Complaints about short-term thinking by public companies have been with us for years. Policymakers and commentators argue that the pursuit of attractive quarterly results often takes precedence over building long-term value. As a consequence, companies might be cutting expenditures that could be important in the longer term, such as investments in research and development, marketing, or talent retention. There is evidence that these claims have merit—and that short-termism on the part of public companies has been increasing.

My former colleagues at McKinsey & Co. have conducted research on this issue over the years, and I’ve found it interesting to think about the implications of their findings in my current job. In a 2013 survey that McKinsey conducted of more than 1,000 C-suite executives and board members, three-fifths said that the pressure to generate strong short-term results had increased over the past five years. More recently, McKinsey researchers built a numerical index of short-termism based on financial data on 615 companies and found that it had risen markedly (though with some ups and downs along the way) since 1999. And in separate research at Duke University and the University of Washington, four-fifths of chief financial officers in a survey admitted that their companies had traded off long-term value in favor of short-term earnings.

Why do we see this behavior? Why do public-company executives seem to feel pressure from investors to focus on the short term?

One explanation may be the increasing role of activist shareholders, who acquire large ownership positions in public companies and, in many instances, press for short-term gains. By one estimate, the number of companies worldwide targeted with demands by activist investors increased from 607 in 2013 to 922 in 2018, more than a 50 percent increase.

Another factor could be the rise of firms’ valuations and leverage. Both place downside pressure on public company executives, in an environment where potential acquirers (like private equity firms) are flush with capital.

CEOs have to be attentive, also, to the shrinking tenure of chief executive officers. The pressure from boards and markets is relentless; small wonder executives emphasize near-term performance.

Still another factor may be changes to executive pay that favor the use of performance-based compensation such as grants of stock and stock options. These are supported by the tax system but leave executives highly focused on the day-to-day performance of their stock.

I am not writing to advocate a policy response to short-termism; that’s a question for others, outside the Fed. But I do believe it’s a part of the economic environment that monetary policymakers need to understand.

One notable macroeconomic effect of short-termism is that it could lead to under-investment in areas such as research and development—and underinvestment hurts productivity growth. Some research shows that business investment has been low relative to measures of corporate profitability since the early 2000s; productivity growth has been slow over the same period.

Short-termism, in a low-rate environment, could create a bias in favor of mergers and acquisitions over organic growth. When a company embarks on building a new factory or adding to its sales force, it bears new costs right away, while the benefits only come later. In contrast, when the same company makes an acquisition, the one-time costs are written off and—if accretive—the benefits are visible immediately. This bias in favor of M&A can bring about greater market concentration and market power across the economy. And, in turn, greater market power could lead to lower productivity and pressure on prices, as I discussed in the Richmond Fed’s most recent annual report.

Finally, short-termism makes business more sensitive to the sentiment of the moment. In principle, this greater sensitivity should be neutral in its economic effects over the long term as sentiment waxes and wanes. But corporate leverage has increased to historically high levels, and this leverage, combined with the long duration of the current expansion, may be causing firms to react more strongly to negative sentiment during this period, affecting hiring, investing, and pricing. Increased short-term focus may be making this reaction function more pronounced.

For all of these reasons, I watch short-term behaviors closely when thinking about monetary policy.

Thanks, and enjoy the issue.

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TOM BARKIN
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND