

PERSPECTIVES

The Economics of Short-Term Performance Obsession


Alfred Rappaport

Pages 65-79 | Published online: 02 Jan 2019

Cite this article <https://doi.org/10.2469/faj.v61.n3.2729>

Sample our Law Journals

>> [Sign in here](#) to start your access to the latest two volumes for 14 days



References

Citations

Metrics

Reprints & Permissions

Read this article

We Care About Your Privacy

We and our 854 partners store and access personal data, like browsing data or unique identifiers, on your device. Selecting "I Accept" enables tracking technologies to support the purposes shown under "we and our partners process data to provide," whereas selecting "Reject All" or withdrawing your consent will disable them. If trackers are disabled, some content and ads you see may not be as relevant to you. You can resurface this menu to change your choices or withdraw consent at any time by clicking the ["privacy preferences"] link on the bottom of the webpage [or the floating icon on the bottom-left of the webpage, if applicable]. Your choices will have effect within our Website. For more details, refer to our Privacy Policy. [Here](#)

We and our partners process data to provide:

I Accept

Reject All

Show Purpose



Abstract

In theory
practice
term per
this beh
allocate
decision
earn
most en
the obse
Accordin
function
generate
select st

l markets. In
to short-
atives blame
ices likely to
investment
DCF basis
ow is the
alleviating
I well-
bility to
holders. To
weight to

short-term performance, particularly earnings and tracking error. Corporate executives

blame the behavior of the investment community for their own obsession with short-term accounting earnings. 'Short-termism' is the disease; earnings and tracking error are the carriers.

The gap between theory and practice prompts four basic questions:

- Why do investment managers focus on quarterly earnings? The fascination of investment managers with quarterly earnings is not terribly puzzling. In fact, it is perfectly rational in a market dominated by agents responsible for other people's money but also looking out for their own interests. The problem is that earnings data are not well suited to use in valuation.
- Can stock prices be allocatively efficient when short-term earnings, tracking error, and a host of non-DCF criteria dominate investment decisions? The most basic function of capital markets is to allocate scarce resources to enterprises with the most promising long-term prospects. Perfect resource allocation assumes flawless foresight. Allocative efficiency, or how well market prices allocate resources, depends on the skills of informed buyers and sellers with competing estimates of DCF values.

- Can investment managers earn excess returns if they buy and sell stocks they believe are undervalued relative to DCF? ... trains, resource, candid, improv, earning

- Is corporate ... it also in ... short- ... value. ... earnings, ... eating ... value

After ad ... lucing short- ... ance ... es cash flows



and accruals, classifies accruals by levels of uncertainty, provides a range and the most likely estimate for each accrual, excludes arbitrary, value-irrelevant accruals, and details assumptions and risks for each line item.

The second step is to change the incentives for corporate managers. The current standard incentive stock-option plan has performance targets that are too low, sets holding periods that are too short, and can induce too little or too much risk taking. To overcome the shortcomings, I recommend a system of extended time horizons and indexing options to a peer-group index or, alternatively, a discounted equity-risk options plan.

The third step is to change the incentive scheme for investment managers. Earnings obsession will persist as long as investment managers have inadequate incentives to focus on companies' long-term prospects. To change the focus, the closed-end fund needs to be revived. For this purpose, investment firms need to make total compensation at closed-end funds competitive with the amount managers could earn if they moved to an open-end fund, extend the performance evaluation period to three to five years, pay annual bonuses on the basis of rolling three-year to five-year performance, motivate long-term value creation by deferring some payouts and placing them "at risk" against future performance, and finally, require portfolio managers to make meaningful investments in the fund.

My thank
Michael
Linda Vi

ty Leibowitz,
eynor, and



Relate

ESG an

s >

Gunnar Friede et al.

Journal of Sustainable Finance & Investment

Published online: 15 Dec 2015



[Investing for long-term value creation >](#)

Dirk Schoenmaker et al.

Journal of Sustainable Finance & Investment

Published online: 12 Jun 2019



[The Search for the Best Financial Performance Measure >](#)

Jeffrey M. Bacidore et al.

Financial Analysts Journal

Published online: 2 Jan 2019

[View more](#)



Information for

- Authors
- R&D professionals
- Editors
- Librarians
- Societies

Opportunities

- Reprints and e-prints
- Advertising solutions
- Accelerated publication
- Corporate access solutions

Keep up to date

Register to receive personalised research and resources by email

 Sign me up

- 
- 
- 
- 
- 

Open access

- Overview
- Open journals
- Open Select
- Dove Medical Press
- F1000Research

Help and information

- Help and contact
- Newsroom
- All journals
- Books

Copyright

Accessib

Registered
5 Howick Pl

or & Francis Group
orma business

