A Note on Short-Termism

Trustee Leadership Forum for Retirement Security

Overview:

Short-termism in financial markets has long been a topic of discussion. Since the financial crisis of 2008, however, the risks of short-termism in investing and the proliferation of short-term practices, including some almost impossibly short-term practices like high speed trading, has raised the topic's profile.

The financial crisis pointed to potential links between short-termism, systemic risk, and underperformance in the financial sector. The topic has gained attention globally from groups not typically associated with fundamental critiques of finance, like the OECD and the World Economic Forum.

> **Short-Termism** is "the focus on short time horizons by both corporate managers and financial markets, prioritizing near-term shareholder interests over the long-term growth of the firm."
>
> *From "Understanding Short-Termism" by J. W. Mason,2015*

What is Short-Termism? In practice, short-termism covers a wide range of activities:

Trading Practices - trading based on momentum and price movements rather than value, epitomized by high-frequency trading, and seen in shorter holding periods for stocks

Activist Investors - pressure from activist investors that push companies towards short-term moves meant to pay off investors, but which may come at the expense of long-term wealth creation, including strategies like share buybacks, or cutting research and development to meet quarterly earnings targets

Leveraged Buyouts - which pull capital out of firms and pile them with debt (common in some private equity funds)

Short Selling - or betting against a firm's value using leverage (a strategy used by many hedge funds).

CEO Pay Tied to Share Price - and other incentive structures that promote management strategies focused on share price and investor sentiment rather than the long-term health of firms

Money Manager Incentives Based on Short-Term Performance - like tying pay to quarterly or annual returns, rather than longer term performance, can dis-incentivize long-term value creation

These short-term investing strategies offer immediate rewards, but may have consequences for the long-term. Seeking immediate high returns without accounting for long-term implications may lead to underperformance for long-term investors, and, by extension, underperformance for the economy as a whole.

Short-termism can seem like a riddle: those investors with the most weight in the market are thought to be large asset owners with long-term time horizons, but it is their investment strategies that promote short-termism in the market. In theory, large asset owners like pension funds have the potential to guide the financial system back in the direction of long-term investing and away from short-term expectations which are, even today, increasingly driving the market. (World Economic Forum, 2011) In practice, they often help create the problem by rewarding managers and companies for short-term behavior.

Long-Term Investing requires ***patient***, ***engaged***, and ***productive*** capital:

"**Patient capital** allows investors to access illiquidity premia, lowers turnover, encourages less pro-cyclical investment strategies and therefore higher net investment rate of returns and greater financial stability.

"**Engaged capital** encourages active voting policies, leading to better corporate governance.

"**Productive capital** supports infrastructure development . . . leading to sustainable growth."

From OECD Project on Institutional Investors and Long-Term Investment
(Della Corce, Stewart, & and Yermo, 2011)

What Kind of Risk Might Short-Termism Pose?

Short-termism, with its disproportionate focus on quarterly returns, may be weakening firms and the economy as short-term investment strategies leave companies with less to invest in research and development and growth. (Mason, 2015) With so much focus on near-term returns, firms are doing less planning for future success, and are less willing to take on projects that may require multiple years - and patient capital - to develop. (The Conference Board, 2015) (Barton, Focusing Capital on the Long Term, 2014) Instead of productive investment in the real economy, short-termism may promote bubbles, financial instability and general economic underperformance by incentivizing activity which benefits the few while providing little value to society.

Short-term financial strategies may also have the effect of taking capital out of the productive economy, increasing the holdings of high-net worth individuals, and adding to the growth of income inequality. (Stiglitz, ReWriting the Rules of the American Economy, 2015)

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Barriers for Pension Funds to Long-Term Investment

Institutional investors, including pension funds, face real, though not insurmountable, barriers when considering long-term investing. Considering potential barriers may be helpful to trustees as they endeavor to move their fund further in the direction of long-term investing.

> ***Liability Profile*** – the degree to which the fund must service short-term obligations, such as upcoming payments to beneficiaries (World Economic Forum, 2011)
> ***Funding Regulations*** – timelines and penalties imposed by regulators
> ***Herding*** – benchmarking against others' performance and the tendency of investors to move together in their investment strategy
> ***Decision-Making/Governance Structure*** – the ability of the investment team and trustees to execute a long-term investment strategy (World Economic Forum, 2011)
> ***Investment Beliefs*** – whether the institution believes long-term investing can produce superior returns (World Economic Forum, 2011)

What Can Trustees Do?

At pension funds, especially defined benefit funds with fixed liabilities, short-termism can be driven heavily by regulatory requirements around funding status. Funding regulations and liability constraints are very real issues for pension trustees. Despite these constraints, there are a number of concrete ways that pension funds may work to move their funds towards a longer view of investing. Pension trustees may want to examine their fund's ***governance structure*** and ***investment beliefs*** to understand where long-termism can be fostered. Trustees may also want to support ***investor mandates*** through active engagement with firms or directives to money managers, and the integration of ***environmental, social and governance factors*** into the investment decision making process to support a long-term investment strategy.

Short-Termism and Investment Strategy

Governance – Examining how fund governance is structured, and whether it supports long-term investing can be useful. Trustees may want to look at how decision making around long-termism is made at their fund, and how trustees fit into that structure. Identifying where within the governance structure questions of short- and long-term investing are discussed and decided, and engaging that structure, is important for making change. Trustees can generate discussion around questions like:

"How do ***benchmarks*** for relative performance incentivize (or disincentive) long-termism?"

"Are ***money manager incentives*** promoting short-term gains or long-term value creation?"

"To what extent is our fund's ***investing strategy*** incenting the use of short-term strategies, like high-frequency trading, leveraged buy-outs, short-selling, or share buybacks?"

"How are we ***engaging as active owners*** with firms to encourage long-term investment decisions?"

Investment Beliefs – Pension trustees can look to their funds' investment beliefs statement (or move to create one) for their fund to gain clarity about working assumptions on long-term investing. "Investment Belief Statements are important", says Steve Lydenberg, Founding Director of the Initiative for Responsible Investment, "because they help trustees, fiduciaries, and others responsible clarify their views on the nature of financial markets through which they must operate and how these markets function." (Lydenberg, 2011) CalPERS' investment belief statement #2 (see side bar) is a good example of how funds can integrate long-termism into an investment belief statement.

CalPERS Investment Beliefs Statement #2
A long time investment horizon is a responsibility and an advantage.

Long time horizon **requires** that CalPERS:

A. Consider the impact of its actions on future generations of members and taxpayers.
B. Encourage investee companies and external managers to consider the long-term impact of their actions.
C. Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives.
D. Advocate for public policies that promote fair, orderly and effectively regulated capital markets.

Long time horizon **enables** CalPERS to:

A. Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk.
B. Invest in opportunistic strategies, providing liquidity when the market is short of it.
C. Take advantage of factors that materialize slowly such as demographic trends.
D. Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available.

CalPERS Investment Beliefs Statement

Every investment decision CalPERS makes is informed by its ten investment beliefs, including the funds' decision in the fall of 2014 to exit hedge funds.

Investor Mandates – Engagement with firms and active ownership can be used to communicate an investors' preference for long-term investment strategies. Asset owners can provide investment professionals with a clear mandate to place value on long-termism ". . . rather than to compete in horse races judged on short-term performance". Investors can "demand long-term metrics from companies" (Barton, Focusing Capital on the Long Term, 2014), discourage stock buybacks, use "Say on Pay" votes to discourage outsized CEO compensation, or look at whether incentives are tied to short-term or long-term outcomes.

Integrating Environmental, Social and Governance (ESG) Factors – Investors with a Socially Responsible Investment (SRI) approach, tend to have less portfolio turnover (Santisteve, 2014). SRI investors integrate consideration of issues like the quality of jobs, environmental impacts, how firms are run, and the impact of investment on the world into their investment process.

Short-Termism and Systemic Change

To the extent allowable, pension funds and trustees may want to encourage change at a level beyond their fund to support long-term investment. This could include:

SEC Changes

- place direct limits on buybacks
- increase reporting requirements for buybacks
- institute a proxy access rule that incentivizes long-term investment

Legislative Changes

- create a financial transaction tax which discourages high frequency trading
- remove tax incentives that encourage firms to reward CEOs through incentive based pay
- limit private equity's use of leverage and dividend recapitalization
- focus economic policy on the real economy – ie, jobs and infrastructure

Many of these ideas are explored in the report "Ending Short-Termism: An Agenda for Growth" by Mike Konczal for The Roosevelt Institute.

Conclusion

Short-termism and the risks it poses, both at a portfolio level and to the wider economy, has gained increased global attention in recent years as these strategies have proliferated. Pension funds are large, influential investors, making trustees potential leaders in moving the economy towards more long-term investing and away from volatile short-term investing practices.

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