

**Understanding
Short-termism:
the Role of Corporate
Governance**

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Glasshouse Forum

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Executive summary

Short-termism involves situations where corporate stakeholders – investors, managers, board members, and auditors – show a preference for strategies that add less value but have an earlier payoff relative to strategies that would add more value in the long run. Short-termism has been debated frequently, not least during the recent global recession, but has received surprisingly little academic attention. Although researchers tend to agree on the definition of the concept, they do not agree on how to demonstrate the sub-optimal nature of these decisions. It is hard to establish whether short-term decisions are actually detrimental to long-term value creation.

This report contends that short-termism is caused by a self-reinforcing shortening of time-horizons produced by the interaction between on the one hand shareholders – pension funds, private equity, hedge funds – and on the other managers. Short-termistic behaviour is amplified by gatekeepers mediating these relationships – securities analysts, credit rating agencies, auditors. Short-termism therefore should be regarded as a social process, in which a certain behaviour is reinforced by the reaction of others. It reflects the complex interaction between the incentives and orientations of different stakeholders. This relational character of short-termism helps explain why it is hard both to measure and difficult to address through simple policy instruments aimed at one group of stakeholders. No single policy in isolation is likely to curb short-termistic behaviour among managers, shareholders and gatekeepers at the same time.

This report puts forward the following policy recommendations: Managers' remuneration needs to be tied to long-term performance. Excessively high levels of managerial pay must be countered and the use of equity-based incentive schemes must be limited or tempered with explicit long-term vesting periods. Managers also need to have longer employment tenures. Fund managers must also have their compensation schemes linked to the long-term interests of the principals. A speculation tax would also be helpful. The flow of information must be improved so that factors such as quarterly earnings reports are not perceived as being crucial.

Preface

This report has its origin in a roundtable discussion which Glasshouse Forum arranged in Stockholm on 16–17 June 2008. The discussion was part of the project “Short-termism in the long run”. The conclusion of the secretariat was that although there is a widespread impression that short-termism is a growing problem, the phenomenon has proven hard to empirically confirm. In particular, it is difficult to show that the strategies considered short-termistic result in long-term value destruction, since such argumentation has to be contrafactual. It was also found hard to identify any single actor who could be considered responsible for short-termistic behaviour. It looked rather to be the result of an interaction between different stakeholders.

Glasshouse Forum therefore commissioned Professor Gregory Jackson, one of the participants in the roundtable discussion, to write a report that summarised research to date and to formulate a theoretical framework for understanding short-termism and its relation to corporate governance. We are convinced that this report, written together with Anastasia Petraki, will stimulate and deepen the discussion on short-termism. It concludes with a series of policy recommendations aiming to reduce the tendency towards short-termism. Although Glasshouse Forum itself is not a policy-recommending organisation, we encourage our contributors to formulate such recommendations.

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“To gain time is to gain everything.”

V.I. Lenin

1. Introduction¹

Debates over short-termism come and go from the public eye along with the business cycle. Heavily debated during the economic turmoil of the 1980s, the issue receded to the background during the 1990s information technology boom. The subsequent explosion of managerial pay, the crisis of Enron, and the arrival of new players within the financial markets have brought the topic back into the limelight (see Tonello 2006). Now in the midst of an unprecedented global financial and economic crisis, the time is right to ask a fundamental question regarding the corporate economy: do managers and investors tend to pursue short-term gains in ways that have detrimental effects on the long-term prospects of companies or even national economies? This question has even greater relevance given the historically unique challenge of restructuring the global economy to mitigate climate change, which requires enormous investments today in order to guarantee the sustainability of our economic and social fabric in the future.

Short-termism involves situations where corporate stakeholders (e.g. investors, managers, board members, auditors, employees, etc.) show a preference for strategies that add less value but have

¹) The research was made possible by the generous support of the Glasshouse Forum, and we are grateful for the comments and supportive advice from Johanna Laurin Gulled, the members of the Advisory Board of the Glasshouse Forum, and participants in the roundtable conference “Short-termism in the long run” held on June 16–17, 2008 in Stockholm, Sweden. The authors are extremely grateful to Ania Zalewska for her extensive input in the early stages of the project and critical comments on a previous draft. We would also like to thank Steve Brammer, Michel Goyer, Tim Muellenborn, and Paul Windolf for their comments, as well as participants of the Society for the Advancement of Socio-Economics (SASE) annual conference held on July 16–18, 2009 at the Sciences Po in Paris, France. We also thank David J. Houghton for his excellent assistance in creating the graphical representation of short-termism. All errors remain our own.

an earlier payoff relative to strategies that would add more value but have a later payoff. While many factors may lead stakeholders to act myopically, short-termism describes situations where short-term focus becomes a systematic feature of an organisation. Short-termism is thus closely linked with the rights and responsibilities of stakeholders within corporate governance. Under certain institutional conditions, corporate governance may mutually reinforce the short-term orientations of stakeholder and lend them a systemic character.

This report to the Glasshouse Forum will outline a theoretical framework for understanding short-termism and its relation to corporate governance. Social scientific approaches to short-termism have been hindered by a number of conceptual, methodological, and empirical barriers. This report will review the existing literature on short-termism, but also seek to reinterpret these debates within the context of corporate governance, where managers, shareholders and other stakeholders may have different and sometimes conflicting time horizons for making economic decisions. This report suggests that short-termism is caused by a self-reinforcing and dynamic calibration (shortening) of time horizons produced through the interactions between shareholders and managers, and amplified by several roles played by gatekeepers in mediating these relationships. This relational character of the short-termism phenomenon helps explain why it is both hard to measure, and difficult to address through simple policy instruments aimed exclusively at one stakeholder group.

The report will proceed as follows: Section 2 of the report defines short-termism in relation to intertemporal choices, drawing on economic and other social scientific approaches. Section 3 looks at the time horizons of key stakeholders, including managers, different types of shareholders and gatekeepers. Section 4 brings these elements together into a single framework for studying short-termism as a corporate governance issue. We interpret short-termism as an intertemporal agency conflict, where different actors may have different time horizons but mutually adjust or “calibrate” their expectations with regard to each other. Section 5 concludes with the implications for potential public policies and corporate practices aiming to reduce short-termism.

2. What is Short-termism?

“Short-termism” is a ubiquitous term, but has received surprisingly little critical academic scrutiny. Everyday usage often describes short-termism in terms of its causes or consequences, such as when impatient capital markets lead to underinvestment in R&D. Yet it remains difficult to precisely define what short-termism is and undertake rigorous empirical analysis. This section will show that despite the strong consensus over basic definition of short-termism as a suboptimal decision favoring short-term gains over long-term rewards, researchers do not agree on how to empirically demonstrate the sub-optimal nature of such decisions. Despite a large body of suggestive evidence and policy debate, this section aims to explain why the social scientific foundations of the short-termism debate remain relatively underdeveloped to date.

2.1 Definition

Short-termism arises in the context of *intertemporal choice*, where the timing of costs and benefits from a decision are spread out over time (Loewenstein and Thaler 1989). The survival of a firm often depends on achieving short-term results (Merchant and Van der Stede 2003), and ideally these actions will extrapolate into positive long-term performance. However, in many situations, the course of action that is best in the short-term is not the same as the course of action that is best in the long-run. Actors may suffer from *myopia* when they have difficulty of assessing long-term consequences of their actions (Marginson and McAulay 2008). But arguments regarding short-termism go a step further in claiming that decision making or behaviour of certain actors are *demonstrably suboptimal*. For example, Marginson and McAulay (2008) define short-termism as “a preference for actions in the near term that have detrimental consequences for the long term”. Similarly, Laverly (1996) states: “I characterize economic short-termism as representing decisions and outcomes that pursue a course of action that is best for the short term but suboptimal over the long run.” Most literature on short-

termism thus agrees on the basic idea – by emphasizing the short-term, individuals or organisations either sacrifice or forgo potentially greater long-term value.

Despite basic agreement on the concept of short-termism, different authors have applied the idea in relation to different sets of actors. Whereas some see the causes of short-termism in managerial behaviour, others focus on investor orientations. Narayanan (1985) defines short-termism by assuming a manager who has to make a decision between two investment strategies A and B. The net present value (NPV) of A is lower than that of B but A produces positive cash flows earlier than B, and the manager will opt for A despite the fact that it is clearly inferior from the long-term view. Here short-termism reflects a suboptimal decision made by a manager. Narayanan argues that managers may make decisions “sacrificing the long-term interests of the shareholders” and thus links short-termism to the agency problems between shareholders and managers.

Yet similar arguments apply to investors. In his study of the UK stock market, Miles (1993) explored “the hypothesis that in the Anglo-Saxon economies the interaction of financial markets with managerial decision making results in a suboptimal level of long-term investment”. Managers face pressure from financial markets to make an inferior choice by not investing sufficiently in long-term projects. Dickerson et al (1995) similarly focuses on the financial system’s influence, but gives a broader description: “companies cut expenditure on items such as R&D, training, capital expenditure and other factors which might improve longer-term economic performance in order to maximize current profits and hence dividends.” Here shareholders may have short-term preferences and reduce long-term investments to raise dividend payments in the present. This again reflects agency problems, since shareholders fear that managers will “consume” these funds rather than invest them and therefore may demand short-term returns.

2.2 Challenges in Studying Intertemporal Decision Making

While the definition of short-termism is intuitively clear, the study of short-termism has remained underdeveloped. Finding the “right” model for understanding short-termism is not straightforward due to a number of fundamental conceptual challenges. Economists have usually conceptualized short-termism in relation to models of discounted utility (DU). Here economic actors face an optimization or maximization problem, but choose a project that is demonstrably “wrong” in relation to a baseline model. Actually defining such a baseline has proven quite difficult for at least four inter-related reasons:

Time preference: Economic models of decision making rightly assume discounted utility of future rewards.² But no theoretical criteria have been established for assessing whether a particular actor discounts the future “too much” and thus give some proportionately greater weight to cash flows that occur closer to the present (Dobbs 2009, p.127).

Time horizon: Most studies assume actors’ preferences to be consistent over time, and thereby do not look at how actors define their own time horizons. While some studies consider two years as an empirically useful rule of thumb for distinguishing the short-term from the long-term (Tonello 2006), this benchmark is somewhat arbitrary. Time horizons for assessing future returns may be different between managers and investors, or between different groups of investors (Hasty and Fielitz 1975). Likewise, stakeholders may have a long time horizon in mind, but divide up a long period into short intervals that are applied to particular investment decisions (Garmaise 2006).

²) The discount rate is defined in terms of the relative weight someone attaches, in period t , to their well-being in period $t + k$.

Model of valuation: Many studies criticize project assessment methods based on net present value, where expected cash flows are discounted by the opportunity cost of holding capital from now (year 0) until the year when income is received or the outgo is spent (Demirag 1998). While the DU model assumes that the discount rate should be the same for all types of goods and categories of intertemporal decisions, new findings in behavioural economics show that gains are discounted more than losses, small outcomes more than large ones, and improving sequences over declining ones (Kahneman and Tversky 1979).

Uncertainty: Actors may behave myopically or make risk-averse decisions to avoid uncertainty about the future. As the time horizon for decision making extends into the future, the scope of uncertain situations increases. The interdependence between uncertainty and time horizons lead actors to care about when events occur – hence, these two factors are nearly impossible to separate outside of controlled experimental settings. Frederick et al. (2002, p.382) argue that “because of this subjective (or ‘epistemic’) uncertainty associated with delay, it is difficult to determine to what extent the magnitude of imputed discount rates (or the shape of the discount function) is governed by time preference per se, versus the diminution in subjective probability associated with delay”. Or as Baz et al (1999, p.279) argue, “the perception of long-run risk can be hard to isolate from the decision-maker’s concern for the early (or late) resolution of uncertainty when externalities prevails”.

2.3 Extensions and Alternatives

Short-termism may be perfectly “rational” within the framework of economics, provided that we assume an “appropriate” discount rate. Alternatively, cognitive approaches in psychology and behavioural economics offer a variety of new tools and models for understanding intertemporal decision making. These approaches are not

based strictly on the idea of optimization but seek to understand *ecological rationality*. Decisions may be ecologically rational if they work effectively in particular types of situations (Gigerenzer 2007; Todd and Gigerenzer 2007). Rather than attributing short-termism to individual-level psychological factors leading to irrational behaviour (see discussion in Lavy 1996), this approach focuses attention on the organisational-level factors that influence how the time horizons and preferences of individuals are created and reinforced within particular settings. While no unified alternative model exists for studying intertemporal choice, we can find some important insights for understanding short-termism:

First, time preferences reflect a variety of heterogeneous situational motives that cannot be summarized by a single discount rate (Frederick et al. 2002). For example, actors place different levels of utility to the future based on the impulsive nature of their decisions, different capacities to commit to planned future actions, or different inhibitions or sets of social constraints (Loewenstein et al. 2001).

Second, preferences may be inconsistent over time (Caillaud and Jullien 2000). For example, we may choose to go to the gym tomorrow rather than today, but we change our mind when tomorrow actually comes. In particular, future income is likely to be undervalued if it requires sacrifices in the present.³ This insight underlines the importance of mechanisms for commitment to prevent actors from making short-term decisions and protecting “the goose that lays the golden eggs” (Laibson 1997). Conversely, “keeping options open” (Dore 2000) may lead actors to undervalue long-term future assets.

3) People generally prefer smaller and sooner payoffs to larger and later payoffs when the smaller payoffs are in the immediate present. But this preference changes if the choice is between alternatives that are both relatively distant. For instance, when offered the choice between US\$50 now and US\$100 a year from now, many people will choose the immediate \$50. However, given the choice between \$50 in five years or \$100 in six years, almost everyone will choose \$100 in six years, even though that is the same choice seen at five years’ greater distance (Caillaud and Jullien 2000). This type of complex discount function is examined under the label of hyperbolic discounting.

Third, actors may value different categories of goods or outcomes (e.g. gains vs. losses) differently based on certain rules of thumb or heuristics (Shelley 1993). Decisions are influenced by framing effects, either related to habits (Tversky and Kahneman 1991; Wathieu 1997) or the expectations of others. These heuristics reflect different sets of interests, perceptions of value or aspiration levels – for example, managers may place more value on long-term results than investors do or vice versa (Blanchet-Scalliet et al. 2008).

Fourth, organisational mechanisms may help actors reduce or cope with uncertainty by generalizing from old to new situations (Todd and Gigerenzer 2007). If better options may emerge in the future, how can actors decide when to stop their search and stick with a current choice? Here the satisficing heuristic may be relevant (Simon 1955), since actors may stop search for alternatives as soon the level of past aspirations is met. Rather than optimizing future utility based on all available information, people may value projects in more relativistic and past-oriented terms.

Figure 1 summarizes and contrasts the traditional economic and more ecological approaches to short-termism. Economics has faced problems in identifying benchmarks for the optimal level of discounting future utility due to its reliance on a single discount rate, assumptions about the consistency of preferences, the problems in defining a “correct” valuation model, and incorporating issues of uncertainty, risk and asymmetric information into intertemporal decision making. Consequently, scholars continue to debate whether short-termism is a real phenomenon and how one would go about defining or measuring it. Meanwhile, newer approaches grounded in ecological rationality draw attention to the more situational motivations of actors toward time, the potential inconsistency of preferences over time, the importance of real world decision making heuristics, and finally the social mechanisms for actors to orient their actions in time. Commitment (Meyer and Allen 1991), trust (Luhmann 2000) and reputation (Burt 2005; Kim 2009) may all be relevant organisational factors that help actors overcome uncertainties and act “as if” the behaviour of others was certain.

Figure 1: *Alternative Frameworks for Studying Intertemporal Choice*

	Short-termism as optimization problem	Short-termism as ecological rationality
Time preference	Single discount rate	Situational motivations towards time
Time horizon	Consistent preferences across the time horizon	Inconsistent preferences across the time horizon
Valuation model	“Correct” valuation model defined by observer	Various decision heuristics used by actors
Actor orientations to reduce uncertainty	Myopia, Risk aversion	Commitment, trust, habit, governance

2.4 Methods and Measurements of Short-termism

Empirical studies of the time horizons of corporate stakeholders remain surprisingly scarce. Policy makers often cite the increase in stock market turnover or shortening tenures of managers as evidence of a trend toward more short-term decision making. While intuitively useful, these measures are indirect at best. For example, using figures on stock market turnover to infer average holding times of stock does not allow one to infer the actual distribution of holding periods. Thus, it is difficult to conclude whether rising turnover is driven by increase in speculative trading only or whether institutional investors are actually reducing the number of longer-term investments. Still, more detailed research on equity holding periods would be a useful step forward. Other approaches rely on survey evidence where managers give information about their orientations on a self-reporting basis. Interestingly, these studies tend to find very strong evidence of short-term bias.

The harder issue remains: establishing whether short-term decisions are actually detrimental to long-term value creation. This question is often a counterfactual one in the sense that once a short-term decision is taken, we cannot know the possible effect of a different, longer-term decision. Thus, most studies adopt indirect proxies of either short-term or long-term decisions (see Appendix 1). Short-

term orientations are often proxied by the earnings restatements by corporations, which reflect overly aggressive accounting practices and overestimation of short-term profitability. This literature links variable or equity-based forms of executive compensation with the increased propensity of firms to engage in earnings management and earnings restatements, thus showing some suggestive evidence of short-termism. Restatements reflect earnings that were overstated, and reflect short-termism by managers, who apparently have chosen an investment strategy that has a faster payoff in order to inflate earnings. Still, other cases of short-termism could easily be missed since these decisions need not lead to earnings restatements. Consequently, using earnings restatements as a proxy for short-termism is only indicative at best.

Long-term orientations are usually studied by examining the rate of investment in R&D under the assumption that R&D expenditure is long-term in nature, imposing a short-term cost but enhancing profitability only months or usually years later. R&D may also be inherently risky in the sense that future benefits are uncertain. To the extent that firms invest in R&D or investors hold shares in firms with higher levels of R&D, managers and investors can be said to have a long-term orientation.⁴ While R&D is a useful proxy of long-term orientation, this measure is incomplete. In their case, R&D is the focal point of their operation so it is unlikely that managers would choose to reduce it in favour of other investments with faster and more certain payoff. Other long-term drivers of value may not be picked up (e.g. employee skills, corporate reputation, etc.), and these investments may be at least equally relevant. Likewise, the salience of R&D as a key measure may differ across different types of firms and industries. For example, pharmaceuticals firms would be unlikely to cut R&D, but may take other short-term measures.

3. Short-termism as a Problem of Corporate Governance: An Actor-Centred Approach

The previous section discussed the very fundamental challenges faced by scholars in measuring and documenting short-termism. The

absence of a commonly accepted benchmark by which short-termism can be identified and estimated presents a serious obstacle in verifying its existence. Our analysis attempts to overcome this obstacle by shifting away from the usual question of “how short is too short” (optimization) and asking a related but distinct question: “why do corporate stakeholders favour the short or long-term” (governance)? By examining the interaction between stakeholders with distinct time preferences, we do not claim to have resolved the debates over existence of short-termism. Rather, we hope to identify clearly and focus attention on the mechanisms that trigger changes in time horizons of key players from the perspective of corporate governance.

While myopic decisions may be due to natural cognitive limits in the face of uncertainty, these decisions may compound into “short-termism” if such decisions are taken repeatedly and become institutionalized. Short-termism thus reflects a systematic character of decision making within an organisation shaped by organisational culture, processes, or routines (Laverty 2004). In seeking to understand these organisational features, here our focus is on how corporate governance shapes intertemporal choices within the organisation (e.g. affecting time preferences, time horizons, heuristics, or uncertainty as discussed in Section 2). Corporate governance involves the rights and responsibilities of actors with a stake in the firm (Aguilera et al. 2008; Aguilera and Jackson 2003). Our actor-centred framework (Scharpf 1997) will focus on three broad categories of actors: managers, various types of shareholders, and “gatekeepers”.⁵

4) Other conceivable measures might include other long-term investments such as spending on employee training or the propensity to retain staff during economic downturns.

5) Atherton, Lewis, and Plant (2007) examine short-termism in relation to three links in the investment chain: between individual and institutional investors, investors and managers, and analysts.

3.1 Professional Managers

Managers occupy positions of strategic leadership in the firm and exercising control over business activities. Managers may make myopic decisions for a variety of reasons. Miller (2002) explains that “managerial myopia indicates cognitive limitations in relation to the temporal dimension of decision making, and, at the extreme, analyzes the implications that arise when decision makers find themselves without the necessary information to assess even the present state.” The discussion of “faulty decisions” by managers (Laverty), “cognitive limitations” (Miller), and the “difficulty in assessing” (Marginson and McAulay) stress the informational aspects of decision making—managers may be unable to correctly assess and appraise investment projects. Indeed, Laverty (2004) shows that managers are less short-term oriented when they have better information about the tradeoffs between short- and long-term results. In short, managers may be myopic and make faulty project evaluations, but this does not in itself constitute short-termism.

As an alternative approach to short-termism, our framework seeks to specify organisational mechanisms that shape the identities and interests of managers toward a short-term orientation in a systematic way. First, borrowing from stewardship theory, we examine whether managers’ *professional orientations* reinforce short- or long-term time horizons by influencing their relative autonomy or commitment to the firm (Davis et al. 1997). Professional orientations are an element of wider managerial ideologies, and thus derive from the cognitive toolkits for solving managerial problems and efforts to legitimate authority in different historical times and places. Second, the *financial and career incentives* of managers may also influence time horizons. Such incentives are shaped by executive compensation practices and labour markets for top executives. We argue that these two dimensions of management are influenced by a variety of institutions, constituting the complex “social world” of management (Aguilera and Jackson 2003). In **Figure 2**, we posit that different combinations of professional orientations and incentives may lead to self-reinforcing long-term time horizon, wherein the manager acts as a steward of long-term interests. Conversely,

incentives and orientations may lead managers to act as opportunists, who pursue short-term opportunities with little regard for future consequences. However, some combinations may also lead to institutionalized forms of “role conflict”, such as when long-term professional orientations are threatened by short-term incentives or where short-term orientations may be incompatible with long-term incentives of career development.

Figure 2: Managerial Time-Horizons

		<i>Incentives</i>	
		Short	Long
<i>Professional Orientation</i>	Short	- “manager as opportunist”	Role conflict
	Long	Role conflict	+ “manager as steward”

Professional orientations of managers. The professional orientations of managers may be described in terms of managerial ideology: “the major beliefs and values expressed by top managers that provide organisational members with a frame of reference for action” (Goll and Zeitz 1991, p.191). Ideologies allow managers to legitimate their authority and decisions toward other stakeholders (Bendix 1956). But ideologies also shape the perception and framing of organisational problems through taken-for-granted cognitive templates and toolkits for decision making (Guillén 1994). Ideologies may become institutionalized through mimetic processes of diffusion (e.g. managerial education), normative processes (e.g. establishment of professional groups), or coercion (e.g. state regulation) (DiMaggio and Powell 1991). Managerial ideologies are complex historical constellations of ideas and interests. How do managerial ideologies shape the time horizons of managerial decision making?

Different time horizons are embodied in the *decision heuristics* or *investment appraisal practices* adopted by managers. Short-termism may result from the application of faulty or biased methods for assessing investment projects (Laverty 1996). Most measures

that rely solely on financial data lead to underestimating the intangible payoffs, such as from trained employees or reputation (Atherton et al. 2007). Survey evidence also shows how the use of certain valuation practices like net present value models may lead to short-termism, not only due to the omission of non-financial returns but also through the use of excessive discounting, which undervalues cash flows that accrue further in the future (Lefley and Sarkis 1997).

While a large literature in psychology has examined decision heuristics as an individual phenomenon, at a broader organisational-level, we argue that decision heuristics as cultural artefacts are closely linked to managerial *experience and education*. For example, more experienced managers may be less tempted to prefer short-term decisions since their knowledge and skill may lead them to greater appreciation of the consequences of focusing on quick returns at the expense of long-term performance and potential future rewards (Narayanan 1985). Thus, different forms of managerial expertise may influence the ability or willingness to assess a long-term investment and avoid managerial myopia (Marginson and McAulay 2008; Miller 2002). In particular, managers' understanding of "extra-financial" assets and risk factors is likely to influence their propensity to be myopic (Atherton et al. 2007). Conversely, to the extent that managers are oriented to stock prices, Liu (2005) finds that they may behave myopically due to "managers' effort to achieve a high stock price by inflating current earnings at the expense of the firm's long term interest, or intrinsic value. Managers can inflate current earnings by under-investing in long-term intangible assets." Managers' focus on stock prices is closely related to the perception that investors are focused largely on short-term (quarterly) earnings estimates. Hence, managers may adjust their time horizons to their perceived views of investors (Demirag 1998; Grinyer et al. 1998; Marston and Craven 1998).

Looking at the USA and Britain, several studies document the long-term change in managerial ideologies toward the paradigm of shareholder-value (Lazonick and O'Sullivan 2000). One important factor here concerns *managerial education*. American managers typically receive education in "general" management, with a strong

emphasis on finance. In particular, the rise and expansion of MBA education has been linked to the dominance of the "financial conception of the firm" and its focus on shareholder returns (Fligstein 2001; Khurana 2007). The diffusion of shareholder value as management ideology in the last decade is widely considered to have reinforced the short-term focus of managers on quarterly earnings and associated practices such as share buy-backs that aim at changing short-term stock prices (Lazonick 2007).

Finally, a growing trend in board composition around the world regards the role of independent or *outside directors*. This shift from an "advising" to a "monitoring" board has been part of a long-term shift in corporate governance toward shareholder value as a dominant corporate ideology (Gordon 2007). While independent directors are encouraged to increase the accountability of managers, outside directors may simply lack the amount and quality of information that insiders have. The information available may be too dependent on formal disclosure, too focused on finance rather than strategy and operations, and hence prone to undervalue long-term future projects. Conversely, other studies have found effective evaluation of top managers may be associated with a majority of inside directors (Hill and Snell 1988; Hoskisson et al. 1994) or participation of other stakeholders such as employees in the board (Addison et al. 2004). For example, some studies on Germany suggest that employee representation on boards results in higher capital market valuations due to the fact that employees have strong inside knowledge of company operations that aid in the monitoring of management (Fauver and Fuerst 2006).

Financial and career incentives of managers. Managers have their own objectives and ambitions as individuals. In particular, the time horizons attached to incentives (or lack thereof) through executive compensation schemes or within managerial labour markets shape the extent to which short- or long-term corporate strategies will translate into higher individual income. This subject has received a lot of attention within the corporate governance debate. Although agency theory suggests that incentive schemes are needed to align managerial incentives with those of shareholders, the structure of

executive compensation schemes may also cause short-termism. For example, opportunistic managers may reject long-term investment projects, crucial for the future welfare of the firm, in order to concentrate on other short-term alternatives whose earlier payoff boosts allows them to maximize their own monetary incentives (Lavery 1996). Managers may also exhibit moral hazard, pursuing investments with faster payoff, either because it was a less risky option in the short-term or due to insufficient long-term incentives.

The adoption of more sophisticated, variable or equity-based *executive remuneration schemes* has been advocated as a means to solve agency problems by giving managers proper incentives to improve good corporate performance. However, the nature of the reward can influence a manager to follow a short-term investment strategy by creating excessive incentives on short-term results or failing to focus on performance metrics reflecting long-term value creation or sustainable strategies of growth. For example, a survey of UK, US and German manufacturing firms show that packages that include shares, option and any kind of profit-related scheme are connected with a higher probability of short-term orientation relative to other types of schemes (Coates et al. 1995).

Criticism of executive pay is not new in itself, but a new wealth of evidence has accumulated to suggest that executive pay is itself a core problem of contemporary corporate governance (for the most comprehensive critical assessment, see Bebchuk and Fried 2004). The core argument is that executives have a substantial influence over their own salaries, and have used this power to weaken the link between pay and performance. For example, recent studies have shown that the size of stock options outstanding had a very strong influence on the prevalence of earnings restatements (Denis et al. 2006; Efendi et al. 2004). Other recent studies of earnings management suggests that executives with unexercised stock options were more likely to manage real earnings management through abnormal changes in cash from operations, production costs, or discretionary expenses such as R&D (Cohen et al. 2008). Thus, a number of authors now closely link the problems surrounding gatekeeper failure to the growing incentives of managers to inflate short-term earnings. Even advocates of share options, such as Michael Jensen,

have started telling executives to “just say no” to Wall Street, and criticized managers’ focus on short-term earnings games (Fuller and Jensen 2002). Other studies show that the relative talents of CEOs have little influence of stock market capitalization, which are driven by firm size and market sentiment (Kolev 2008; Tervio 2008). The money paid to attract “top” executives doesn’t improve market returns relative to the “less talented” and cheaper executives (Wyld and Maurin 2008).

The career patterns of managers have a strong influence on the time-horizon of decision-making. One aspect concerns the prospect of job turnover. *Managerial turnover* describes situations where a very high probability exists that managers change jobs quickly and frequently. High turnover may prevent the building of long-term trust relationships and weaken social bonds (Webb 2004), thus undermining the importance of reputation, norms of collegiality, and other social devices for increasing commitment of people to the long-term future of the firm. If managers change positions often, they are more likely to choose short-term projects over long-term ones. For example, Palley (1997) found that high turnover leads managers to invest only in short-term projects in order ensure that the rewards take place while they are still in the firm. This strategy discounts the risk of having lower or even no return in the long-term, should they have stayed at the same company. Conversely, if managers have the possibility of longer job tenure, they are more likely to pursue some long-term projects, possibly to diversify against this risk.

A related factor that may exacerbate or mitigate the problem of managerial turnover is the *duration of the employment contract*. Short duration contracts may be associated with high job turnover, but may also enhance uncertainty and focus managers on the short-term even in cases where short-term contracts are regularly renewed. The longer the contract duration is, the more benefit managers have from long-term projects and less incentive to exclude them in favour of short-term ones (Narayanan 1985). Frequent job change or contract renewal places managers under pressure to demonstrate concrete results in order to establish or maintain their reputation.

3.2 Shareholders

Many studies suggest that shareholders may put too much value on short-term firm performance and push managers to inflate performance measures or alter strategy even if it is harmful for the company in the long run (Chaganti and Damanpour 1991; Hansen and Hill 1991; Kochhar and David 1996; Samuel 2000). Studies of institutional investor myopia typically examine whether higher levels of institutional investor ownership are associated with outcomes such as corporate R&D investment, which act as a proxy for long-term investment (Bushee 1998; Hansen and Hill 1991). Yet while some studies find evidence of short-termism, other studies find that institutional investors promote R&D, engage in monitoring, or improve the market value of firms with good future prospects but low current profitability (Davis 2002).

These mixed results suggest the need to differentiate between different categories of shareholders, and develop a more complex understanding of investor behaviour (Aguilera et al. 2008; Aguilera and Jackson 2003). While some institutional investors are quite sophisticated and potentially long-term, other transient investors with high turnover are associated with lower R&D and focus on short-term earnings (Bushee 1998, 2001; Liu 2006).

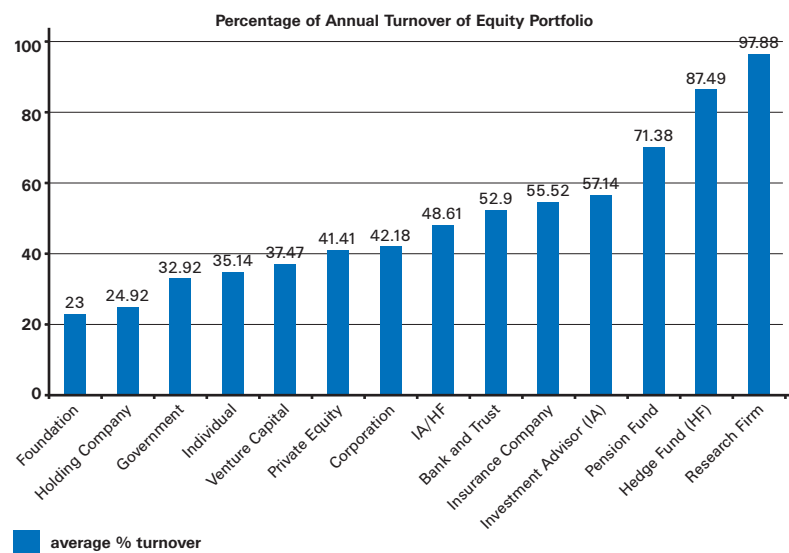
Figure 3 shows the percentage of turnover within the equity portfolios of various UK based investors in the year 2007. Foundations, holding companies, government and ordinary individuals hold shares for 3 to 4 years on average. Notably, private equity and venture capital firms also fall toward this longer-term end of the spectrum, since they require a certain amount of time to take firms profit, implement restructuring and resell (or conversely, make initial investments leading to an IPO). By contrast, pension funds and hedge funds have very high levels of turnover in the range of 70 to 90 per cent per year. Pension funds have diversified portfolios and a high number of stocks in their portfolio. Hedge fund strategies are more heterogeneous and complex, as shall be discussed below. But a high proportion of funds engage in long-short strategies with very short investment horizons in effort to capture arbitrage gains.

Meanwhile, other institutional investors fall in the intermediate

range at around 50 per cent turnover per year. Mutual funds (here investment advisors) are predominantly perceived to be short-term investors. Due to their high liquidity requirements and strong focus on quarterly earnings, mutual funds tend to avoid shareholder activism (Ryan and Schneider 2002). Mutual fund ownership is also negatively correlated with corporate social involvement (Cox et al. 2004; Johnson and Greening 1999). Mutual funds have a preference for external innovation involving visible changes to the company structure, rather than more incremental forms of internal innovation (Hoskisson et al. 2002). Meanwhile, life insurance companies are sometimes seen as longer-term investors with relatively high engagement in corporate social responsibility (Brandes et al. 2006; Cox et al. 2004). Still, life insurance firms tend not to engage in shareholder activism (Ryan and Schneider 2002). Finally, banks in many European countries are among the most stable form of investor concentrated on enhancing long-term value (Black 1992). Yet UK banks also have similarly low levels of activism as other institutional investors (Ryan and Schneider 2002).

Despite this variation, the long-term trend suggests a very strong rise in overall stock market turnover. Looking at the New York Stock Exchange, the percentage of institutional investor ownership has increased three-fold from 20 per cent in 1980 to over 60 per cent today. Likewise, levels of turnover have expanded from around 30 per cent to nearly 100 per cent of stock market capitalization during the same period (Windolf 2009). This result implies either that the average holding period of stocks has declined dramatically or at least that the volume of very short-term speculative trading has increased in relation to overall stock market value.

Figure 3: Portfolio Turnover, by UK Investor Type



Myopic behaviour by shareholders may be a rational reaction to high risk or uncertainty (see Section 2). Indeed, the securitization of certain assets may help increase the supply of long-term capital to the extent that short-term liquidity increases – the stock market allows various short-term investors to come and go, but capital still remains available to the corporation for long-term productive investment (Windolf 2008). Not all cases of rapid trading or even myopia lead to short-termism at an institutional level. Hence, our approach is to identify organisational mechanisms that influence investors’ identities or interests in ways that favor short-term time horizons. Here Figure 4 presents a similar framework as our analysis of managerial time horizons by considering the following two factors: the organisational orientation toward different time horizons and the incentives for short- or long-term strategies within those horizons.

Figure 4: Shareholder Time Horizons

		Incentives	
		Short	Long
Organisational Orientation	Short	- “Impatient capital” Hedge funds	Role conflict Pension funds
	Long	Role conflict Private equity, some hedge funds	+ “Patient capital” Family owners, commercial banks

Organisational orientation. Although earlier research focused on institutional investors in general (Hansen and Hill 1991; Kochhar and David 1996), various types of shareholders have very different types of orientations. Institutional investors adopt a variety of organisational forms in response to different regulation, and different objectives of their principles. As collective actors, institutional investors are themselves constituted as organisations with their particular structure, governance, and regulations. These organisational and broader institutional factors result in distinct investment strategies (Bushee 1998; Dong and Ozkan 2008; Liu 2006). What factors shape the orientation of investors to the short vs. long term?

A first dimension of investor orientation concerns *whether shareholders engage with the firm as owners, or whether they are essentially traders of stock* (Hendry et al. 2006).⁶ Traders may pursue a variety of investment strategies and have heterogeneous portfolios, but they have in common the focus on predominately financial criteria for their investment and aim to make gains on the trading of stock. Meanwhile, owners refer to shareholders having some strategic motivations in exercising control over company decision making, such as in the context of restructuring, family control,

⁶ Elsewhere, a similar distinction is used between the strategic and financial interests of owners (Aguilera and Jackson 2003).

inter-firm business networks, and so on. Put another way, trading represents a preference for exit as a response to organisational decline, whereas ownership suggests the exercise of voice as a way to alter the course of the organisation and thus share in the responsibility for future outcomes. Yet as Hirschman (1972) pointed out, the choice between exit and voice is mediated by the degree of loyalty – and hence related to the organisational identities of shareholders.

In distinguishing between owners and traders, we examine shareholders' involvement in corporate governance. Black (1992) suggests that a “concern related to institutional competence [in corporate governance] involves the institutions' time horizon... short-sighted institutions won't do much monitoring because the payoff from oversight is long-term.” In other words, organisational commitments to ownership based on engagement or voice in corporate governance are likely to reflect or be mirrored in long-term orientations in investments. Hence, Black (1992) argues further:

part of the promise of institutional voice is that it may reduce shareholder and creditor myopia. Enhanced voice may improve information flow, and thus enable shareholders to rely less on short-term earnings as a signal of long-term value. Greater ability to engage in monitoring may also make institutions more willing to be long-term investors. Weak institutions have little choice but to vote with their feet for a takeover bid at a reasonable premium to market.

Most research assumes or implies that more involvement in corporate governance issues and longer holding periods characterize “better” policies and may limit short-termism.

Another related aspect of investor orientation concerns their *organisational capacity to evaluate and monitor firms*. Kochhar and David (1996) find that “[short-term] investors may lack access to proprietary firm-specific information, and therefore find it difficult to evaluate the long-term value of a firm. Instead, they may focus on performance measures, like current earnings, that are easily quantifiable. Thus, they behave like arbitrageurs to ‘churn’ or frequently turn

over their portfolio of stocks in order to capitalize on all possible short-term gains”. Shareholders may focus only on short-term benefits to the extent that they lack information or have troubles quantifying intangible (human and other) assets, thus giving too much weight to measures of return that refer to a relatively short-period of time. If the reported return is low, they reshuffle their portfolio. Bushee (1998) identifies a group of “transient” investors who hold a diversified portfolio and high trading turnover, who exhibit this behaviour. Likewise, the lack of long-term engagement of shareholders may be related to *conflicts of interest*, as in case of corporate pension funds (Davis and Kim 2007).

Investment orientations are also influenced by the *decision heuristics* and valuation methods used to appraise the firm itself within the stock market. Stock market evaluation is often argued to be short-term when a too high discount rate is used for medium- and long-term cash flows, thus “underweighting” their importance (Black and Fraser 2000; Miles 1993).

Investment incentives. What situations create incentives for investors to realize short-term gains and externalize the costs of sacrificing longer-term gains? Incentive problems may arise because the *delegation* of investment decisions results in conflicts between principles and the *personal incentives of agents*. Even if an investor prefers a long-term orientation, actual investment decisions may be made by fund managers within the organisation or contracted out to external fund managers in different organisations. Incentives may be given to fund managers that shorten time horizons or fail to reward long-term investments in an effort to control or monitor these managers. In studying institutional investors, Hansen and Hill (1991) argue that the myopic institutions behaviour arises because “institutional fund managers are under considerable pressures from their superiors to perform. When they make decisions they respond to organisational pressures and their own desires for job security and advancement. This translates into risk aversion and short-run focus”. Similarly, Chaganti and Damanpour (1991) find that “institutional money managers cannot afford to take a long-term view because their performance is evaluated frequently”.

A related situation arises where the intermediation of investment leads to agency problems between the principles bearing ultimate risks for an investment and the *organisational incentives of agents*. The rise of financial services has led to a growing amount of intermediation, where investment advisors manage “other people’s money” and has become detached from risk taking (Windolf 2008). Fund managers chase high rates of return due to the competition with other fund managers to gain and retain clients’ business. With high returns also comes greater risk, and hence the long-term value creation of the firm is likely to be undervalued. While beyond the scope of this report, the growth of derivatives and options market have increased the ability of financial institutions to originate and distribute liabilities without bearing the ultimate risks, thereby raising new questions about the relationship between new financial instruments and short-termism.

3.2.1 Mapping the different types of institutional shareholders

Using the two dimensions of organisational orientation and investment incentives enables us to map and compare certain types of institutional shareholders. Taking into account the form and operational purposes it should be possible to indicate whether a particular type will be more prone to act short-termistic. Among the diverse group of institutional shareholders we concentrate on pension funds, private equity, and hedge funds. Not only is there extended research on these types but their role in society and how they should be regulated is also a focal debate point.

Pension Funds. In theory, pension funds should have a long-time horizon since their liabilities to members occur in the long-term and thus create incentives to improve their portfolios’ long-term value. Often it is claimed that pension funds cannot exit their investments by selling large blocks of stock (Pound 1988). Some evidence does exist for the long-term focus. First, pension funds may be focused on long-term innovation. In their study of shareholding patterns and innovation, Hoskisson et al. (2002) find that pension fund managers

are likely to have a longer-term orientation and emphasize internal innovation. Other studies also link pension fund ownership with long-term changes in corporate strategy promoting internationalization (Tihanyi et al. 2003). Second, pension funds may be more involved in corporate social performance (CSP) than other types of investors, reflecting a high degree of commitment (Johnson and Greening 1999). Other studies find that long-term institutional investment is positively related to adoption of socially responsible business practices (Cox et al. 2004). The authors argue that “the benefits of CSP accrue in the long run while much of the investment takes place in the short run”. Accordingly, one would hardly expect short-termistic investors to engage in CSP. Consequently since pension funds are long term institutions and promote more CSP, they are less likely to be short-termistic. Third, pension funds are widely thought to be activist shareholders and have high levels of engagement in corporate governance (Ryan and Schneider 2002; Woidtke 2002). For example, long-term investors were found to encourage stock option expensing, which raises short-term costs to the firm but increase long-term sustainability (Brandes et al. 2006).

Yet pension funds experience a number of role conflicts, as some elements of their organisation create rather short-term orientations. Pressure-resistant funds are largely limited to public sector pension funds, such as CalPERS, or funds with strong union control. But even among these funds, the degree of activism varies widely and does not generally extend to core issues, such as nominating directors (Choi and Fisch 2008). Survey results show that while a majority of funds do engage in low cost forms of activism (e.g. participating in corporate governance organisations, writing comment letters to the SEC or withholding votes), over 80 per cent never sponsor or solicit proxy votes on shareholder proposals, roughly 88 per cent have never created focus lists for activism, and 90 per cent never nominate names of director candidates (Choi and Fisch 2008). Only 11 per cent of funds engaged in activism to fulfil fiduciary duties or pursue the public interest.

Additionally, pension funds are not immune to principal agent problems. Along the investment chain from the contributors to the trustees to the fund managers, conflicts may arise similar to those

of any organisation. The trustees may focus on the long-term well-being of the fund and protect the interests of the contributors but fund managers may develop the same harmful opportunistic behaviour. This may be particularly true if they are under pressure to present a constant stream of good results, measured by short-term metrics as discussed above (Chaganti and Damanpour 1991; Hansen and Hill 1991; Kochhar and David 1996; Samuel 2000).

Private equity. The topic of private equity investment is highly complex and has been at the forefront of debates over corporate governance in recent years. Private equity firms typically raise money from wealthy individuals or other institutional investors to form funds with specific orientations, often lasting ten years or more (Fenn et al. 1995; Metrick and Yasuda 2008). Private equity funds acquire either new companies with growth potential (venture capital) or mature companies that are underperforming (buy out) to improve performance, add value, and sell them at a higher price. While venture capital is usually considered a patient and long-term style of investment, debate over short-termism stress the role of buy-out funds focused on more mature firms.

Private equity funds usually have an intention to own and operate the acquired firms for some period of time – they are more owners than traders. One European study showed that the average holding period is 5.3 years and only 16 per cent of exit cases occur within two years (Gottschalg 2007). Similarly, among companies acquired between 1980 and 2007 by private equity, 69 per cent were still under private equity ownership in the end of 2007 (Strömberg 2008). Private equity is more actively involved in corporate governance and strategic issues than similar public companies (Acharya et al. 2008). This focus of owners is sometimes even argued to be a reason why private firms are a superior organisational form to public ones (Jensen 1989).

Given the fact that private equity investments have low liquidity and require time to mature, many scholars suggest that private equity will focus on long-term prospects to enhance the market value of the firm when they exit (Acharya et al. 2008; Achleitner et al. 2008; Dai 2007). Yet private equity firms do need to sell their

equity stake at some point in order to realize these gains and the source of these gains remains extremely controversial. While some gains may be due to improved quality of management and better incentive structures, critics argue that private equity is often associated with asset stripping, poor labour relations, and very high levels of debt for the target company. Creating long-term value involves deeper structural changes and longer periods of time. Meanwhile, performance may improve through short-term measures like laying-off employees or lowering fixed costs. However, the loss of qualified employees and assets of high operational importance could be extremely damaging for the firm in the long-run.

Despite many critical analyses of the PE industry, the actual extent of short-term behaviour remains difficult to determine, particularly since PE industry is well known for its secrecy. For example, one study focused on the time orientation of private equity examined the patent applications before and after acquisition and found that firms acquired by private equity don't show any negative change (Lerner et al. 2008). According to the authors "these findings appear inconsistent with claims that private equity firms generate profits by sacrificing necessary long-run investments". Other studies suggest that the statistical evidence for short-termism is inconclusive (Bacon et al. 2009; Wood and Wright 2009). Still, opposing forces act on private equity. On one hand, private equity firms have high stakes of the acquired companies and have thus more incentives to be active in monitoring and add value. On the other hand, private equity firms receive very high fees and face high expectations from other investors to provide spectacular returns, particularly as institutional investor money increasingly flows into private equity funds.

The result is a corporate governance paradox. Private equity firms are highly engaged as owners, yet have very strong incentives to exit within a relatively short period in order to recoup or realize profit on their investment. In fact, the PE business model is based around exit – founders exit via an IPO, top managers exit via golden parachutes, investors exit via M&A premiums, and so on. Private equity firms do make strong financial commitments to the firm, but often contract away these risks by substituting high levels of debt. This approach has some inherent danger of externalizing long-term

costs onto other stakeholders, who remain linked to the firm after private equity exits.

Hedge funds. Hedge funds are often claimed to be focused largely on short-term opportunities for arbitrage rather than long-term fundamentals or strategies of value creation (Dai, 2007). Hedge funds' main purpose is to secure against market risk. While some samples of hedge funds suggest very short-term trading strategies and high turnover (Kahan and Rock 2007), those more activist hedge funds have longer time horizons and holding periods often well over one year (Brav et al. 2008). However, hedge funds pursue a very wide range of other strategies, including classic value investment, thus making it is nearly impossible to generalize about hedge funds without careful qualification of different strategies and types of funds.

One distinctive strategy of hedge funds is *short-selling*, whereby funds borrow stock from other investors for a fee, sell the equity, and hope to buy it back at a lower price in the future. This strategy is designed to generate profits irrespective of market conditions. Another distinctive strategy is *event-driven* trading, where funds attempt to capture value through arbitrage around particular or expected events, such as mergers or restructuring. In this context, shareholder activism is pursued by hedge funds as an explicit profit maximization strategy that differs from the approach of other institutional investors like pension or mutual funds: it is directed at significant changes in individual companies (rather than small, systemic changes), it entails higher costs, and it is strategic and *ex ante* (rather than incidental and *ex post*) (Kahan and Rock 2007). Hedge funds tend to be independent from other financial institutions, and less constrained by conflicts of interest from engaging in activism. Notably, the fee and equity structure of the funds give managers very high powered incentives to engage in activism. Thus, hedge funds occupy something of an intermediate role between less active institutional investors and the strategic control utilized by private equity firms (Brav et al. 2008). However, Fichtner (2008) argues that hedge fund activism often aims to “gear the corporate governance of firms toward the shareholder value model of short-term profit maximization”. Achleitner et al. (2008) likewise argue that: “our findings

indicate that hedge funds buy minority stakes in order to implement measures which mitigate agency problems and hence create wealth in the short run or in order to benefit from merger arbitrage”.

The implications of hedge fund investment for corporate governance remain hotly debated. This debate has been fuelled by the weak regulation, the frequent use of offshore domiciles, and lack of transparency. The key question here is whether hedge funds are inherently short-termist. Bratton (2006) has extensively studied hedge fund activism in corporate governance, concluding that these cases are not driven by short-termism. First, hedge funds collect money largely from large institutions or wealthy individuals, and thus can require commitment of investors' funds for relatively long time periods. Second, hedge funds often take stakes in the range of 5–10 per cent of target firm equity with the aim to strategically influence the policies of the firm. Third, hedge fund activism is highly successful with estimates ranging from some 38 per cent to 60 per cent of cases (see also Klein and Zur 2006). Hedge funds often take a seat on the board or gain other major strategic concessions. The goal of engagement was to force a merger (33 per cent), a sale of substantial assets (33 per cent), or increase the payments of dividends at cash rich firms (40–50 per cent of target firms). Fourth, among his cases, 54 per cent of hedge fund investments were still being held over a year later. The target firms were sold in another 33 per cent of cases, thus ending the hedge fund investment. Only in some 19 per cent of cases did hedge funds exit their investment without a major change in strategy.

Yet it remains difficult to conclude whether these strategies are short-termist. No evidence exists to suggest that target firms are systematically underperforming – on the contrary, some studies claim that hedge funds target firms with above average profitability (Klein and Zur 2006). Nor do we have ample evidence on the long-term development of firms after hedge fund intervention. Some evidence suggests that target firms pay higher dividends and have higher leverage, but no evidence exists that firms cut R&D spending one year after hedge fund engagement (Klein and Zur 2006). Nonetheless, the short time-frame of operations and high portfolio turnover could indicate the possibility of opportunism. Hedge fund

investments have unusually high levels of both risk and return. Despite high abnormal returns to activism on average, these gains have declined over time (Brav et al. 2008; Clifford 2007). Finally, the tactics of hedge funds are often considered aggressive and often use hostile measures to coerce managers into adopting changes. Still, the overall picture remains ambiguous:

Looking at the specific activities of hedge funds, there is often an inherent ambiguity as to whether they sacrifice valuable long-term projects in favor of short term gains. Consider Deutsche Börse's (DB) failed attempt to acquire the London Stock Exchange (LSE) [...] DB's CEO wanted to acquire the LSE and convinced the board that doing so was a good idea. Hedge funds that had acquired large stakes in DB disagreed. They maintained that the plan to acquire the LSE represented wasteful managerial empire building and that DB's cash reserves should instead be distributed to shareholders. Now, if the investment in acquiring the LSE was a valuable long-term project, then the involvement of the hedge funds would have had the effect of pushing the company toward the lower value outcome: an outcome worse for long-term shareholders than acquiring the LSE. If the hedge funds were right that the investment was simply a bad investment driven by delusions of grandeur, their opposition benefited both short-term and long-term shareholders... Short-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism... At the same time, among the problems associated with hedge fund activism, the very existence of a short-termism problem is the least proven, its manifestations – if it does exist – are the most manifold, and potential solutions are the least evident (Kahan and Rock 2007).

In sum, hedge funds engage in a wide range of strategies. Short-selling is short-term oriented by nature, but these strategies may not be myopic in themselves – rather, opportunities for short-selling are created by market inefficiencies including those leading to overvalu-

ation of the firm or other forms of investor bias. Other hedge fund strategies involve longer time horizons and high levels of engagement. Hence, the case for short-termism remains debated.

3.3 Gatekeepers

Coffee (2006) defines a gatekeeper as “a reputational intermediary to assure investors as to the quality of the ‘signal’ sent by the corporate issuer. The reputational intermediary does so by lending or ‘pledging’ reputational capital to the corporation, thus enabling investors or the market to rely on the corporation’s own disclosures or assurances where they otherwise might not”. Gatekeepers in that sense can be securities analysts, credit rating agencies, and auditors – but also extending to other professions such as lawyers or media journalists. These actors provide directed advice to investors, helping to shape expectations, interpret information, and legitimate particular strategies. They also advise managers regarding those investor expectations or other issues.

Gatekeepers play a central, but hitherto neglected role within corporate governance. They occupy a boundary role principally providing information and advisory functions. Yet due to the importance that markets place on this information, gatekeepers play a powerful role within corporate governance by shaping the perceptions and interactions between market actors – managers, shareholders, investors, and in general the public. For example, Healy (2001) finds that gatekeepers, including financial analysts, business press, and rating agencies, significantly affect stock prices by shaping the flow and evaluation of information from corporate disclosure. In the context of short-termism, information asymmetry and uncertainty are key triggers of myopic behaviour and hence short-termism. Gatekeepers have a particular role as informational intermediaries since managers’ private information can be unavailable to the shareholders (Narayanan 1985) and their actions may be partially unobservable (Laverty 1996). Overcoming such asymmetric information problems is important for stakeholders to avoid making suboptimal investments (Dickerson et al. 1995).

Gatekeepers came under a lot of negative criticism with the Enron case. Apreda (2002) writes: “this disgraceful tale of malfeasance uncovered the ultimate actors that should be blamed for: the gatekeepers. They neglected their fiduciary role and damaged the credibility of many institutions and practices either in corporate or global governance.” Bruner (2008) thus stressed the importance of gatekeepers as part of the regulatory framework for financial markets. Windolf (2005) also focused on gatekeepers’ ability to transform uncertainty into risk and thereby provide essential support the operation of financial markets. Whereas entrepreneurial decisions are truly uncertain, analysts and others look at these strategies in terms of risks for investors. However, this can only be done in the very short-term perspective – such as forecasting the profitability of those investments next year and then comparing the results. This “framing” of corporate activity in terms of its short-term risks is one of the major constraining factors whereby financial markets encourage short-termism.

Many gatekeepers are also riddled with various conflicts of interest (Palazzo and Rethel 2007). Some of these conflicts of interest occur at the personal level, where individuals have strong incentives to engage in self-dealing or attempt to favor different clients such as through the use of market timing or spinning of certain stocks. Other conflicts occur at the organisation level, particularly where gatekeepers are cross-selling multiple types of services to similar clients as in the case of audit firms. In the remaining discussion, we deal primarily with the potential of such organisational conflicts of interest to cause short-term orientations.

Securities analysts. Securities analysts collect information, evaluate performance, make forecasts, and recommend that investors buy, hold or sell the stock of the firms they cover. Recent literature has drawn attention to how security analysts are not only passive players within the marketplace, but exert strong power by setting agendas and influencing the cognitive frameworks through which investors evaluate firms. In his pioneering study of U.S. firms, Zuckerman (1999) has shown how low coverage by analysts led to a substantially lower valuation of company stock prices and

discounting of expected dividend payments. An interesting survey by Francis et al. (1997) indicates that quarterly earnings are indeed more important than other company features for analysts. They looked into presentations made by companies to analysts, but show that analysts react much stronger to quarterly earnings than other types of information. Even when presented with details of long-term investment plans, analysts still focus more on short-term results. Analysts tend to ignore “extra-financial” features like human resources, which are very important for the long-term wellbeing of the firm (Atherton et al. 2007).

The lack of demand for long-term information among analysts may lead markets to react too strongly to a missed earnings target with negative consequences for the share price. Several studies have found that the use of quarterly earnings reports increases stock return volatility more likely to undervalue long-term strategies and assets (Bhojraj and Libby 2005; Rahman et al. 2007). So, managers are under pressure to present good short-term quantifiable results, sometimes at cost of long-term investments. Conversely, Zorn and Dobbin (2003) have shown how long-term changes in strategy and structure of American corporations correspond to the changing norms favored by securities analysts, such that “meeting the profit targets of stock analysts became a preoccupation among corporate executives”. Short-termism arises as a self-reinforcing feature where managers may do what they perceive analysts to care about and concentrate their abilities on inflating the quarterly earnings results.

While analysts may generally increase the informational efficiency of markets, at least some empirical studies suggest that analyst evaluations may be strongly biased (Healy and Palepu 2001). Based on a case study of analyst ratings during the “new economy” boom, Beunza and Garud (2004) show how analysts shape the cognitive frames used by investors to overcome uncertainty and justify taking on investment risks based on very new and different models of valuation of IT firms. In a more extensive empirical study, Trueman (1994) demonstrated that analysts’ forecasts do not reflect private information in an unbiased manner. Rather, analysts make forecasts that are closer to prior expectations and more similar to other analysts’ forecasts than what would be justified according to their avail-

able information. This suggests a strong element of herding⁷ among analysts. Another source of bias concerns possible conflicts of interest. In the case of Enron, Healy and Palepu (2003) show how biased analysts played a critical role in perpetuating fraud, particularly due to the conflicts of interest by sell-side analysts connected with investment banking.

Credit rating agencies. Rating agencies are analysts focused on the credibility, and play an important role in market self-regulation. Although the evaluations of ratings agencies play an important role in defining risks and demonstrating compliance with state regulation, ratings agencies are not legally responsible for providing wrong information. Sinclair (1994) discusses how rating agencies have become increasingly important as governance mechanism. Bruner (2008) argues that “rating agencies have power to regulate admission to bond markets and articulate public policy in so doing with no straightforward form of accountability to constrain them”. Conversely, fund managers adjust their portfolios based on judgments of credit ratings agencies (Bruner and Abdelal 2005). Kerwer (2002) stresses that while rating agencies are key “standard setters” and help transform uncertainty into calculable risk, when their analysis is biased they “absorb” uncertainty which makes “unpleasant surprises more likely”. In sum, credit rating agencies are in the unique position where it’s hard to hold them accountable to the public (Pinto 2008).

Auditors. Auditors are of special interest because of their exposure to conflicts of interest. Although auditors enhance the credibility of accounting reports, audit firms face an incentive problem: they are more likely to act in the interests of managers who hire them and not in those of the firm’s investors. This conflict of interest is one of the factors that made the Enron case possible (Healy and Palepu 2001, 2003). In his influential account of “control fraud”, Black (2005) has focused on the crucial position of auditors and how the recognition of accounting reports by auditors can permit fraud by corrupt companies.

During the 1990s in the USA, the quality of audits declined,

while the marketing of non-audit services by auditing firms increased in parallel. For example, the number of earnings restatements issued by listed corporations more than tripled since 1990 (Coffee Jr. 2003, p.17), and has continued to climb through 2002. More worrying was the fact that the size of earnings restatements increased greatly, revealing that income smoothing had given way to much more aggressive accounting practices aimed at the earlier realization of income. A key explanation here is the explosion of non-audit income through consulting services (Coffee Jr. 2003). The main issue here is not necessarily the desire of auditors to retain the larger share of consulting-related income, but the fact that mixing these two services give client firms a low visibility way of firing (or reducing the income) to auditing firms (Gordon 2002). It seems clear that auditing firms were prone to avoid these short-term losses by adopting more critical appraisals, but ultimately undermined long-term benefits – most spectacularly in the case of Arthur Anderson.

Figure 5 summarizes the key mechanisms leading actors to adopt short-term orientations.

7) Evidence of analyst herding can be found in (Welch 2000). More on herding literature can be found in (Avery and Zemsky 1998; Devenow and Welch 1996; Nofsinger and Sias 1999). On investment manager herding, see Bikhchandani and Sharma (2001).

Figure 5: Cognitive and Relational Mechanisms Promoting Short-termism

Actors	Triggers	Specific Mechanisms	Potential policies/practices as remedy
Managers	Professional Orientations	Decision heuristics	Wider information dissemination and less use of short-term measures for share evaluation (Demirag 1998)
		Experience and knowledge of “extra-financial” assets and risks	Less focus on investment appraisal methods like NPV and more training about including non-financial factors (Lefley and Sarkis 1997, Account Ability 2005, Atherton et al 2007)
		Education	
		Role of independent directors	Strengthen accountability to external stakeholders, including investors and employees
	Incentives	Job turnover Contract duration	Longer contract duration (Narayanan 1985, Palley 1997, AccountAbility 2005)
		Remuneration package	Less use of shares, options, and profit-related schemes and more weight on sales orientated compensation (Coates et al 1995). Progressive taxation.
Shareholders	Organisational Orientations	Engagement in corporate governance	Encourage patient capital by linking shareholder rights to holding period (Aspen 2009 report)
		Organisational capabilities for monitoring	Increase communication and transparency (Aspen 2009 report; CFA Report)
		Decision heuristics	Assess performance using long-term strategic plans by managers (CED Report)
		Intermediation relative to ultimate risk bearers	Apply a higher degree of accountability and enhanced fiduciary duties to financial intermediaries (Aspen 2009 report)
	Incentives	Delegation of investment decisions	Disclosure of asset manager incentive metrics (Aspen 2009 report; CFA report; AccountAbility 2005)
		Agency problems along the investment chain Exposure to ultimate risks	Align asset manager compensation with long-term client interests (CFA report). Speculation tax.
Gatekeepers	Orientations	(absence of) professions	Employ one advisor for each different “gatekeeper” service
	Incentives	Personal and impersonal conflicts of interest	Clearly separate gatekeeper function from corporate operations to ensure impartiality

4. Short-termism as a Social Process

Section 3 described the orientations and incentives of key stakeholders in corporate governance individually. Yet corporate decision making is not the sole result of any single group of stakeholders. Corporate governance involves a sociological “double contingency” in the sense of Parsons and Shils (1951, p.105), who describe this as follows:

...since the outcome of ego’s action (e.g. success in the attainment of a goal) is contingent on alter’s reaction to what ego does, ego becomes oriented not only to alter’s probable overt behavior but also to what ego interprets to be alter’s expectations relative to ego’s behavior, since ego expects that alter’s expectations will influence alter’s behavior...

Both investors and managers know that both know that both could individually pursue a different strategy depending on the reaction of the other. This social process of contingency and expectation adds a temporal dimension to the standard agency theory model.

Figure 6 (page 49) presents a stylized model of possible interactions between managers and shareholders. In the ideal case, both managers and investors would perceive each other as having long-term orientations. The scenario could be described as the “Sustainable company”, wherein all stakeholders share a long-term vision of the firm and their role in it (**bottom right cell**). While agency problems may still exist with regard to the distribution of value among stakeholders, both investors and managers share a long-term orientation and commitment to the firm. Put another way, neither party will prematurely exit the relationship and thereby be able to externalize the long-term consequences of strategic decisions onto third parties (Dobbs 2009). Without a mutual commitment to long-term objectives, the time horizon will be inherently subject to conflicts among stakeholders and thereby remain unstable and open to opportunistic short-term behaviour.

While this type of long-term outcome is likely to be desirable, it is equally important to draw attention to the limiting case of over-

commitment to the long-term. Stakeholders may become over-committed to the organisation, postponing short-term gain indefinitely or failing to preserve options for creating value by pursuing outside alternatives (e.g. exiting the firm, liquidation, merger, etcetera). For example, the hazards of over-commitment in risky or uncertain ventures help explain the incremental or tournament-like pattern of investment in venture capital firms or joint ventures, as well as the corresponding governance structure (Folta 1998). Others suggest that corporate governance mechanisms supporting exit, such as golden parachutes as a form of executive compensation, may create long-term value for all stakeholders by reducing vested interests or over-commitment of managers to particular strategies (Evans and Hefner 2009).⁸

A more conflictual scenario arises when managers prefer long-term strategies, but perceive shareholders to be interested in short-term results (**top right cell**). For example, stakeholder models of corporate governance have come under growing pressure as the long-term orientations of company insiders have come under pressure from capital markets (Jackson 2005; Vitols 2004). Institution investors often call for more rapid company downsizing, and fail to fully value the contribution of essential human assets to the competitive success of the firm (Aoki and Jackson 2008), such as when Moody's famously downgraded Toyota's bond rating in 1998 citing its policy of lifetime employment. However, short-term orientations of investors are not sufficient to produce short-termism without additional governance mechanisms to influence managers. Shareholders may lack power to assert their agenda on managers (e.g. the absence of a takeover market). Alternatively, managers may be able to shield themselves from influence from short-term shareholders by forming coalitions with other long-term shareholders, such as family owners, banks, or cross-shareholdings with other firms. This point is extremely important, since it suggests that the short-term investment horizons of traders in secondary markets are not necessarily a problem. Indeed, investors only cause short-termism when their time horizons begin to influence the time horizons of managers and hence spill over from financial markets to the "real" economy.

An inverse, but equally conflictual scenario arises when

investors pursue long-term strategies, but these are threatened by short-term and opportunistic behaviour of managers (**bottom left cell**). This scenario is a classic agency theory situation. However, to the extent that agency problems cannot be sufficiently resolved by other institutional mechanisms (e.g. independent directors), investors may react by pursuing short-term strategies that do not require them to trust managers, such as demanding higher short-term dividend payments and lower levels of reinvestment. Indeed, agency theory suggests that shareholders may prefer short-term payouts in order to limit the scope for managerial opportunism. If a surplus exists at the end of a financial year, shareholders may prefer to get higher dividends paid now rather than managers re-investing into the firm in the next period, because shareholders fear that managers may "consume" this extra amount (Dickerson et al. 1995). This constellation may therefore also gravitate toward short-termism to the extent that shareholder re-calibrate their time horizons to those of short-term oriented managers.

Agency conflicts arising from the misalignment of managerial and investor time horizons in both of these scenarios may therefore *potentially* lead to short-termism, but this is not always the case. To the extent that one set of actors has limited power or can hedge against the influence of the other, these situations may lead to isolated cases of myopia rather than systematic processes of short-termism. However, each scenario raises the possibility that one group (ego) may adapt their behaviour to the expectations of the other (alter). For example, managers may begin to re-orient themselves to the short-term horizons of investors trading in financial markets.⁹ However, mutually reinforcing short-term orientations are likely to create externalities vis-à-vis future managers and shareholders, as well as other stakeholders. Let us examine this process in more detail.

8) These limiting cases may be fruitfully explored within the "real options" approach to decision making (Dobbs 2009).

9) Indeed, such adjustment may help "solve" agency problems, since one might conclude that no agency problem exists because the time horizons of different stakeholders are aligned.

Sociological research has introduced the concept of *temporal calibration* to describe the process by which actors with different time horizons engage in mutual or one-sided adjustment to the horizons of other actors (Noyes 1980). One interesting aspect of this process is the asymmetrical nature. If ego has a longer time horizon than alter, ego has the control to adjust herself by shortening her time horizon – but not necessarily vice versa.

Temporal calibration, by the adjustment of one’s time horizon for purposes of improved communications, or even for purposes of bringing about social reform, does not imply the abandonment of that longer time horizon which makes either concept or early support possible. One does not, simply by stressing the short term advantages, diminish such inherent long-term or moral gains as justice, economic liberty and the security of a society in which no one need be poor. It is simply that the short term advantages are ‘easier to sell’. (Noyes 1980, p.269)

Managers facing short-term pressures may adjust their strategy in alignment with the perceived expectations of shareholders (Chaganti and Damanpour 1991) – thus, pushing toward a more systematic and self-reinforcing pattern of short-termism (**top left cell**). In this case, managers may try to inflate earnings, but do so by cutting down investment in long-term assets that is important for the future of the organisation, like R&D and employee training. In fact, one reason why managers would deliberately sacrifice long-term in favour of short-term investments might be in order to inflate reported earnings, even if this is not in the best long-term interests of the shareholders. Conversely, investors may shorten their time horizons if they perceive managers to be driven by short-term considerations or lack trust in management. To the extent that investors feel unable to monitor managers effectively or derive long-term expectations about company performance, risk-averse investors may demand greater results in the short-term, thereby placing further pressure on managers.

In such cases where both managers and shareholders are

focused on the short-term, one important feature may be the absence of a manifest intertemporal agency conflict – both actors have calibrated their time horizon to the short-term. Samuel (2000) described the following pattern of self-reinforcing myopic behaviour: “shareholder myopia means the tendency of shareholders to focus on the behaviour of stock prices in the short term as opposed to the long term. Managerial myopia implies managerial behaviour focused on improving earnings in the short-term at the expense of long-term growth.” The absence of agency conflicts may help to explain the fact that advocates of the stakeholder model often frame their criticisms of the shareholder-value of the firm in terms of short-termism – here both current managers and shareholders externalize adverse effects on third parties such as employees or future managers and investors. The same fact may also explain why the very issue of short-termism remains so disputed in Anglo-Saxon countries, where the normative ideal of corporate governance is centered on shareholder value maximization.

Figure 6: *Intertemporal agency conflicts: a simple framework*

		<i>Managers' preferences</i>	
		Short	Long
<i>Shareholders' preferences</i>	Short	- “Short-termism”	Agency conflict Long-term managers pressured by short-term investors
	Long	Agency conflict Long-term investors undermined by short-term opportunism of managers	+ “the Sustainable company”

The interactions between shareholders and managers are also influenced by gatekeepers. Gatekeepers may help resolve conflicts in ways that may help “calibrate” the expectations and orientations of actors toward long-term evaluations of company value. As such, gatekeepers do not strongly influence the incentives of managers and shareholders, but have a strong role in shaping and legitimating par-

ticular orientations of other stakeholders. Consequently, gatekeepers may bias interactions among these stakeholders toward the pattern of “short-termism”. If gatekeepers focus only on use easily quantifiable financial measures to assess the potential of a firm, they may undervalue the ever-important benefits of long-term investments with intangible payoffs (Atherton et al. 2007). If gatekeepers focus on short-term figures like quarterly profits, this pushes managers to inflate those figures in expense of long-term investments.

If managers perceive capital markets (and the participants in them) to be short-term in their share price evaluation, then they will be short-termistic in their investment strategy (Demirag 1998; Grinyer et al. 1998; Marston and Craven 1998; Samuel 2000). Interestingly, a two-country comparison showed that managers in Sweden seem to be far less influenced by their perceptions of capital markets’ reaction than in the US (Segelod 2000), which may be due to differences in managerial orientations (Section 3.1) in these two institutional environments.

The more interesting theoretical implication of these interactions may relate to the notion of self-reinforcing dynamics that create organisational lock-ins sometimes known as path dependence. Here initial orientations of ego are reinforced by the orientations of alter, creating a self-reinforcing dynamic. While third party gatekeepers, regulators, or other institutional factors may help mitigate such interactions, these factors can equally serve to amplify these effects. Once such as cycle is in place, it may be impossible for actors to unilaterally change their strategies – even if both actors would prefer to shift to a different long-term pattern, in principle. This process aspect of short-termism may help explain why managers, investors and analysts often feel trapped into playing the “earnings game”, despite the fact that everyone involved is critical of the process (Tonello 2006).

5. Conclusion: Implications for Policy, Practice and Future Research

This report has stressed that short-termism is not an isolated phenomenon. Rather it reflects the complex interactions between the incentives and orientations of different stakeholders. While it remains difficult to demonstrate empirically that particular stakeholders’ orientations are “too short” from an economic perspective, we can find substantial support for the idea that stakeholder orientations reinforce each other in ways leading to a shortening of time horizons. Key triggers here are the mechanisms whereby the short-orientations of managers and investors become self-reinforcing. For example, stock-options help managers “internalize” the short-term focus of investors and quarterly earnings statements by managers help focus investors on short-term targets.

Given the systemic nature of the problem, the authors of the 2009 Aspen Institute paper on “Overcoming Short-Termism” argued that “effective change will result from a comprehensive rather than piecemeal approach”. No single policy in isolation is likely to address short-termistic behaviour among managers, shareholders and gatekeepers at the same time. Indeed, various past reports¹⁰ on policies against short-termism have in common their stress on systemic policies and recommendations that address different levels of the problem.

This section will briefly review a number of implications for policy and practice that flow from our analysis. New policies and practices are needed that shift the *incentives* of key stakeholders toward more long-term goals, either through adoption of best practices, regulation or taxation policies. But the complex nature of short-termism also relates to “softer” factors related to the *professional and organisational orientations* of those stakeholders – that is, their self-understanding, social norms, and formal rights and responsibilities. These issues go to the heart of corporate governance

10) See Appendix 2 for reports with recommendations for policies or corporate actions needed to address short-termism.

itself, affecting the checks and balances between corporate stakeholders in ways to assure that stakeholders with long-term interests are given sufficient voice in decision making. The successful institutionalization of long-term behaviour is only likely when adopting such practices increases their legitimacy in the eyes of other stakeholders.

5.1 Redefining the Role of Managers

Managerial incentives can be positively influenced by improving the quality and long-term nature of incentive schemes. While paying for performance is widely considered to be an essential element of good corporate governance (Kaplan 2008), the spread of equity-related pay packages has been associated with substantial abuse – rising to excessive levels and displaying little downside risks for poor performance (Bebchuk and Fried 2003, 2004). This suggests the need to tie remuneration to long-term performance in line with corporate strategy and discourage high job turnover among executives by increasing commitment to the firm.

Encouraging a long-term orientation of managers suggested a number of discrete types of policies aimed at managerial incentives. First, the use of excessive levels of managerial pay must be limited. Several distinct policies could be applied here including imposing salary caps in legislation, making explicit recommendations about appropriate levels (e.g. based on a ratio of CEO to average employee salary) as part of corporate governance codes, or applying more progressive forms of taxation. Second, the use of equity-based incentive schemes must be limited or tempered with explicit long-term vesting periods. A remuneration package that relies heavily on firm equity and/or stock options may encourage managers to resort to short-term measures that temporarily inflate the stock price. Imposing high tax rates on profits made by early option exercise or share sale may potentially induce managers to hold on to firm equity for a longer time period. Along with higher tax rates on profits made from shares and options, their vesting period can be lengthened. The faster a manager gains control over his

shares and/or options the shorter the time he is connected to the company. Third, pay schemes must be linked to longer-term and non-financial measures of performance. For example, remuneration can be linked to performance averages over a couple of years instead of only the preceding one financial year. Salary can also be linked to other stakeholder-oriented outcomes, such as linking wage increases or bonuses to the percentage increase in average wages of employees. Also, the use of explicit non-financial performance targets may be an important instrument in assuring long-term focus. For example, executives may be rewarded for achieving key goals related to reductions in CO₂ emissions even where these are costly in the short-term. Fourth, reshaping the incentive system for managers also presupposes that managers have longer employment tenures with the firm. Longer contract duration may be one device in establishing a long-term bond between the company and the individual by providing job security and appreciation. More generally, it is also crucial to provide career pathways within the company structure so as to fulfill the professional ambition of managers throughout different stages of their career.

Despite their importance, changing incentives alone will not suffice in curbing managerial short-termism without looking at the wider factors shaping managerial orientation. We suggest three areas of policies to address the wider normative and ethical commitments of top executives as a professional community. First, a rethinking of management education is needed to reemphasize issues of business ethics and sustainability (Khurana 2007). Currently, MBA education has placed undue stress on financial management, and has sought to focus managerial expertise on strategies that maximize financial returns. If, however, themes such as ethics and sustainability rise into prominence, managers can also recognize more clearly their long-term responsibility toward company stakeholders and the broad society. A second and related aspect of this concerns training and use of alternative metrics of corporate accounting and performance. While approaches such as the balanced scorecard have their critics, greater emphasis on understanding and developing alternative metrics is an important area for managerial practice. The use of alternative accounting frameworks is playing a growing role for firms seek-

ing certification or implementing standards related to corporate social responsibility. Disclosure of long-term oriented metrics of performance will also aid external stakeholders, including institutional investors, to better evaluate the long-term prospects of the company and thus understand its true underlying value. Third, the composition and legal duties of corporate boards should be reevaluated to assure sufficient representation of and accountability to long-term stakeholder interests. Bringing management into greater dialogue with wider stakeholder constituents will help assure greater independence of decision making and give voice to long-term concerns related to the company. Importantly, this step must move beyond the usual call for greater use of outside directors, who may also have relatively short-term attachments to the firm and suffer from lack of independence from the CEO.

5.2 Increasing the Long-term Commitments of Shareholders

A key focal point of policy suggestions on short-termism concerns the promotion of “patient capital”. As in the case with managers, a number of policies have been suggested to counteract the immediate incentives of investors to pursue short-term gains at the expense of the longer-term. Many such incentives relate to additional layers of principle-agent problems along the investment chain, and thus result directly or indirectly from the management practices used to incentivize fund managers. Fund managers trade in “other people’s money”, but may compete for business on basis of their ability to demonstrate short-term returns.

In addressing such incentives, a number of policy areas can be identified. First, the incentives of fund managers need to be aligned with the long-term interests of principles. When it comes to remuneration, fund managers face the same issues of agency as do corporate managers. Consequently, their compensation scheme should be linked to long-term performance metrics as well. Additionally, principles should be informed of the remuneration structure of fund managers, and thereby exercise greater control over the managers’ trading activities or at least assess whether pay policies are in the

best interests of the principles. A second point concerns the role of disclosure within financial markets. Financial markets participants should be made more aware of the structure of funds and underlying financial instruments. To the extent investors are better informed, they may recognize the benefits of longer holding periods and stronger commitment to the companies they invest in. Third, the powerful and direct way to discourage impatient capital and promote long-term holding periods remains policies to make the trade of recently purchased securities more costly. This can be achieved by imposing high tax rates on profits made by trading securities that were purchased within a short time period in the past. This is known as “speculation tax”. Most countries already do impose modest “speculation tax” on the purchase or transfer of financial assets, such as stocks or foreign currencies (Baker 2008). For example, in Europe, the UK imposes a 0.5 per cent tax on shares, but this figure is 1 per cent in Sweden or Denmark and as high as 1.6 per cent in Finland. Germany also has an explicit speculation tax, whereby profits made on share trading with holding times of less than twelve months are subjected to income tax.

Again, changing incentives alone is unlikely to make a fundamental change in shareholders’ role in corporate governance. Additional measures would be needed to go to the root of shareholders’ orientations and self-understanding within corporate governance. Here several additional areas for policy change can be identified. First, policy measures can increase the accountability of financial intermediaries to long-term shareholders. Particularly in cases such as pension funds, stakeholder representation within fund trustees may help shape accountability and increase orientations of funds to long-term sustainable investment strategies. Second, regulation can help further by setting guidelines or requirements for certain types of funds regarding voting practices at shareholders’ meeting, and disclosure of votes or voting policies. Such measures may support funds to act more as long-term owners, rather than simply as traders. This can be achieved by disclosing on a regular basis the rules and procedures that shareholders must follow when exercising their power. Finally, additional voting rights may be established for shareholders who do not exit their investments

quickly. Such policies, as found already in France, reward loyalty with greater voice of shareholders in corporate decision making in proportion to the length of the holding period. Other types of rights such as the ability to nominate board members could be introduced as well, when shareholders have completed a vesting period of a particular length.

5.3 Improving Information, Enhancing the Independence and Outlook of Gatekeepers

A central theme in debates over short-termism concerns the widespread use of quarterly earnings reports. Markets – investors and analysts – always look at it to assess the firm’s performance and consequently the stock price. Remuneration packages are often linked to quarterly earnings. Therefore managers are under double the pressure to present evermore higher earnings. Similarly, fund managers have to present high rather short-term returns to fund trustees. Consequently, the chief argument on fighting short-termism is to minimize the use of quarterly earnings in any form of analysis. Instead it is recommended to introduce corporate reports that include the long-term strategies and objectives of a firm. Similarly, a strong criticism in the short-termism debate concerns the use of investment appraisal methods that exclude non-financial factors.

Efforts are needed to improve the quality and flow of information between them. Better information should increase awareness of the aspects and consequences of short-termism. This consideration suggests several areas for new policy initiatives. First, more forward-looking and long-term orientated reporting and disclosure structures could be supported by policies to require an “enhanced business review” in the annual report. The purpose of such a reform would involve performance measures that are calculated over a longer time period. Along with these measures, forward-looking reports on strategic objectives should be included in order to demonstrate the potential of projects that appear to be costly in the short-term but are estimated to have a considerable payoff in the future. This approach also dovetails with recent discussion on reporting related

to corporate social responsibility initiatives. Second, following on from this, companies need to be encouraged and supported to utilize frameworks for non-financial reporting. Along with a strategic statement, a company should present information on company policies that can increase firm value but do not appear in financial statements. These policies could concern enrichment of human capital through employee training programmes, community engagement activities or environmental protection projects that improve the company’s reputation etcetera. These measures add significant value but are often underrepresented because their positive effects cannot be fully estimated in advance and become effective only after some time. A final area concerns regulation to assure the independence of gatekeepers. Sarbanes-Oxley and other post-Enron reforms to corporate governance have already gone a long way to critically reexamine the role of gatekeepers with regard to possible conflicts of interests. But in order to enhance the quality of information and focus on long-term performance, the financial crisis has demonstrated that the role of gatekeepers continues to demand attention. One basic issue is the regulation of non-audit transactions by auditor firms, but extends onward to other issues such as restrictions on transactions by sell-side analysts.

5.4 The Future of Corporate Governance

This report has argued that short-termism will only be addressed by sometimes small but coordinated changes across a wide range of policy areas. It goes beyond the remit of this report to discuss the prospects or problems with specific policies. Indeed, these touch upon a wide array of technically complex areas of corporate law, business practice, and financial market regulations. However, a good starting point would be to develop a detailed review of such existing policies in these areas. Future research might compile an overview of existing policies in different countries, thereby identifying the range of available policy instruments and examining evidence on their relative effectiveness. To our knowledge, no country has consciously undertaken a set of coordinated policies to specifically

counteract short-termism. Yet a large number of relevant, yet little known policies exist already. For example, French shareholders receive double voting rights after holding their shares in excess of two years (Schmidt 2004). Likewise, Germany passed a new law on executive compensation in 2009 calling for limits of total compensation to “reasonable” levels and tightened the criteria applied to performance-related pay.

The choice of policy instruments is likely to be controversial – ranging from voluntary measures and market incentives to various forms as self-regulation (e.g. codes with comply-or-explain principles) to mandatory legislation. In our view, all these policy instruments are likely to be important, but certain policy trade-offs arise with regard to different ways of regulating corporate governance (see Filatotchev et al. 2007). Whereas voluntary measures have the virtue of flexibility and avoiding one-size-fits-all solutions, voluntarism has important limits. Likewise, codes have proven quite effective in promoting best practices in certain areas of corporate governance – such as the requirement of non-executive directors in the UK combined code. But codes also require supportive market-based mechanisms to be effective. Hence, formal regulation will also be required in tandem with other measures.

The existing institutional diversity of corporate governance around the world also means that the solutions to short-termism will not lie in adopting a single new model of corporate governance. Rather, different countries and regions will have to develop their own approaches based on their own experiences with different degrees and forms of short-termism and tailor solutions to fit with other complementary mechanisms of corporate governance existing already (Aguilera et al. 2008).

Despite the complexity of the task, the time is ripe to rethink corporate governance with a view to the long-term. Many of the current “best practices” in corporate governance are geared toward institutionalizing decision making based around the idea of maximizing value for shareholders, as viewed in the moment. Still, in looking to the future, open questions remain about whether or not short-term value maximization leads to long-term sustainable advantages. Indeed, short-termism is most likely to occur precisely

in that moment when we feel that little may be gained from waiting.

Appendix 1: Selective Overview of Empirical Studies on Short-termism

Author	Data	Dependent variable	Explanatory variables
Bange and De Bondt (1998)	US, 1977–1986, 100 firms with large R&D	R&D earnings management	<i>Independent:</i> all control variables <i>Control:</i> trading volume/No of shares (positive); institutional stockholdings (negative); company risk (positive); free cash flow; long-term debt/assets; relative change in salary and bonus; new CEO; % of shares owned by CEO (negative); career years left; CEO is outsider; R&D tax credit
Bushee (1998)	US, 1983–1994	dummy=1 if R&D is cut relative to the prior year	<i>Independent:</i> percentage of institutional holdings (negative); three dummies if investor is transient (positive), quasi-indexer (insignificant), dedicated (insignificant) <i>Control:</i> prior year's change in R&D; change in industry R&D-to-sales ratio; change in GDP, Tobin's Q; change in capital expenditures; change in sales; market value of equity; distance from earnings goal relative to prior year's R&D; leverage; free cash flow
Bushee (2001)	US, 1980–1992, 673–973 firms per year	3 year change in percentage holdings by each group of institutions	<i>Independent:</i> total shares held by institutional investors to total share outstanding (negative); % of shares held by banks/insurance/investment advisers/pensions/endowments and dedicated/quasi-indexer/transient (positive) institutions <i>Control:</i> 3 year change in: ratio book value per share to stock price; present value of forecasted abnormal earnings over next year to stock price; present value of one-year-ahead terminal value to stock price; log market value of equity; S&P common stock rating; time listed on CRSP tape in years; dummy=1 if firm listed on S&P 500, liquidity; dividend yield; beta; unsystematic risk; leverage; market-adjusted returns over prior year; change in annual earnings per share; dummy=1 if firm's earnings greater than zero; average sales growth over prior three years; R&D intensity
Cheng et al. (2005)	US, 2001–2003, 989 firms	R&D/sales ratio	<i>Independent:</i> dummy=1 if dedicated guiders (negative) <i>Control:</i> industry dummies; Tobin's Q; firm size; leverage; analyst long-term growth forecast; sales; number of analysts following; capital expenditure; free cash flow deflated by lagged total assets
Hansen and Hill (1991)	US, 1976–1987, 129 research-intensive firms	R&D/sales ratio	<i>Independent:</i> institutional holdings (positive) <i>Control:</i> lagged R&D spending; cash resources; leverage; market share; diversification; market concentration; industry control; year
Holden and Lundstrum (2009)	US, 1990–2002, 378 firms upon which Chicago Board Options Exchange has introduced LEAPS	R&D/sales ratio	<i>Independent:</i> LEAPS volume in year 0 as percentage of total equity option volume (positive) <i>Control:</i> -
Johnson and Rao (1997)	US, 1979–1985, 421 firms	R&D/sales ratio	-
Kochhar and David (1996)	US, cross-section 1989, 135 firms	number of new product announcements	<i>Independent:</i> total institutional ownership (positive) <i>Control:</i> R&D intensity; size; leverage; unrelated diversification; related diversification; insider ownership; industry
Liu (2005)	US, 1996–2002, 919 restatements	dummy=1 if the quarterly financial report is later restated	<i>Independent:</i> shares held by institutional investors to shares outstanding (some positive); dummies=1 if: transient (positive) /quasi-indexer (insignificant) /dedicated investor (insignificant) <i>Control:</i> log of assets; Tobin's Q; log CEO salary; ratio of options to salary
Meulbroek et al. (1990)	US, 1979–1985, 203 firms	R&D/sales ratio	-
Samuel (2000)	US, 1972–1990, 603 firms	capital expenditures; advertising expenditures; R&D expenditures	<i>Independent:</i> shares held by institutional investors to shares outstanding (positive for capital; insignificant for advertising; some negative for R&D) <i>Control:</i> cash flow; sales
Wahal and McConnel (2000)	US, 1988–1994, 2500 firms	expenditures for PP&E; expenditures for R&D	<i>Independent:</i> shares owned by institutional investors (positive); portfolio turnover (some positive) <i>Control:</i> Tobin's Q; growth; leverage; profitability; insider ownership

Appendix 2: Recommended actions on corporate level

	Less focus on quarterly earnings	Introduction of long-term metrics in investment appraisal	Inclusion of strategic direction and long-term objectives in corporate reports	Tie executive remuneration to long-term performance	Disclosure of asset manager's incentive metrics	Enhanced communication and transparency	Longer CEO and corporate executives' tenure
Aspen Institute "Overcoming Short-Termism"	x			x	x		
Aspen Institute "Long-Term Value Creation: Guiding Principles for Corporations and Investors"	x	x		x		x	
Business Council of Australia "Seeing Between the Lines"	x	x	x	x		x	
Centre for Financial Market Integrity "Breaking the Short-Term Cycle"	x	x	x	x	x	x	
Committee for Economic Development "Built to Last: Focusing Corporations on Long-Term Performance"	x	x	x	x			x
The Conference Board "Revisiting Stock Market Short-Termism"		x	x			x	
World Economic Forum "Mainstreaming Responsible Investment"		x	x	x	x	x	

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