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PERSPECTIVES

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 beh... ...ices likely to allocate ... ...nvestment decision... ...DCF basis earn exc... ...ow is the most eff... ...alleviating the o...

Accordi... ...l well-function... ...bility to generate... ...holders. To select st... ...weight to short-te... ...executives blame the behavior of the investment community for their own obsession with short-

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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.

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After ad … ducing short- term pe … ance reportin … es cash flows and acc … 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 thanks to Martha Amram, Jack Bogle, Bruce Johnson, David Larcker, Marty Leibowitz, Michael ... eynor, and Linda Vi...

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