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Worries about short-termism grip America's business elite—wrongly, perhaps

EARNINGS season is under way and America's best-known companies are queuing up to parade their second-quarter results. Alcoa kicked things off on July 9th and more than 200 companies will report during the week of July 16th alone. This quarter's earnings are expected to be rather unexciting; analysts think that profits at S&P 500 firms will grow by an average of just 4.4% compared with the same period a year ago. The bigger story lies behind the numbers, and the lengths to which managers will go in order to meet the market's immediate expectations. Consensus is growing that the issue of short-termism—an excessive focus on the next quarter at the expense of the longer term—is one that must be addressed.

In June the Aspen Institute's Corporate Values Strategy Group published a set of principles designed to "reassert long-term orientation in business decision-making and investing". Signatories to date include the Council of Institutional Investors, the Business Roundtable and other assorted bigwigs. A few days later the Committee for Economic Development (CED), a well-connected think-tank in Washington, DC, weighed in with "Built to Last", another report bewailing short-termism. These reports follow others in the same vein.

Why the furrowed brows? The problem is not new, but it is getting worse, says William Donaldson, a former chairman of the Securities and Exchange Commission and a CED trustee. The CED report lists several symptoms of growing short-termism, including increased levels of share trading, pay packages linked to short-term earnings, pressure from activist hedge funds and reduced tenures for bosses. The consequences include too much management time spent shaping analysts' expectations in the run-up to quarterly reports. More damagingly, say the worriers, short-termism leads to cuts in long-term investment.

A 2004 survey of chief financial officers by John Graham, Campbell Harvey and Shiva Rajgopal showed that a majority of managers were prepared to sacrifice a profitable long-term project to hit their quarterly numbers. American firms are still willing to think ahead: the country's research-intensive firms spend more on R&D as a percentage of sales than their equivalents in Japan, Germany and elsewhere. In the past accounting fixes, such as playing around with accruals, allowed executives to hit their quarterly targets while keeping up long-term spending. But now that such fiddles bear the stigma of Enron, says Mr Harvey, a professor at Duke University, long-term spending is more vulnerable.

The new reports suggest a number of ways in which executives can be encouraged to lift their eyes to the horizon. Getting rid of earnings guidance is a common theme. So too is providing better information about companies' long-term prospects. Tying compensation more tightly to the long term is another preoccupation. The Aspen Institute thinks that executives should be required to hold shares in their former employers for a period after they have left. It also advocates being able to claw back money from former managers if the accounts have to be restated.

Most of these ideas are unobjectionable. More detailed discussion of long-term plans can only be a good thing. The advantages of issuing earnings guidance are unclear. An analysis by McKinsey, a consultancy, shows that guidance has little obvious impact on either share-price valuations or volatility. Companies seem to be realising this for themselves. The latest guidance survey by the National Investor Relations Institute shows that increasing numbers of firms are opting not to offer it. But a study by Joel **Houston**, Baruch **Lev** and Jennifer Tucker in 2006 found no evidence that companies that stop issuing guidance increase long-term spending.

Crisis? What crisis?

The bigger question is whether the diagnosis itself is correct. "If short-termism is such a problem, how come this country is doing so well?" asks Mr **Lev**, an accounting professor at New York University. Another piece of McKinsey research into management practices at 4,000 firms across 12 countries, released on July 12th, concludes that American companies are the best run.

Some of the trends cited by the CED and others as evidence of short-termism are indeed unhelpful, if only to investors. Higher turnover in share portfolios boosts transaction costs and dents returns, for instance. But others are more to be welcomed than lamented. Take those near-sighted hedge funds. A 2006 study by Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas showed that activist funds generally outperform the market.

Nor are shorter tenures for chief executives necessarily a bad thing. According to research by Booz Allen Hamilton (BAH), a consultancy, North American bosses who presided over sub-standard returns in 1995 were as likely to have a lengthy stay in their posts as those who did well. By 2006, the mediocre performers had much less chance of chalking up a long tenure. "Performance has become a driver of tenure," says Richard Rawlinson of BAH approvingly. But surely bosses at some firms need a while to prove themselves? According to Weber Shandwick, a public-relations firm, even bad bosses get a fair crack of the whip: the average tenure of departing North American bosses of big companies was longer than that of their European and Asian counterparts in 2006.

What of the argument that pay packages ought to be more geared towards the long term? Only if they are less geared towards time served. At almost two-thirds of American firms, executive pay packages include time-vested restricted stock—shares that can be sold only after a certain period but that, unlike options, have real value even if the share price falls. This rewards managers for staying in their jobs, but does little to encourage better long-term performance; grants of shares based on profit or revenue growth, for example, might be a better approach. Irv Becker of Hay Group, a consultancy, expects to see American pay packages move gradually towards such performance-based rewards.

Mr Donaldson, one of the critics of short-termism, says he is really calling for a better balance between the short term and the long term. As the debate gathers momentum and starts to head towards more sensitive ground, such as quarterly reporting itself, finding the right balance may require more people to speak up in favour of the positive aspects of short-termism.