

Financial markets and short-termism

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Abstract:

The debate about the “short-termism” induced by the financial markets has gone viral. The usefulness of these markets has come under question along with the goal of maximizing shareholder value. After recalling how these markets are beneficial to business investments, attention is focused on how they give rise to problems of governance, in particular short-termism. There is much empirical evidence for this. Decisive factors related to this short-termism are the targets set for earnings, the prospects for investors and the thresholds for incentive pay to managers. This has significant implications for innovation, investments and jobs. A good education in finance and better calibrated pay incentives would probably help set limits.

Does the market lead to short-termism? This question is not new. Thirty years ago, some corporate leaders talked about the pressure that the financial markets exerted on decision-making, notably in France. This issue went viral in the United States, where many politicians, academics, corporate executives, attorneys, judges, consultants and even institutional investors adopted a position against the short-termism resulting from the pressure exerted by the financial markets. This pressure was said to be the cause of everything wrong: underinvestment, downward social mobility, rising inequality and even climate change. Questions thus arose about the usefulness of the financial markets and the objective of maximizing shareholder value. One sign of short-termism has been the increase in share buybacks, which supposedly make shareholders richer in the short run but, in the long term, harm investments, innovation and wage-earners.¹

¹This article has been translated from French by Noal Mellott (Omaha Beach, France). The translation into English has, with the editor's approval, completed a few bibliographical references. All websites were consulted in May 2020.

The debate about short-termism has swelled into an intense controversy. It is, therefore, worthwhile briefly reviewing the reasons why financial markets exist and describing their real effects on the economy and firms. What are the financial markets good for? What is short-termism? What evidence proves that it exists? Can we gauge this phenomenon's macroeconomic scope? What are the origins of short-termism, and the way out of it? Given the breadth of these questions, this article cannot be exhaustive. Its intention is to simply recall a few established facts, share a few strongly held ideas and raise a few questions.

The financial markets and corporate governance

The objective of the capital markets is to orient savings toward investment opportunities that will create wealth for investors and, ultimately, for society. Thanks to these markets, investors can diversify their risks and obtain liquidity. This lowers the rate of return demanded by investors and, consequently, the financial cost to firms, thus bolstering their potential for investment. After all, some unprofitable investment opportunities become profitable when a lower (in some cases, half) rate of return is demanded.

The setting of prices on the financial markets produces information for corporate leaders. These executives have information from within the firm, but the market aggregates investors' expectations, thus providing information useful for decision-making. Since the market value is based on expectations about future flows of liquidity, it measures (by anticipation) performance and thus makes it possible to evaluate the choices made by heads of corporations. The indexing (of part) of the pay of top executives on market value disciplines their actions and pushes them to seize investment opportunities rather than maximize current performance.

By lowering the cost of capital, offering information and taking into account the future growth of streams of liquidity, the financial markets should cause the level of investment to rise and should make corporate management more efficient. On the other side of the ledger however: diversification, liquidity and the production of information might also weaken corporate governance.

Diversification versus control

There is a conflict between the need for diversification and for control. The more diversified an investor's portfolio, the less control he can exercise over the firms in it. This slackens the market's discipline of corporate executives, who might try to pursue their own interests instead of representing the interests of shareholders (JENSEN & MECKLING 1976). From another perspective, diversification reduces the involvement of shareholders in the firm — their cognitive input, the knowledge they convey to executives.² Incentive pay based on the stock market price of shares realigns executives' with shareholders' interests by solving the first problem (discipline) but not the second (shareholders' involvement).

² On this, see Charreaux's (2002) seminal article.

The power of certain institutional funds makes it possible to have a significant holding in a firm and to benefit from the possibilities of diversification. This recent trend thus attenuates the problem of balancing diversification with control. If a single institutional fund has a major holding in a majority of firms in a sector however, other problems might crop up, in particular the distortion of competition in that branch of the economy.

Long-term value and short-termism

The condition for liquidity is to have a large enough volume of transactions and, as a consequence, capital from short-term and very short-term investors, who are not interested in the investments that the firm will make and that will affect the value of securities beyond the period when they hold them. The primary form of short-termism is to forsake long-term investments in order to maximize current profits. Some investments (in particular intangibles) might gradually create value and thus raise the market price of shares. According to Edmans (2011), employee satisfaction is correlated with outperformance for shareholders. These good tidings suggest that there is no inconsistency between the value for shareholders and for employees. But a different interpretation of this finding is that employee satisfaction is an intangible asset that is not reflected *ex ante* in the value of securities. A tension is thus likely to arise between the firm's need of short-term investors in its capital in order to generate liquidity and the underinvestment that could come out of this. Consistent with this hypothesis is Garel and Petit-Romec's (2018) finding that employee satisfaction is positively correlated with the average time that institutional investors hold shares in the firm.

Given the foregoing, we can distinguish between a share's short-term and long-term values. The long-term value takes account of the investments made without anticipating a share value. Obviously, if executive pay is tied to the share value, short-termism will be made worse since the price of a share poorly reflects long-term investments. Even if the share price correctly reflects such investments, short-termism can arise when corporate executives and certain market players have an erroneous idea about the formation of value. In particular, the short-term production of the financial information (forecasts and targets for earnings) on which the market feeds — an information that often conditions incentive pay for executives — might be at the origin of short-term biases.

Shareholder value, stakeholder value, externalities and short-termism

Another short-termism is the failure to undertake actions that generate stakeholder value as defined by Charreaux and Desbrières (1998), *i.e.*, value for all of a firm's partners, whether financial or not. Neglect of the externalities (*e.g.*, a degraded environment) that a firm shifts onto society can also be a form of short-termism.

To take an example: investments in occupational health are intangible, and their benefits will be observed years after the adoption of occupational health programs, which lower both absenteeism and turnover while increasing employee productivity and reducing health insurance costs (MOUSSU & OHANA 2016). Not only do these programs have a very high

pay-off, they are also investments that align the interests of shareholders, employees and society. Not investing in such a program is evidence of a short-term view of both shareholder and stakeholder value and of a short-term approach to externalities.

In general, quality products, good working conditions, long-term relations with suppliers... are conducive to increases in shareholder value. The creation of long-term shareholder value is usually aligned with the creation of value for (nonfinancial) stakeholders. Interestingly, it has been proven that environment-friendly behaviors lead to lower capital costs (CHAVA 2014) and increase the value of shares. It is, therefore, reductionist to set shareholder and stakeholder value at odds and assume that externalities do not have at least some repercussions on the value of a firm and, therefore, of its securities.

Whether considering tangible or intangible investments, externalities or the relations with (nonfinancial) partners, short-termism refers to the tension between the maximization of short-term performance indicators and the maximization of the long-term value of the firm and of its stock. As previously pointed out, this tension might come from the pressure exerted by investors whose goal is to maximize their investment's short-term value. It might also be linked to the "short-termist ideas" that some managers and market players have about the formation of value. Pay incentives might help correct this bias on condition that they are well calibrated.

The financial market's effects on growth and investment

Research has documented the impact of the financial markets on growth. As the pioneering study by King and Levine (1993) has shown, the financial system's level of development is positively correlated with a country's long-term growth. Furthermore, sectors that need more outside funding grow faster when the financial system is well developed (RAJAN & ZINGALES 1998). In addition, the growth of industries that depend on outside funding is independent of whether the financial system is oriented toward the market or toward banks (BECK & LEVINE 2002). The factors that count are the level of development of the financial system and the quality of the legal system.

Recent studies have focused on short-term pressures in stock markets. For one thing, listed companies invest less than unlisted firms even though they enjoy lower financial costs, which would lead us to expect the contrary (ASKER *et al.* 2015).³ For another, when innovative firms went public (via an initial public offering on NASDAQ), the quality of in-house innovation fell: there was an exodus of talented employees, and such firms started buying other firms in order to continue innovating (BERNSTEIN 2015).

³ Preliminary tests have revealed similar effects in a sample of European firms. Cf. Madalena Da Costa Dias Caetano's master's thesis, ESCP Europe, June 2016.

The role of financial analysts

Financial analysts, major players in financial markets, have the task of formulating and circulating the information indispensable for evaluating assets, in particular, for making predictions about the expected earnings per share (EPS). These predictions are aggregated into a consensus that then becomes a target for earnings. Some studies have concentrated on analyzing the impact of this coverage by financial analysts on the decisions made by firms. The number of analysts who monitor a firm was found to have a positive effect on the corporation's investments in tangible assets (DERRIEN & KECSKÈS 2013) and to curb irresponsible actions (JO & HARJOTO 2014). Strong coverage was, however, correlated with a low level of innovation (HE & TIAN 2013), and made it less probable that the company would undertake an occupational health program (MOUSSU *et al.* 2018).

So, the impact of financial analysts on the firms covered by their reports turns out to be ambiguous. The fact that intangible investments (in innovation, and workplace health) decrease with the number of analysts covering a firm suggests that this coverage is related to short-term behaviors. Additional findings reveal that the impact of coverage by analysts is all the more negative insofar as a firm is close to achieving its targets and as it is exposed to short-term shareholding.

The effects of short-term investors

In line with the preceding remark, Fan *et al.* (2017), when examining the impact of liquidity shocks, have observed a decrease in innovation when liquidity increases. They attribute this to the presence of short-term investors. Likewise, according to Cremers *et al.* (2019), an introduction of short-term institutional investors in a firm's capital is correlated with a decrease in R&D, since the purpose is to swell earnings, generate positive surprises, and thus boost the price of shares in the short term. Nonetheless, the presence of institutional investors is positive for both the quantity and quality of corporate investments in R&D (AGHION *et al.* 2013).

Measurements of short-term performance, stock buybacks and incentive pay

The financial markets need measurements of various sorts. One of them is the EPS. This omnipresent metric must, however, be used with precaution when making inferences about the value of securities. Forgoing an intangible investment might swell the EPS but harm future growth and destroy wealth. In like manner, share repurchases inflate the EPS, but destroy wealth if they entail giving up on making profitable investments.

We are forced to admit that EPS targets tend to have deviant effects. Nearly half of the corporate executives in a survey said they would rather cut a profitable investment than fail to reach the target set by analysts (GRAHAM *et al.* 2005). According to Terry's (2017) empirical observations, executives in listed firms tried to meet or beat EPS targets, in particular by cutting investments in R&D.

As for stock buybacks, according to Almeida *et al.* (2016), 37% of the total amount of share repurchases is spent by firms that would have missed the EPS target without a repurchase. These buybacks are intended to beat the target, but they negatively affect investments and employment in the year following repurchases. As for the effect that exists on R&D, it seems transitional.

Incentive pay for top executives depends on reaching a performance level that, in nearly half of contracts, is set in relation to the EPS (BENNETT *et al.*, 2016). Pay-for-performance is an incentive, but the existence of thresholds has deviant effects. As Bennett *et al.* (2016) have shown, using EPS targets to set pay discourages R&D and encourages a “manipulation” of performance. This comportment has also been observed when contracts providing for incentive pay expire. Executives then tend to cut investments and act on financial communication channels so as to generate positive anticipations with regard to earnings (EDMANS *et al.* 2017).

The impact of debt

One way to increase the EPS is to take on more debt and use it to repurchase shares. A frequent argument for this practice, which has spread widely over the past ten years, is the extremely low cost of carrying debt. As proven a long time ago however, increased indebtedness in a listed firm negatively affects investments and job growth. This negative effect tends, however, to be interpreted positively with respect to market discipline (JENSEN 1986): debt keeps the firm from making poor investments by extracting “free cash flows” (*i.e.*, the cash available once profitable investment opportunities have been funded). This very mechanical view of debt supposes that a firm’s investment opportunities can be identified. However these opportunities come out of a process in which cognitive talents, efforts and “organizational capital” play an important part (MOUSSU 2000). While the perceived level of pressure might discipline bad behaviors, it might also decrease the store of cognitive talents and organizational capital.

The widespread view that the pressure exerted by debt acts efficiently on investment has come under criticism. Focusing on investments in occupational health, which have been documented as being very profitable to shareholders, Moussu and Ohana (2016) have shown that indebtedness negatively affects the probability that a firm will invest in health at the workplace. For this reason, the increase over the past ten years in the indebtedness of (in particular French) firms is to be closely monitored, especially when it stems from the determination to maximize short-term indicators.

The macroeconomic scope of short-termism

The previous findings let us see several ways that financial market ratings lead to short-termism. A recent current of research, launched by American law professors, has tried to qualify the scope of these findings. For instance, Fried and Wang (2019) have argued that, although S&P 500 firms distributed \$7 trillion to shareholders via dividends and buybacks from 2007 to 2016 (96% of their aggregate net income), *“net shareholder payouts by all public firms during this period were only 41% of net income”*. Given the growth of cash balances and of investments in R&D during the period, the authors have dismissed the idea that short-termism deprives firms of the capital needed for investments. Adopting a similar position, Roe (2019) has said that the rhetoric of short-termism is spreading fast for psychological and behavioral reasons instead of being based on clear, empirical evidence. In contrast with the aforementioned microeconomic analyses, he has advocated an overall view, namely that venture capital funding and private equity are essential for financing innovation, which is still very strong in the United States (Roe 2018).

Given their macroeconomic approach, these studies make a helpful contribution to the debate, but they should not obfuscate the problems of governance that stem from the financial markets. To the best of my knowledge, Terry’s paper (2017) alone has proposed estimating the macroeconomic impact of short-termism. Interested in the increase in R&D volatility due to the shocks coming from short-termism, he has estimated this impact to amount to a nearly 0.5% reduction in consumption (considering, however, that all firms, whether listed or not, are subject to the same pressure). By comparison, estimates for the business cycle are of a magnitude of 0.1-1.8%; and the gains in international trade, 2-2.5%. The effects are, therefore, significant.

Conclusion

The decision to align the interests of corporate executives on shareholder value has led to a “financialization” of firms with, as a consequence, the rise of short-termism. Incentive pay for executives has grown considerably. Several studies have brought to light short-term biases that call for attention.

A frequent issue with short-termism is that pay incentives are poorly calibrated and, too, based on false beliefs. Like the return on equity (RoE) in banks (MOUSSU 2018), reaching short-term targets for earnings does not mean that the firm will create value in the medium and long terms. All “good” courses on finance hark on this. Unfortunately, this sure knowledge collides with reality in the field, where short-term indicators are omnipresent in financial analyses and soon come to bias the views of the best educated. A pernicious tendency is that those who condemn short-termism figure among the leading advocates of the idea that share repurchases and dividends create wealth for shareholders. These arguments run counter to the principles of finance; they merely amplify erroneous beliefs and legitimate the existing methods of distribution, since, ultimately, these practices supposedly create wealth for shareholders! A better finance is, therefore, indispensable.

Corporate executives have a very ambiguous position in this debate. On the one hand, the immense majority of them say that they are under pressure to reach short-term targets. On the other hand, despite their blaming short-termism, we never hear them question the methods used to index their incentive pay. The fact that the pay of certain top executives has grown so strongly over the past twenty years (JENSEN & MURPHY 2004) is, for sure, not a factor to be overlooked. Besides, short-termism often stems more from the perception that executives have of market expectations than from actual market requirements.

To break free from short-termism, pay systems will have to be overhauled, in particular the thresholds that trigger incentive pay; and the references to EPS or RoE will have to be restricted or abandoned. It has been fully documented that employee satisfaction, investments in occupational health, the control of environmental risks... are linked to the creation of wealth for shareholders in the long run. Adopting objectives for maximizing value in the long term should, therefore, suffice for reintroducing the long term into corporate decision-making, and thus for making better investments while taking account both of the benefits for stakeholders and of externalities.⁴ Given the confusion between short-term indicators and value, we should, however, be cautious about the idea that maximizing long-term value will suffice to provide appropriate incentives. It is probably necessary to use criteria other than financial ones to work out plans for paying top executives.

Finally and somewhat paradoxically, changes might come from the pressure exerted by institutional investors, who were initially considered to be responsible for short-termism. Larry Fink (BlackRock) has repeatedly called on the corporate executives of listed firms to look for investment opportunities rather than repurchase shares or pay out dividends, to procure on the market information about their long-term strategy and to evaluate the effects of externalities on society. These repeated exhortations should end up orienting behavior toward the long term.

⁴ This is, in effect, the meaning of the findings by Flammer and Bansal (2017), namely: shareholder resolutions on long-term compensation are vectors in favor of innovation, employee engagement, the environment, and operational and shareholder performance.

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