The Imaginary Problem of Corporate Short-Termism

By Mark J. Roe

Corporate "short-termism" may not be as interesting as Donald Trump's latest gaffe, but it's becoming an issue in the 2016 presidential race. Corporations, the idea goes, are being run too much with an eye toward quarterly earnings instead of the long-term good of their businesses, their employees and the economy. Investors are to blame, and something needs to be done. Hillary Clinton has proposed making changes to capital-gains taxes and holding periods to encourage long-term investments.

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But it isn't just Democrats who are concerned about short-termism. Daniel Gallagher, a Republican member of the Securities and Exchange Commission, has voiced similar concerns, as have other conservative politicians and pundits. In the corporate world, proposals regularly emerge that boards and CEOs need more autonomy from investors to better run companies for the long-term.

Among those who opine on the topic, most take for granted that corporate short-termism is pervasive, and more important damaging to the U.S. economy. But is it? Or is it a small issue on which we could do better but that's been blown out of proportion by those fearful of change? I see it as just that.

There is academic evidence of short-termism at play. A 2006 survey of more than 400 senior financial executives by professors from Duke University and the University of Washington found that "a surprising 78% of the surveyed executives would destroy economic value in exchange for smooth earnings."

Yet there's also considerable evidence that stock markets don't discourage long-term business plans. Institutional investors haven't penalized companies for bumping up research-and-development spending, even though the payoff may be years down the road. Think of Amazon, Apple and Google, each of which spends billions on R&D. Oil companies make multi-decade investments in oil fields without the stock market impeding them. High stock valuations in favored sectors—dot-com in the past, high-tech and biotech today—represent stock-market *long-termism*, as many of these companies have no hope of producing revenue or profits in the short run to justify their lofty valuations.

Some complain that today's corporations aren't investing cash back into their businesses to expand capacity. But that's just what long-term investment should produce in a weak economy with below-normal capacity utilization. Firms should wait until they anticipate using current capacity well before expanding.

In the U.S., it should be remembered, private-equity firms and venture capitalists finance a great deal of innovation. What counts is whether viable innovation happens, not where it happens and who is providing the capital.

Typical American shareholders, like Fidelity Investments, Vanguard and other mutual funds, haven't shortened their holding period for stocks. While a growing fringe group of "program traders" use algorithms to buy and sell stock furiously and in the short-term—based on tiny movements in stock price and trading volume—they have little if any effect on corporate governance.

Moreover, investors aren't the only and maybe not even the most important place to look for short-term pressures: Managers and boards want good results on their watch, and CEOs shorten their management horizons as they reach the end of their tenure. Proposals to free managers further from investors by giving them more autonomy could thus worsen, not help, the problem.

Critics need to acknowledge that short-term thinking often makes sense for U.S. businesses, the economy and long-term employment. Bad short-termism is when boards and managers forgo good long-term business opportunities simply to meet quarterly earnings targets. Bad long-termism, obviously, is when they invest in businesses that have no future. There is an increasingly fine line between the two.

The world is riskier today, change is faster than ever, and new technologies can quickly destroy markets and businesses. It makes no sense for brick-and-mortar retailers, say, to invest long-term in new stores if their sector is likely to have no future because it will soon become a channel for Internet selling.

Why then, since the evidence is weak and mixed, is short-termism taken so seriously? It resonates politically because it satisfies the desires of people who don't want rapid change. Boards and managers—a natural Republican constituency—want to keep their jobs, autonomy and status; if short-termism ideas provide a wedge to keep investors from agitating for boardroom change, so much the better. And their workers—a natural Democratic constituency—would like change to be slow or nonexistent, to better protect their jobs.

That combination can create an insalubrious bipartisanship, with Republicans and Democrats each protecting their separate natural constituencies.

At least in the short-run.

Mr. Roe is a professor at Harvard Law School.