Is there room for the long term in market financing?

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Abstract:
The financial markets have often been criticized as places where only profits count, where the dictates of short-term earnings override long-term interests. This article focuses on equity markets in order to weigh several factors and see whether these markets are inherently incompatible with the long run. After considering how the theories of agency and efficient markets have explained the importance of stock market prices as an inexorable means for measuring a firm's current situation, attention is drawn to the fact that market players are now different owing to their priorities and time frames. In the era of fintechs and blockchains, bringing long-term considerations into a market's objectives is no longer, we must concede, a utopia…

Market finance (a term that covers all financial activities involving a market mechanism) has often been accused of many a woe, even more vigorously in the wake of financial crunches.[1] Without discussing the many and various positions staked out on this topic, we notice that the public often has a negative opinion of the financial markets as places of speculation, where investors are mainly motivated by profit-seeking and driven by greed. Immediate profits thus trump long-term prospects, by their very nature, elusive and uncertain. Some critics even go farther, not hesitating to compare players in the financial markets (namely, traders) to gamblers, nor to liken trading rooms to casinos, where the stimulant of speculation strongly resembles a gambler's addiction (ARTHUR *et al*. 2016).[2]

[1] For example, the following article on the financial markets' destructive force during the euro crisis: https://www.spiegel.de/international/business/out-of-control-the-destructive-power-of-the-financial-markets-a-781590.html.

[2] This 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.

Even within firms, more than one corporate executive has been heard more than once voicing complaints about the pressure exerted by the frequent release of statistics on earnings and by the expectations of financial analysts, whom they have to constantly satisfy lest the price of their firm's securities drop. In their survey of 401 senior financial executives and in-depth interviews with 22 other executives, Graham *et al*. (2006:2) stated, "*A surprising 78% of the surveyed executives would destroy economic value in exchange for smooth earnings*" from quarter to quarter. According to them, earnings that are volatile or are not in line with analysts' expectations carry a higher "*risk premium in the market*"; and the system "*encourages decisions that at times destroy long-term value to meet earnings targets*". Some CEOs have taken a stand by openly criticizing the "torture" inflicted by Wall Street. Elon Musk has gone so far as to declare that being a public company "*subjects us to the quarterly earnings cycle that puts enormous pressure on Tesla to make decisions that may be right for a given quarter, but not necessarily right for the long term*".[3] He added that taking the company private would enable it to make faster progress in the transition toward sustainable energy.

These comments fit into an old argument about the advantages and disadvantages of taking a company public, of switching from private shareholding to become a listed firm with open shareholding. CEOs have recurrently complained about "going public", since they then have to "*deal with day-traders, activist raiders, and other short-term shareholders who are looking for a quick buck and are not actually invested in their company's long-term value creation*" (SCHLEIFER 2019). Some of them do not pause to declare that it is much more advantageous to manage a firm that has stayed private, especially if the shares are concentrated in the hands of a few, often long-term and trusted, shareholders (*e.g.*, a firm with its capital held by the founding family) than to have to, like any public firm, cope daily with the whims of the financial markets — let alone the costs and obligations of going public.

According to Asker *et al*. (2011), private firms invest, on the average, "*nearly 10% of total assets a year compared to only 4% among public firms*" (of a comparable size and in the same industry). These researchers have also found that private firms are much more responsive than public companies to changes in investment opportunities. They have concluded that their survey can be interpreted as evidence of the sizeable hidden cost of going public. They have used the data from their sample (approximately 250,000 "firm-years" on the American market from 2001 to 2007) to unearth a major distortion between the investment practices of listed and unlisted companies. Meanwhile, the number of listed firms in the United States was halved between 1975 and 2016, specifically their number per million inhabitants fell from 22.4 to 11.2 (DOIDGE *et al*. 2018).

As a simplistic stylized fact, this view of "market shareholding", which opts for speculation and immediate profits, can be set opposite a long-term vision, initially borne by the firm's founders and then relayed to top executives as turnover took place in the staff's ranks. The earnings *diktat*, the outcome of the requirements imposed by short-term investors obsessed with immediate profits, ultimately results in repeated dilemmas for CEOs, who have to choose between investing today to prepare for tomorrow or making profits today

[3] *Cf.* https://www.washingtonpost.com/business/2018/08/17/trump-calls-regulators-consider-changing-how-often-companies-report-earnings/

while leaving to others the management of tomorrow's problem.[4] This often means giving up certain long-term, strategic projects. As the research by Graham *et al*. (2006) has shown, corporate executives in listed companies regularly destroy value to bring their quarterly earnings in line with analysts' expectations (so as to "smooth" earnings). One firm will prefer paying dividends or repurchasing some of its shares rather than reinvesting, while another will decide to make drastic cuts in R&D, despite this activity's strategic long-term value.

Although the existence for a long time now of a multitude of big, prosperous listed firms is evidence that long-term development and market financing are quite compatible, several academic studies have suggested that the pressure in favor of short-term earnings often gives rise to practices that destroy value for the firm. Recent research has also drawn attention to the lack of long-term investments in public policies and insisted on not sparing efforts to prepare for tomorrow, if only to make life easier today (LONG-TERM… 2018). However this article will focus on corporate financing,

Many players, various priorities

Market behavior is determined by the behavior and weight of players on both sides of the market: those who issue securities and those who invest. Herein, the term "investor" has its broadest meaning to refer to any individual, software or robot that acts in behalf of a private person or a legal entity. A "robo-advisor", an online service that manages savings by applying algorithms to data in order to provide financial advice, is programmed to be executed automatically (*e.g.*, yomoni.fr and nalo.fr). Each investor has a specific profile of risks, priorities and time horizons that are inherent to it (or programmed in the case of a robo-advisor).

On the side of investors, we find trading algorithms — in particular, high-frequency trading, which has grown strongly in recent decades and now accounts for a large percentage of transactions.[5] Driven by algorithms capable of reacting in less than a millisecond, this sort of trading pays no heed to the strategies of the firms whose securities are being bought or sold. It exploits statistical differences within a very short-term time frame, and sometimes even causes strong, temporary price fluctuations that are not at all correlated with sound information about a firm's securities. Some pundits think that this algorithmic trading contributed to the flash crash on 6 May 2010, when the Dow Jones lost about 10% of its value in fewer than five minutes but bounced back up, in the next fifteen minutes, to its initial value. In the meantime, the values of many securities were, of course, temporarily aberrant.

[4] Industrialists are not the only corporate leaders faced with this dilemma between short- and long-term interests. Political office-holders, for example, also face it.

[5] Although high-frequency trading has become less profitable in the past few years, it still represents more than half of the transactions on American stock markets, and nearly 80% on some short-term markets (*e.g.*, currency markets). *Cf.* "How high-frequency trading hit a speed bump", *Financial Times*, 1 January 2018, https://www.ft.com/content/d81f96ea-d43c-11e7-a303-9060cb1e5f44.

Also on the side of investors, we come upon institutional investors who, on the contrary, pay close attention to corporate executives in the firms where they place their money and remain rather indifferent to short-term variations, since they have opted for a long-term investment horizon.[6]

On the side of the companies issuing securities, we meet corporate executives, who are usually capable of communicating about their vision for their firm. For example, Jeff Bezos has always clearly formulated his vision and long-term priorities in his letters to shareholders.[7] For Amazon, we can conclude that the market has proven its patience by backing an aggressive policy of international development that, for years, required major investments and forwent short-term profits. According to Bezos, the interests of clients and of shareholders coincide in the long term, but not necessarily in the short term.

The difficulty of estimating long-term value

It would be false to declare that markets fail to understand the long term. Looking at some so-called growth securities,[8] we observe that the market might set a high value on the securities of firms that have no chances of turning a profit in the short term or even before several years. Even though there is room for taking account of long-term projections in market financing, this financing is affected by information asymmetry between the parties issuing securities and the parties investing and by the usual problems related to efficient markets. It is necessary to be sure that all relevant information has been communicated to the market, while hoping that this information will be "perfectly" interpreted and understood. The farther away the horizon however, the more doubtful the objectivity of efficiency. The market needs intermediaries in order to be able to operate under conditions of information asymmetry.

To summarize, either investors have to be sufficiently informed about the firm whose securities are to be bought or sold in order to make an enlightened decision and clearly understand the stakes; or else they delegate this understanding to intermediaries who are experts, *i.e.*, financial analysts.

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[6] Bertrand Collomb, president of the board and CEO of Lafarge at the time, recognized the plurality and segmentation of investors, while stating his preference "*for those who are interested in what makes a firm work and who think long-term*". See the interview with him in 2003: "Le PDG rencontre l'actionnaire: une heure pour convaincre" at

https://www.ecole.org/fr/seance/455-le-pdg-rencontre-lactionnaire-une-heure-pour-convaincre.

[7] GREGG T. & GROYSBERG B. (2019), "Amazon's priorities over the years, based on Jeff Bezos's letters to shareholders", 17 May at https://hbr.org/2019/05/amazons-priorities-over-the-years-based-on-jeff-bezoss-letters-to-shareholders.

[8] This phrase refers to the classical dichotomy made for professional investors between growth and value investing. The so-called "value securities" are subject to a temporary undervaluation in relation to their estimated worth in the long term.

The influence of agency theory

Besides the difficulty of estimating a firm's value (since this calls for formulating hypotheses about its long-term development, which is always less than certain), the primacy given to the stock market price as the requisite metric for measuring a firm's current value is related to the dominant position of shareholders in agency theory, specifically the principal-agent dilemma. This theory has developed out of Milton Friedman's (1970) well-known article, in which the economist criticized any concern for corporate social responsibility as an acceptance of a "*socialist view*". Businessmen who said they were sensitive to this issue were said to be the "*unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades*". For Friedman, "*the executive is an agent serving the interests of his principal*", *i.e.*, the firm's owners, its shareholders. This is the corporate executive's major responsibility; any other responsibility lies outside his (and the firm's) competence. In 1976, the economists Jensen and Meckling laid the formal foundations of agency theory by formulating the principal-agent problem as a contract whereby the principal recruits an agent to perform in his name a task implying a delegation of decision-making from himself to the agent. This recruitment and delegation are necessarily done under conditions of imperfect information.

The subsequent development of agency theory led to a current of thought among not only academics but also practitioners who supported the idea that corporate managers had to be mainly concerned with the interest of the "owners" (*i.e.*, shareholders) and that the metric of importance to the latter was the stock market price. Research on agency theory has often focused on the incentive procedures for making the interests of the principal and agent compatible so that the former is not tempted to serve his own personal interests to the detriment of the principal's. According to this approach, and given a few simplifications, it is certain that a firm does not have the purpose of saving the world or even imagining its impact on society. According to Friedman, this would amount to trespassing on the prerogatives of government. Instead, firms must be restricted to what they can do, namely organize production as a function of their competitive advantages and serve their shareholders, who are all alike: they are mainly and unanimously motivated by the creation of value. For Friedman, the best metric available for evaluating the creation of value is financial returns.

The growing importance of societal issues

Both firms and investors are increasingly voicing a concern for ethics, social responsibility and about the negative externalities (such as pollution) of doing business. It is worthwhile noting that the firm's "social responsibility" was, already in 1970, a major preoccupation. Friedman's article contrasted with a stormy shareholders' meeting at General Motors (GM), when a group of shareholders asked the president of the board to appoint three independent board members to see to the public interest and set up a committee that would evaluate GM's performance in, for example, matters of safety and pollution.

Given the overwhelming presence nowadays of the Internet, smartphones and social networks, it the ability of shareholders to bring, directly or indirectly, pressure to bear on firms has, we can be nearly certain, increased considerably. The development of “green” or “socially responsible” finance responds to the demands of citizens whose savings replenish the chain of finance. In this sense, the financial markets simply relay investors’ priorities to the entities that issue securities.

The creation of long-term stock exchanges

A first, apparently emblematic example of this growing awareness of the need for firms to have access to a market where investors are sensitive to long-term considerations has been the recent creation of the Long-Term Stock Exchange (LTSE: https://ltse.com), which was approved as a new securities exchange on 10 May 2019 by the SEC, the US regulatory authority. Its founder, Eric Ries, a Silicon Valley entrepreneur, declared that he wanted to build a market “*where companies can run their businesses with the stewardship that similarly aligned shareholders, stakeholders and society demand […] Our vision is that companies in every industry will be able to go public while continuing to prioritize and pursue strategies for long-term success*”.[9] He thus hints that the existing markets do not actually do that. This new stock market has led to a coalition of long-term investors who are asked to adhere to a charter.

True, this is but a declaration of principles. It will, however, be worthwhile seeing how these principles are worked out and applied. This position statement implies that the entrepreneurs who want to “build to last” or the investors who are looking for socially responsible firms are currently unable to find on existing stock markets the long-term mentality and sensitivity they value, whence Ries’ decision to open a marketplace for them.

Advances in economic theory and managerial science

While agency theory has dominated Anglo-American capitalism for a long time now, many a voice has drawn attention to points that it has overlooked or oversimplified. Hart and Zingales (2017) have emphasized the problems that arise because decisions about production cannot be fully separated from the question of externalities and their consequences for society — consequences often closely related to topics (such as global warming) about which more and more investors are concerned. The firm’s objectives have to be reviewed to reflect the “*maximization of shareholder welfare [which] is not the same as maximization of market value*” (HART & ZINGALES 2017). Also pointing to the flaws of agency theory, Bower and Paine (2017) have insisted on the need for a model of corporate governance more oriented toward all stakeholders. Such a change will be possible, they realistically concede, only if the firm’s management and board are able to adopt a broader, long-term approach to business without being worried about the risks of interference from “owners” whose liability and responsibility are so very limited. These authors have also criticized agency theory for confusing shareholders with owners, a confusion that has led many theorists astray.

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[9] Source: https://ltse.com/articles/stock-exchange-for-new-generation-of-public-companies.

Technology for long-term incentives

Technology now seems mature enough for instituting a granular system of incentives with rewards for long-termism. For example, electronic security tokens, which represent a share (or part of a share) in a financial security or asset, are being traded on blockchains. Most courts of law consider them to be dematerialized financial securities. Though not yet widely used, these tokens are at the center of several efforts to set up standards for them so as to stimulate their development and use.[10] They could be used to establish categories of securities that are locked up for a few years (*i.e.*, that cannot be resold before a given date) and to offer incentives (*e.g.*, dividends) that are indexed on the duration of the shareholding period.

Such ideas are circulating, some of them for a long time now (and have been put to use for initial public offerings, IPOs). Modern technology should help reduce their administrative costs (for monitoring or surveillance) and reshape post-market operations. For example, it is now much easier, thanks to digital technology, to track operations and verify the conditions related to these tokens, as on a blockchain (COLLOMB & LÉGER 2017).

Conclusion

Current market mechanisms are definitely capable of bringing the parties who invest and who issue securities into contact, parties with quite different concerns. Some entrepreneurs pursue long-term goals while some investors, lacking any vision at all, are algorithms making very short-term calculations. It would be too simple to say that investors necessarily have a short-term horizon. Some of them (institutional investors) hold shares for longer than a year (sometimes owing to regulatory pushing or fiscal pulling). Likewise, it would be naive to believe that all corporate executives who turn to the markets for funding necessarily have a long-term vision for their firm.

Nor is it my intention to criticize high-frequency trading, nor to determine whether it is a factor in market volatility or a factor of financial instability for the entities that issue securities (a still much too complicated question), nor to score such and such a behavior as "good" or "bad". Many of the criticisms referenced herein were aimed at American stock markets and their current operating procedures (with the requirement to report earnings quarterly and with financial analysts playing a key role as intermediaries). For sure, these markets are far from optimal; but for many users, they work, and even work satisfactorily.

The point I would like to make is that the preoccupations and priorities of the players in a financial market are sometimes misaligned. How to favor firms that seek to make long-term investments for taking account (beyond current regulatory requirements — after all, law is not virtue) of the externalities of their business activities? One way would be to set up markets that advocate long-term principles and adopt controls that force the players there to uphold these principles. This approach is not new. The idea of favoring long-term shareholders by modulating dividends per share as a function of the shareholding period

[10] https://thesecuritytokenstandard.org

has been circulating for several decades now. However current technology should help us set up these specialized markets at a low cost — markets that better align the value of shares with the stated objectives of market players. It is not an accident that the aforementioned LTSE comes from Silicon Valley. Without prejudging fintechs as a solution, I am convinced that their growth will continue fostering platforms and stock markets of this sort, where participation will be subject to the adherence to values that are not just financial.

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