THE PUZZLE OF SHORT-TERMISM

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INTRODUCTION

When pondering the question of the "sustainable corporation," as we did in this symposium, one of the intractable problems is the nature of the corporation to produce externalities. By noting this characteristic, I am not making a moral point but an economic one. The nature of the firm is to create financial wealth by producing goods and services for profit; without regulatory or contractual limits, the firm has every incentive to externalize costs onto those whose interests are not included in the firm's current financial calculus. In fact, because of the corporation's tendency to create benefits for itself by pushing costs onto others, the corporation could aptly be called an "externality machine."[1]

The obvious kind of externality is the one that happens in the same time frame as the benefits gained. These current externalities take a number of forms. A company might refuse to provide health benefits to its employees, leaving Medicare or Medicaid to pick up the tab.[2] The company might save on production costs by skirting environmental laws, thereby forcing communities, neighbors, or employees to suffer risks of harm that do not need to be accounted for on the company's financial statements.[3] Alternatively, the

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1. *See* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 49–65 (2001) (calling the corporation an "externalizing machine").

2. *See, e.g.*, WAL-MART: THE HIGH COST OF LOW PRICE (Brave New Films 2005).

3. *See* Joseph Kahn & Jim Yardley, *As China Roars, Pollution Reaches Deadly Extremes*, N.Y. TIMES, Aug. 26, 2007, at A1; Jane Perlez & Raymond Bonner, *Below a Mountain of Wealth, a River of Waste*, N.Y. TIMES, Dec. 27, 2005, at A1.

company could sell shoddy products to one-time purchasers, produce goods in sweatshops, or underfund employees' pension funds.[4]

These kinds of externalities are routine to notice and remark on. They are also the subject of some push-back from stakeholders and regulators. Those who bear the cost can assert their interests in various ways.[5]

The more difficult kind of externality to address—especially if our focus is on the sustainability of the corporation—is the *future* externality. What I mean here is the kind of cost that a corporation's management can externalize to the future. From management's perspective, the future is a much more attractive place to push off costs. Stakeholders who must bear such future costs will be less aware of those costs than current costs, and even if they do learn of such future costs, they will be less able to gain the attention of regulators.

The aim of this Essay is to ask about one particular kind of future externality: future costs to shareholders. I recognize that shareholders are not usually the focus in a discussion of externalities. In the present, their interests are sufficiently (even if not perfectly) aligned with those of management that we need not concern ourselves with externalities borne by shareholders other than through the usual corporate governance tools. But in the case of future externalities, the analysis is more complex. Current shareholders may prioritize present returns over future returns,[6] and current shareholders may not expect to be future shareholders at all. This means that corporate managers have incentives not only to externalize costs to current and future stakeholders whose interests they can ignore but also to *future shareholders* as well. This means that corporations will, by their very natures, be fixated on the short term.

If one is worried about the sustainability of corporations from an environmental, social, or political perspective, the problem of "short-termism" has to be a central worry. This is because, at least

4. *See* Steven Greenhouse & Michael Barbaro, *An Ugly Side of Free Trade: Sweatshops in Jordan*, N.Y. TIMES, May 3, 2006, at C1; Roger Lowenstein, *The End of Pensions?*, N.Y. TIMES MAG., Oct. 30, 2005, at 56, 62–63; *Fact Sheet Making Change at Wal-Mart*, UNITED FOOD AND COMMERCIAL WORKERS INT'L UNION, http://makingchangeatwalmart.org/fact-sheet/ (last visited Aug. 23, 2011). For a related (and more provocative) example, see Kent Greenfield, *September 11th and the End of History for Corporate Law*, 76 TUL. L. REV. 1409 (2002).

5. *See, e.g.*, David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANN. REV. FIN. ECON. 103 (2010) (reviewing empirical research on shareholder voting).

6. *See, e.g.*, Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 994–98 (2008) (discussing propensity of investors to choose a mutual fund based on past performance irrespective of future performance).

according to many who have thought seriously about the topic,[7] in the long run the interests of corporations conflate with those of society as a whole. (For the sake of this Essay I will assume this to be the case, though I have stated some disagreement elsewhere.[8]) Short-termism is a problem whether we focus our attention on the sustainability of the corporation or the ethics of its management.[9]

Short-termism is also costly economically, since the economy as a whole benefits when companies have a long-term strategy. The economy is a summation of the fortunes of the millions of companies and individuals that make it up; if most companies make decisions that prioritize the short-term at the expense of the long-term, we all suffer.[10] A nation's wealth grows more over time when companies invest for the future and maintain their viability as a going concern.

The financial crisis of 2008 brought into sharp relief the economic costs of short-term management. Among the competing theories on the cause of the financial collapse—the over-dependence on derivatives, the overuse of leverage, the culture of greed and entitlement in the finance industry, just to name a few[11]—a focus on the short term is an omnipresent narrative thread. If managers and financiers had taken a more long-term view of the health of their own companies and the fortunes of their investors, we might not have seen the myriad other problems come to such a head. The addiction to leverage, derivatives, and greed that caused the market to become a casino would only have been possible in a business culture where short-term gains are prioritized over long-term costs. What might have been assumed to be costs that would be suffered some time in the distant future are being absorbed now. John Maynard Keynes was wrong on this point: in the long run, we are *not* all dead.[12]

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7. *See, e.g.*, Andrew C. Coors & Wayne Winegarden, *Corporate Social Responsibility—Or Good Advertising?*, REG., Spring 2005, at 10, 10 ("A profit-centric firm provides the optimal amount of socially responsible behavior."); Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine) at 32.

8. *See* KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 134–42 (2006).

9. Kent Greenfield, *Corporate Ethics in a Devilish System*, 3 J. BUS. & TECH. L. 427 *passim* (2008).

10. *See* Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.–Oct. 1992, at 65, 76–77 (arguing investors should take a long-term view).

11. *See, e.g.*, LIAQUAT AHAMED, LORDS OF FINANCE: THE BANKERS WHO BROKE THE WORLD 14 (2009); WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET 303, 426, 531 (2010).

12. JOHN MAYNARD KEYNES, A TRACT ON MONETARY REFORM 80 (1924) ("But this *long run* is a misleading guide to current affairs. *In the long run* we are all dead.").

So despite some naysayers,[13] the problem of short-termism is very real. Shareholders hold their stocks, on average, for less than a year, and even less for small companies.[14] Institutional investors have been said to be particularly bad on this front, acting "more as traders, seeking short-term gain."[15] Managers admit that they make decisions that harm the company in the long-term in order to meet short-term earnings expectations.[16] In 2006, both the Conference Board and the Business Roundtable, two of the nation's most prominent business organizations, issued reports "decrying the short-term focus of the stock market and its dominance over American business behavior."[17] And, let's remember, that was two years *before* the collapse.

But there is a puzzle. In contrast to the others who suffer the costs of future externalities, future shareholders have a way to communicate with present-day managers and shareholders. They "communicate" with the present by way of the market. What I mean is that in a well-functioning, efficient market, present-day decisions that exact a future cost will affect present-day stock price. Current stock price will be affected by future losses because current stock price is a function (in part) of future profitability of the firm. With that truth in mind, why do managers focus on the short term? Why would a company benefit from short-term management? If short-termism is a problem because it falsely inflates the company's stock price, how does that occur? That is, why would share prices be inflated rather than depressed for such a company?

I. THE SHORT-TERM PUZZLE

Consider that any shareholder who sells her stock in order to profit in the short-term is selling to someone else, who by definition believes that the stock is selling for less than it is worth. Share turnover is not by definition a problem, then, since for every seller there is a buyer. Moreover, it ought to be irrational for Wall Street analysts to require—and company management to make—decisions that hurt the company in the long run but allow the company to meet short-term earnings projections. In such situations the share price should *fall* rather than increase or stay steady. The reason is

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13. *See, e.g.*, George W. Dent, Jr., *Stakeholder Governance: A Bad Idea Getting Worse*, 58 CASE W. RES. L. REV. 1107, 1109–11 (2008) (denying a problem with short-termism exists).

14. LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 277–78 (2007).

15. ROBERT KUTTNER, THE SQUANDERING OF AMERICA: HOW THE FAILURE OF OUR POLITICS UNDERMINES OUR PROSPERITY 144 (2007).

16. MITCHELL, *supra* note 14, at 1.

17. *Id.*; *see also* Lee Drutman, *The Long Term Value Moment*, AM. PROSPECT, July 9, 2007, http://prospect.org/cs/articles?article=the_longterm_value_moment (cataloging various studies pointing out the pathologies of short-termism as a business strategy).

that in an efficient market, share price is a reflection of the company's value. If decisions are being made to decrease the true value of the firm then the share price should reflect that.[18]

To offer a concrete example, let's say a company chooses to adjust its accounting treatment in such a way as to accelerate earnings and delay costs for the current quarter. This will give the *appearance* of a greater profit in the current period, perhaps allowing the company to report to Wall Street analysts that the company has met its earnings expectations. But no rational, informed investor would pay a higher price for shares in such a company since the company's value *has not changed in reality*. Rather, since the company is still making the same products or providing the same services, its long-term prospects have not changed for the better and may have changed for the worse if management has been spending its energy on accounting rather than productive pursuits.

Indeed, if the company is in fact being managed for the short-term at the expense of the long-term, the share price should *fall* dramatically and consistently. The rational buyer would not be willing to pay any more for each share than the sum of the total dividend payments coming to her in the future on the basis of that share (discounted to present value).[19] And if shareholders know that the company has made future dividends less likely because of management's short-term orientation, then the market price of the stock will reflect this even if the short-term earnings are inflated. Indeed, share price should be expected to fall consistently over the period of such managerial strategy. Again, to make the point concrete: if managers intentionally manage a company to accelerate all profit and earnings into the next five-year period and then go bankrupt, no informed shareholder should purchase shares of that company at the current price. The shares will be worthless in five years, and fall dramatically in value between now and then.

In figuring out this puzzle, allow me to make an assumption that will simplify the analysis as we go. Allow me to assume that

18. Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS. L. REV. 513, 534 (arguing that for adherents of Efficient Market Hypothesis, any discussion of short-term versus long-term strategies and interests is misguided because in a perfectly efficient market, common stock prices should reflect the sum of all dividends and all payouts to be expected in the future, discounted to their present value); *see also* R.A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 67–68 (2d ed. 1983); VICTOR BRUNDEY & MARVIN CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 479–82 (2d ed. 1987); BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 480–81 (4th ed. 1962).

19. *See* Robert J. Shiller, *Market Volatility and Investor Behavior*, 80 AMER. ECON. REV., 58, 58 (1990) (surveying literature confirming that rational investors price stocks as present values of forecasted dividends, and forecasts are based on lagged real dividends).

there are two kinds of companies: one that manages for the short-term and one for the long-term. The short-term company seeks to maximize profits and earnings in the near future and disregards the long-term. If decisions can be made to transfer value from the future into the present day, the management will do so—even if it will decrease the total value of the firm aggregated over time. (I'll set aside for the moment *why* management would do this.) Long-term-oriented companies will make decisions that seek to maximize the value of the company over time. If decisions can be made in the short-term that cost the company money but will pay returns in the future, then the company will do so—even if in so doing the company will be unable to recognize profits in the near future.

In a company whose management team is oriented toward the long-term, one would expect to see a greater-than-usual dedication to sustaining the company as a going concern over time; a larger commitment to maintaining the loyalty of those who have made investments in the company, whether by way of capital, infrastructure, or work; a dedication to the development of products or services that will pay off in the future; a diversification of firm endeavors and investments to guard against short-term shocks in the financial or consumer markets; and so on.[20]

On the other hand, a company focusing on the short-term will also have a number of strategies at its disposal.[21] Here is an illustrative list, which is hardly exhaustive:

> Cuts in research and development, in order to use the capital that would be spent for R&D to increase dividends or retained earnings temporarily, at a cost to the long-term health of the company;
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> Accounting adjustments (either legal or illegal) to accelerate recognition of revenue and delay recognition of expenses, inflating current earnings at the cost of deflating future earnings;
>
> The sale of profitable divisions or subsidiaries for cash, realizing future earnings of the division as a cash payment in the present, usually at a discount;
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> A greater dependence on debt to finance company expenses and projects, which increases the company's leverage, inflating

20. *See* Estreicher, *supra* note 18, at 550–53 (outlining long-term investment strategies and acknowledging an alarming underinvestment in long-term business strategies).

21. *See generally* John R. Graham, Campbell R. Harvey & Shivaram Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3 (2005) (identifying various kinds of short-term strategies and analyzing managerial behavior with regard to such short-term pressures).

> returns on equity as long as the company is doing well and the market is trending up, but with increased risk of insolvency if the market goes down;
>
> The use of executive compensation schemes that prioritize the satisfaction of short-term financial goals, incentivizing management to look only a few steps ahead;
>
> Breaches in implicit or explicit contracts and understandings with company stakeholders, which allow the company to seize the value of past investments by such stakeholders without paying them their expected returns (an example of this would be a change in company policy away from a commitment to providing stable employment and instead increasing its use of short-term, low-wage employment);
>
> Cuts in employment generally, since savings in labor costs occur in the short-term and costs to the company arising from a decrease in employee loyalty and specific human capital valuable to the company are incurred in the longer term;
>
> A disregard for latent risks in the company's products or services, whether such risks be environmental (such as the risk of global warming brought about by the use of sport-utility vehicles), social (the social cost of violent media, for example), or financial (the risk of financial crisis brought about by the overuse of risky financial derivatives);
>
> Stock buybacks, which increase share price in the short term but deplete the company's capital that could be used for a more productive purpose; and
>
> A focus on share price rather than the corporation's value as a whole or the value of the corporation to its non-equity shareholders.

Each of these short-term strategies will likely impose long-term costs onto the firm but have short-term benefits to the company, the management, or certain shareholders. There may be situations in which such long-term costs are worth the short-term gain—for example, when the company needs to satisfy some short-term financial obligation (to pay a legal judgment, say) and can only do so if R&D expenditures are put off. But by definition most of these strategies will be bad decisions for the firm in the long run.

This is not to say that a company that refuses to engage in such short-term decisions will necessarily succeed. Managers make mistakes, and some mistakes are quite costly. Moreover, to the extent that a company's time horizon is long, it may be more difficult to know whether a long-term strategy pays off more than a short-term strategy. Also, a long-term strategy is more difficult: not only must a company's management make decisions that are focused on success five, ten, or twenty years out, it must also make short-term, tactical decisions that work as well. A part of a company's long-term strategy must always be to survive in the short term.[22]

So here we get to the nub of the problem: if by definition short-termism is costly to companies in the long run and to the economy as a whole—because the economy is a summation of the well-being of everyone—then why do we see the short-term management tactics described above?

II. PUZZLING OUT THE PUZZLE

One possible answer lies in the nature of management. To state the obvious, companies are controlled by managers, and some managers intend to be at the company for a long period of time and therefore look toward the long-term.[23] Other managers want to make their money and get out. This would explain why some managers would *want* to manage their companies for the short term.[24] But it does not explain why the market does not consistently punish such behavior. If managers make decisions that will hurt the company in the long-term for selfish reasons, why does the share price not fall?

Another answer might be that that some investors, too, focus on the short-term, so that they buy stock of companies so oriented. But even that does not fully answer the question, since short-term-oriented shareholders should not be able to realize any benefit from owning shares in a short-term-oriented company. If dividends are inflated in the short-term at the cost of the long-term fortunes of the company, whatever benefit realized from the short-term dividends will be more than set-off by the decline in the stock price brought about by the decline in the real value of the company.

In other words, if a company's short-term strategy is known to the investing public, then the future drop in the value of the

22. *See* Robert M. Feinberg, *In Defense of Corporate Myopia*, 16 MANAGERIAL & DECISION ECON. 205, 209 (1995) (arguing against the effects of imposing so-called "long-term management" through tax, subsidy, or regulatory incentives, which the author claims may lead to unproductive rent-seeking activity and other inefficient behavior unintentionally induced by such incentives); Gregory Jackson & Anastasia Petraki, *Understanding Short-termism: The Role of Corporate Governance*, GLASSHOUSE F., 48 (2011), http://www.glasshouseforum.org/pdf/GF_jackson-petraki_short-termism.pdf (arguing that short-termism may be a rational managerial response to shareholder myopia in the face of high risk or uncertainty).

23. *See* Kevin J. Laverty, *Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Practice and Research*, 21 ACAD. MGMT. REV. 825, 832 (1996).

24. *See id.*

company will be "baked in" to the current price.[25] No benefit should be gained from such a strategy if indeed it is known to the investing public. As the costs of the short-term strategy become clearer, the stock price will plummet, and those holding the shares of such a company will find fewer willing buyers.

As for companies with long-term strategies, the future earnings will be reflected in current prices as well, so the stock price will be trading at a fairly high price-to-earnings ratio. (The value of the future earnings will not be fully captured by the current share price, however, since investors will discount future earnings in relation to the time value of money and will also likely impose a "risk discount" in connection with the probability that the company will not actually realize the benefits of its long-term strategy.) All in all, in a perfectly informed market, the value of long-term-oriented companies will tend to be recognized as such, and their share values will so reflect.[26]

III. THE INFORMATION FALLACY

Of course this argument depends on an unreasonable and simplistic assumption—that the market is perfectly informed.[27] In fact, investors are not perfectly informed, and it is often costly or impossible to determine whether companies are being managed for the long- or short-term.[28] That is, it is often costly or impossible to determine whether an increase in quarterly earnings is evidence of a short-term orientation that will be costly to the company in the long-term, or if the increase is due to the realization of returns from a successful long-term strategy.

This fact poses a significant difficulty for public policy. Profits and earnings for a long-term-oriented company may be

25. *See id.* at 833–34 (finding that many writers have argued, and many managers believe, that the stock market undervalues investments that will pay off only in the long run).

26. *See* Allan C. Eberhart, William F. Maxwell & Akhtar R. Siddique, *An Examination of Long-Term Abnormal Stock Returns and Operating Performance Following R&D Increases*, 59 J. FIN. 623, 648 (2004) (finding that investors systematically underreact to R&D investment, an example of a long-term management decision, partly because they are not always fully informed).

27. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 764 (1985) ("[T]he legal rush to embrace and apply the efficient market hypothesis has been overly precipitous and occasionally unwise."). Scholarship has called into question the Efficient Market Hypothesis's ("EMH") empirical and theoretical claims. *See, e.g.*, Stanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Fully Informed Markets*, 70 AM. ECON. REV. 393, 405 (1980); Emanuel Sciubba, *Asymmetrical Information and Survival in Financial Markets*, 25 ECON. THEORY 353, 370 (2005); William K.S. Wang, *Some Arguments that the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341 *passim* (1986).

28. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanics of Market Efficiency*, 70 VA. L. REV. 549, 580 (1984).

indistinguishable from profits and earnings for a short-term-oriented company. It is easy to show the numbers; it is rather difficult for most investors to determine the reason for such numbers. In fact, a company that is utilizing some of the short-term managerial strategies listed above may show profits and earnings that are greater than companies with a long-term focus. And capital markets may not "punish" such short-term management if it is not clear that the inflated earnings are based on strategies that are costly in the long-term.

When a company's management strategy is not known, or is not widely known, a company that is being managed for the short-term may have a share price that is inflated, only for the price to fall along with earnings when the strategy becomes clear. Those investors holding the stock at the time of the fall will suffer the financial loss. A windfall will be gained by those who are holding the stock during the run-up of the stock price and are fortunate enough to sell before the drop. Also, a windfall will inure to managers who time their departure before the drop.

As for long-term-oriented companies, the depressed short-term earnings brought about by the long-term strategy will not be easy to distinguish from depressed earnings caused by bad management or a short-term strategy that has run its course. The stock price will also be discounted because it will be unclear to investors what the true strategy really is. This in turn makes the company ripe for takeovers.

So in a world in which (1) short-term management can result in short-term bumps in profits and earnings and (2) such earnings and profits are indistinguishable (or costly to distinguish) from those coming from long-term-oriented companies, then (3) the market will be slow in punishing short-term-oriented management. That is, there will be a lag between the implementation of a short-term management strategy and when the chickens come home to roost—it may take some time for the capital market to price the shares correctly.

The other side of the story should be told as well: it will often be difficult and costly to distinguish between a company that is showing a low level of short-term profits and earnings because of the costs of implementing a long-term strategy and a company that is showing a low level of profits and earnings because of poor management or a failure of strategy. So the share price of the company that is actually being managed for the long-term—but showing no signs of success as of yet—will trade deceivingly low.

The existence and extent of this lag time between the establishment of a long- or short- time horizon and the recognition of the costs or benefits thereof in the stock price will depend on a number of factors. The most prominent of these will be how obvious the strategy is to investors in the market. The more obvious the strategy, the more efficient the capital markets will be in "pricing" the securities issued by the company. If a company that is pursuing a short-term strategy is able to camouflage it as a long-term strategy, the stock price will be falsely inflated until the strategy becomes sufficiently clear to the investing public that they recognize that it is overpriced. Only then will the share price fall to a level that correctly reflects the company's value.

Most investors will not invest the time to distinguish between the long-term companies that are not yet making money and the companies that are simply floundering. Instead, they will look toward companies that are showing profits and earnings. The problem here is that some of these companies—investors will assume—are realizing the benefits of successful long-term strategies, while others are simply exchanging long-term benefits for short-term profits at the cost of the company's long-term prospects.

IV. SOPHISTICATED INVESTORS IN AN UNINFORMED MARKET

Note that nothing I have said so far will be unknown to sophisticated investors. They know that earnings and profits in the short-term do not necessarily translate into long-term success. They know that a failure to show short-term earnings does not necessarily mean that the company is destined to fail. But they also know that it is costly to figure out which is which, and that what counts to them is the value of their portfolio as a whole over time, not the profits from a single investment.

So in maximizing the value of their portfolio, sophisticated investors face a variety of choices. If such investors have a short-term focus, perhaps because their own time horizons are short because of imminent retirement or the like, then they have no incentive to try to pick the long-term successes and hold for the long-term. These investors will instead look for companies whose stocks will pay off in the short-term, whether such payoff comes as a result of short-term strategies with long-term consequences or as a result of companies that are realizing the payoffs of long-term strategies.

As for long-term investors—individuals planning for retirement years in the future or investment funds that hold accounts for such people—one might expect that they would tend to "buy and hold" investments in companies that appear to be strong for the long-term, even if short-term earnings are disappointing or foregone. That is true for some long-term investors, but certainly not all. Such long-term investors, whether individuals or institutions, face a choice: they can (1) try to identify companies that have successful long-term strategies but whose stock is undervalued at present; or (2) identify companies with high earnings and profits in the short-term. Some of the latter group will be truly successful companies; some will be companies that are utilizing strategies to emphasize short-term gain at the expense of long-term gain.

Both strategies are in fact followed by long-term investors. Both have their risks and costs. Under the first strategy, the risk is that the investments chosen will not in fact pay off, and the major cost is the expense of discovering long-term-oriented, undervalued companies. The cost of research under the second strategy is much less—an investor need only look at numbers. The risk of the second strategy is holding too long. If a stock's inflated value becomes obvious to the market, the stock price will plummet. In other words, the key to the second strategy is timing. Get in, ride the wave, and get out before it crashes; then take your money and find another investment in the short-term market.

It is important to note a key fact about the second strategy: a short-term investment strategy will become even more successful if the investor can control the timing of the investment's withdrawal to capture as many of the short-term gains as possible before the inevitable downgrade in stock price.

Most investors do not have any way to do that. They can only try to stay ahead of the curve by trading often and quickly, usually on the slightest sign of downturn in a stock. This makes the market as a whole more volatile, since small upticks in stock price will attract a host of short-termers looking for a place to put short-term money, and small downturns will cause many short-termers to flee in fear that the small downturn is the beginning of something worse. But such a strategy is highly risky, and unlikely to maximize gains over time (witness that very few mutual funds outperform index funds over time).[29]

V. MAKING A SHORT-TERM STRATEGY WORK IN AN UNINFORMED MARKET

What if an investor *could* time their investments? The gains from the short-term strategy could be immense. The long-term value of their portfolios would be the summation of a series of above-market, short-term gains. And the strategy could be maintained as long as there are enough investment opportunities available so that the money investors pull out of one company can find a place to land elsewhere. But how could such timing be accomplished?

Let us imagine a situation in which investors—whether individual or institutional—can affect the time horizon of a company, to accelerate earnings and capture as much of the company's future value as possible in the near term. Let us also imagine a situation where they could keep that information

29. *See* David McPherson, *Index Funds vs. Actively Managed Funds: Which is Better?*, ABC NEWS (Oct. 20, 2009), http://abcnews.go.com/Business/PersonalFinance/index-funds-actively-managed-funds-best/story?id=8866429 (citing a Morningstar study that found only thirty-seven percent of actively managed U.S. stock mutual funds beat their respective Morningstar indexes).

camouflaged from the market generally. How would they do that? The answer is by taking over management of the company or by buying enough stock in a company that the management is forced to listen to you.

Obviously, such a tactic would be available only to investors with significant capital to invest. But if investors are successful in doing so—buying off management or buying up companies—then the company can be made to do the things that shift future company value to the present. For example, the company can buy back stock, increasing immediate returns to investors; pay management exorbitant compensation, in effect taking present and future earnings of the company as individual compensation; sell off portions of the company for cash, distributing the cash as a dividend; or leverage the company highly, multiplying the return on equity at the cost of increased risk for the firm in the long-term.

Moreover, while the investors themselves are managing the company in such a way, they need not make the true implications of their decisions clear to the investing public.

One mechanism for taking control of companies in this way is private equity. In fact, private equity funds are *defined* by this trait: they take over companies and manage them as private corporations, free from many of the reporting obligations required of public companies. Also, certain hedge funds have such large amounts of capital to throw around that they may be able to get similar results from management without actually taking over the companies.

And note that many managers may *want* to maximize short-term earnings at the expense of the long-term. Managers find it advantageous to use short-term strategies as well. It is much easier to meet next quarter's Wall Street earnings expectations, by hook or by crook, than it is to guide a company toward a long-term goal. And if their compensation consists primarily of stock and stock options, then they have incentives to consider themselves investors rather than managers. When this is true, they can manipulate the company using the strategies described above to maximize their own short-term gain at the expense of the long-term health of the company, and time their departure before the company falls back to earth.

VI. WHAT TO EXPECT IN A SHORT-TERM MARKET

So that's the story of how short-term-oriented investors could collude with, or become, short-term-oriented management to cause businesses to manage for the short-term without being punished by the market in the short term. Such a strategy will hurt the company in the long term and impose external costs onto company shareholders and stakeholders with long-term interests—as well as society and the economy in general. But such costs will not be borne in the short term by the investors or managers. As long as they "get out" in time, they will be able to enjoy above-market returns. And as long as they can continue to find companies that are susceptible to the same strategy, they can maintain above-market returns for the duration. But of course such returns are not truly a reflection of anything other than being a winner in a zero-sum game. The returns are not a reflection of excellent management, or product innovation, or the creation of value. They are only, in economists' terminology, the "extraction of rents," the shifting of financial gain from someone who is losing at least as much. The fact that those who are losing exist mostly in the future does not make the losses any less real.

There is one last thing to recognize: in a market where companies are being increasingly managed for the short term, the typical "Main Street" investor will not stay in the dark forever. Investors who do not have the access or capital of the hedge funds and private equity funds will eventually recognize what is happening. So they, too, will start investing with a view toward the short term, and be extremely sensitive to downticks in stock price that might be signs of a more serious downturn. This will in turn make the market as a whole more volatile. And as volatility increases, the entire market will become less secure. More and more investors will either lose their shirts or simply leave the market and put their money elsewhere. And eventually, the costs of short-term management will be such that the entire economy will suffer. The chickens will eventually come home to roost.

Over the last few years, I have noticed some roosting chickens. You?