SchumpeterCorporate short-termism is a frustratingly slippery idea

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AS AMERICA'S economy has misfired over the past decade, several grand theories have emerged about what went wrong. Economists fret about secular stagnation, debt hangovers and whether demography explains sluggish growth. In American boardrooms, meanwhile, a widely held view is that a dangerous short-termism has taken hold. This theory contends that investors and executives have become myopic, leading firms to invest too little. Like many business ideas, short-termism fits the experience of some individual business people. But as a theory about how the economy works it is too nebulous to be much use.

People have always worried that financial markets cannot see beyond their noses. In 1936 John Maynard Keynes noted that the horizon for investors was "three months or a year hence", even though they were trading the securities of firms and governments that would probably last for decades. Since the crisis of 2008-10, worries about short-termism have risen again. Bosses fret that if they miss quarterly earnings forecasts they will be fired. Activist hedge funds seeking a quick buck are said to spook big corporations. The average share changes hands every 200 days for firms in the S&P 500 index. Terrified companies, the argument goes, no longer invest in their business and instead bribe their owners. For every dollar of operating cashflow S&P 500 companies make, excluding financial firms, they spend 44 cents on capital investment and 56 cents on buy-backs and dividends.

A new study by McKinsey drills deeper. The consultancy took about 600 firms and labelled some as short-termist if they exhibited five habits: investing relatively little, cutting costs to boost margins, initiating lots of buy-backs, booking sales before customers pay and hitting quarterly profit forecasts. The study concludes that 73% of firms are short-termist. The elite 27% of firms that are long-termist performed better, McKinsey reckons, seeing their profits increase by, on average, 36% more than short-term firms between 2001 and 2014. The methodology is robust, and controls for the fact that some industries grow faster.

Surely it is an open-and-shut case? Not really. The theory of short-termism suffers from three difficulties: it isn't an accurate description of what is happening across America's economy; it doesn't deal with the question of causality and, last, it is a distraction from the real difficulty.

Take accuracy first. There are plenty of signs that short-termism is not a problem. Those timorous chief executives serve longer than the average Roman emperor did: bosses departing in 2015 had an average of 11 years in office for S&P 500 firms, the highest figure for 13 years. Activist hedge funds own less than 1% of the stockmarket. The average share is traded many times because of a cohort of high-frequency computerised traders. But their churning masks the sharp rise of passive funds, which already own 13% of the market and which hold shares indefinitely.

Supposedly myopic markets often look far into the future. The bond market lends to the government for 30 years for an interest rate of just 3%. Equity investors place huge values on firms that won't make serious profits for years and years. Amazon is the world's fifth-most valuable firm, with a colossal $400bn market capitalisation. About 75% of that value is justified by profits that are expected to be made a decade or more from now. It is probably the biggest bet in history on a company's long-term prospects.

Firms are not investing at weirdly low levels. Frightening figures on them starving themselves to splurge on buy-backs are misleading. Investment—capital spending plus research and development—is 9% of sales for S&P 500 firms, in line with the 25-year average (excluding financial companies). For the economy, private-sector capital spending, excluding housing, is at 12% of GDP, equal to the average since 1945. On both measures investment is not that far from the frothy levels seen in 2000, during the dotcom boom, the last time companies went wild. Buy-backs are so high because profits are abnormally high, which in turn may reflect the rising level of concentration in most industries. Were firms to try to invest all their surplus funds, they would need almost to double investment to a reckless 17% of sales. If Ford invested all its record cash flows, based on 2016 figures, it would double its plant in 30 months, an act of insanity in the car business.

What about the second flaw, causality? The McKinsey study makes clear that this is hard to demonstrate. Do short-term firms become weak or do weak firms rationally adopt strategies that might be judged short term? Almost all managers think that their firms have a right to grow, but in any industry it is natural that some firms stagnate or decline just as some of their rivals expand. Shrinking firms should reduce costs and return cash to investors.

Consider IBM. Its sales have sunk back to where they were in 1997. Over this period it has slashed costs and ramped up its margins, cut investment by half and halved its number of shares through buy-backs. By one account these were myopic choices that caused IBM's decline. By another they were tough decisions, made in response to Big Blue's retreat as a new generation of technology firms took over leadership of the industry. In the end, labelling IBM as long-term or short-term doesn't clarify much.

From here to eternity

The final flaw is that short-termism is a distraction. Many big firms wallow in lucrative stagnation. Profits are abnormally high even as the cost of capital is low. The theory of short-termism suggests that the solution is to prod incumbent firms to invest vast amounts and insulate their managers from investors. But there is another approach that gets to the root of the problem: incumbents' fat profits need to fall. Competition policy needs to weaken the entrenched position of established firms and help new entrants. That would make the economy more dynamic, boost wages and end the era of surplus profits that are put to no use. It's not a message many powerful CEOs are keen on.