look at the investment strategy in more detail to evaluate the chances of longer-term success.

The focus group noted that while large pension and super funds hold most of their equities over the long term, they also want the freedom to invest in short term investments if opportunities arise. Further, although such funds claim to be interested in the long-term perspective, the dominant perspective getting through to companies from investors is that of the short-term traders. The long-term investor message is not getting through the investment chain. Super funds may also be unwilling to unilaterally address short-termism and/or poor governance practices in the companies in which they invest because they are uncomfortable about being seen to take on companies alone.

5.1.2 Fund managers

Research by Li Jin at Harvard Business School concludes that the short investment horizons of fund managers are related positively to their investors’ short investment horizons. The research suggests that fund manager investment short-termism is caused by investor short-termism, but not the other way round [20]. Even if their clients, the investors, claim not to evaluate performance in the short term, regular reviews and the importance placed on performance within these reviews sends a message to the fund managers that short-term performance is indeed important.

Rob Brierley, a senior institutional adviser with Perth broker, Hartleys, blames fund manager performance assessment and rewards for short-termism,

The performance of the average funds manager in Australia gets measured on a quarterly basis, so they can't help but be fixated by investments with a time horizon of three to 12 months...That then does not favour investment techniques which identify strategic or real long-term value [21].

Pension fund trustees rate performance as the most important issue on which they monitor fund managers (cited in [8]). Therefore, although the signals sent by trustees and investors may not be deliberate, fund managers nonetheless perceive pre-occupation with their short-term performance. Some perceive the problem of short-termism to be even more acute in Australia than elsewhere. Simon Potter (Director of Hardman Resources) claims Australian fund managers and institutions are too focused on the short-term outlook and too risk averse compared to their international peers. They are “influenced by short-term cash flow issues. In comparison, UK analysts would look at the full life-cycle of the assets rather than the...near-term cash-flow, which is volatile and exposed to risk.” [21]

Evidence suggests that it is rational for fund managers to be concerned about short-term performance. Li Jin’s research shows that mutual fund investors chase recent fund performance. Underperformance puts fund managers at risk of being fired. New fund flow is sensitive to performance and fund outflow constitutes automatic partial liquidation. Therefore, managers who focus on long-term payoff at the expense of short-term valuation might not survive to see the long-term profit realized, and even if they do, their assets might be substantially reduced [20].

With fund managers rewarded for their analysis of, and investment in, the short-term, financial performance of companies, there is little incentive to evaluate the long-term, non-financial projects that could create sustainable value. In Australia, fund managers tend to benchmark to indices and so are relative performance players [21]. When managers are compensated on relative performance, it gives them an incentive to sell stock when a peer starts selling. Relative compensation is believed to promote ‘bandwagon’ investing and unwillingness to hold stocks for the long-run [5]. Even if a fund manager is generating positive returns it can often be “safer to be wrong with the majority than to be right alone” [5], so fund managers tend to misallocate capital rather than follow their own instincts on investment strategies.

The first project focus group discussed the importance of super funds sending the right signals to fund managers. Unless fund managers receive the message that super funds are committed to long-term value, behaviour will not change. Manager selection was also identified as an issue. It was noted that fund managers are selected and retained on the basis of short-term performance.

5.2 The analyst link

Analysts significantly contribute to the short-term nature of financial markets. They are rewarded for deal flow and so have an interest in generating activity rather than developing knowledge about long term value to inform investment decisions [2]. They tend to market popular stocks, rather than stocks that are mis-priced, and so contribute to the herd mentality [22].

Short-term earnings dominate analysis. This is self-reinforcing because investors see share prices react to earnings information and thus equate this to a better guide to prices (Rappaport in [8]). Decisions on investment are thus not made on sound valuations. Comparative, rather than absolute, analysis of value can lead to inefficient allocation of capital. Graham et al conclude that, “Analysts are complicit in the earnings game” [5]. If firms fail to meet their predictions, they are embarrassed. They might also find it worthwhile to let a ‘bellwether’ stock (a single company stock that has an enormous influence on the direction of the market) beat the earnings estimate to reduce the risk of other stock prices in the industry falling and making their predictions for the other firms look bad [5]. Analysts prefer smooth earnings as it increases future predictability. Analysts typically do not incorporate long-term drivers of value, such as environmental performance,

in their analyses. They perceive that there is little demand for such analysis in the marketplace. However, in ignoring such factors they are ignoring important sources of risk.

The first project focus group commented that by focusing only on short-term issues, analysts are potentially overlooking important information. This could lead to them missing sources of value, misallocating capital and underestimating the impacts of issues like climate change that will become increasingly important.

As discussed below, analyst preferences impact significantly on corporate decision-making. Survey evidence shows that “CFOs view institutional investors, followed by analysts, as the most important marginal investors in their stock ... Individual investors are a distant third.” [5].

5.3 The corporate link

As discussed above, corporate executives (CFOs) are often willing to sacrifice potential long-term investment benefit to meet short-term earnings targets and to achieve smooth earnings. The research by Graham et al demonstrates that long-term investment, such as research and development, is foregone in preference for short-term strategies, such as cost cutting measures.

The first project focus group discussed the notion that corporate managers operate in, and accept, a culture in which short-term earnings are all-important. This leads them to make decisions with positive short-term returns, even if long-term returns are potentially greater. Companies are perceived to be in a predicament. They are reluctant to allocate capital to address long-term issues because they are concerned that the market won't welcome such decisions. Yet, they recognise the importance of addressing the issues. Participants had mixed views on the willingness and preparedness of management to discuss long-term issues with investors.

Research provides evidence of the underlying reasons for such behaviour:

Rules of the game

Working within the system, corporate executives recognise “rules of the game” that influence their decision-making. The study by Graham et al identifies these rules as [5]:

- (i) “the stock market values predictability of earnings because market participants hate the uncertainty created by a firm failing to hit the earnings benchmark or by earnings that are not sufficiently smooth;
- (ii) there is a widely held belief that every firm manages earnings to hit targets, so if one firm does not manage and misses a target, it will get punished;
- (iii) because everybody manages earnings, if a firm misses a benchmark, it likely has revealed previously hidden problems at the firm, which worsens the perception of future growth prospects;
- (iv) managers try to maximize smoothness in earnings—volatile earnings are bad because they convey higher risk and/or lower growth prospects; and
- (v) firms should voluntarily disclose market-moving information because doing so results in lower information risk.”

Manager motivation

Given the perceived rules, it is hardly surprising that managers take actions to meet short-term targets even at the expense of long-term value. The research found that managers are motivated to maximise short-term earnings to [5]:

- Build credibility with the market;
- Maintain or increase stock price;
- Improve the external reputation of the management team, which helps provide personal career protection and opens opportunities outside the firm; and
- Convey future growth prospects – a strong share price is perceived to indicate a healthy, successful organisation

Managers may also be risk averse and prefer to deal with the certainties associated with the short-term rather than rely on less comprehensive information to take risks on long-term projects.

The importance of stock price

Stock price is of particular concern to CFOs because [5]:

- They believe that short-run stock price affects the cost of capital
- They are subject to job insecurity if the stock price falls
- They think the labour market assesses their skill based on short-run stock prices
- They seek to attract equity analysts to cover their stock
- They seek to avoid embarrassing inquiries by stock analysts if the stock price falls

Fear of takeover is a further strong incentive for managers to maintain their share price in the short-term. If a company does not act in the interests of its shareholders, it can risk being acquired by a stronger organisation. “Companies place a premium on stable cash flows, high security and high returns to pay high dividends to shareholders in order to secure the firm against predatory take-over” [8].

The first project focus group discussed the nature and source of signals received by corporate managers. Companies receive signals from two main sources – analysts and corporate governance channels i.e. investors. It was suggested that the analyst signal is drowning out other signals and boards perceive analysts as effectively setting their share prices in the market. Companies are also affected by day traders, with whom they do not have time to communicate. Companies are concerned about their share price due to takeover vulnerability and the need to access capital at reasonable rates of interest.

Performance assessment and remuneration

Job protection, linked to near-term performance, is a high priority for managers. One way to ensure job security is to excel in performance appraisals, however, these “are focused on single, short-term monetary measures of business performance, such as divisional income, product contribution margin and cost reduction. This leads to data manipulation.” [23].

The shareholder value-based model has changed the way corporate managers are rewarded. Salary packages moved towards remuneration based on stock options. Options are criticised for fixating managers on short-term performance, while not exposing them to the downside risk of management actions, thereby not fully aligning their interests with those of shareholders.

The focus group discussed the mismatch between the need for corporate executives to take a long-term approach, as they make risk judgements and take decisions with long-term implications, and remuneration structures that reward executives for short-term performance. Executives have higher earning potential from short-term rather than long-term reward structures and their performance assessment is based on narrow financial and operational measures.

Leadership

The phenomenon of executive churn has implications for the short- and long-term success of a company. CEOs tend to be exalted by the market, to the point where an incoming or outgoing CEO can have a marked effect on the short-term share price. CEOs also typically have short-term tenures (four to five years) and so tend to have little interest in the long term success of the company [13]. The CFA Institute notes however, that the actions and decisions of CEOs have consequences much longer than the length of their tenure [7] which, in Australia, is an average of 4.4 years, almost half the average of their overseas peers [24].

The research by Graham et al also points to the position of the CFO in the internal power relations of the firm. This is dependent on the traditions and culture of the particular firm. Numerous writers refer to the polarised domains of strategic managers, informed by sociological and cultural theory, and CFOs whose decision-making is informed by the rational classic economics model [18].

Top management styles also have a significant influence on lower management (a 'distant leadership' effect). Marginson and McAulay indicate that trade-off decisions at lower management levels in favour of the short-term closely match those of top management [3]. Therefore, the short-term outlook of corporate leaders can impact on the decision-making of lower management.

6 Conclusion

Short-termism in the finance sector is a complex and multi-faceted issue that has developed over time. There are contributory factors at the global, institutional, organisational and individual levels

On a broad scale, institutional factors, such as short-term political cycles, influence the financial markets as both are intertwined. Changes to the way business is run over the last thirty years have also contributed to short-termism.

This research has identified key systemic factors as:

- Disclosure and reporting requirements and practices;
- Regulation and policy;
- Market drivers such as the rise of speculative investment;
- Insufficient financial education; and
- Societal and behavioural factors such as increasing short-termism in society generally.

Within organisations, there are pressures to conform to the existing system. At the level of individual links in the chain, job insecurity and performance assessment and reward mechanisms contribute significantly to myopic behaviour. Short-termism is self-reinforcing, with each link in the chain exerting short-term pressure on other links in the chain.

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