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PERSPECTIVES

# The Economics of Short-Term Performance Obsession

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Pages 65-79 | Published online: 02 Jan 2019

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

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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? This question is particularly relevant in a market where resources are allocated to enterprises based on short-term earnings and tracking error. It is also relevant in a market where resources are allocated to enterprises based on short-term earnings and tracking error.

- Is corporate short-termism a result of the behavior of the investment community or is it also a result of the behavior of the corporate executives? This question is particularly relevant in a market where resources are allocated to enterprises based on short-term earnings and tracking error. It is also relevant in a market where resources are allocated to enterprises based on short-term earnings and tracking error.

After addressing these questions, we will be in a better position to understand the role of short-termism in the investment process and its impact on corporate performance.



reporting. A “Corporate Performance Statement” is suggested that separates 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 m

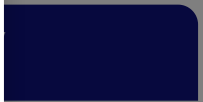


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