The imaginary threat of short-termism

Mark Roe | Harvard Law School | 20 October 2015

The idea that financial markets are too focused on the short term is gaining ground in the media and among academics. And now it is attracting political attention in the United States.

Investors' obsession with short-term returns, according to the new conventional wisdom, compels corporate boards of directors and managers to seek impressive quarterly earnings at the expense of strong long-term investments. Research and development suffers, as does long-term investment in plant and equipment. Similarly, short-term thinking leads major companies to buy back their stock, thereby sapping them of the cash they need for future investments.

None of this is good news for the economy - at least, it wouldn't be, if it were real. Upon closer inspection, the supposed negative consequences of investor short-termism appear not to be happening at all.

While institutional investors do trade stock regularly, and sometimes rapidly, financial firms like Fidelity Investments, Vanguard, and other mutual funds have maintained 12- to 15-month holding periods for stocks for decades. Moreover, while much has been made of a new fringe of program traders that moves in and out of stocks in nanoseconds, the belief that this rapid computer-driven trading makes it impossible - or even difficult - for corporate managers to adopt a long-term perspective is not supported by the facts.

In the US, neither R&D nor overall investment is declining. Indeed, many industries pursue long-term investments, notwithstanding their short-term stockholders.

For example, pharmaceutical companies cannot develop new products on a quarterly basis; they must operate with multi-year time horizons. The oil industry cannot open and close oil fields on a quarterly basis; companies must spend a decade or more investing in developing new fields. And remaining on the cutting edge of innovation demands that tech giants like Apple, Intel, Amazon, and Google continue to play the long game. If these industries and companies can take a long-term view, what is stopping other firms from doing so?

Of course, it is true that these industries and companies do not always serve the economy faithfully and well. But the problems associated with them - from price hikes of life-saving drugs to serious environmental damage - are not the result of managers' excessive focus on short-term stock-market results.

Excessive program trading is a poor use of resources, but it rarely undermines effective management for a simple reason - investors who trade only trade, they do not participate in corporate governance and, sometimes, they do not even vote for directors. Given this, managers and boards can ignore short-term trading activity - and they usually do.

Critics might point out that managerial compensation is typically tied to the company's stock price, meaning that short-term trading could affect managers' remuneration. But, if this is true, it does not have to be. Boards can, and sometimes do, choose to tie managers' compensation to longer-range, rather than current, stock performance.

Moreover, "short term" need not connote something pernicious. It can mean flexibility and adaptability. Actions that are criticised as "short-term thinking" may, in some cases, be steps toward abandoning old businesses and failed solutions, helping the company adjust to a changing economy. The video rental chain Blockbuster was not thinking short-term when, seeing the rise of Netflix's DVD mailers and streaming video, it decided to close its brick-and-mortar stores.

Concerns that stock buybacks are draining healthy, promising companies of cash needed for investment and research are similarly misplaced. True, buybacks can undermine a particular firm's ability to invest in its own future, causing incumbent employees and managers to lose out. But that firm - often a long-established one - frequently is no longer the best place for that cash. Indeed, the cash should leave old-line firms with weak futures and end up where it can be deployed more effectively, benefiting the economy as a whole.

Excoriating short-termism resonates widely, because it justifies protecting those with a stake in the status quo - including blue-collar workers with high wages, well-paid CEOs and senior managers, and directors with prestigious positions - from rapid change. For those who are doing well, change can be uncomfortable. Yet few are willing consciously or explicitly to oppose change for pure self-interest (and those who do are unlikely to be successful). Better that they embrace loftier rationales, one of which is the supposed danger of "short-termism."

It is probably not a coincidence that similar rhetoric has long been prominent in business and political discourse in Western Europe, where incumbent employees and firms enjoy greater protection than in the US. But it has now made its way into the US presidential election campaign, with Democratic presidential hopeful Hillary Clinton attacking short-termism in financial markets. This - together with expressions of concern about short-termism from conservative pundits and regulators - suggests that the US could soon become subject to stronger pressure to slow the pace of change in the corporate world. And that is unlikely to be good for the economy in the long run.

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