

MEDIA RELEASE

Winning paper calls for an end to ‘pandemic’ of short-termism

Mums and dads the ultimate losers from short-term thinking in business and investment, Portfolio Construction Conference told

Sydney, 25 August 2011: A research paper condemning the increasing trend toward short-term thinking, planning and measurement in business and investment has been awarded ‘Editor’s Pick Award’ at this year’s Portfolio Construction Conference.

The paper, entitled ‘The Economic Costs of Excessive Short-termism’ was co-authored by Hyperion’s CIO, Mark Arnold and Portfolio Manager, Jason Orthman. It examines the economic costs of short-termism by key industry agents, including corporate management, active fund managers, asset consultants, super fund trustees and ‘mum and dad’ investors.

Presented by Hyperion CEO and MD, Dr Manny Pohl, the paper was named the best Due Diligence Forum (DDF) Research Paper from a total of 32 initial submissions, of which 20 were accepted and 5 were shortlisted by an expert panel for the ‘Editor’s Pick Award’.

The paper provides sweeping evidence of the way an increasing focus on short-term gratification is distorting the behaviour of companies, markets and investors – leading to impaired financial performance and ultimately, significant losses to equity holders.

“Rappaport describes short-termism as a disease and short-term earnings and tracking errors as the carriers, and we can see that this is increasingly cascading through multiple sections of the economy and society becoming entrenched and systemic,” said Mr Arnold and Mr Orthman.

While identifying the impact of short-termism is straight-forward, developing a cure for the pandemic is harder.

“Fixing this issue requires a major shift in mindset and, especially, the fortitude to foster and measure long-termism,” they said.

“All the behavioural finance evidence shows us that people tend to over-emphasise the importance of recent events and let emotion rather than rationality dictate their behaviour.

“This is particularly true for corporate management, which in recent years has increasingly focused on achieving short-term EPS and DPS growth targets at the expense of long-term growth and sustainability. It’s an approach that only reduces long-term shareholder value – often quite quickly.

“Hallmarks of this kind of short-termism include the over-use of financial leverage during strong economic conditions, underspending on essential R&D, marketing and key staff and a deferral of attractive long-term capital investments because of a likely short-term negative impact on earnings,” they claimed.

According to both authors, duration of tenure is another example of short-termism’s negative effect and is evident among both corporate management and active fund managers. They said that domestic executives cannot focus on delivering long-term – five to ten years’ – value, when they are likely to be in charge for much shorter periods. Duration of departing CEOs from the world’s largest

2,500 companies has declined from 10 years in 1995 to 8 years in 2000 and 6 years in 2009. And turnover in Australia is even higher, with average tenure of 4.4 years. That means that, in the absence of clear results a CEO's position is arguably under threat after just two years.

Similarly, both Mr Arnold and Mr Orthman cite examples that show many active fund managers have been pushed towards short-term thinking in an attempt to avoid underperformance. This is despite evidence that suggests periods of underperformance relative to peers or the benchmark is to be expected.

"Short-term relative underperformance risk, combined with the client's ability to withdraw funds at any time, causes many fund managers to undertake activities to reduce this risk," said Arnold and Orthman.

"The widespread use of index hugging is a prime example. Couple that with the fact that the average period of tenure for the head of an Australian equity team is under three years, compared to the 5 to 10 years needed to deliver significant alpha and there is clearly an issue."

However, the ultimate cost of excessive short-termism is too often borne by mum and dad investors.

"As most investors and super fund members' main objective for investing their savings is to have sufficient savings for retirement, trustees' and investment managers' decisions should be framed based on the key factors that drive long-term investment returns," they said.

The paper outlines several suggestions to address this issue, including:

- For corporate management: setting long-term strategic goals, ceasing short-term earnings guidance and changing remuneration structures from short-term earnings to long-term sustainable value accretion for equity holders.
- For active fund managers: extending performance measurement to five years or more, payment of annual bonuses on the basis of rolling medium to longer term performance and the requirement for portfolio managers to make meaningful investments in the fund.
- For mum and dad investors: superfund investors need to lengthen time periods in which they provide reports and focus their commentary on the long-term returns achieved by the fund and relevant benchmarks, as well as providing realistic and fundamental based long-term return estimates.

Ends

Notes to editors:

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