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The Economics of Short-Term Performance Obsession

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Abstract

In theory, discounted cash flows (DCFs) set prices in well-functioning capital markets. In practice, investment managers attach substantial weight in stock selection to short-term performance, particularly earnings and tracking error. Corporate executives blame this behavior for their own obsession with short-term earnings. Are stock prices likely to allocate financial resources efficiently when short-term earnings dominate investment decisions? Can investment managers who identify stocks as mispriced on a DCF basis earn excess returns? This article explains why maximizing long-term cash flow is the most effective way to create value for shareholders and charts a course for alleviating the obsession with short-term performance.

According to economic theory, discounted cash flows (DCFs) set prices in all well-functioning capital markets. A company's value depends on its long-term ability to generate cash to fund value-creating growth and pay dividends to its shareholders. To select stocks in practice, however, investment managers attach substantial 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 the market has mispriced on a DCF basis? Only individuals with brains, resources, a long investment horizon, and no agency conflicts are promising candidates for exploiting mispricings. If managers' chances of success are to improve, the market's fascination with the short term and its obsession with earnings will have to change.

- Is corporate management's focus on short-term earnings self-serving, or is it also in the best interests of its shareholders? Managers with career concerns and short-term incentive compensation arrangements are predictably obsessed with earnings, but a focus on short-term earnings compromises shareholder value. Maximizing long-term cash flows rather than managing for short-term earnings, even in an earnings-dominated market, is the most effective means of creating value for continuing shareholders.

After addressing these questions, I present a three-pronged program for reducing short-term performance obsession. The first step is to improve 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 meaningful investments in the fund.

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