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The Perils of Short-Term Thinking

It's hard to ignore shareholder demands for quarterly earnings miracles. But too often what looks like "success" today can inhibit a company's competitiveness tomorrow.

Increasingly outspoken activist shareholders and a culture of instant gratification permeate today's global boardrooms. Forget the annual report: these days, shareholders' decisions often hinge on financial analysts' quarterly financial expectations – and, with perks, jobs and bonuses at stake, more and more senior executives are unable to ignore them.

Pressure to produce short-term results has increased in the last five years, according to 63 percent of global executives who responded to a recent McKinsey & Company survey. This fosters what the business community has come to call "short-termism", defined by the *Financial Times* as "an excessive focus on short-term results at the expense of long-term interests".

New INSEAD research shows that - far from ensuring steady profits – "short-termism" can be destructive in the long haul.

Managers under short-termism's sway "may be encouraged to trade market-share for competitive position so as to increase current earnings… hence short-term gains in profit margin may be at the cost of a long-term competitive position," Javier Gimeno, INSEAD Professor of Strategy and Yu Zhang, Assistant Professor of Strategy at the University of California argue in their paper "Earnings Pressure and Long-Term Corporate Governance: Can Long-Term-Oriented Investors and Managers Fend Off Short-Term Analyst Earnings Pressures?".

With a growing number of executive compensation packages rewarding short-termism, it takes guts and willpower to keep the non-immediate future in focus.

Building a Long-Term Corporate Culture

Gimeno has three pieces of advice for corporate leaders looking to avoid mistakes due to short-term pressures.

"The first would be if you are thinking of taking [several] actions...(in many cases it could be about the intensity of competition) just to optimise long-term earnings, don't do it. This is not going to be good for you. It may be good for your job, or your income in the short-term, but it is going to damage the company."

Secondly, do things to attract long-term investors. This will provide protection against overreactions to short-term performance evaluations.

And lastly, review company incentives. "What we've found is that managers who have a lot of vested, stock-based incentives are not making the right decisions," says Gimeno. "On the other hand, if CEOs have unvested incentives – i.e. stocks, restricted stocks, or unvested options that they cannot immediately exercise – they are forced to look to the future rather than making stock-based responses today."

"Aligning stock-based incentives to the time horizon of the strategy is very important," he underlines.

Another important factor, notes Gimeno, is separating the roles of chairman and CEO. Assuming the chairman understands that part of his role is to filter out some of the short-term pressures put on the CEO, then separating the two positions can help companies avoid making short-sighted choices and can provide long-term alignment of objectives for management.

Don't Draw the Curtains Just Yet

Of course, there's a more drastic way for companies to insulate themselves against investor demands: Going private. Without having to deal with Wall Street's vagaries and red tape, managers are free to focus on long-term goals – or so the privatisation logic goes.

But, Gimeno argues, there is a more "enlightened" way to engage with public markets, including those inquisitive securities analysts. Companies, he says, should share with analysts not just earnings information but also dimensions that are predictors of their future strategic performance.

"This might be customer retention, customer satisfaction, the ability to produce high-quality products or the revenues coming from new products over the past three years… [by doing so] you are using the power of the analysts to force you to pursue those long-term objectives."

But there's a catch. As analysts come to understand a company's long-term strategies, so will their competitors. Gimeno advocates practicing selective disclosure to keep rivals from getting a peek at the playbook.

A Thriving Ecosystem

Despite urging companies to play the long game, Gimeno said they shouldn't shun "transient" investors. "In fact," he said, "this is an ecosystem. You need short-term investors in order to create a market and to give information about prices. But if all the investors were short-term what you would see is huge volatility in the market. The two investor types actually feed on each other and support one another… the more short-term investors, the more chances for long-term investors to find opportunities. And the long-term investors create some buffer against the short-term pressures for the others."

For Gimeno, Amazon stands as the best model of a thriving corporate ecosystem. "You could criticise them because for many years, despite sitting in a fantastic market share, they were not really producing large earnings, they were reinvesting additional gains in market share.

"But clearly you see there a situation, where an entrepreneur who owns a substantial share of the company in addition to long-term investors who are really investing in a very strong competitive position, which is going to have great value in the future.

"That's a company to look at."

Javier Gimeno is Professor of Strategy at INSEAD.

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