Long-term Thinking: Capital for the Future

Keynes didn't expect that his words "In the long run, we are all dead" would have so many advocates now, though, this time, we are talking about a different topic. Short-termism, a myopia that enjoys short-term payoff on the expense of long-term gains, is no longer new in the daily business.

In 2016, Aspen Institute and McKinsey & Company showed concerns about the phenomenon: at top 400 American public companies, around 80 percent of their managers admit that they would sacrifice company's long-term value for the quarter's earnings target.[1] Similar situations are observed in Europe, China, Russia and other countries. In the modern society of today, environmental awareness and the calling for sustainable development still fail to protect us from the lure of the short-term payoff. As a result, many investments and activities end up causing financial, political, environmental, and social problems.

Then what can be done? Many consider regulations on financial market, environmental protection campaigns, welfare and new recourse development. However, it is always more effective to launch one comprehensive project to change the framework from scratch and GUIDE the capital in the market to good use than initiate hundreds of separated projects for remediation. The idea is to make the capital serve for the future by itself through finding the causes for short-termism and making the long-term development more attractive. When decisions are made for the long run, various problems and conflicts will be avoid from the beginning.

To start with, it is crucial to understand that short-termism is neither an innovation of today, nor a 100% bad thing in the inter-temporal problems. As long as we are still human beings with bounded rationality, short-termism will be our company, more or less. After all, it is not easy to think in the future while living in the present. The key is not about making choice between short-term and long-term, but finding the balance of the two.

On the causes of current excessive short-termism, one possible explanation goes to the fast-paced urban culture and materialism. Nevertheless, this is only the tip of the iceberg. With improved market, financial innovations, regulations and better-educated participants, things are supposed to be better, aren't they? But why do more and more people fall into the trap of short-termism? Why does the problem intensify now?

In fact, many companies' short-termism is not out of their will. This could be partly attributed to the companies' short-sighted investors (Laverty 1996). For them, "beautiful" quarterly issued numbers and rising stock prices have the final say. As expected, managers sign their names on the projects with instant payoff and highest profit to please the board of the directors and investors. After all, who would like to

[1] Alana Semuels, How to Stop Short-Term Thinking at America's Companies, https://www.theatlantic.com/business/archive/2016/12/short-term-thinking/511874/, 2016.12.

put their job at risk for the “goodness” of the far future? In addition, what makes things worse is that this investor-caused myopia is not a one-way street, but an interactive and reinforcing process: the company with a short-sighted manager are more likely to attract short-sighted investors (Brochet 2012). A vicious cycle.

However, the blame on the investors is not the whole story. A deeper reason might be the lack of confidence on the future. People are worried. When the future is gloomy, short-term thinking prevails: why should I wait for another 5 years instead of getting the money right now if the situation will be even worse? In other words, excessive attention to the present means excessive uncertainty in the future. And this is not something out of blue. Slack demand and sluggish market all over the world, yellow vests in the Champs-Elysees Avenue, wall on the border of USA and Mexico, anti-refugee protests in Germany and Sweden, Brexit in the coming year...... Financial bumbles, political conflicts, as well as social instability, unnerve everybody. Without a stable and secure investment environment, it is hard to convince investors to put their money aside for the future and invest in the long run. Therefore, creating a good investment environment is of significance.

Knowing the main causes, things become much easier. What we need to do is to establish a stable and long-term oriented social and market system with the cooperation among governments, companies and individuals.

Governments:

1. Political and Social Reform

Economic problem is never merely economic. It twists with political, cultural, and social problems. Short-termism gives us a glimpse on investors’ worries about the future. If a majority of investors lose confidence on the market, a global recession is inevitable. To this extent, sending political and social reform signals for safe and promising future will be the “cardiac stimulant” to the economy and fundamental solution to the short-termism. For instance, the government could make investment in business, initiate projects to mitigate social and political problems and make the plan available to the public so as to ease the uncertainty of the economy.

2. Economic Incentives and New Pricing & Valuation System

When it comes to attract long-term capital, some economists suggest to establish a long-term stock market. Experiment has been made but end up unsatisfying result. The problem lies in the way we define a long-term investment. Long-term information based decisions can lead to a short-term sell as well. A better method is to know whether he or she makes the decision on the long-term information instead of calculating “the holding period of a shareholder”(Edmans 2017). Thus, it is necessary to make more long-term information available and create incentives for long-term investment without discouraging short-term trade.

① New Long-term Metrics in Reporting and Accounting

Thomas Bayes’ theory of prior distribution and posterior distribution lays the foundation for the modern investors’ expectation on financial products. Expectation will be revised accordingly when new information arrives. Price changes once expectation changes. That is how information influences the market. Short-term information plays an important role in price setting just as long-term one does but the concept that make all the decision on quarterly data is a monster. In the attempt to encourage long-term investment, a simple and straight idea is to make long-term index “visible”.

Releasing new long-term data in reporting and accounting helps to switch the public focus to the long run. On the one hand, re-design the current trade table on the exchange screen by adding long-term indexes such as R&D investment and net profit in the past 10 years. On the other, make it compulsory for all the financial related platforms and software to include long-term index.

The second step is much more sophisticated and demanding. Anti-short-termism calls for further revision on reporting and accounting system. Currently, R&D is the main index for long-term investment measurement. But that is nowhere near enough. In accounting, for example, environmental and social contribution and related expense is recommended to be added into companies’ intangible asset. Other new metrics for company’s performance evaluation and long term investment measurement deserve scholars’ study.

② Floating Discount Rate System

Price is the key of the market. All market participants are sensitive to price. Existing asset pricing system is mainly based on the method of discounting future cash flow by a given rate of return. This discount rate shows the value of the time, namely, one dollar today is more valuable than one dollar tomorrow. But things will be different if less discount rate is assigned to cash flow in the future. Suppose a company has cash flow of 1 million in the coming 3 years and 3 million in the 4th year. Let us have a look at how floating discount rate system influences the stock price.

Given a constant discount rate of 5% for all 4 years:

$$P = \frac{1}{(1+5\%)} + \frac{1}{(1+5\%)^2} + \frac{1}{(1+5\%)^3} + \frac{3}{(1+5\%)^4} = 5.1914$$

Given a declining discount rate of 5%, 5%, 4% and 3%

$$P = \frac{1}{(1+5\%)} + \frac{1}{(1+5\%)^2} + \frac{1}{(1+4\%)^3} + \frac{3}{(1+3\%)^4} = 5.4139$$

Less discount rate for the cash flow, higher the stock price. In this way, floating discount rate re-evaluates the importance of cash flow that happens in different time. Once a proper discount rate is given, the future cash flow will not be ignored, which greatly encourages long-term investment.

③ Tax Exemption for Long Term Shareholders

The longer the term, the less the tax. For example, shareholders who hold the stock for more than 1 year can enjoy tax exemption on his capital gains income or other process during the trade. Meanwhile, special tax exemption fund needs to be raised ahead so as to replenish the budget without influencing government’s daily activities.

Companies:

1. New Incentive and Assessment Mechanism

If the incentive and assessment system is short-term oriented, how could it be possible to encourage managers to think in the long run? Indeed, profit is often the driving force of running a company. But in many occasions, short-term profit goes against long-term development. A good incentive system makes managers feel “safe” and “confident” even if they have to make long-term decisions that might hurt the short-term profit. One plausible method is to add a parallel incentive system that gives extra points to managers if they could justify their decision by showing how it will benefit the company in the long run. Managers are supposed to be assessed by financial report and their managerial report at the same time. And contractual protection policy can also be supplemental method.

2. Term Expansion

Short managerial term causes as many problems as bad assessment system does. In the first decade of the 21th century, the average term of managers in the top 2500 listed companies declines from 8.1 years to 6.3 years.[2] And the number is even lower this decade. Managers have to show their ability in a short time period, but long-term investment takes time. Good projects might be rejected because a long payback period. The phenomenon happens in politics too, since short-term investment makes both political achievement and corruption easier (Iconio Garrì 2010). However, if managers or politicians are in charge for a longer period, they could make long-term plans.

Individuals:

1. Effective Dialogue With the Company and the Government

An effective dialogue is the best way to reduce information asymmetry. Different kinds of investors invest in different companies. Knowing what the company is doing now and what it will do in 10 years is crucial to investors’ investment decision. So does the dialogue with the government. Thus, individuals are encouraged to tell the company and the government about their concerns, participate in the quarterly or annual meetings and fully take advantage of the Q&A session afterwards. The more dialogues, the more information, and the better understanding.

2. Self-education

For many individuals, part of their myopia comes from wrong judgement on the market and company as well as their value and conception. Self-education for a right mindset is the key. Joining in various education programs helps all market participants to better comprehend the status quo.

To conclude, excessive short-termism is a complicated problem asking for more public attention. A united project requiring cooperation among governments, companies and individuals is necessary in order to encourage long-term thinking. Raising fund for financial incentives, seeking advice from scholars on upgrading existing financial report and pricing system, creating new incentive mechanism for managers, along with initiating education programs for individuals, are all part of the

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[2] Rappaport Alfred. Saving capitalism from short termism: how to build long term value and take back our financial future. Directors&Boards. 2011 3rd Quarter, Vol.35 issue 5, p44-44.1p.

project. But the emphasis is always on the social stability and market confidence. Challenges and opportunities are two sides of one coin. It's time to slow down, and think in the long run. As long as most people invest and work in a sustainable way, the capital will go to the right place to serve for our better future.

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