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Missing the Target: A Review of Mark Roe's New Book on U.S. Stock-Market Short-Termism

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Concerns about stock-market-driven short-termism are not new. According to the *New York Times* of October 29, 1929, Roosevelt criticized the "fever of speculation" as the Wall Street crash gained momentum. In his *General Theory*, written in the shadow of that great market upheaval, Keynes deplored the role of speculation in setting market prices:

The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment today is "to beat the gun," as Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.

But by the end of the last century, we were more relaxed. Free market capitalism and financial markets were in the ascendency. In 1999, Bill Clinton revoked the Glass-Steagall Act, whose justification was separating sober deposit takers from "casino" investment banks; and Peter Mandelson, a British Minister, told his Silicon Valley audience that the once-socialist Labour Party was now "intensely relaxed about people getting filthy rich."

But things go in cycles, and the Global Financial Crisis of 2008 triggered a significant change in the zeitgeist. The accepted narrative is now that short-term executives chasing short-term bonuses egged on by short-term shareholders brought misery upon the world. While short-term incentives might have played a part (although how much is contested), a bigger issue with banking crises has always been that while the benefits of risky behavior accrue fully to a bank's shareholders and executives, its costs are significantly "externalized" and distributed.

Nevertheless, the short-termism narrative caught hold with, as just one example, SEC Chair William Donaldson claiming that "one of the root causes" of the crisis was the "excessive focus by too many corporations on achieving short-term results." The professional-industrial complex then swung into gear. Dominic Barton, Global Managing Partner of McKinsey, declared in *Harvard Business Review* in 2011 the need to "Fight the Tyranny of Short-Termism." The now well-recognized villains were put on parade: quarterly earnings reporting, reduced average holding periods for stocks, high frequency trading, dispersed share ownership, and short-term investment mandates and incentives. The solutions offered included differential voting rights for longer-term shareholders, increased time horizon for executive pay plans, and more committed boards. The ideas, though not all bad, were clearly predicated on the idea that stock-market short-termism is a *big* problem, indeed perhaps capitalism's *biggest*. This view was reinforced by law firms that, through prominent and effective lawyers such as Martin Lipton, continued to press the case for greater protection for boards from shareholder interference, especially in relation to takeovers.

Barton's article opened a further front related to stakeholders. Trust in capitalism can be rebuilt only by recognizing the interdependence between business and society, a company and its stakeholders. Thus, the concern about short-termism became entwined with the concern about shareholders versus stakeholders. In other words, a social concern about time horizons became conflated with a concern about the extent to which business imposes costs on the rest of us. This interest in "stakeholder capitalism" has exploded, with Google searches for the term increasing ten-fold over the last three years. So far has the pendulum swung from the assumption of shareholder primacy that in 2019, the Business Roundtable felt emboldened to redefine the purpose of a corporation in a way that elevated the priority of other stakeholders alongside shareholders—a group that was symbolically listed last out of five constituencies that a corporation serves.

So the narrative of pervasive short-termism, and the need to protect corporations and the economy from it, is now well established. Frenetic short-term trading and aggressive activists chasing immediate increases in profit prevent corporations from thinking long term. Dispersed institutional investors provide companies with no protection from these forces. On the contrary, they squeeze cash out of the corporate sector by pressuring companies to undertake excessive share buybacks rather than supporting long-term investments in R&D and employee training and skills development. The relentless pressure for short-term results also means companies neglect long-term social problems like climate change, biodiversity, human rights, diversity, and inequality as they seek to meet the stock market's expectations.

The assumption of stock-market short-termism has had tangible political and regulatory implications, whether in the provisions of Elizabeth Warren's Accountable Capitalism Act, SEC proposals for revised disclosure rules that would make hedge fund activism harder, the U.K.'s abandoning of requirements for quarterly reporting, or proposals in the EU to change directors' duties. We see regulators and politicians from across the spectrum making proposals for corporate governance rules or regulation of companies and markets based on the premise that stock-market short-termism is a major problem.

Clarifying and challenging this premise is the main undertaking of a new book by distinguished Harvard professor of law and economics Mark Roe. Although full of subtlety and qualification where and when needed, the book's main message is nicely conveyed by its title: *Missing the Target: Why Stock Market Short-Termism Is Not the Problem*.

Where Are the Economy-Wide Effects?

Having set the scene, Roe makes a reasonable assertion: If all of these problems are real, we should be able to see evidence of them in the economy-wide numbers. In this context, Roe makes an extremely important point. Many claims about short-termism's effect on the economy are extrapolated from firm-level studies, but this extrapolation may not be valid. Let's suppose that executives cut R&D in an attempt to boost the stock price shortly before a block of options vest. This may be a cut in R&D that is a permanent loss to the economy. Or it may just be a shift in R&D spending from a period close to when a large block of options vest to another period. There may be no net change in R&D. And let's suppose that share buybacks do reduce the cash for investment by large listed companies. That may simply release cash to be recycled into better investment opportunities in small listed or private firms. The overall impact on investment may be neutral, but the investment may be going to more productive opportunities, which is better for the economy. And this in fact is what the evidence seems to suggest.

Roe finds little evidence of short-termism's ills showing up in economy- wide effects. Although investment in capital expenditure has declined in the U.S. during the past three or four decades, it has also declined across the OECD countries. Moreover, it has declined at a *faster* rate in some countries, such as Germany, where stock markets play a much smaller role in capital allocation than in the U.S. and where, as a result, we would expect the forces from stock-market short-termism to be weaker. Changes in investment may simply reflect the changing nature of economies as they develop, with an increasing focus on intangible investments that show up as expenses on the P&L rather than as capitalized expenditures (that get amortized over time).

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In support of this idea, R&D as a percentage of U.S. GDP has increased steadily over the last four decades. The number of patents awarded annually has also increased, and particularly sharply since around 2009. This overall increase in R&D has been achieved while U.S. government-funded R&D has actually declined, forcing the corporate sector to pick up this slack.

The idea that share buybacks are starving companies of cash also doesn't hold water for Roe. Share buybacks have indeed increased in value since 2000, but they have largely been offset by the increases in borrowing during the same period. And what we have seen, then, is a change in the capital structure of many of America's largest and most mature companies—those that make up the S&P 500—as opposed to a net cash outflow from corporations. Indeed, the cash holdings of S&P 500 companies have risen sharply since 2000—and so any problems with investment in large companies do not seem to come from lack of funds.

Finally, the idea that U.S. stock markets are excessively short-term just doesn't seem to accord with the fact that so many of the largest, most successful U.S. companies are valued at very high price-earnings multiples—multiples that reflect prospects for profit that extend decades into the future. Moreover, at the smaller end of the market, it is becoming *more* common for companies to IPO *before* they make a profit. Again, this doesn't sound like the work of short-sighted investors.

But, as Professor Roe reminds us, what evidence we have reflects only what actually happened. And so we don't know *the counterfactual*, what might have happened if we had a more patient and far sighted corporate finance and governance system. Perhaps in a world that wasn't so short term, R&D would have risen *even faster* than it actually did. And maybe capital investment might have risen in the U.S. *despite falling* elsewhere in the OECD, and stock market valuations for both successful and start-up technology firms might be *even higher* than they are today. But given the lack of evidence of pervasive effects, the burden of proof, as Roe also points out, falls on critics of stock-market short-termism to produce evidence of major and lasting harm to the U.S. economy.

Short-Termism and Social Harms

Even if short-termism isn't harming the economy, perhaps it's harming society in other ways. Dominic Barton's 2011 *Harvard Business Review* article opened up the stakeholder front in the battle against short-termism. It is this stakeholder-oriented short-termism—which Roe calls "Type B" short-termism—that may even be of greater concern today. In pursuit of short-term profits, corporations are said to be exploiting workers (to the extent of tolerating slavery in supply chains), plundering the environment and so causing a collapse in biodiversity, and spewing carbon dioxide into the atmosphere, the devastating costs of which will be borne by future generations.

Roe contends that this view is largely a category confusion, an error of analysis. Social harms arising from corporate behavior are more the costs arising from externalities than from corporate shortsightedness. Using the example of the DuPont Teflon scandal, he asserts that companies that can get away with externalizing costs onto society with impunity will continue to do so even as they aim to maximize their own long-run value. The key issue is not short time horizons but rather the failure to punish and deter the externality. Roe argues that poor treatment of workers, environmental degradation, climate change, and the financial crisis can all mostly be explained as the rational behavior of long-run value-maximizing companies that benefit from negative externalities that are not reflected in either their stock prices or the prices of the products they sell. The cause of this behavior is a selfish mindset, not a short-term one.

This analysis perhaps underplays the way in which short-term thinking may cause shareholders and managers to underplay risks that could emerge far in the future. We don't need to think of the stock market as a huge Ponzi scheme—one in which investors' frantic selling to the next ill-informed mug continues right up until the moment global warming engulfs us—to believe that issues like climate change, whose effects are distant and uncertain, may be underweighted in corporate decision-making relative to nearer, more measurable goals. Executive pay schemes, which are largely based on relatively short-term goals, can add to these problems. While lengthening the time horizon of pay can help (although this step seems to meet stronger resistance from the supposedly farsighted corporate managers than their allegedly short-term-oriented shareholders), there is a limit to how long this time horizon can be, given the typical tenure of today's CEOs of not much more than half a decade.

But overall, Roe's point is well made. While we can't say there is *no* negative social impact from stock-market short-termism, the evidence points overwhelmingly to the larger problem of the persistence of negative externalities that companies can feel confident of exploiting for the foreseeable future, especially given their own lobbying prowess and the reluctance of governments to impose the taxes and other penalties that could limit such externalities. The increased attention now being paid by investors to "double materiality"—that is, effects on a company's stakeholders that, although not financially costly today, are likely to be so in the future—suggests that the adverse social impacts that are truly attributable to a foreshortened time horizon are increasingly being dealt with. But not every social ill comes down to time horizons. Indeed most do not.

Firm-Level Evidence of Short-Termism

Having addressed the economy-wide effects of short-termism, which are notable mainly by their absence, Roe turns to analysis of the company-level evidence on the stock market's impact. The middle chapters of the book examine the findings of some quite technical academic papers in a way that is nonetheless accessible for practitioners in business, finance, or regulation. Roe systematically, carefully, and fairly weighs the evidence from the many studies produced on either side of the argument. In this, Roe does us a rare but important service. Most books on capitalism and its supposed ills are full-throated whether in attack or defence. By contrast, Roe's analysis is balanced, respectful, and attentive to all sides. In his desire to be even-handed, Roe at times appears to be bending over backwards, sometimes even understating the extent to which the evidence in the round supports his argument.

The debate about short-termism is plagued by "gotchas": studies whose findings are aggressively interpreted and produced by polemicists as a smoking gun. Among the most cited studies claiming to find evidence of short-termism is John Graham, Campbell Harvey, and Shiva Rajgopal's survey of the CFOs of some 400 U.S. companies in which over 75% of *executives* admit their willingness to sacrifice value to smooth earnings. On the opposing side, however, is research that includes seminal studies of the beneficial effects of hedge fund activism—one by Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, and another by Lucian Bebchuk, Brav, and Jiang—including improvements in the longer-run performance of the targeted companies, and positive spillover effects across the targeted industries.

But, of course, any academic study is set within a confined context, and similar studies in different contexts may well come to different conclusions. Methods of analysis can affect results and are always the subject for debate. And since academic findings can be surprisingly difficult to reproduce even in very similar settings, perhaps the most reliable way to draw inference from academic research is to see what aggregate conclusions can be drawn from the collections of the best, peer-reviewed studies in a given field. Roe does a superb job of this, avoiding the temptation to cherry pick studies to fit his conclusions, while considering the merits and weaknesses of studies on both sides of the argument.

Roe's conclusion: the evidence is mixed, but the studies arguing against stock-market short-termism are slightly more persuasive overall than those making the case for it. In a world that craves knock-out blows this may leave the reader unsatisfied. But Roe doesn't need a knock-out blow. His argument isn't that stock-market short-termism doesn't exist anywhere, just that it's not the major problem it's made out to be. He doesn't need to hit the baseline, two feet inside does him just fine. Coupled with the argument that firm-level studies can't be extrapolated into economy-wide conclusions because of offsetting system-level effects, the conclusion is compelling: the case for stock-market short-termism being widespread and damaging just hasn't been made.

Misdiagnosis Leads to Mistreatment

If we make the wrong diagnosis of the sickness, the wrong treatment will be prescribed. If climate change is a problem of time horizons, then policies that address stock-market short-termism will fix it. But if it's largely a problem of persistently unpriced externalities, then the right solution is some form of carbon tax or direct regulation designed to discourage the activity; even companies focused on the long term will continue to emit more carbon than is good for us until acted upon by outside forces, like regulators and tax authorities. In short, misdiagnosis leads us to focus on the wrong stuff.

Roe's argument is that focusing on stock-market short-termism, which is at most a small problem, distracts attention from bigger problems and better solutions. The precipitous decline in *government*-funded basic research and R&D has nothing to do with the stock market. It results from Washington policymaking. The disruption people feel from rapid technological change is not coming from stock-market short-termism. Declining corporate investment in hard assets is more likely coming from an economy shifting to intangibles, weakened antitrust policy, and the general shift of manufacturing to East Asia. The failure to address climate change has much more to do with the externality of carbon emissions being largely untaxed and unregulated than with the allegedly short time horizon of the stock market.

Instead of focusing on the big issues that might make a difference, misdiagnosis of the problem leads to eye-catching proposals that will almost certainly do more harm than good. Giving boards and executives more power won't lead to their inherent long-term orientation being unleashed for the good of the U.S. economy. Far more likely is that reduced shareholder scrutiny will lead to increased entrenchment, pursuit of executives' self-interest, and even greater short-termism. After all, inherent short-term pressures within organizations appear to be driven far more directly and significantly by finite careers and short-term bonus plans. If anything. these pressures are *counterbalanced* by investors' longer-term orientation, not caused by their short-termism. Giving more votes to shareholders that hold shares for longer ignores the critically important difference between investors' holding periods and time horizon orientation: a short-term holder can have a long-term orientation as they seek to gain from improving the value derived from the long-term prospects of a company. Banning, limiting, or providing obstacles to buybacks and activism will only undermine the process of creative destruction that spurs the innovation and productivity improvements that ultimately enhance living standards across the economy. Reducing shareholder rights in favor of stakeholders will increase the bias towards the status quo in an economy that needs to reallocate capital even more rapidly to respond to climate change and emerging technologies.

The pervasiveness of the narrative of short-termism among corporate leaders, law courts, regulators, and politicians creates an environment where these flawed solutions find oxygen, resulting in likely more costs than benefits.

An Alliance of Interests in Promoting the Short-Termism View

Roe finishes his analysis by putting the debate on short-termism into a broader political context that seeks to explain the powerful alliance of interests among the leading promoters of the short-termist narrative.

Short-termism is often confused with speed of change. Key technologies are diffusing at an ever-increasing rate. While it took 71 years from its invention for the telephone to reach half the U.S. population, it took 10 years for internet access to do the same. The number of patents awarded annually roughly doubled between 1963 and 1993, but has quadrupled in the 20 years since. The average life of listed corporations halved from six to three decades between 1970 and 2010. The average age of a company in the S&P 500 fell from 61 years to 18 years between 1958 and 2012.

This increasing rate of innovation and corporate change increases real and perceived uncertainty in the population. Even as the economy grows overall, certain segments—some particularly influential politically—are experiencing an intensity and frequency of change that is discomfiting. Those losing stable well-paid manufacturing jobs may find it hard to replicate their wages, even if they are prepared to move to find work. Even if the statistics on job turnover don't fully reflect the story of increased uncertainty, perception can end up standing in for reality. The stock market is the transmission mechanism for much of this change. Criticism of stock-market short-termism, Roe says, may be a cry to slow the change down.

Governments have an interest in spreading, and then responding to, this narrative. It is much easier for politicians to deflect blame for voters' discomfort onto the time-honored scapegoat of financial markets than to undertake the harder tasks of making rapid change tolerable for the population as a whole: reforming education systems, increasing investment in worker skills and training, and strengthening or expanding the social safety net. Corporate executives and their advisers also have powerful incentives to support the argument. How satisfying if freedom from accountability and an easier life can be had in the name of working toward the greater good of stopping short-termism. And corporate advisers know which side their bread is buttered. Telling clients what they want to hear is normally a better commercial strategy than the converse.

Even the language used makes a difference. Who will readily admit to being short-term-oriented? Short-term suggests unreliability, instability, and obsession with tactics. Long-term suggests reliability, stability, and attention to strategy. But in a world of rapid change, short-termism can be confused with the virtue of adaptability and long-termism can be confused with the vice of inflexibility. Repeated use of loaded language reinforces a belief set that is psychologically comforting to many key constituencies, but ultimately misleading.

Roe's closing assessment is hardly comforting. He sees fundamental economic forces accelerating change coming up against resistance from a population experiencing disruption on dramatically compressed timescales that today are now much shorter than a working lifetime. Stock-market short-termism is a convenient narrative for the creative destruction wrought by technological change—but it is also alas a force with considerable power to unite voters, politicians, and business leaders in a misguided charge towards the wrong target. We can expect this conflict to continue.

Roe's book is very readable and the arguments lucid. But its strength—its rationality, rigor, balance, and downright *reasonableness*—may also be perceived as its main limitation. It's not a polemic or a call to arms. It's not going to set social media on fire. As a result, I fear it won't be read as widely as it should. But it is essential reading for policymakers, regulators, and anyone else interested in corporate governance, financial markets, and regulation that will actually make a positive difference to society. If the book reaches that audience only, it will have done its job.

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