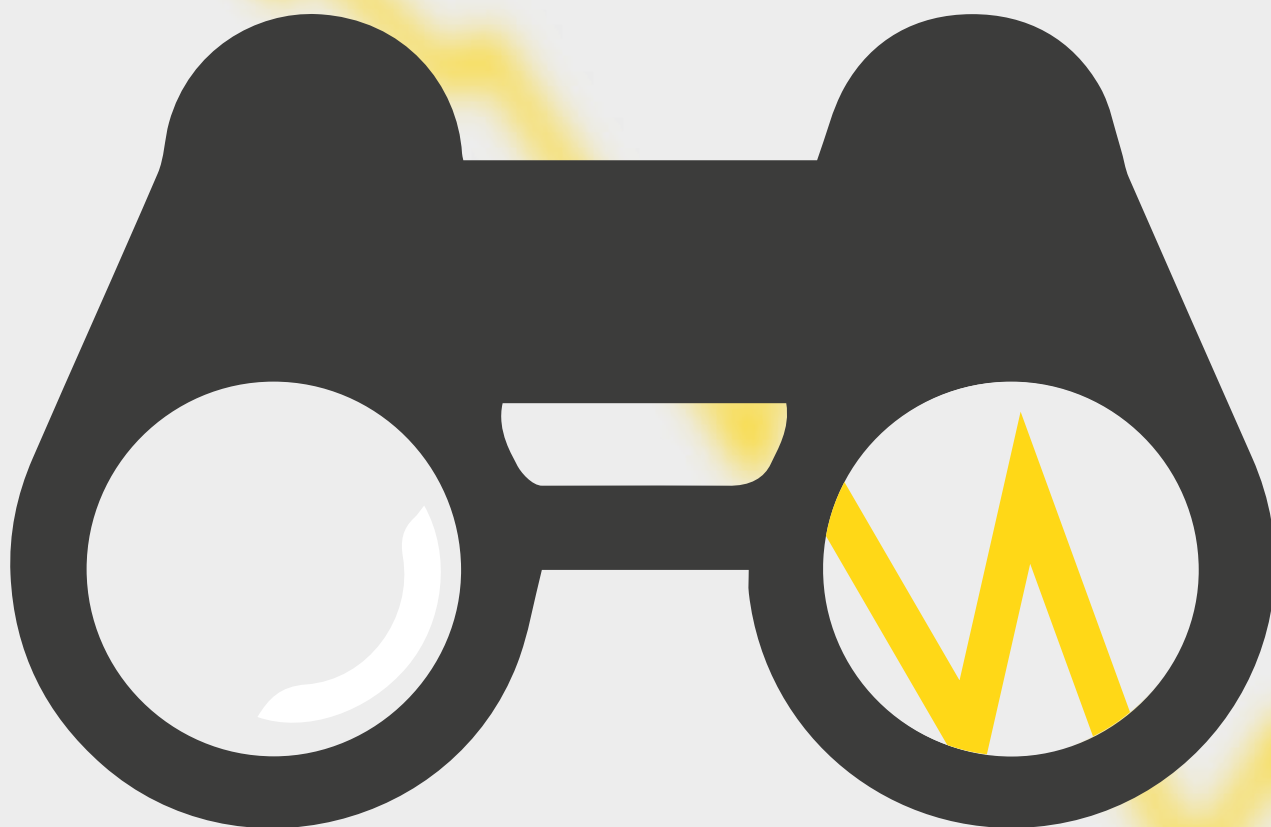


Short-termism in business: causes, mechanisms and consequences

EY Poland Report



Building a better
working world

Table of Contents

Executive Summary	1
1 What is short-termism?	5
2 The causes of short-termism among public companies	11
2.1 Factors contributing to the short-termist behaviour of investors	13
2.2 The instruments of investor pressure on the executives	17
3. The consequences of short-termism	21
3.1 The channels of the impact of short-termism on a company's performance	23
3.1.1 Shortened CEO tenure	23
3.1.2 Neglect of investment activity	24
3.1.3 Neglect of human capital	25
3.2 EY empirical analysis	27
3.2.1 The companies' performance variables (explained variables)	28
3.2.2 The impact variables (explanatory variables)	29
3.2.3 Statistical analysis	35
3.2.4 Summary of the econometric results	38
3.2.5 Summary of the empirical analysis	43
4. Conclusions	45

Abbreviations and definitions

SPIQ	Standard & Poor's Capital IQ
GICS	Global Industry Classification Standard
LTIP	Long-Term Incentive Plan

Executive Summary

The right balance between a short- and long-term perspective is crucial for the sustainability of a successful business. However, there is a lot of evidence, not least the recent financial crisis, to show that long-term objectives have often been neglected because of too much concentration on short-term goals. This is the short-termism phenomenon, which deteriorates firms' competitiveness, increases systemic risk, and reduces the long-term potential of the entire economy. This EY Poland Report contributes to the discussion on short-termism through empirical research conducted for the 1024 largest companies listed on the European stock markets.

Short-termist behaviour is particularly visible in the case of public companies, which are often under pressure from their shareholders to deliver short-term outcomes. Among the factors that contributed to this pressure are: new technologies, reduced trading times and transaction costs, increased market volatility, media coverage, and the increasing role of institutional investors.

Shareholders have instruments to effectively execute their expectations of short-term outcomes. These instruments include shaping the remuneration schemes of the executives based on their short-term performance, as well as the ability to remove executives from office if they do not meet investor expectations. Short-termism is often reinforced by companies' market communication and financial reporting practices, which largely focus on the short-term performance and, from the shareholders' point of view, serve as an instrument for monitoring their short-term goals. Consequently, short-termism often results in "earnings management" rather than building the long-term value of the company.

There are different channels through which short-termism may adversely affect companies and the economy as a whole. These are: shortened CEO tenure, the neglect of investment activity and the neglect of human capital. EY's empirical analysis focuses on the former two.

In light of a significant shortening of the executives' contracts and performance evaluation intervals, we show that addressing the issue of management stability should be of great importance. The results of our research indicate that an increased CEO tenure positively influences the company's profitability and market capitalisation. In particular, an additional year of CEO tenure leads, in the long-run, to an average increase in the company's annual profitability (ROE) by 0.3 p.p. Interestingly, we do not find any relation between the time-orientation

of cultures and the average tenure of executives. This further strengthens the view that, as far as listed companies are concerned, short-termism has become a global, culture-wide phenomenon.

A reduction in investment expenditures is another important channel of the impact of short-termism on a company's performance. Capital outlays are often made with the aim of improving the firm's long-term competitiveness and capacity. EY's analysis shows that a rise in capital expenditures to total assets ratio by 10 p.p. in the long-term leads to an increase in the average ROE by 4.5 p.p., while a rise in capital expenditures to total revenue ratio by 10 p.p. leads, in the long-run (here 15 years), to an average increase in the growth of the company's market capitalisation by 7.1 p.p. However, in the short-term, investment outlays may lead to a deterioration in reported financial indicators, which in turn may result in a decline in the company's share price. We confirm that by showing that increasing the capital expenditures to total revenue ratio by 10 p.p. leads to a short-term decrease in the company's market capitalisation growth by 1.6-3.9 p.p. Therefore, while executives recognise the problem of excessive short-termism, they may be reluctant to allocate capital to achieve long-term goals as they want to avoid missing the short-term consensus estimate and thus disappointing the company's shareholders. Available survey results confirm that executives would delay or sacrifice projects creating long-term value in order not to miss short-term earnings targets.

With respect to that, an important finding of the EY's research is that the longer the CEO tenure, the higher (on average) are the company's investment outlays. In particular, an additional year of CEO tenure leads, on average, to an increase in the firm's capital expenditure to total revenues ratio by 0.2 p.p.

Our estimation results also point to a positive impact of appointing an insider successor on the company's profitability, both in the short- and long-term. It may reflect an additional dimension of the CEO's valuable experience as that of the company's insider. However, we do not find this effect on the company's long-term market value. Neither have we identified any impact of an outsider or an insider successor on the company's investment activity.

In addition, the obtained results indicate that increasing the role of Long-Term Incentive Plans (LTIP) in the CEO remuneration scheme positively influences the company's ROE in the short-term. That effect, however, has not been identified for the market capitalisation or

investment activity of the company (long-term effects of the LTIP have not been analysed).

Short CEO tenure and neglect of investment outlays decrease a company's long-term value and profitability, as well as the ability to adapt to new market conditions and compete on a global scale. In this way, if short-termism affects many firms, it translates into the reduced potential of the entire economy. Consequently, tackling the problem of the shortened executives' contracts may be one way of addressing the issue of short-termism.

Reducing the problem of short-termism requires the involvement of all stakeholders. In particular, executives excessively focus on the short-term performance in response to market expectations and pressure from investors. Engagement with the investor community should therefore be an important part of the strategy to counter the problem of short-termism.

One way of improving communication with stakeholders may be related to changes in the reporting framework, in particular amending the structure of information towards more long-term, fundamental guidance. This may help in shifting the focus of investors towards the long-term value and true drivers of business success, as well as attracting new, long-term investors.

Another measure would be to incentivise executives to pay more attention to long-term value creation. This may be achieved through structuring the remuneration schemes of executives so that a significant portion of their compensation is based on the long-term performance of the company.

Yet another solution recommended in the literature is to provide tax and regulatory incentives for long-duration holdings of securities and disincentives for short-duration holdings.

Taking into account the costs that short-termism entails, not only for public companies, but also for the whole economy, we strongly recommend considering a wide range of measures that may help to address the excessive focus on short-term goals. If dealt with effectively, it would improve the capacity and competitiveness of national businesses, encourage long-term value creation and contribute to the welfare of society.



01

An aerial night view of a city skyline, likely Tokyo, with numerous illuminated skyscrapers and buildings. A thin yellow diagonal line runs from the middle-left towards the top-right of the image.

Section 01

What is short-termism?

'Anybody can manage short. Anybody can manage long. Balancing those two things is what management is'

Jack Welch, General Electric CEO

What is short-termism?

The actions that we take in our everyday life have consequences. These consequences, however, may vary over time. Whereas some of our decisions result in immediate outcomes, for others it takes time, even years, to see the effects. Decision-making becomes more complex if actions leading to long-term benefits require short-term sacrifices, or if achieving short-term goals comes at the cost of long-term objectives.

For instance, we have to make a choice between current consumption, which gives us some benefits straightaway, and savings, which are usually connected with some increased, but delayed, gains. Therefore, if we want to be rewarded with a higher cash-flow, and thus consumption in the future, we have to sacrifice part of our today's consumption, which - by definition - is not something that we are happy about. Another example of such decision-making problem is whether to continue the full-time education or start a professional career right away. Extended full-time education is usually related both with a direct cost (tuition fee) and alternative costs (one could start a job earlier and earn wages instead of studying). Moreover, it often requires a lot of effort to pass all the courses, so it entails personal costs as well. However, in the longer run, additional years spent in education are usually connected with a better salary, higher social status and/or prestige. Therefore, the decision whether to study (and how much) or not, is actually an investment decision that takes time and effort before it pays off.

Similar dilemmas are faced by businesses. When someone starts a new firm, the costs and sacrifices come first - only after time, sometimes many years, will the whole investment reach the break-even point. And sometimes it never does. The trade-offs between long-term and short-term benefits reiterate throughout the whole lifecycle of the company. For instance, the firm can distribute its profits in the form of dividends, resulting in short-term rewards to the owners (individual or institutional shareholders), or it can use these funds to finance investments in new productive capacities or technologies. In fact, hardly any companies use all of their surplus cash either for dividends or for investment. On the one hand, if we neglect investment activity then the firm, even if initially successful, will gradually lose its competitive advantage. On the other hand, if we focus too much on the long-run goals, the company might fail to produce the outcomes necessary to survive until the long-term benefits materialise. In particular, the firm may lose liquidity if investors or banks do not accept such a policy and cut off external financing. Or investors may simply lose their patience and remove the CEO from office. The right balance between a short- and long-term perspective is crucial for the sustainability of a successful business. Jack Welch, the author of the opening quote, understood that perhaps better than anyone else during his 20 years in office as a CEO of General Electric. During his term, the market capitalisation of the company increased by more than 2 800%.¹

¹ GE (2014), *Past Leaders*, John F. Welch, Jr., Chairman & CEO 1981 - 2001, <http://www.ge.com/about-us/leadership/profiles/john-f-welch-jr>

However, recent experience, not least the financial crisis, has shown that instead of ensuring a balance, long-term objectives have often been neglected because of too much concentration on short-term goals (see Frame 1). This results in the phenomenon of **short-termism**, which we define as **the excessive focus of decision-makers on short-term goals at the expense of longer-term objectives. Short-termism results in insufficient attention being paid to the strategy, fundamentals and the long-term value creation of a firm or an institution.** It must be stressed that caring about short-term goals should not be considered a problem *per se*, the problem of short-termism occurs when decision-makers *sacrifice* long-term goals, or even neglect to formulate them, and instead excessively concentrate on short-term benefits.

A legitimate question is whether we should care about the short-termism issue? One might say that it is the problem of certain companies and we should let the market do its job. However, there are at least several arguments why we should care. First of all, short-termism may apply not only to companies, but also to other institutions, including public regulators. If short-termism dominates the policy of the latter, its consequences might affect all the market participants. If, for example, government policy is determined by a short-term perspective, it may have adverse macroeconomic and social consequences, including an impact on economic growth, the unemployment rate or price dynamics. In particular, the government may be tempted to increase public expenditures before elections with the aim of winning more votes. Such a short-term oriented policy, however, might result in long-term costs, because an

increase in public debt due to the initial fiscal expansion would have to be compensated for by the subsequent fiscal tightening, leading to an economic slowdown and increased volatility of the business cycle. This would clearly affect all the households and companies in the economy.

Secondly, an excessive focus on short-term goals may result in a similar and simultaneous behaviour of many other firms and institutions. In particular, this behaviour may take the form of excessive risk taking to maximize short-term earnings. For example, financial institutions may invest in assets with hidden risk or take on excessive debt just to increase their short-term profits.² In such a setting, short-termism may lead to *systemic risk*, affecting the stability of the entire economic system. This has become evident especially in the case of large financial institutions issuing subprime mortgages, which allowed them to make fast but unsustainable profits. It led to the housing bubble, the burst of which resulted in the global economic crisis (see Frame 1). Therefore, short-termism may lead to macroeconomic imbalances followed by a sudden economic downturn.

Finally, to the extent that short-termism leads to the neglect of investment activity, it reduces firms' international competitiveness and their capability to respond effectively to new market challenges. Short-termism thus results in the reduced potential of individual companies, but also of the whole economy.

Based on the above, there is little doubt that alleviating the problem of short-termism would contribute to building a better working world. On the one hand, there is an increasing amount of literature on the mechanisms underlying the problem of short-termism

2 Lynne L. Dallas (2012), *Short-Termism, the Financial Crisis, and Corporate Governance*, Legal Studies Research Paper Series, Research Paper No. 12-078.

and its destructive impact on companies. Many reports and articles confirm that the decisions of CEOs bringing fast gains both to shareholders and to executives, often entail long-term costs to the company. On the other hand, there is little empirical research on this matter, other than that based on surveys. This EY Poland report aims to reduce that gap.

The goal of this report is to contribute to the discussion on short-termism through empirical research conducted for European companies, which - to our knowledge - have not been the subject of many studies so far.

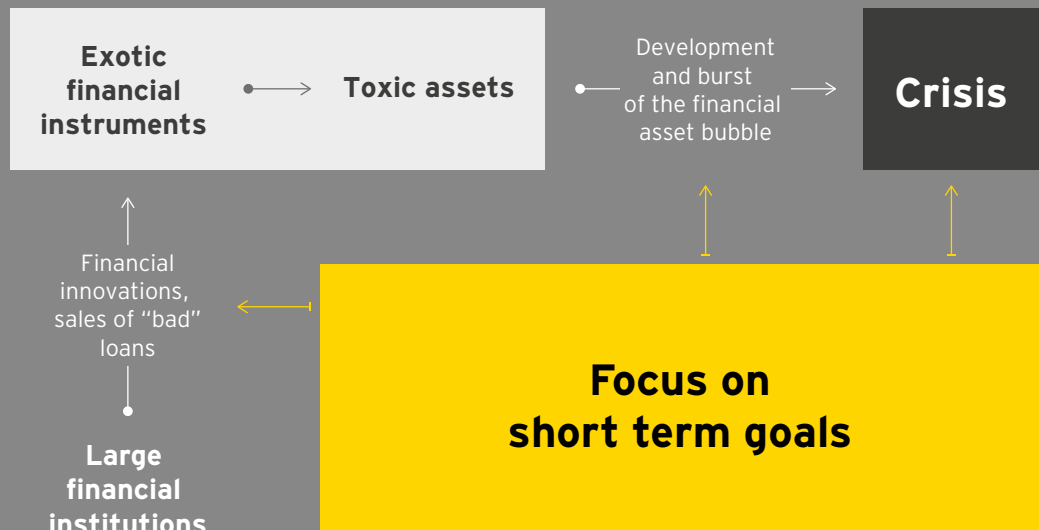
The report is structured as follows. Section 2 describes the causes of short-termism in the context of incentives faced by the decision-makers in a company. In Section 3 we discuss the consequences of short-termism, with a particular focus on listed companies. This part of the report draws on the available literature, as well as on EY's empirical findings for European companies. Details of our methodological approach, including the technical description of data and econometric models, are included in the Appendix.³

³ The Appendix to this report is available on the EY website: www.ey.com/PL/short-termism

Frame 1

Short-termism and the financial crisis.

Chart 1. The role of short-termism in the recent financial crash on the US real estate market



Source: EY.

Short-termism phenomenon played a key role in the chain of events that led to the economic meltdown beginning in 2007. Before the financial crisis outburst, large financial institutions were interested in selling as many loans as possible, creating an “originate-to-distribute” model. The idea was to charge fees for giving credit, and then to use extremely complicated financial instruments in order to disperse the risk throughout the financial markets. This made it possible for banks to grant mortgages even to creditors unable to repay them (NINJA loans – “no income, no job and no assets”), as the consequences were disguised by the complexity of the financial innovations. Moreover, those responsible for granting loans were not so much interested in the quality as in the quantity of new mortgages, for which they were rewarded with bonuses.

In this way, an increasing number of consumers could afford a house financed through a mortgage, which led to skyrocketing housing prices. In reaction to this ballooning demand, the financial markets started to act as if real estate prices would rise forever, loosening the creditworthiness criteria even

further. And still, under the then-binding supervision standards, ever-rising housing prices made financial institutions’ balance sheets look more and more healthy, reinforcing the above cycle.

Finally, many financial institutions reached a moment at which the consequences of short-termism became evident – the real estate bubble was about to burst. It became clear that the situation in the housing market was unsustainable and that “subprime mortgages” would likely inflict serious damage on the whole US financial sector. Exotic financial instruments, so far treated as an attractive innovation making housing loans a relatively safe source of profit, suddenly became recognised as extremely risky and overvalued assets. This left banks with a huge amount of “toxic assets”, raising the urgent need to repair their balance sheets, which required a significant tightening of credit criteria. This in turn adversely affected non-financial companies as the across-the-board credit crunch left many of them unable to finance their activity. As a result, the economic slump became more and more severe and was spreading around the world.

* The discussion in this frame is based partly on Dallas, op. cit. and Amiyatosh Purnanandam (2010), *Originate-to-Distribute Model and the Subprime Mortgage Crisis*, AFA 2010 Atlanta Meetings Paper.



02

Section 02

The causes of short-termism among public companies



The causes of short-termism among public companies

- ▶ Public companies are often under pressure of investors who expect short-term outcomes
 - ▶ Factors contributing to the short-termist behaviour of investors include: new technologies, globalisation of financial markets, reduced trading times and transaction costs, market volatility, constant media scrutiny of market conditions with an emphasis on the short-term performance indicators, and the increasing role of institutional investors
 - ▶ Shareholders may execute their pressure on the company by shortening the tenure of executives or influencing their remuneration schemes
 - ▶ Public companies' communication and reporting practices often amplify the short-termism problem. Issuing earnings guidance and frequent financial reporting obligations make executives excessively focus on meeting the market short-term expectations, notwithstanding the long-term value of the company
-

There are many sources of short-termism in the behaviour of firms, but in the case of public companies one factor deserves particular attention. This is the market pressure exerted by shareholders on the executives, and in particular on the CEO

of a company to deliver financial results in a short time span. It is a major reason for the shift in focus of firms and their management towards short-term goals at the cost of long-term strategy.

2.1

Factors contributing to the short-termist behaviour of investors

Among the factors that contributed to the short-termist behaviour of shareholders are new technologies, reduced trading times and transaction costs, market volatility, media coverage, and the increasing role of institutional investors - all adding to short-term performance pressure. There are now fewer barriers to short-termism.

In recent decades, globalisation and technological progress have led to a substantial reduction in transaction costs, making it much easier for investors both to allocate and reallocate their funds. For instance, nowadays people do not have to call or visit a broker to buy securities - they can make transactions via the Internet at any time and with little or no commission fee. This makes it possible for investors to easily move their capital from one company to another, or even to switch to completely different markets, such as the corporate debt market, the sovereign debt market or the derivatives market. They can also easily move their capital between the markets of different countries. Having so many investment opportunities makes it much easier for investors to allocate their funds according to their own risk profile and preferences towards returns.

In addition, the rapid development of new technologies has resulted in spreading new information around the world within minutes, anytime, day or night, making it possible for investors to respond almost immediately to changes in the market situation. This has created new possibilities for investors to

pursue short-term profits and has strengthened the tendency in the modern society of expecting immediate returns. Moreover, constant media scrutiny of market conditions with an emphasis put on short-term performance indicators may exacerbate investors' concentration on the current situation, while neglecting a broader picture of companies' condition.⁴

Such an abundance of high-frequency information translates into a likely information overload and makes it hard for individual investors to process all the data in a timely manner. Their natural response is often to pass the funds to a specialised investment entity with the ability to process and use the massive amounts of information in order to find the best investment opportunities - to institutional investor (see Chart 2). This is a legal entity that can carry out transactions using funds from many various sources - individuals or other institutional investors. Examples include banks, pension funds, investment funds, hedge funds and private equity funds, whose role has substantially increased in equity markets over the last half a century. For instance, in the mid-1960s, institutional investors held around 16% of all publicly listed stocks in the USA, and 46% in the United Kingdom, whereas in the 2010s these numbers have increased to around 60% and 89%, respectively.⁵

⁴ Louise Pocock (2013), *Curbing Excessive Short-Termism. A Guide for Boards of Public Companies*, Thought Leadership Paper, Australian Institute of Company Directors, <http://www.companydirectors.com.au/Director-Resource-Centre/Publications/Book-Store/Short-termism-thought-leadership-paper>

⁵ Çelik, S. and M. Isaksson (2013), *Institutional Investors as Owners: Who Are They and What Do They Do?*, OECD Corporate Governance Working Papers, No. 11, OECD Publishing, <http://www.oecd.org/naec/Institutional%20investors%20as%20owners.pdf>

Chart 2. Sources of pressure exerted on managers by investors.



Source: EY.

Institutional investors are assessed with regard to the overall return from their portfolios, and compared with the results achieved by their competitors. Moreover, the technological changes have allowed clients of institutional investors to track their performance on a continuous basis, which has reinforced their focus on short-term returns. In such a setting, the longer-term perspective is often lost, as clients of investment funds are unwilling to wait that long and can shift their money from one investment fund to another with a single click (usually at a negligible transaction cost). As a result, institutional investors may feel an incentive to focus on short-term results in order to retain their clients.

In the pursuit of the required short-term return on the managed assets, institutional investors usually carry out frequent adjustments of their portfolio structure, without much attention being paid to the fundamentals of the individual companies. This, in turn, results in disregarding the long-term strategy

and fundamental value of the firms owned by a particular institutional investor. What gains importance is the performance of a given company in the short run. If it is not satisfactory, shares held in that company might be replaced with other securities within seconds. This tendency has been reinforced by the fact that fund managers are usually assessed on the basis of their short-term performance. They may be graded and fired on the basis of short-term outcomes even when the purpose of the investment is to provide for retirement benefits in many years.⁶ In such a setting, even if fund managers believe that a company is a promising long-term investment, they may not purchase its stocks just because of what the price might do in the short-term.⁷

Shortening of financial institutions' investment horizon has been reflected in the average holding period for stocks in professionally managed funds that has dropped from about seven years in the 1960s to less than one

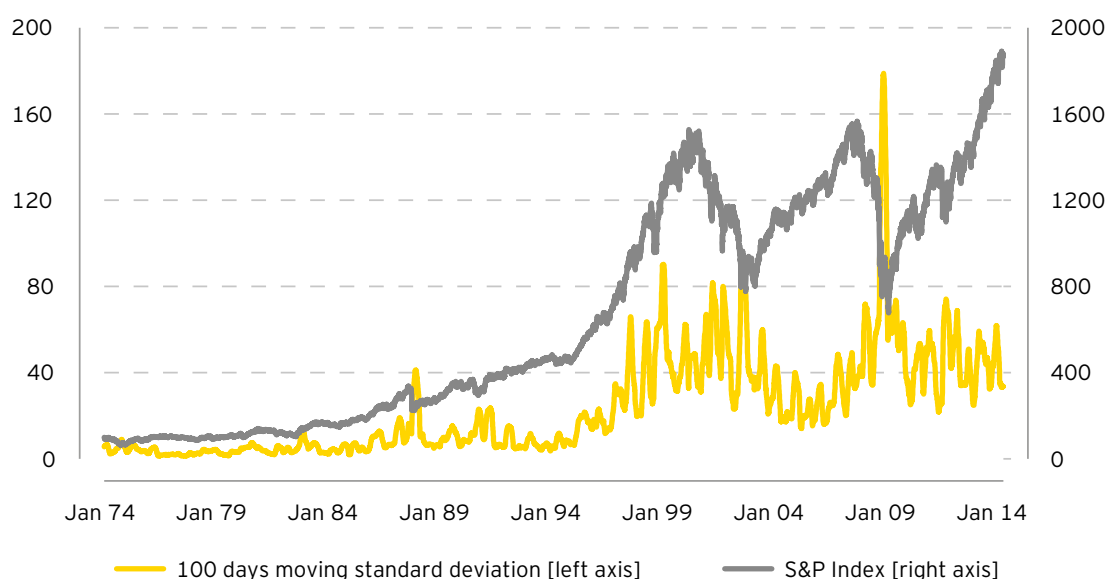
⁶ David Gonski (2012), *A Competitive Country Picks Winners*, The Australian Financial Review

⁷ Pocock, op. cit.

year today.⁸ Although individual investors' horizon has also been shortened, it is longer than that of institutional investors.^{9 10} Given an increased role of institutional investors in financial markets, this may indicate that there is an increasing pressure on the management of companies to deliver short-term results in order to avoid the sale of their shares and

the decline of their company's market capitalisation. Indeed, there is a literature providing evidence that short-term trading by transient institutional investors leads to "earnings management" and that short-termism is pervasive in the business community, causing long-term damage to both financial and nonfinancial firms.¹¹

Chart 3. S&P 500 daily price return index over the last 40 years, close value, and the 100 days moving standard deviation [index points]



Source: EY calculations based on Reuters EcoWin data.

⁸ Alfred Rappaport (2006), *Ten Ways to Create Shareholder Value*, September Harvard Business Review: OnPoint 1, 2-3 <<http://analystreports.com.yale.edu/internal/S2008/tenways.pdf>>.

⁹ Limei Che, (2011), *Investors' performance and trading behaviour on the Norwegian stock market*, A dissertation submitted to BI Norwegian Business School for the degree of Ph.D., Series of Dissertations 5/2011, BI Norwegian Business School.

¹⁰ OECD (2011), *The Role of Institutional Investors in Promoting Good Corporate Governance*, Corporate Governance, OECD Publishing.

¹¹ See, for example, Dallas, op. cit.

The development of the global financial markets, together with the increasing role of institutional investors, has been accompanied not only by a surge in the volume of trade in shares, but also by stronger fluctuations in share prices (see Chart 3). Increased financial market volatility makes it more difficult for the individual investors to analyse the data. This strengthens their propensity to outsource the management of their funds to financial intermediaries – institutional investors. Moreover, when markets are volatile, it is more difficult for investors to assess the long-term potential of a company, which increases their focus on short-term indicators and further discourage long-term investors. Financial markets volatility thus amplifies the problem of short-termism.

The fact that short-termism is pervasive and entrenched in companies' management has been confirmed by empirical studies investigating the discount factor that board members apply to future cash flows. The discount factor is the rate at which economic agents reduce the value of delayed

cash-flows relative to the immediate payoffs. Therefore, if the discount factor is high, the value assigned by the economic agent to the future benefits is low, relative to the present benefits. High discount factors thus point to a short-termism problem, which we define as excessive focus on short-term goals.

In this regard, it is worth quoting the results of the survey conducted among CEOs from all Fortune 1000 firms in 1995, which showed that the average discount rate applied to future cash flows was equal to 12.2%, *"distinctly higher than equity holders' average rates of return and much higher than the return on debt during the last half-century."*¹² In a more recent study from 2011, Andrew Haldane and Richard Davies found that, among UK and US listed firms, *"cash-flows 5 years ahead are discounted at rates more appropriate 8 or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead; and cash-flows more than 30 years ahead are scarcely valued at all."*¹³ Both studies thus provide evidence that public companies are suffering from the problem of short-termism.

¹² James M. Poterba and Lawrence H. Summers (1995), *A CEO Survey of U.S. Companies' Time Horizons and Hurdle Rates*, Sloan Management Review, <http://sloanreview.mit.edu/article/a-ceo-survey-of-us-companies-time-horizons-and-hurdle-rates/>

¹³ Andrew Haldane and Richard Davies (2011), *The Short Long*, Speech delivered at the 29th Société Universitaire Européenne de Recherches Financières Colloquium, Brussels, www.bis.org/review/r110511e.pdf

2.2

The instruments of investor pressure on the executives

Investors that are interested in the short-term returns often exert pressure on the company's management to deliver fast results. However, one might wonder why executives should submit to this pressure, rather than simply stick to the policy consisting of the balanced long-, medium- and short-term goals. The answer may lie in the instruments that shareholders have in order to effectively execute their expectations of short-term outcomes. We discuss some of these instruments below.

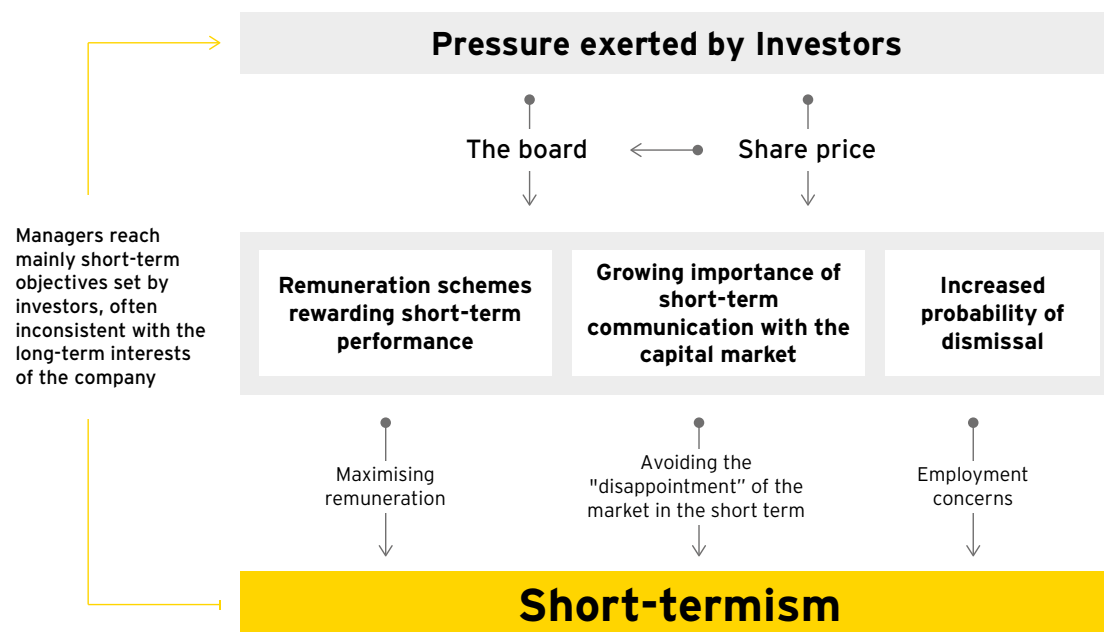
There are a variety of corporate governance styles and each country has its own institutional setting regarding the delegation and execution of power within public companies. In spite of these differences, there is a common factor in the form of a supervisory board or a board of directors appointed by the shareholders to represent their interests (we refer to such bodies as to *the board*).¹⁴ The board has the power to appoint and dismiss the CEO, as well as to establish the remuneration scheme (or to delegate these responsibilities to other bodies accountable to the board).

Remuneration schemes are one of the standard tools of influencing the CEO's behaviour. Most of us are interested in maximising our pay and so are the executives. Therefore, if executives' bonuses depend on achieving some short-term goals, such as an increase in the market capitalisation or annual revenue growth, they have incentives to pay more attention to these performance indicators at the cost of longer-term value creation.¹⁵ In addition, executives may own stock options with short vesting periods, which might stimulate actions to boost the short-term performance because it would allow executives to benefit from selling their holdings before the long-term costs of their decisions materialise. Such remuneration schemes are therefore likely to cause the CEO to focus heavily on the company's short-term results.

¹⁴ In Germany and other continental European countries, the *supervisory board* and the *executive board* are separate and usually the former appoints the latter. In the US and the other Anglo-Saxon countries, these two bodies act as a single *board of directors*.

¹⁵ Malcolm S. Salter (2012), *How Short-Termism Invites Corruption... And What to Do About It*, Working Paper No 12-094, Harvard Business School.

Chart 4. The reactions of CEOs to the pressure on short-term profits exerted by investors



Source: EY.

The risk of being removed from office is another factor influencing the CEO's behaviour. A failure to achieve short-term goals might disappoint shareholders and result in the negative assessment of the executives. This may even lead to the dismissal of the CEO before the end of his term, or the decision not to reappoint him for another term. In some countries, it is even a matter of the institutional setting within the listed company that the CEO has to be reelected annually (as this is the case in many of the largest listed companies in the UK).¹⁶ In such a setting, the position of CEO is more vulnerable than in the past, meaning that executives have strong incentives to satisfy the short-term needs of the shareholders in order to safeguard their positions.

Yet another factor reinforcing the short-termist behaviour of the executives is the market communication and financial reporting practices, which largely focus on the short-term performance. Indeed, in some countries it is obligatory for the listed companies to issue quarterly financial statements in addition to their annual reports. From the shareholders' point of view, it improves the transparency of the listed firms, but at the same time it serves as an instrument for monitoring their short-term goals. Moreover, shareholder pressure has made many executives introduce further changes in their communication policy. In particular, many companies issue "earnings guidance", which is the official prediction formulated by the company regarding its

¹⁶ Pocock, op. cit.

future profits.¹⁷ Analysts often use this guidance as a reference point from which to build their forecast. The problem arises when the performance of the company is assessed almost exclusively against the consensus estimate, while the broader picture is neglected. In particular, whereas a certain level of return on equity ratio in some circumstances might be perceived as an extremely good result, if it misses (negatively) the consensus estimate, it is perceived as a failure and may lead to the sale of shares in the company (especially by institutional investors) and a subsequent decline in the share price. From the point of view of the long-term goals of the firm, this might not be a problem as it continues to grow in fundamental terms. However, it may adversely affect the assessment of executives, just because they did not meet the investors' expectations.

As a result, many executives have become hostages of their communication with the market and of the consensus estimates. This has increased the risk that too much effort is made on meeting or exceeding short-term market expectations, which may come at the cost of neglecting longer-term opportunities for the company's development.

A good illustration of this trade-off can be seen in the results of the survey conducted in 2004¹⁸ by the US National Bureau of Economic Research, indicating that 78% of 401 financial executives stated that they would sacrifice economic value to prevent earnings to depart from the assumed path in the short term.

The short-term market communication has attracted so much attention towards the fulfilment of the short-term goals of the shareholders that, in 2007, the U.S. Department of Commerce launched a report with recommendations to stop issuing the earnings guidance, or at least lower their frequency and make them more comprehensive.¹⁹ It also recommended that all the stakeholders be provided with additional information on the long-term business strategy, which might be much more informative of the company's actual situation than merely short-term data.

¹⁷ As Warren Buffet warned in his 2000 Chairman's Letter, "(...) it is both deceptive and dangerous for CEOs to predict growth rates for their companies. They are, of course, frequently egged on to do so by both analysts and their own investor relations departments. They should resist, however, because too often these predictions lead to trouble.", <http://www.berkshirehathaway.com/letters/2000pdf.pdf>. Cited in: Commission on the Regulation of U.S. Capital Markets in the 21st Century (2007), *Report and Recommendations*, U.S. Chamber of Commerce.

¹⁸ John R. Graham, Campbell R. Harvey, Shiva Rajgopal (2004), *The Economic Implications of Corporate Financial Reporting*, NBER Working Paper 10550.

¹⁹ Commission on the Regulation of U.S. Capital Markets in the 21st Century, op cit.

03

Section 03

The consequences of short-termism



The consequences of short-termism

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- ▶ The main channels for the negative impact of short-termism on a company's performance include shortening of the CEO's tenure, reduced investment activity of the firm and neglecting human capital
 - ▶ Econometric analysis shows that stability of management positively influences company's profitability and market capitalisation
 - ▶ An increase in investment expenditure improves company's long-term performance. However, in the short-term capital outlays lead to a decline in the share price of a company, which may discourage some executives from undertaking profitable investment projects
 - ▶ There are two channels through which the CEO's tenure influences the performance of a company: (1) direct positive impact of the executive's experience and (2) indirect impact of the CEO's tenure through a positive effect on investment activity, which improves the long-term performance of a company
 - ▶ Consequently, the worldwide tendency of shortening the CEO's tenure has to be assessed negatively
-

We already know the mechanisms that lead to the short-termist behaviour of company executives, but what consequences does excessive focus on short-term outcomes have - for the company, for investors, for the economy? To answer this question, we must first conduct a literature review to identify

potential channels through which short-termism may affect the situation of firms. In the next step we run an empirical analysis focusing on the impact of selected channels on European companies. We measure this impact with respect to selected performance variables of the company (market capitalisation, return on equity ratio).

3.1

The channels of the impact of short-termism on a company's performance

There are numerous channels discussed in the literature through which short-termism may impact on a company's performance. Among them, three deserve particular attention:

1. Shortened CEO tenure
2. Neglect of investment activity
3. Neglect of human capital

3.1.1

Shortened CEO tenure

As shown in Section 2, shortening of the CEO's tenure is one of the instruments of pressure exerted by shareholders on executives. This might negatively affect the performance of a company for a number of reasons. First of all, experience plays a major role in management – a CEO might need some time before developing a better understanding of the functioning of the firm and its main potential drivers. This, in turn, may be crucial for formulating and achieving a company's long-term strategy. A firm frequently replacing its CEO might be even unable to formulate such a strategy at all. And even when such a strategy is formulated, it may be challenging to achieve it under unstable management, because frequently replaced executives might be tempted to depart from the policies pursued by their (unsuccessful) predecessors. In light of this, the findings of Karlsson et al. (2008) indicating the shortening of the average tenure of the CEO may be a source of concern.²⁰ In particular, the authors show that the mean tenure of outgoing CEOs among the 2,500 top listed companies in the world dropped from 8.8 years in 1995 to 7.2 years in 2007. Moreover, Favaro et al. (2010) indicate that this tendency continued, with the mean tenure declining further to 6.3 years in 2009.²¹

At the same time, as emphasised by the authors, in the second half of the 20th century it was typical for a CEO to leave a company after a 10-15-year tenure. The European case is a bit different in that, instead of a decrease, we observed a slight increase in the average tenure of outgoing CEOs between 1995 and 2007. On the other hand, however, in that period the average tenure of an outgoing European CEO was very low relative to the world average. At the beginning of that period, it was lower than 6 years, and after only a slight improvement up to 2007, it still remained below the global average.

Due to shortening of executives contracts and performance evaluation intervals, CEOs have a strong incentive to pursue short-term objectives, notwithstanding long-term consequences of their decisions. Executives may also tend to focus on outcomes that will materialise during their expected tenure, and thus disregard longer-term effects that will occur after they have left the company. Moreover, in such an institutional setting executives may take on excessive risk, because exceeding short-term targets may result in being rewarded a significant bonus, whereas in the case of a failure the cost of losing the job may not be that high, as long as the expected tenure is short.

While this channel of the impact of short-termism on companies is discussed in the literature, it is rarely investigated with the use of advanced quantitative methods. This study aims to fill that gap.

²⁰ Per-Ola Karlsson, Gary L. Neilson, Juan Carlos Webster (2008), *CEO Succession 2007: The Performance Paradox*, from strategy+business issue 51, Booz & Co.

²¹ Ken Favaro, Per-Ola Karlsson, Gary L. Neilson (2010), *CEO Succession 2000-2009: A Decade of Convergence and Compression*, strategy+business issue 59, Booz & Co.

3.1.2

Neglect of investment activity

A reduction in investment expenditure is another potentially important channel of the impact of short-termism on a company's performance. This is because capital outlays entail immediate costs and impact on the company's current financial statements, whereas investment-related benefits are usually delayed and often uncertain. Investment activity also affects the company's dividend policy, for it reduces a portion of earnings that could otherwise be distributed to shareholders. Therefore, executives who focus on delivering short-term results may have incentives to neglect investment outlays, which might increase the expected dividend and thus the price of company shares.

Therefore, in the short run the neglect of investment activity might lead to an improvement of the financial situation of the company, which might be rewarded by the markets. However, in the long run, this could lead to a deterioration of the company's competitiveness and its ability to adapt to rapid changes in the market.²² Short-termism, through neglect of investment outlays, may therefore lead to an inefficient allocation of funds by public companies.

The literature on the relationship between short-termist behaviour and investment activity is much richer than in the case of shortened CEO tenure. For instance, Mein Cheng, K.R. Subramanyam and Yuang Zhang (2007)²³ conducted a study of 1406 US firms and found that firms that frequently issued quarterly earnings guidance (which turns out to be strongly related to excessive focus on short-term goals) met or beat market consensus more frequently, but invested less in R&D and reported a lower long-term earnings growth rate than companies that

issued the guidance only occasionally. The literature also discusses the behaviour of executives who are under pressure to rapidly improve the financial results of their company. According to the already cited 2004 survey,²⁴ in order to meet the earnings target, 80% of respondents would cut spending on R&D, advertising and maintenance, 55% would delay starting a new project and 41% would turn down a positive NPV project altogether.

While companies recognise the problem of the excessive short-termism, they may be reluctant to allocate capital to address long-term issues because of market expectations.²⁵ The mechanism of the neglect of investment activity was also confirmed by the study of Sankjeev Bhojraj, Paul Hribar, Marc Picconi and John McInnis (2009), who investigated the performance of 1686 firms that had missed their earnings per share target by one cent (0.01 of a US dollar) and 2893 companies that had beaten this target by one cent over the period 1988-2006.²⁶ The authors show that firms that marginally beat earnings forecasts ('by a penny'), but achieved that for example through the reduction of R&D expenditures, faced short-term stock price increase relative to firms that marginally missed the earnings forecasts, but did not resort to cutting such expenditures. More importantly, this tendency reversed over a 3-year period, showing that the consequences of such spending decisions are different in the short and in the long-term. In other words, short-term gains are often outweighed by long-term costs.

²² Louise Pocock, op. cit.

²³ Mei Cheng, K.R. Subramanyam, Yuang Zhang (2007), *Earnings Guidance and Managerial Myopia*, <https://www.kellogg.northwestern.edu/accounting/papers/k.r.%20subramanyam.pdf>

²⁴ Graham et al, op. cit.

²⁵ Alison Atherton, James Lewis and Roel Plant (2007), *Causes of Short-termism in the Finance Sector, Discussion Paper (final)*, Institute for Sustainable Futures, University of Technology Sydney.

²⁶ Sanjeev Bhojraj, Paul Hribar, Marc Picconi, John McInnis (2009), *Making Sense of Cents: An Examination of Firms That Marginally Miss or Beat Analyst Forecasts*, *The Journal of Finance*, vol. LXIV, NO. 5.

3.1.3

Neglect of human capital

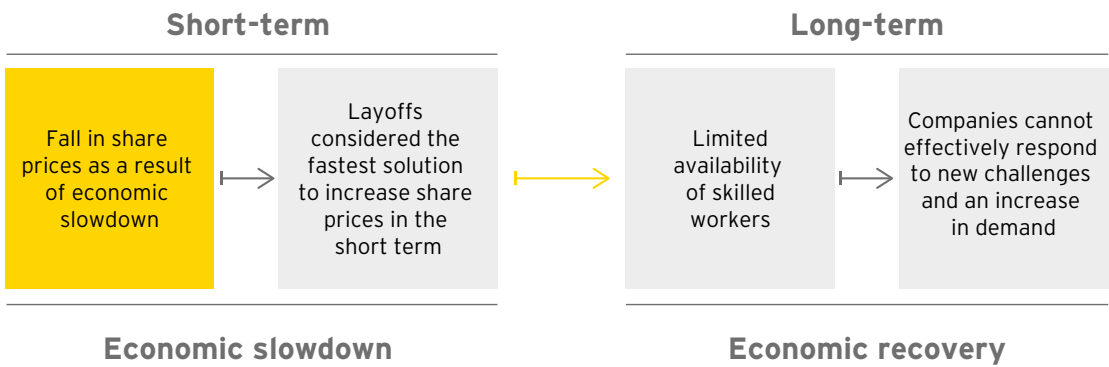
Another important asset of a company that may be adversely affected by the short-termism phenomenon are the company's employees. For example, executives who want to improve short-term financial statements may have an incentive to save on the training of their staff, or to refrain from the recruitment process. Both would reduce costs incurred by the company in the short-term, but it would be achieved by neglecting investment in human capital. Such consequences of the short-termist behaviour are confirmed by the results of a survey conducted in 2012 among British entrepreneurs, managers, and trade union members.²⁷ Respondents to the survey perceived short-termism as a significant or major impediment to the growth and development of the British business. Such an opinion was shared by 92% of the members of the Institute of Directors (IoD, which associates mainly small and medium enterprises), 86% of leaders of trade unions, 67% of members of the Intellect organisation (associating IT, communications and electronic industries), and 60% of business leaders. Among those who perceived it as an impediment, around 60% of IoD members, 45% of Intellect members, 58% of trade union representatives, and 30% of business leaders stated that, among other things, it took the form of a disincentive to recruit.

Neglect of human capital can also take different forms, including excessive reduction in employment. Layoffs are often believed to be good for a company that is in trouble as a means to repair its financial situation and as an incentive to boost productivity. This is why layoffs are usually welcomed by the financial markets as they are often associated with the company's determination to carry out painful reforms and to seek savings. There are many situations in which this is true, but sometimes layoffs become excessive and harmful. This is particularly the case during an economic slowdown when many executives, driven by short-term incentives, take all measures available to avoid disappointing the company's shareholders. In such a situation, cutting employment is one of the quickest ways to reduce costs and improve the figures presented in the financial statement. Indeed, announcing a significant layoff is one of the surest ways to increase stock prices in the short term.²⁸

²⁷ George Cox (2013), *Overcoming Short-termism within British Business. The key to sustained economic growth*, An independent review commissioned by the Labour Party.

²⁸ Ron Ashkenas (2012), *Thinking Long-Term in a Short-Term Economy*, Harvard Business Review, <http://blogs.hbr.org/2012/08/thinking-long-term-in-a-short/>.

Chart 5. Layoffs as a measure to improve short-term results



Source: EY.

The short-term benefits of an excessive reduction in employment are outweighed by subsequent costs that are incurred in the longer term. In particular, cutting the headcount does reduce the production capacity (see Chart 5), but this is not a big issue during an economic slowdown, when the capacity utilisation is low and these employees may be idle anyway. However, as the economic situation improves, the company may quickly reach its bottlenecks and further expansion would be limited due to the insufficient availability of skilled workers. Moreover, during the recovery it is much harder to hire skilled

workers that the short-sighted executives got rid of at the time of the temporary slowdown; and finding new employees and training them is time consuming and costly. As a result, short-termism may result in companies suffering from capacity constraints during the economic upturn, as well as their limited ability to seize new growth opportunities and effectively adapt to new market challenges. Consequently, short-termism, if reflected in neglecting a company's human capital, deteriorates the firm's competitiveness and reduces its long-term potential.

3.2

EY empirical analysis

We have already discussed various channels through which short-termism may adversely impact the long-term performance of companies. However, this analysis has been mostly theoretical or based on the survey results. In the next step we aim to conduct a quantitative empirical analysis that focuses on the impact of short-termism on the performance of companies. For that purpose we use a data sample of 1024 of the largest public companies listed on the European stock markets.²⁹ The sample period is 1998-2013. While analysing the performance of companies, we account for a number of basic financial indicators, including:

1. Market capitalisation
2. Return on equity ratio (ROE)
3. Close price of the share
4. Capital expenditures
5. Total revenues
6. Total debt
7. Total equity

The dataset also includes the following information regarding the companies' CEOs over the 1998-2013 period:

- ▶ Tenure of the incumbent CEO;
- ▶ The information whether the incumbent CEO was appointed from the outside or was an insider successor;
- ▶ The structure and level of the CEO's remuneration.

We use the data to construct variables describing the performance of companies (**explained variables**), as well as variables approximating the channels through which the short-termist behaviour may affect the companies' performance (**explanatory variables**).

²⁹ The largest in terms of market capitalisation as of December 1998. The sample comprises only those public companies that were listed over the whole considered period of 1998-2013.

3.2.1

The companies' performance variables (explained variables)

The basic measure of a company's performance that we use in this report is a change in the market capitalisation of a firm. Market capitalisation is a simple and direct variable and reflects the value of a company as the market sees it (or, more precisely, the total value of the shares outstanding in a publicly traded company). Here we assume that the assessment of the firm's performance by the market participants is reflected in its share price, and thus in the market capitalisation. At the same time, we are aware that the market value of the company may be influenced by the change in the global sentiment, for example due to the herding behaviour of foreign investors massively withdrawing capital from the market. We account for such situations by including control variables in our econometric equations, which are discussed in more detail in the Appendix.

An additional performance indicator that we investigate is the return on equity ratio (ROE). It measures a company's efficiency at generating profits from every unit of shareholder equity. As with many financial

variables, ROE is a useful indicator when comparing firms in the same industry. Consequently, in the econometric modelling, among the different control variables (described in the Appendix) we include the average performance of companies in a given sector.

Generally, a high level of ROE should be strongly correlated with the positive growth of the company's market capitalisation, because the market participants tend to reward good news on the company's profits through an increase in its share price. However, there are some fundamental differences between the two variables. For example, market capitalisation is a "stock" variable representing the value of a company and reflecting its past, current and expected activities. ROE, on the other hand, is a "flow" variable reflecting the current fiscal year's performance. ROE may therefore be weakly correlated with ROE indicators recorded in the previous periods and may be subject to more significant changes than market capitalisation. These differences require a separate econometric treatment, which is discussed in the Appendix.

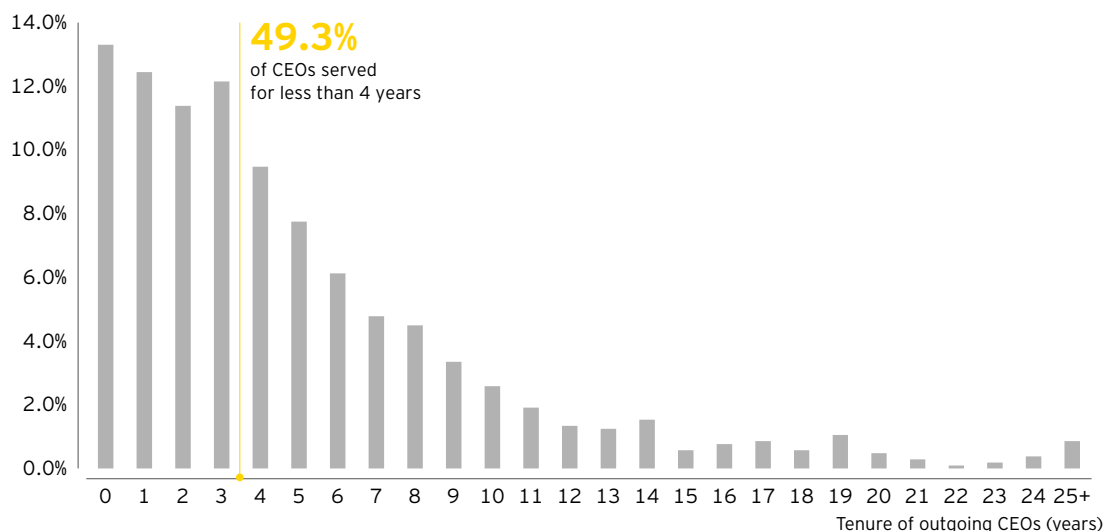
3.2.2

The impact variables (explanatory variables)

The explanatory variables are selected on the basis of the discussion of the channels through which short-termism may impact the company's performance (see Section 3.1). As the first impact variable we consider the tenure of the incumbent CEO, which has been taken directly from the collected dataset.³⁰ A statistical analysis of the CEO tenures shows that the lack of management stability in Europe may be a source of concern. Chart 6 illustrates the tenure distribution

of outgoing CEOs (out of 1045 within our sample): nearly 50% of CEOs that left the company in the 1998-2012 period served for less than 4 years, whereas as many as 13.3% of CEOs did not even work for one full year before leaving. The average tenure of an outgoing CEO over the sample period equalled 5.6 years, which is below the world average (see section 3.1.1).

Chart 6. Tenures of outgoing CEOs in top listed companies in Europe (N=1045)



Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

* The yellow line indicates the cut-off point where the share of CEOs is close to the half of the sample. Lower bounds of the tenure intervals are presented on the horizontal axis of the histogram. For example, '0' number on the horizontal axis indicates CEOs that stayed in the office for less than one year.

³⁰ For more details regarding our dataset, please refer to the Appendix, at www.ey.com/PL/short-termism.

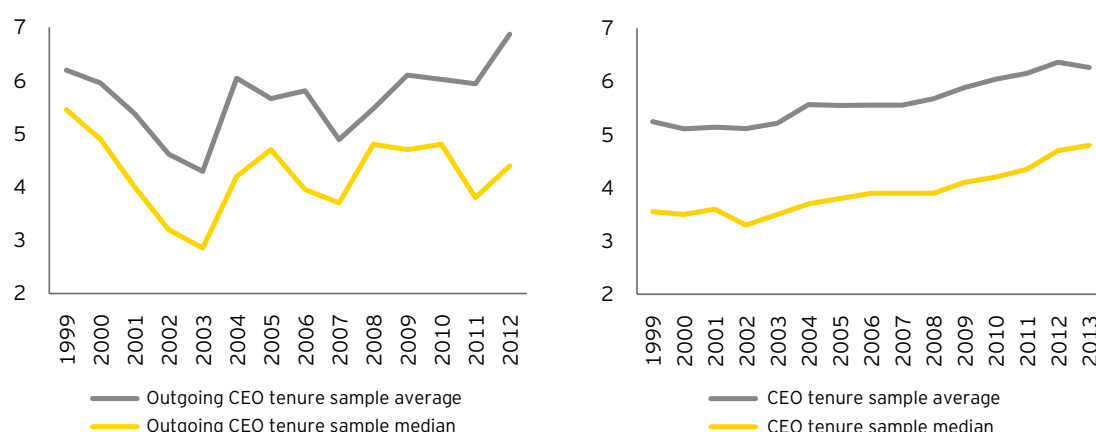
To see how this situation has evolved over time, we analyse the average (mean) and median³¹ tenure of outgoing CEOs calculated for each year in the analysed period (Chart 7).³² Both measures change from year to another, however without any clear tendency that might indicate either an increase or a decrease in the tenure of the outgoing CEO.

A different picture emerges when we calculate the average and median tenure of the incumbent, instead of the outgoing CEO. This time an upward trend is clearly identified. However, while interpreting the latter result, we must keep in mind that in our sample there is a group of firms with stable management and a group of companies that replace their CEOs more frequently (which we can see

very well in Chart 6). The contribution of the former group to the aggregate measure of tenure is increasing, as the (average) tenure of incumbent CEOs in these companies gets higher each year, while the contribution of the latter group becomes smaller and smaller. The averages are non-weighted, so the contribution of experienced CEOs is becoming disproportionately high, resulting in a spurious positive dynamics.

Since the above picture is ambiguous, we complement the statistical analysis with calculations of the CEO turnover rates “over the 1999-2012 period. Chart 8 shows neither an upward nor downward tendency in this area. Instead we see a relatively stable fraction of companies appointing a new CEO in a given year.

Chart 7. Average and median tenure of the outgoing CEO (left panel) and the incumbent CEO (right panel)

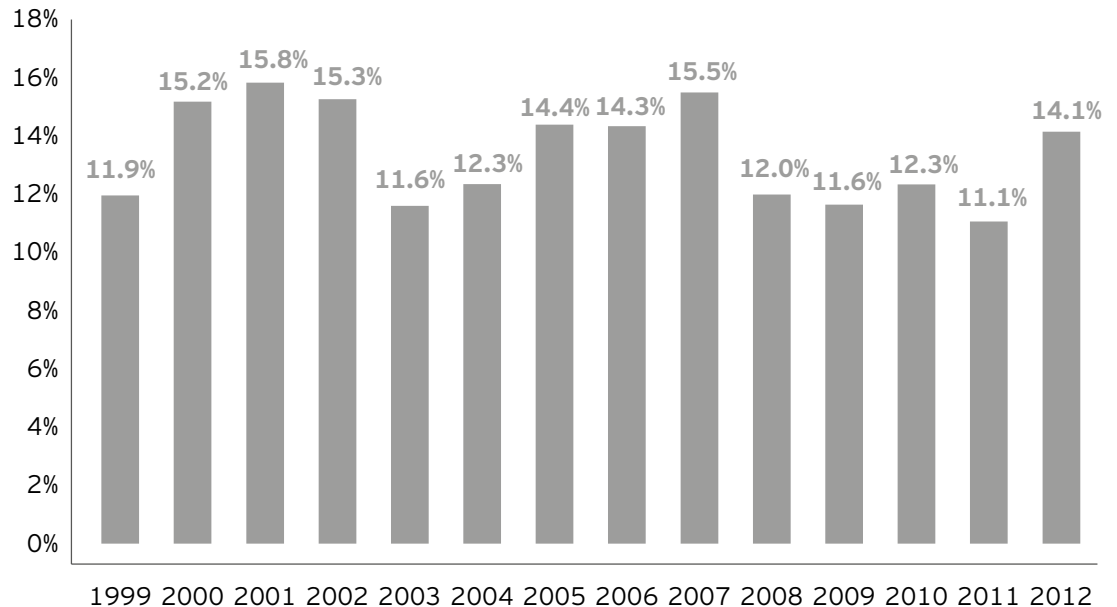


Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

³¹ The mean is defined as the sum of all the values in a given sample divided by the number of entries. The median, on the other hand, is the number that separates the sample into two halves of equal number of entries. In order to calculate the median, we have to sort our entries by their values. Consider the histogram of outgoing CEO tenures in Chart 6, in which half of the CEOs served for less than four years, but the average tenure is much higher and equals 5.6 years. This is because of extreme cases of those CEOs that serve for a very long time, whereas the short-lived CEOs are replaced very often. As a result, the arithmetic average is higher than the intuitive central tendency visible in the histogram. Therefore, a better measure to account for that statistical effect is the sample median. This measure turns out to be considerably lower over the 1999-2013 period than is the case for the average.

³² Note that we drop the year 1998 because we do not have a sufficient number of CEO departures to calculate an accurate aggregate measure for this year.

Chart 8. CEO turnover rates (the share of firms replacing their CEO in a given year)



Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

For the purpose of our analysis, the tenure of the incumbent CEO is a better explanatory variable than the tenure of the outgoing CEO. This is because the latter variable can be observed only occasionally, when a new CEO is appointed. Moreover, for some firms (with the same CEO over the whole sample period) this variable would not be observed at all. Consequently, we would have to remove many firms with the most stable management from our sample. This problem does not apply to the tenure of the incumbent CEO as an explanatory variable, which is observed for each analysed company in every single period.

We also verify whether the tenure of the CEO may be related to the country-specific cultural factors. For that purpose we apply the Long-Term Orientation Index of Hofstede et al. (2010),³³ showing the different time

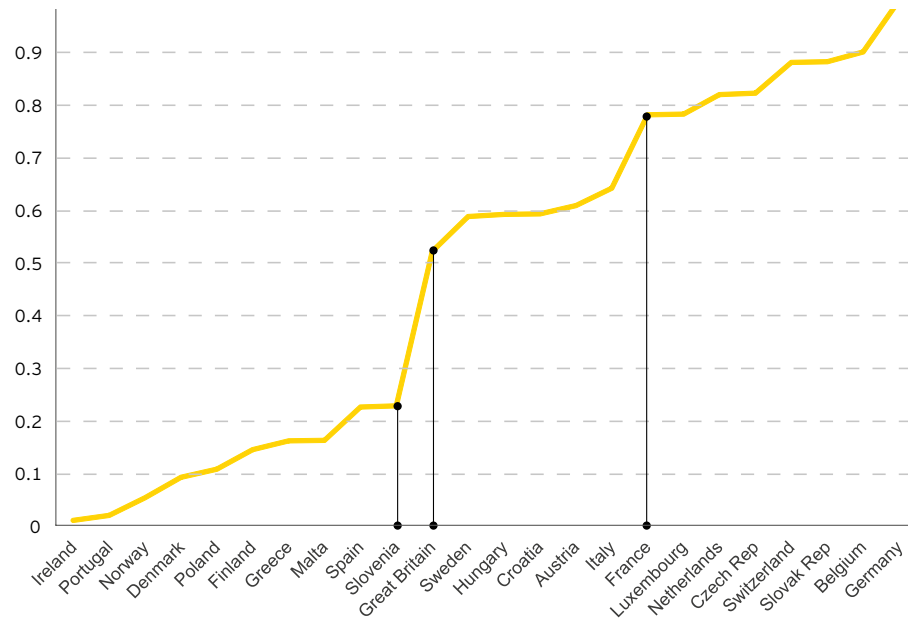
orientation of different cultures. A high value of that index is assigned to cultures with long-term orientation that work towards future goals, while a low value is associated with cultures with short-term orientation that are concerned with the past and present. We list the countries, whose stock exchanges are included in our sample, and rank them from the lowest to the highest value of the Long-Term Orientation Index. Next, depending on the location of the major stock exchange for a given company from our sample, we assign each company to its respective country. This allows us to construct a cumulative distribution function and distinguish four distinct groups of countries, ranked from the lowest to the highest level of the Index (Chart 9). Finally, for each of the above groups we calculate the average tenure of the CEO. Interestingly, as illustrated in Chart 10, we do

³³ Geert Hofstede, Gert Jan Hofstede, Michael Minkov (2010), *Cultures and Organizations* 3rd edition 2010, McGraw-Hill. Dimension Data Matrix available online at www.geerthofstede.nl/dimension-data-matrix.

not find any relation between the time-orientation of cultures and the average tenure of executives. This further strengthens the

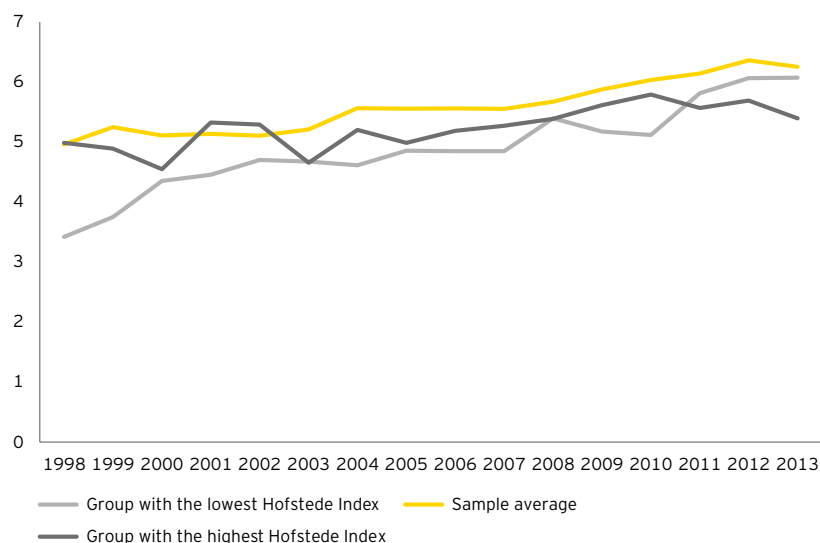
hypothesis that, as far as listed companies are concerned, short-termism has become a global, culture-wide phenomenon.

Chart 9. Empirical cumulative distribution function for the Long-Term Orientation Index



Source: EY calculation based on data from SPIQ, Thomson Reuters and Hofstede et al. (2010).³⁴

Chart 10. Average time in the role among the firms from countries with the lowest and the highest values of the long-term vs. short-term orientation index, in comparison to the sample average



Source: EY calculations based on data from SPIQ, Thomson Reuters, Boardex and Hofstede et al. (2010).³⁵

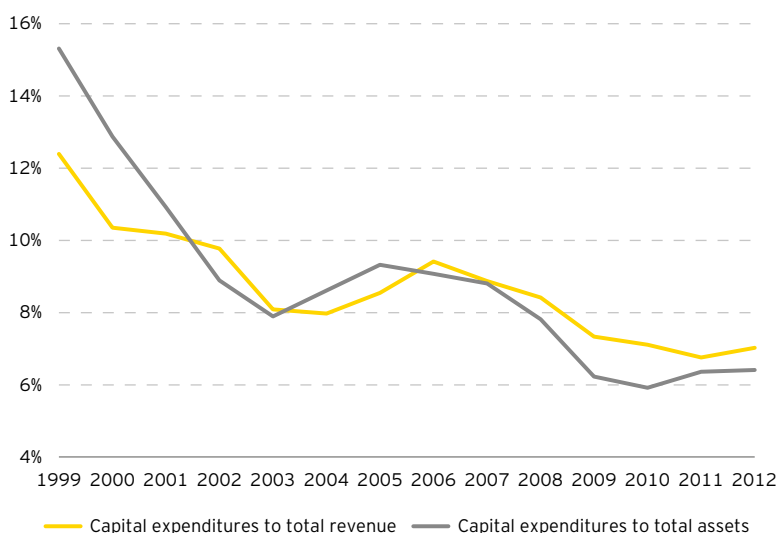
³⁴ Hofstede et al., op. cit.

³⁵ Hofstede et al., op. cit.

The second explanatory variable used in our analysis is the company's investment activity. Obtaining this variable has required some additional transformations. In order to account for the different sizes of the analysed companies, we have calculated the investment activity variable as capital expenditure divided by the total revenue or total assets (approximated by the sum of total debt and total equity).³⁶ In both variants, the analysed

measure of investment activity decreased over the 1999-2012 period (Chart 11).³⁷ Interestingly, such a strong downward tendency was not related to a decrease in the capital expenditures in absolute terms. In fact, expenditure increased over the 1999-2012 period, but at a rate far slower than the increase in total revenues and total assets, which are the denominators of the analysed ratios.

Chart 11. Capital expenditures to total revenue and to total assets ratios



Source: EY calculations based on data from SPIQ and Thomson Reuters.

³⁶ The total revenues have been taken from the current year, whereas the value of the total assets has been taken from the end of the previous year.

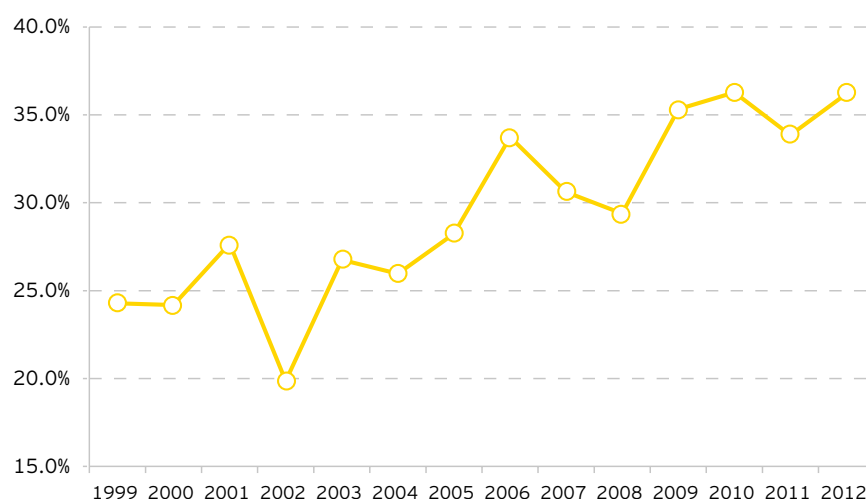
³⁷ Whereas the sample period starts in 1998, Chart 11 begins in 1999. This is because we use the lagged value for the total assets - see the previous footnote.

We use company investment activity as an explanatory, but also as an explained variable. In the former situation we analyse to what extent the capital outlays influence the company's performance in the short- and long-term. However, should that impact turn out to be significant, we would also be interested in investigating whether, for example, the CEO tenure or other variables affect the firm's propensity to invest. We address this issue in our econometric exercise by including investment activity as a performance variable.

Another issue that we investigate is whether it matters for the performance of the company whether the CEO was appointed from the outside or was an insider successor. The latter should have more knowledge of how the company functions whereas the former may bring a fresh perspective to the firm. We test empirically the relative importance of these factors, both for the company's performance and investment activity.

Yet another explanatory variable used in our analysis is the structure of the CEO's remuneration. For that purpose we use data on conditional compensation of executives in the form of long-term incentive plans (LTIPs). Here we define LTIP as a part of the executives' remuneration that is paid in shares, options or cash, but requires a certain condition to be met before the award is made. This condition should be related to the longer-term performance of the company. Chart 12 illustrates that in our sample this form of remunerating executives has been increasing in importance. We therefore investigate whether the LTIP share in the overall remuneration of the CEO matters for the company's performance. However, due to the problem of endogeneity, we analyse this variable in the short-term model only (for more details see the Appendix).

Chart 12. Average share of LTIP in the overall remuneration of the CEO



Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

The remaining explanatory variables include lagged explained variables as well as sectoral control variables, which are discussed in more detail in the Appendix³⁸.

³⁸ Since our sample does not include data on the companies' employment, we do not analyse the "human capital" channel in the empirical part of the study.

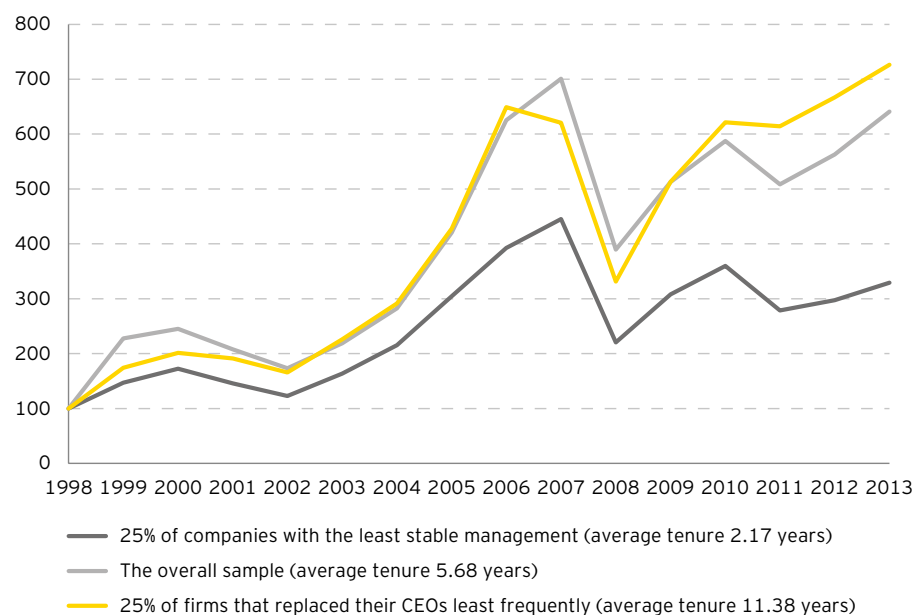
3.2.3 Statistical analysis

To measure the impact of short-termism on a company's performance, we use two different methods: descriptive statistical analysis and econometric modelling. Simple descriptive statistical analysis is based on a comparison of the averages of the performance indicators across particular subsamples (related to the impact variables). Econometric modelling (or econometrics) is the application of formalised mathematical methods in order to find economic (causal) relationships within the data. In other words, econometrics is a toolkit of quantifying the impact of a given explanatory variable (or a group of variables) on some explained variable. We discuss the general merits of econometrics in Frame 2, whereas the details of the models constructed for the purpose of this study are outlined in the Appendix.

We start the empirical analysis of the impact of CEO tenure on the company's performance by calculating the market capitalisation for each company in every single year of the sample period (1998-2013) and compare how the market value evolved over time for the three groups of firms:

- ▶ 25% of firms that replaced their CEOs most frequently over the 1998-2013 period (i.e. companies with the least stable management)
- ▶ The overall sample
- ▶ 25% of firms that replaced their CEOs least frequently over the 1998-2013 period (i.e. companies with the most stable management, see Chart 13)

Chart 13. Market capitalisation index over the 1998-2013 period against frequency of the CEO replacements (1998=100)



Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

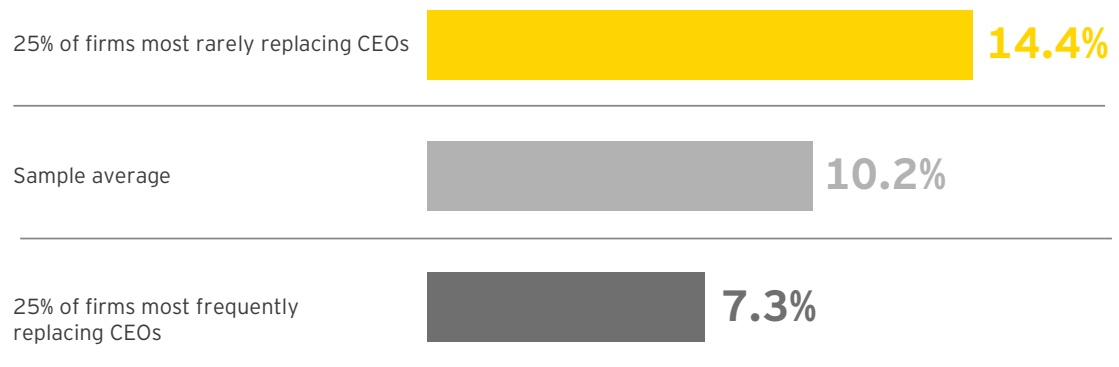
We find that the market capitalisation of companies whose CEOs are characterised by the longest tenure (11.4 years on average) increased more than the market value of firms with less stable top management. The difference is particularly remarkable in the case of the 25% of firms most frequently replacing their CEOs (with an average tenure of 2.2 years) – the increase in their capitalisation is only half of that recorded for the firms that enjoyed the most stable management.

Interestingly, the difference in the performance of companies with the most stable management and the sample average is much smaller than between the sample average and companies that most frequently replace their CEOs. This

suggests that companies gain a lot from an increase in the CEO's experience, but these benefits are particularly strong during the first years of the CEO's tenure, whereas later they continue to grow, but at a more moderate pace.

We also compare the performance of the various groups of firms, categorised by their management stability, with respect to the average value of ROE over the 1998-2013 period. ROE in companies with most stable management turns out to be almost twice as high as in the case of the firms most frequently replacing their CEOs (14.4% vs. 7.3%, Chart 14). Again, companies appear to benefit from CEO stability.

Chart 14. Average ROE over period 2005-2013 against the frequency of CEO replacements

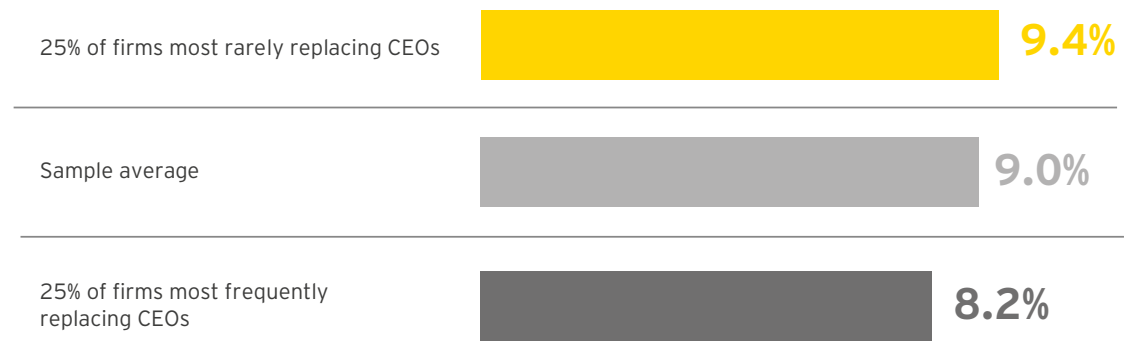


Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

Another variable that is investigated in our empirical study is investment activity. We analyse the relationship between the CEO's tenure and the firm's investment expenditure, as well as the impact of capital outlays on

the performance of the company. Chart 15 illustrates investment activity of different groups of firms over the 1998-2013 period, categorised depending on their management stability.

Chart 15. Capital expenditure to total revenue ratio against the frequency of CEO replacements



Source: EY calculations based on data from SPIQ, Thomson Reuters and Boardex.

The European firms with the most stable management devote a higher proportion of their total revenue to investment outlays than companies with a higher turnover of their CEO. On average, 25% of firms least frequently replacing CEOs had 1.2 p.p. higher capital expenditure to total revenue ratio than companies with the highest turnover rate. This might suggest that lack of management stability may lead to neglect in the investment activity of the firm.

The above statistical results, while helpful in formulating some intuitive hypotheses, do not allow us to draw any conclusions as regards the causality and strength of the relationship between the CEO's tenure and the company's performance. Such an analysis requires the use of econometric methods. These are discussed in more detail in the Appendix to this report, while in the next section we present only the main results.

3.2.4

Summary of the econometric results

As the problem of short-termism hinges upon the inappropriate balance between pursuing the short-term and long-term goals of a company, in our econometric approach we have distinguished two modelling techniques, allowing us to separate the short-run and the long-run relationships between the analysed variables. The short-term approach is based on panel models, whereas the long-term approach uses cross-section models (see Frame 2 and the Appendix). In total, 11 panel models (5 models of the market cap, 3 models of ROE, and 3 models explaining the capital expenditures to total revenue ratio) and 8 cross-section models (2 models of the market cap, 2 models of ROE, 2 models explaining the capital expenditures to total revenue ratio, and 2 models explaining the capital expenditures to total assets ratio) have been estimated. There are two reasons why we

have included so many models in the analysis: (1) the need for robustness checks, and (2) the need to apply a different econometric approach, where the results of econometric testing procedures required that our initial approach be adapted.

The most important results of the econometric analysis, both for the CEO tenure and the investment analysis, are summarised in Chart 16 (for market capitalisation as the performance variable) and Chart 17 (for ROE). In those charts we distinguish short- and long-term variants of the performance variable. We indicate positive and statistically significant relationships with bubbles including "+", negative and statistically significant relationships with bubbles including "-" and statistically insignificant relationships with bubbles containing "?".

Frame 2

Why do we use econometrics?

The main reasons for using econometrics in this study is its ability to assign economic meaning to the correlations found in the data, the possibility to distinguish short-term and long-term effects, as well as the good treatment of unobservable variables and one-offs. Most of these advantages are related to the use of **panel data** in econometric modelling – **panel data econometrics**. The term panel data refers to datasets that have more than one dimension, usually two: the entities (countries, individuals or companies) and the time over which these entities are observed. Every variable (e.g. CEO tenure) is considered in these dimensions, i.e. we know the value of such a variable both for a particular company and a particular year. We discuss the advantages of panel data econometrics below.

Seeking economic meaning in correlations

Descriptive statistical analysis, as used in this study, says a lot about the data, but it is usually improper to infer about economic relationships on that basis alone, due to such things as sectoral differences between firms, which also have to be taken into account. For instance, some sectors tend to be more capital intensive than others. Therefore, a firm from a heavy industrial sector will have a different ‘natural’ level of investment activity to a company from the retail trade sector, making these two firms incomparable. However, if we analyse both firms in relation to their sectoral benchmarks, we are then able to compare them with respect to their investment activity. To fully account for such kinds of differences, it is necessary to divide the firms into a very large number of groups, and then compare their performance, making it difficult to draw general conclusions from the dataset. Contrary to descriptive statistical analysis, such problems can easily be solved with econometrics.

Unobservable variables

Some company characteristics are either unavailable in our dataset or are impossible to quantify at all. In econometrics, we refer

to such variables as unobservable variables. In the case of this study, a good example is the company corporate culture, which can be discussed only in qualitative terms. As we have more than 1000 firms in our sample, we cannot tell the story of the corporate culture of every single company without a substantial loss of important detail. This is why, from the point of view of quantitative methods, it is sometimes reasonable to say that the corporate culture is unobservable. Panel data econometrics easily tackles this issue.

To see the merits of panel data here, imagine that our sample was limited to just one single year. In that case, many of the relations apparent in the data would be spurious. For instance, we could confuse the benefits from a particular corporate culture (which is roughly constant over time) with the impact of the decisions of the particular CEO. However, if we consider the same company at two different points of time, we can observe the increment of the tenure with the corporate culture roughly unchanged. Because in the panel data we have both time and individual dimensions, we can study the differences between companies, as well as developments in a single company over time.

Short-term vs. long-term effects

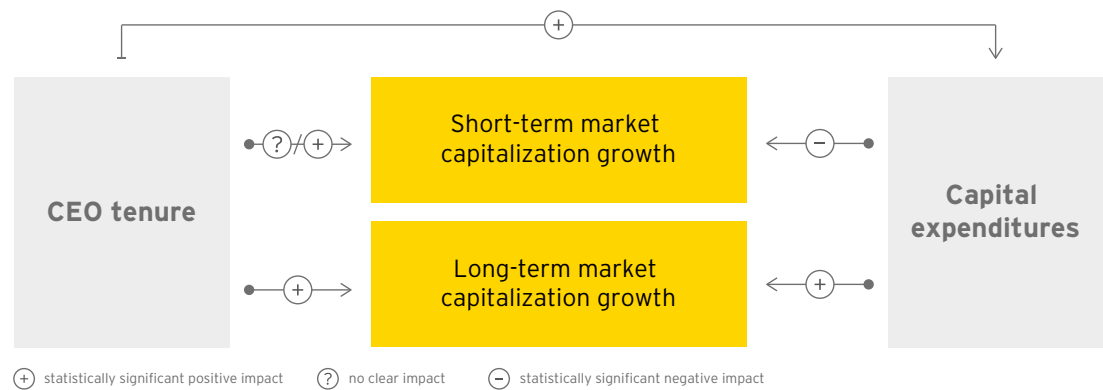
Short-termism is essentially the problem of an imbalance between achieving long-term and short-term goals. With a panel dataset giving both time and company dimensions, econometric methods help make these differences more formal – identifying the short-term and long-term aspects of the phenomena discussed above.³⁹

One-offs

Selecting one single year for our study could bring us incidental results due to some random, one-off events. As we study our sample over 16 years, such accidental factors are averaged out in the panel econometric models. This property gives us more precise estimates of the economic processes apparent within our sample.

³⁹ For the short-term effects, we use panel regressions, whereas to capture long-term relations we run cross-section regressions (which in this case are also part of the panel data econometrics).

Chart 16. The impact of time in the role and investment activity on the long-term performance of a firm - market value



Source: EY econometric analysis based on data from SPIQ, Thomson Reuters and Boardex. For more details see the Appendix.

The main conclusions from the econometric modelling are as follows:

1 CEO tenure has a positive influence on the market capitalisation of a company. Whereas in the short term, this effect is not always statistically significant, the evidence is much stronger in the case of the company's long-term value. These long-term effects are non-linear: the impact of CEO tenure on long-term market capitalisation is positive, but tends to weaken with an increasing CEO tenure (as illustrated by Chart 19). This therefore confirms the hypothesis formulated in section 3.2.3 that the marginal benefits from every additional year in the CEO's chair are decreasing.

2 The positive effects of CEO tenure are even more evident when analysing its impact on the company's ROE. Here the positive effects are strong and statistically significant both in the short and long term. According to estimation results, an additional year of CEO tenure leads, in the long-run, to an average increase in the company's annual profitability by 0.3 p.p.

3 In the long-term, both the company's market capitalisation and the average ROE are positively influenced by the firm's investment activity. A rise in capital expenditures to total assets ratio by 10 p.p. in the long-term leads to an increase in the average ROE by 4.5 p.p., while a rise in capital expenditures to total revenue ratio by 10 p.p. leads, in the long-run (here 15 years), to an average increase in the growth of the company's market capitalisation by 7.1 p.p.⁴⁰ **However, in the short-run, an increase in investment expenditure negatively affects the market capitalisation of the company.** Increasing the capital expenditures to total revenue ratio by 10 p.p. leads to a short-term deceleration of the company's market capitalisation by 1.6-3.9 p.p. (in average terms; the range of the effect reflecting the results of the various models considered). We therefore provide evidence supporting the hypothesis (formulated in section 3.1.2) that executives focusing on short-term results may neglect investment expenditure, notwithstanding the costs that it may entail for the company in the longer term.

4 With respect to that, it is particularly interesting how CEO tenure influences the company's propensity to invest. Our estimation results show that **the longer the CEO tenure, the higher (on average) are the company's investment outlays.** In particular, an additional year of CEO tenure leads, on average, to an increase in the firm's capital expenditure to total revenues ratio by 0.2 p.p. (the same result has been obtained for the capital expenditure to total assets ratio).

5 Therefore, our results indicate that there are **two channels through which the CEO tenure affects the company's performance: (1) a direct positive impact of the executive's experience and (2) an indirect impact on CEO tenure through the positive effect on investment activity**, which improves the company's long-term performance. Consequently, the worldwide tendency of shortening CEO tenure has to be assessed negatively. Whereas in our sample of European companies no such declining tendency has been observed, the low average level of CEO tenure in these firms is in itself a source of concern.

6 In addition to the above variables, we have also analysed whether it matters if the CEO was appointed from the outside or was an insider successor. Our estimation results point to **a positive impact of appointing an insider successor on the company's ROE, both in the short and long term.** It may reflect an additional dimension of the CEO's valuable experience as that of the company's insider. **This effect is also identified in terms of the positive impact on the company's market capitalisation in the short term**, though it is not statistically significant in all model specifications. Moreover, **we do not find the outsider effect on the company's long-term market value. Neither have we identified any impact of an outsider or insider successor on the company's investment activity.**

⁴⁰ It has to be noted, however, that the latter relationship is subject to a substantial estimation error - for more details see the Appendix at www.ey.com/PL/short-termism.

7 Finally, among the explanatory variables of the company's performance, we have included the LTIP share in the CEO's overall remuneration. The obtained results indicate that **increasing the role of the LTIP in the remuneration scheme positively influences the company's ROE in the short term.**

That effect, however, has not been identified for the market capitalisation or investment activity of the company. Due to the endogeneity problem, we have not analysed the impact of the executives' remuneration scheme on the company's long-term performance (for more details on that see the Appendix).

Chart 17. The impact of time in the role and investment activity on the long-term performance of a firm - ROE

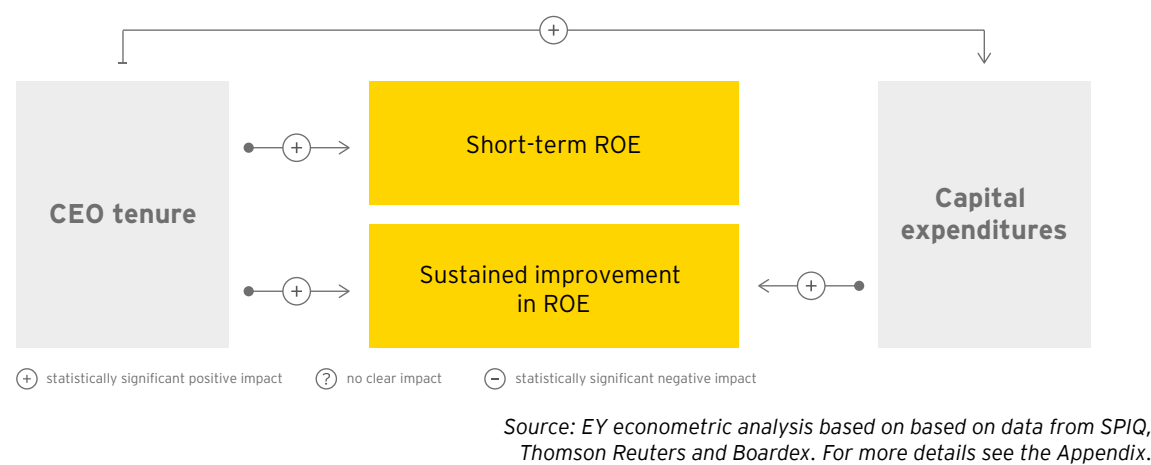
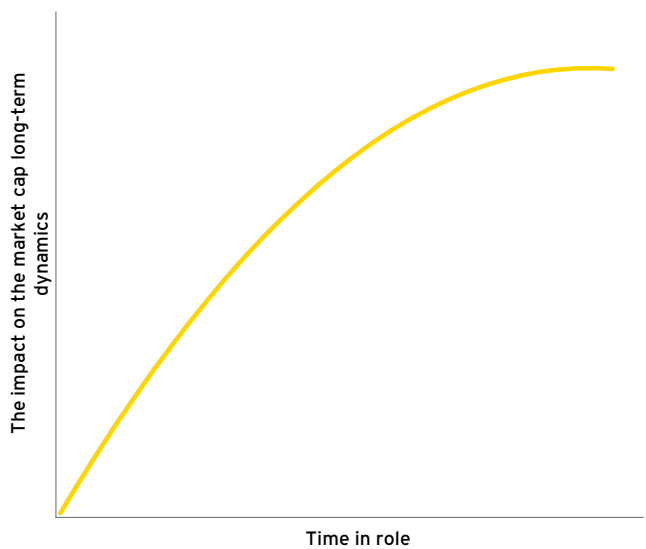


Chart 18. The benefits from every additional year in the CEO's chair according to the long-term econometric model explaining the market cap



3.2.5

Summary of the empirical analysis

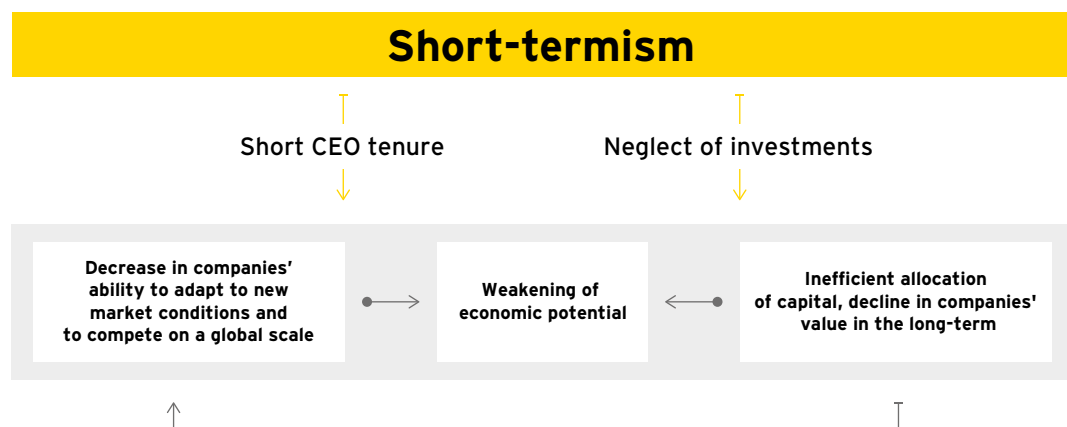
Our empirical analysis has empirically confirmed some theoretical findings of the literature on short-termism. In particular, to the extent that the external pressure of investors on short-term results leads to the shortening of the executives' average tenure, we have shown that this negatively affects the performance of the company and undermines its long-term fundamentals. Our results show that the experience of the CEO is associated with the better performance of the company. This effect, however, becomes weaker with the increasing tenure of the executive, which indicates the decreasing marginal benefits from every additional year of the CEO's experience. Moreover, we identify an additional, indirect impact of the executive's experience on the company's performance. It takes place through the investment channel, since the longer the CEO's tenure, the higher the firm's capital expenditure. Investment activity, in turn, increases the company's profitability and value in the long term.

In the short-run, however, increased capital outlays lead to a decline in the company's market capitalisation. This, in turn, may reinforce the neglect of investment activity by

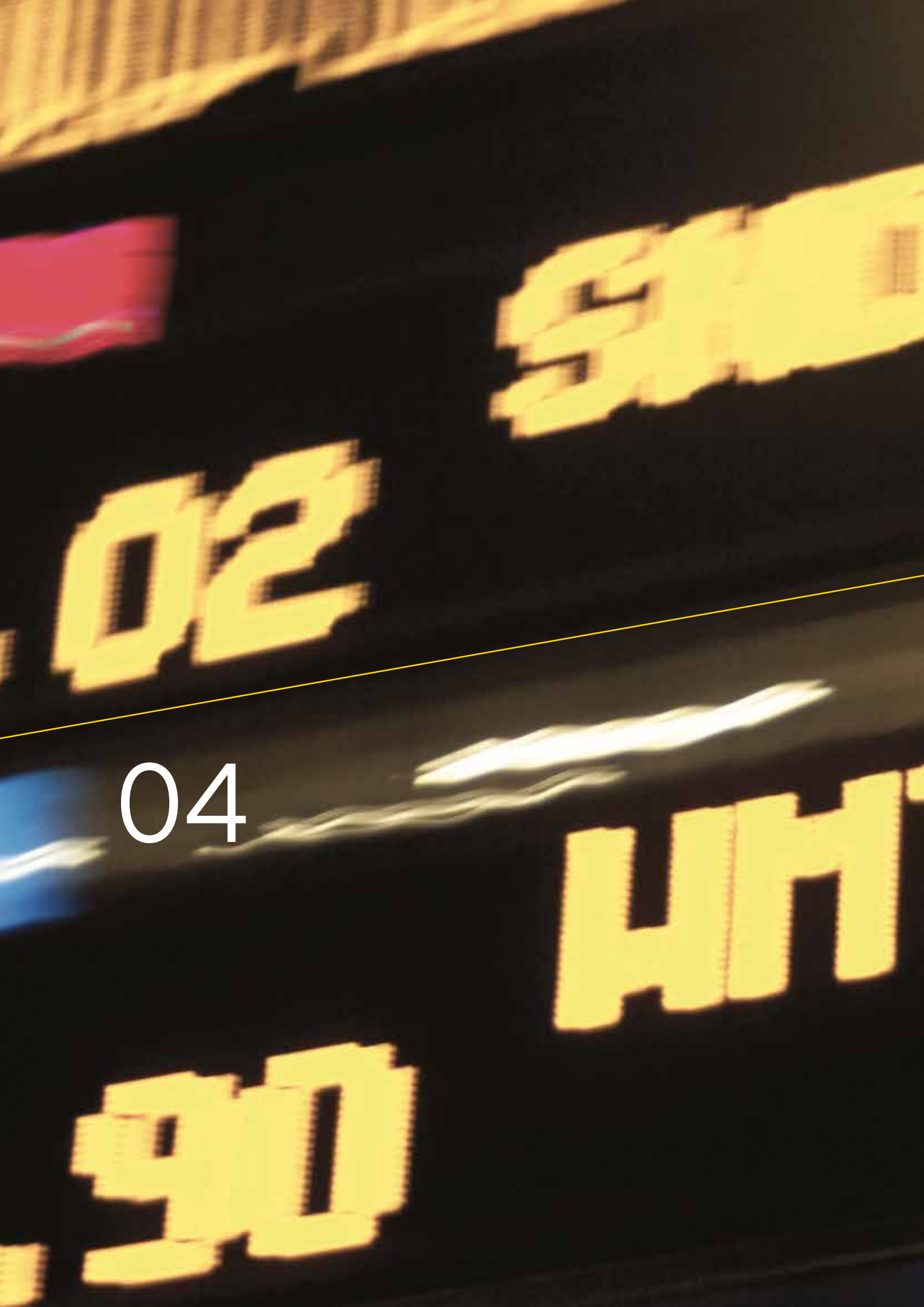
executives who focus on maximising the short-term performance of the company and do not pay much attention to the long-term costs that such decisions entail.

The consequences of short-termist behaviour do not just boil down to individual firms. Short CEO tenure and neglect of investment outlays decrease a company's long-term value and profitability, as well as their ability to adapt to new market conditions and to compete on a global scale. In this way, if short-termism affects many firms, it translates into the reduced potential of the entire economy (Chart 19). Moreover, as already discussed in Frame 1, excessive focus on short-term goals by many firms and institutions may lead to systemic risk, affecting the stability of the entire economic system. This has become evident, especially in the case of large financial institutions issuing subprime mortgages allowing them to make fast but unsustainable profits. This led to the housing bubble, the burst of which resulted in the global economic crisis (see Frame 1). Therefore, short-termism may lead to macroeconomic imbalances that often result in a sudden economic downturn.

Chart 19. Direct symptoms of short-termism in management



Source: EY.



04

Section 04

Conclusions



Conclusions

There is a lot of evidence, not least the recent financial crisis, to show that long-term objectives have often been neglected because of too much concentration on short-term goals. This is the short-termism phenomenon, which is particularly visible in the case of public companies, which are often under pressure from their shareholders to deliver short-term outcomes. Among the factors that contributed to this pressure are new technologies, reduced trading times and transaction costs, market volatility, media coverage, and the increasing role of institutional investors.

On the one hand, one might claim that executives should not submit to investor pressure, and should simply maintain the balance between long-, medium- and short-term goals. On the other hand, however, shareholders have instruments to effectively execute their expectations of short-term outcomes. These instruments include shaping the remuneration schemes of the executives based on their short-term performance, as well as the ability to remove executives from office if they do not meet investor expectations. The short-termist behaviour is further reinforced by companies' market communications and financial reporting practices, which largely focus on the short-term performance and are used by investors as an instrument to monitor the realisation of their expectations. Consequently, short-termism often results in "earnings management" rather than building the longer-term value of the company.

We have distinguished three different channels through which short-termism may adversely affect companies and the economy as a whole. These are: shortened CEO tenure, neglect of investment activity and neglect of human capital. In the empirical analysis we focus on the former two.

Literature provides evidence that there has been a significant shortening of executives'

contracts and performance evaluation intervals. In such a setting, CEOs may have a strong incentive to focus on short-term outcomes that will materialise during their expected tenure, notwithstanding the long-term consequences of their decisions. This tendency may have been reinforced by the fact that investment portfolios that perform well over the long-term do not guarantee that periods of short-term underperformance will be avoided, while it is short-term targets that often constitute the basis of the executives' performance assessment.

Our econometric analysis has confirmed that addressing the issue of management stability should be of great importance. The results of our research show that an increased CEO tenure positively influences the company's profitability and market capitalisation. The impact on the long-term value of the company tends to weaken with an increasing CEO tenure, which indicates that the marginal benefits from extending the length of the executive's contract are particularly strong in the first additional years of the CEO's experience.

A reduction in investment expenditures is another important channel of the impact of short-termism on a company's performance. Capital outlays made with the aim of improving the firm's long-term competitiveness and capacity may, in the short-term, lead to a deterioration in reported financial indicators, which in turn may result in a decline in the company's share price. This has been confirmed by our empirical analysis, which shows that an increasing investment expenditure leads to a short-term drop in the company's market capitalisation. Therefore, while executives recognise the problem of excessive short-termism, they may be reluctant to allocate capital to address long-term issues, because they do not want to miss the short-term consensus estimate

and disappoint investors. Available survey results confirm that executives would delay or sacrifice projects creating long-term value in order not to miss short-term earnings targets. This is a serious consequence of short-termism, confirmed by our empirical analysis, which shows that neglecting investment activity reduces the company's long-term value and average profitability. With respect to that, an important finding of our research is that management stability is conducive to higher investment activity in a company, which in turn increases the long-term value of the firm.

We have shown that there are two channels through which CEO tenure affects the company's performance: (1) a direct positive impact of the executive's experience, and (2) an indirect impact of CEO tenure through the positive effect on investment activity. Therefore, the worldwide tendency of shortening CEO tenure has to be assessed negatively. Whereas in our sample of European companies no such declining tendency has been observed, the low average level of CEO tenure in these firms is in itself a source of concern. Consequently, tackling the problem of the shortened executives contracts may be one way of addressing the issue of short-termism.

Short CEO tenure and neglect of investment outlays decrease a company's long-term value and profitability, as well as the ability to adapt to new market conditions and compete on a global scale. In this way, if short-termism affects many firms, it translates into the reduced potential of the entire economy. Moreover, excessive focus on short-term goals by many firms and institutions may lead to systemic risk, affecting the stability of the entire economic system. This risk is reinforced by the herd-like mentality of institutional investors, which may feed asset price bubbles.⁴¹

⁴¹ Rafaele Della Croce, Fiona Stewart, Juan Yermo (2011), *Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies*, OECD Journal: Financial Market and Trends, Issue 1.

The costs of short-termism may therefore be significant, and all possible actions aimed at addressing this issue should be of great importance, not least to policy-makers. While this report has focused on the impact of short-termism on a company's performance and not on the measures that could be adopted to counter this problem, the latter are briefly discussed below. At the same time, it has to be emphasised that the list of the presented measures is not complete. It simply provides examples of actions that are recommended by certain authors, and thus does not necessarily represent EY's recommendations.

First of all, the mechanisms underlying short-termist behaviour clearly show that reducing the problem of short-termism requires the involvement of all stakeholders. In particular, executives excessively focus on the short-term performance in response to market expectations and pressure from investors. Engagement with the investor community should therefore be an important part of the strategy to counter the problem of short-termism. For executives to effectively balance short- and long-term objectives, they need to cooperate with and create understanding among key external stakeholders. Indeed, Eccles et al. (2012)⁴² show that companies that are more likely to have organised procedures for stakeholder engagement are more long-term oriented, exhibit more measurement and disclosure of non-financial information, and significantly outperform their counterparts over the long term, both on the stock market and in accounting performance.

One way of improving communication with stakeholders may be related to changes in the reporting framework, in particular amending the structure of information towards more

⁴² Robert G. Eccles, Ioannis Ioannou, and George Serafeim (2012), *The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance*, Harvard Business School Working Paper 12-035, - quoted in CFA Institute (2012), "Visionary Board Leadership. Stewardship for the Long Term".

long-term, fundamental guidance. This may help in shifting the focus of investors towards the long-term value and true drivers of business success, as well as attract new, long-term investors. Another way to reduce the market focus on short-term performance, as suggested by some authors,⁴³ might be less frequent reporting on a company's financial performance. Moreover, many companies do not publish earnings guidance because it may reveal little about the firm's true economic performance. Instead, they emphasise factors that should be relevant in appraising business value.⁴⁴

Shifting the communication balance in favour of long-term fundamentals requires setting and disclosing long-term goals, strategies and actions that the firm is to undertake. Reports published by companies should then outline the progress towards achieving long-term objectives.

Another way to address excessive short-termism is to incentivise executives to pay more attention to long-term value creation. This may be achieved through structuring the remuneration schemes of executives so that a significant portion of their compensation is based on the long-term performance of the company. This may take the form of differed compensation arrangements or Long-Term Incentive Plans requiring a condition to be met before the award is granted. It is important that vesting periods for incentive pay are long enough to encourage a longer-term focus,

since poor long-term performance may reduce the value of earlier incentive awards before they can be cashed out or exercised.⁴⁵ In contrast, if executives own stock options with short vesting periods, this might stimulate actions to boost short-term performance, because it would allow executives to benefit from selling their holdings before the long-term costs of their decisions materialise. Such remuneration schemes are therefore likely to trigger the excessive focus of the CEO on a company's short-term results.

Similarly, the short-termist behaviour of investors might be tempered by providing incentives for long-duration holdings of securities, and disincentives for short-duration holdings. As suggested, for example, by Haldane and Davies,⁴⁶ these measures may take the form of tax and/or subsidies, or governance measures linking voting rights to the duration of equity holdings.

Taking into account the costs that short-termism entails, not only for public companies, but also for the whole economy, we strongly recommend considering the measures outlined above, as well as other instruments that may help to address the excessive focus on short-term goals. If dealt with effectively, it would improve the capacity and competitiveness of national businesses, encourage long-term value creation and contribute to the welfare of society.

⁴³ Pocock, op. cit.

⁴⁴ See, e.g., Michael J Mauboussin (2006), *Approaching Level 10: The Story of Berkshire Hathaway*, reproduced in Rappaport (2006), op. cit.

⁴⁵ Brian G M Main, Rolf Thiess and Vicky Wright (2010), *Career Shares as Long Term Incentives*, University of Edinburgh Business School (Edinburgh) and Towers Watson (London).

⁴⁶ Haldane and Davies, op. cit.

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