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Empiricism and Experience; Activism and Short-Termism; the Real World of Business

By Martin Lipton
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Harvard Law School Professor Lucian Bebchuk believes that shareholders should be able to control the material decisions of the companies they invest in. Over the years, he has written numerous articles expressing this view, including a 2005 article urging that shareholders should have the power to initiate a shareholder referendum on material corporate business decisions. In addition to his writings and speeches, Prof. Bebchuk has established and directs the Shareholder Rights Project at Harvard Law School for the purpose of managing efforts to dismantle classified boards and do away with other charter or bylaw provisions that restrain or moderate shareholder control of corporations (see "Harvard's Shareholder Rights Project is Wrong" and "Harvard's Shareholder Rights Project is Still Wrong").

In addition, Prof. Bebchuk has been at the forefront in arguing to the SEC that, despite the specific action of Congress in 2010 to empower the SEC to adopt a rule to require fair and prompt public disclosure of accumulations of shares by activist hedge funds and other blockholders, the SEC should not do so because it would limit the ability of activist hedge funds to attack corporations. In short, Prof. Bebchuk believes that shareholders should have the power to control the fundamental decisions of corporations – even those shareholders who bought their shares only a few days or weeks before they sought to assert their power, and regardless of whether their investment objective is short-term trading gains instead of long-term value creation.

While there is no question that almost every attack, or even rumor of an attack, by an activist hedge fund will result in an immediate increase in the stock market price of the target, such gains are not necessarily indicative of real value creation. To the contrary, the attacks and the efforts by companies to adopt short-term strategies to avoid becoming a target have had very serious adverse effects on the companies, their long-term shareholders, and the American economy. To avoid becoming a target, companies seek to maximize current earnings at the expense of sound balance sheets, capital investment, research and development and job growth. Indicative of the impact of shareholder pressure for short-term performance is the often cited comment by then-Citigroup CEO Chuck Prince in the July 9, 2007 *Financial Times*: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance.” Many commentators have cited pressure to boost short-term performance metrics as one of the causes of the 2008 fiscal crisis, such as Lynne Dallas in her 2012 article in the *Journal of Corporation Law* (“[t]he financial crisis of 2007-2009 was preceded by a period of financial firms seeking short-term profit regardless of long-term consequences”) and Sheila Bair in her last speech as FDIC chairman in 2011 (“the overarching lesson of the crisis is the pervasive short-term thinking that helped to bring it about”). Virtually all of the academic and government studies of the fiscal crisis have concluded that shareholder pressure was a contributing cause.

In August of this year, Prof. Bebchuk released an article describing what he characterized as empirical evidence that attacks by activist hedge funds do not harm companies and their long-term shareholders (see “The Long-Term Effects of Hedge Fund Activism”). I released a paper pointing out serious deficiencies in the methodology, analysis and conclusions that Prof. Bebchuk used and I cited an academic study questioning his statistics, an empirical study to the contrary and real-world experience and anecdotal evidence that activism and its concomitant short-termism destroy long-term value and damage the American economy (see “The Bebchuk Syllogism”; see also “Current Thoughts About Activism” and “Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy”). Apparently, my paper touched a raw nerve. In an attempt to resuscitate his promotion and justification of attacks by activist hedge funds, Prof. Bebchuk has published a new paper (“Don’t Run Away from the Evidence: A Reply to Wachtell Lipton”) accusing me of running away from the evidence; a serious accusation, but demonstrably untrue. Let’s take a look at some of the evidence (empirical, experiential, and overwhelming) that supports my views.

Empirical Evidence

It should be noted that Prof. Bebchuk’s claim that “supporters of the myopic activists view have failed to back their view with empirical evidence or even to test empirically the validity of their view” is patently false. In fact, numerous empirical studies over the years have produced results that conflict with those Prof. Bebchuk espouses. These other studies generally find that activism has a negative effect or no effect on long-term value, particularly when controlling for the skewing impact of a takeover of the target (which generally occurs at a premium regardless of whether the target is the subject of activism). This fact compels a careful assessment and critical review of his study to determine why his results differ from many prior studies – something I attempted to provide in my previous paper. I have provided below a brief, and admittedly incomplete, sampling of such studies.

Director Contests and Firm Performance

● According to Jonathan Macey and Elaine Buckberg in their 2009 “Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation,” there are “[s]everal studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19% to 40% over the two years following the proxy contest.”

● One of those studies is David Ikenberry and Josef Lakonishok’s “Corporate Governance Through the Proxy Contest” (published in the *Journal of Business* in 1993), which reviewed 97 director election contests during a 20-year period in order to examine the long-term performance of targeted firms subsequent to a proxy contest. Their findings were striking: "When the incumbent board members successfully retain all board seats, cumulative abnormal returns are not significantly different from zero over the next 5 years. Yet, in proxy contests where dissidents obtain one or more seats, abnormal returns following resolution of the contest are significantly negative. Two years following the contest, the cumulative abnormal return has declined by more than 20%. The operating performance of these same firms during the postcontest period is also generally consistent with the pattern observed using stock returns."

● Michael Fleming obtained similar results when looking at instances where a dissident obtains board representation in "New Evidence on the Effectiveness of the Proxy Mechanism," a 1995 Federal Reserve Bank of New York research paper. Reviewing a sample of 106 threatened proxy contests between 1977 and 1988, Fleming found statistically significant negative returns of -19.4% in the 24 months following the announcement of a contested election for the 65 firms in his sample where dissidents won board seats – either as a result of a shareholder vote or a settlement. Fleming found that the majority of gains resulting from threatened proxy contests were "attributable to firms which [we]re acquired within one year of the outcome of the proxy contest," suggesting that the gains were due to payment of a takeover premium (consistent with Greenwood and Schor's findings described below), *not* from operating improvements or governance changes.

● Lisa Borstadt and Thomas Zwirlein found very similar results in "The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance," published in *Financial Management* in 1992. These authors examined 142 exchange-traded firms involved in proxy contests for board representation over a 24-year period. They found the following: "A dissident victory in the proxy contest does not necessarily translate into superior corporate performance. Positive abnormal returns over the proxy contest period are realized by firms in which the dissidents win the proxy contest and the firm is subsequently taken over. In contrast, no abnormal performance over the contest period is observed for the firms in which the dissidents win but the firm is not subsequently taken over. For these firms, large negative (although insignificant) cumulative returns are observed in the postcontest period."

Shareholder Proposals and Firm Performance

● In "Investor Activism and Takeovers," published in the *Journal of Financial Economics* in 2009, Robin M. Greenwood and Michael Schor examined Schedule 13D filings by portfolio investors between 1993 and 2006 to investigate the effect of activist interventions on stock returns. They found the following: "[A]ctivism targets earn high returns primarily when they are eventually taken over. However, the majority of activism targets are not acquired and these firms earn average abnormal returns that are not statistically distinguishable from zero. . . . Thus, the returns associated with activism are largely explained by the ability of activists to force target firms into a takeover, thereby collecting a takeover premium."

● In "Pension Fund Activism and Firm Performance," published in the *Journal of Financial and Quantitative Analysis* in 1996, Sunil Wahal reviewed 356 "targetings" by the nine most active funds between 1987 and 1993. "Targetings" included both proxy proposals and nonproxy targeting, and were typically initiated by sending a letter to the target firm (either publicly or privately) followed by a telephone call from the activist fund. Wahal found that, while pension funds "are reasonably successful in changing the governance structure of targeted firms," these changes have no impact on stock performance. According to Wahal, "targeting announcement abnormal returns are not reliably different from zero," and "[t]he long-term abnormal stock price performance of targeted firms is negative prior to targeting and still is negative after targeting." Wahal also found that "accounting measures of performance do not suggest improvements in operating or net income either; accounting measures of performance also are negative prior to and after targeting."

● Two studies released by the U.S. Chamber of Commerce in partnership with Navigant Consulting reviewed shareholder proxy proposals between 2002-2008 and 2009-2012, respectively, for impact on firm performance. The studies, published in May 2009 and May 2013, both focused on shareholder proposals that were identified as "Key Votes" by the AFL-CIO in annual surveys during the respective time periods, including proposals reflecting board declassifications, proxy access and director removal policies. In the first study, "Analysis of the Wealth Effects of Shareholder Proposals – Volume II," Joao Dos Santos and Chen Song reviewed 166 shareholder proposals between 2002-2008 and found "no evidence of a statistically significant overall short-run or long-run improvement and some indication of a long-run decrease in market value for the firms in our sample." In the second study, "Analysis of the Wealth Effects of Shareholder Proposals – Volume III," which reviewed 97 shareholder proposals between 2009-2012, Allan T. Ingraham and Anna Koyfman came to similar conclusions: "We . . . find no conclusive or pervasive evidence that the shareholder proposals assessed in this study improve firm value or result in an economic benefit to pension plans and plan participants. Given that the proxy process imposes costs on both firms and shareholders, and given that there are no proven benefits in terms of corporate performance, the overall net benefit of these initiatives is likely negative."

● Andrew K. Prevost and Ramesh P. Rao studied the impact of shareholder activism by public pension funds in their paper "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?" (published in the *Journal of Business* in 2000), examining a total of 73 firms that received shareholder proposals during the period of 1988-1994. They came to the following conclusions: "Firms that are subject to shareholder proposals only once during the sample period experience transitory declines in returns, but firms that are subject to repeat shareholder proposals experience permanent declines in market returns. . . . Long-term changes in operating performance corroborate the event study results: firms targeted only once exhibit positive but insignificant long-term results, while those targeted repeatedly show strong declining performance."

● Jonathan M. Karpoff, Paul H. Malatesta and Ralph A. Walkling reviewed 522 shareholder proposals at 269 companies between 1986 and 1990 to determine the impact of shareholder proposals on firm performance in "Corporate Governance and Shareholder Initiatives: Empirical Evidence," published in the *Journal of Financial Economics* in 1996. After finding that "proposals are targeted at poorly performing firms," they concluded that, notwithstanding this fact, the "average effect of shareholder corporate governance proposals on stock values is close to, and not significantly different from, zero." In fact, "[s]ales growth declines for firms that receive proposals in relation to sales growth for control firms," "[c]hanges in operating return on sales are not significantly larger for proposal firms than their controls, and are not significantly related to the persistence or intensity of proposal pressure, or to the sponsors' identity," and "[c]hange in operating ROA are not related to the pressure's intensity or sponsors' identity."

● In "Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance," published in the *Yale Journal on Regulation* in 2001, Yale Law School professor

Roberta Romano conducted a review of the corporate finance literature on institutional investors' corporate governance activities, involving seven different empirical studies and a total of over 4,500 individual shareholder proposals. She found that the shareholder proposals had "little or no effect on targeted firms' performance" over the time periods considered in the studies and proposed that improvements might be achieved if the rules were revised "to require proposal sponsors either to incur the full cost of a losing proposal or a substantial part of the cost."

● It is particularly noteworthy that CalSTRS, one of the major public employee pension funds and one of the leaders in proxy voting and investing in activist hedge funds, has recently reported that its aggregate investments in activist funds as of October 2012 trailed the United States public equity market, as shown by this chart from its annual report.

If activist funds fail to achieve attractive returns for their own investors, it raises the question whether pension funds and other fiduciary investors are actually promoting the best interests of the beneficiaries of the funds they manage when they invest in activist funds, given the fact that activist funds promote short-termism with its attendant costs to the rest of the market and to the economy as a whole (see Leo E. Strine's "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term," published in *The Business Lawyer* in November 2010). This month the UK Law Commission published a consultation paper responding to a government request, based on the Kay Review discussed below, "To evaluate whether fiduciary duties (as established in law or as applied in practice) [of investment intermediaries] are conducive to investment strategies in the best interests of the ultimate beneficiaries. We are asked to carry out this evaluation against a list of factors, balancing different objectives, **including encouraging long-term investment strategies** [emphasis supplied] and requiring a balance of risk and benefit."

Takeover Defenses and Firm Value

● Approaching the question from another perspective, William C. Johnson, Jonathan M. Karpoff and Sangho Yi investigated the impact of takeover defenses on firm value in "The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms" (April 29, 2013 working paper, available at http://papers.ssrn.com/abstract=1923667). Looking at a sample of 1,219 firms that went public between 1997 and 2005, the authors tested the "bonding hypothesis of takeover defenses" – that is, the theory that "takeover defenses increase the value of managers' commitments to maintain their promised operating strategy and not to opportunistically exploit their counterparties' investments in the IPO firm," which, "in turn, encourages the firm's counterparties to invest in the business relationship, yielding benefits for the IPO firm." The authors reported the following findings:

(1) IPO firms deploy more takeover defenses when they have large customers, dependent suppliers, or strategic partners;

(2) The IPO firm's value is positively related to its use of takeover defenses, particularly when it has large customers, dependent suppliers, and/or strategic partners;

(3) The IPO firm's subsequent operating performance is positively related to its use of takeover defenses, particularly when it has large customers, dependent suppliers, and/or strategic partners;

(4) When the IPO firm announces its intention to go public, its large customers experience a change in share values that is positively related to the IPO firm's use of takeover defenses; and

(5) After the IPO, the longevity of the IPO firm's business relationship with its large customer is positively related to its use of takeover defenses.

According to the authors, these results are explained by the fact that "takeover defenses … help to economize on the cost of building and maintaining value-increasing trading relationships between the IPO firm and its counterparties." As a result, "at IPO firms whose values depend heavily on their relationships with customers, suppliers, and strategic partners, takeover defenses appear to increase value by bonding the IPO firm's commitment to these relationships."

● In "The Impact of Antitakeover Amendments on Corporate Financial Performance" (published in *The Financial Review* in 2001), Mark S. Johnson and Ramesh P. Rao examined a sample of 649 antitakeover amendments adopted between 1979 and 1985 to determine the impact of the passage of antitakeover amendments on firm share price. Contrary to the management entrenchment hypothesis, the authors found that "antitakeover amendments are relatively benign events that do not significantly impact managerial behavior," and that "antitakeover amendments are not associated with deleterious effects to shareholders in terms of their impact on various fundamental firm performance measures."

Managerial Behavior and Pressures to Achieve Short-Term Performance

● Jie He and Xuan Tian's "The Dark Side of Analyst Coverage: The Case of Innovation" (forthcoming in the *Journal of Financial Economics*) examined the effect of analyst coverage on firm innovation to investigate how the pressure to achieve short-term performance impacts managerial behavior. The short-term pressures exerted by activist investors are often no different than those generated by stock analysts, and in many instances activist investors merely piggyback on stock analyst commentary when they launch attacks. Examining a sample of 25,860 firm-year observations relating to U.S. listed firms during the period of 1993-2005, He and Tian explored the "innovation output" of firms (as measured in terms of the number of (i) patent applications filed in a given year that are eventually granted and (ii) non-self citations each patent receives in subsequent years) in relation to the intensity of analyst coverage (as measured by the average number of earnings forecasts issued for the firm each month). The authors found that "an exogenous average loss of one analyst following a firm causes it to generate 18.2% more patents over a three-year window than a similar firm without any decrease in analyst coverage" and that "an exogenous average loss of one analyst following a firm leads it to generate patents receiving 29.4% more non-self citations than a similar firm without any decrease in analyst coverage." He and Tian determined that this evidence "is consistent with the hypothesis that analysts exert too much pressure on managers to meet short-term goals, impeding firms' investment in long-term innovative projects."

● Natalie Mizik published similar findings in "The Theory and Practice of Myopic Management," featured in the *Journal of Marketing Research* in 2010. In this study, Mizik reviewed the operating performance, marketing spending, R&D spending and stock price performance of 6,642 firms between 1986 and 2005 to assess the financial consequences of the practice of cutting marketing and R&D spending to inflate short-term earnings. In order to isolate firms that were potentially engaging in "myopic management," Mizik filtered for firms that simultaneously reported greater-than-normal profits, lower-than-normal marketing expenses and lower-than-normal R&D spending. Mizik then compared the stock performance of these “potentially myopic” firms against the performance of “nonmyopic” firms. Potentially myopic firms initially experienced much better stock performance than the firms that failed to meet performance expectations. However, after four years, “the portfolio of potentially myopic firms ha[d] a negative return of -15.7%, far below the return to the two nonmyopic benchmark portfolios (29.2% and 13.3%) and the S&P 500 return of 21.6%.” Mizik concludes that “[m]yopic management might have some short-lived benefits – it leads to higher current-term earnings and stock price – but it damages the long-term financial performance of the firm because the initial gains are followed by greater negative abnormal returns.”

● Aleksandra Kacperczyk’s “With Greater Power Comes Greater Responsibility?” (published in the *Strategic Management Journal* in 2009) tested the effect of takeover protection on the amount of corporate attention paid to shareholders and non-shareholding stakeholders, respectively. Looking at a sample of 878 firms between 1991 and 2002, Kacperczyk found that “an exogenous increase in takeover protection leads to higher corporate attention to community and the natural environment, but has no impact on corporate attention to employees, minorities and customers,” and that “firms that increase their attention to stakeholders experience an increase in long-term shareholder value,” measured over the two-year and three-year periods following the increase in takeover protection.

● Other empirical studies have shown that pressure from investors with short investment horizons can influence management to engage in financial misreporting. In “Institutional Ownership and Monitoring: Evidence from Financial Misreporting” (published in the *Journal of Corporate Finance* in 2010), Natasha Burns, Simi Kedia and Marc Lipson examined a sample of firms that restated their earnings between 1997 and 2002, finding that ownership by “transient institutions” (those with short investment horizons) are positively related with an increase in the likelihood and severity of an accounting restatement. The authors concluded that “[i]t is precisely these institutions, which trade frequently and therefore are likely to focus management attention on short-term reported performance, that provide incentives to manipulate earnings.”

● Another relevant study coming out of the financial crisis examined whether the corporate governance characteristics of banks impacted the likelihood of banks requiring government “bailout” support during the financial crisis. In “Shareholder Empowerment and Bank Bailouts” (a 2012 working paper), Daniel Ferreira, David Kershaw, Tom Kirchmaier and Edmund Schuster created a “management insulation” index ranking the degree of banks’ management insulation based on their charter and by-law provisions and on the provisions of the applicable state corporate law that make it difficult for shareholders to oust management. They found that, in a sample of U.S. commercial banks, banks in which managers are “fully insulated” from shareholders were roughly 19 to 26 percentage points less likely to receive state bailouts than banks whose managers were subject to stronger shareholder rights. The authors explained that “[b]ank shareholders may have incentives to increase risk taking beyond the socially-optimal level” and that, “in search for higher returns, bank shareholders had incentives to push their banks towards less traditional banking activities.”

● In his article “Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?” (published in *Contemporary Accounting Research* in 2001), Brian Bushee examined a sample of 10,380 firm-years between 1980 and 1992 to determine whether institutional investors exhibit preferences for near-term earnings over long-run value. Bushee found that “the level of ownership by institutions with short investment horizons (transient institutions) and by institutions held to stringent fiduciary standards (banks) is positively (negatively) associated with the amount of value in near-term (long-term) earnings." Bushee found no evidence that banks "myopically price" firms by overweighting short-term earnings potential and underweighting long-term earnings potential. However, in transient institutions "high levels of transient ownership are associated with an over- (under-) weighting of near-term (long-term) expected earnings and a trading strategy based on this finding generates significant abnormal returns. This finding supports the concerns that many corporate managers have about the adverse effects of an ownership base dominated by short-term-focused institutional investors."

● The above result is consistent with an earlier empirical study by Bushee that examined the influence of shareholder demographics on earnings management by managers. In "The Influence of Institutional Investors on Myopic R&D Investment Behavior," published in the *Accounting Review* in 1998, Bushee investigated whether institutional investors create or reduce incentives for corporate managers to reduce investment in research and development to meet short-term earnings goals. Examining a sample of all firm-years between 1983 and 1994 with available data, Bushee found that "a high proportion of ownership by institutions exhibiting transient ownership characteristics (*i.e.*, high portfolio turnover, diversification, and momentum trading) significantly increases the probability that managers reduce R&D to boost earnings." Bushee believed that "[t]his result supports the widely-argued view that short-term-oriented behavior by institutions creates pressures for managers to sacrifice R&D for the sake of higher current earnings" among those firms with high levels of transient ownership.

● William Pugh, Daniel Page and John Jahera, Jr.'s "Antitakeover Charter Amendments: Effects on Corporate Decisions" (published in the *Journal of Financial Research* in 1992) tested whether managers adopt a longer-term investment strategy after their firm passes antitakeover charter amendments. Examining a sample of firms that adopted antitakeover charter amendments between 1978 and 1985, the authors found that "firms increase spending on fixed capital as a percentage of both sales and assets the year of passage and for several years thereafter," and that overall results with respect to R&D expenditures "appear to support the managerial myopia hypothesis."

● A recent survey of 1,038 board members and executives by McKinsey & Company and the Canada Pension Plan Investment Board found startling levels of short-term orientation among corporate executives. As reported in the *Wall Street Journal* on May 22, 2013, this study found the following:

- Sixty-three percent of business leaders indicated the pressure on their senior executives to demonstrate strong short-term financial performance has increased in the past five years.

- Seventy-nine percent of directors and senior executives said they felt the most pressure to demonstrate strong financial performance over a time period of less than 2 years. Only 7% said they felt pressure to deliver strong financial performance over a horizon of 5 or more years.

- However, respondents identified innovation and strong financial returns as the top two benefits their company would realize if their senior executives took a longer-term view to business decisions.

- Yet, almost half of respondents (44%) said that their company's management team currently uses a primary time horizon of less than 3 years when they conduct a formal review of corporate strategy. Seventy-three percent said this primary time horizon should be more than 3 years and 11% said the horizon should be more than 10 years.

● The McKinsey findings are consistent with an earlier study published in the *Financial Analysts Journal* in 2006. In "Value Destruction and Financial Reporting Decisions," John Graham, Campbell Harvey and Shiva Rajgopal described the results of a survey of 401 senior financial executives. Going a step further than the McKinsey study, the authors asked executives if they would be willing to sacrifice long-term value in order to smooth earnings. An "astonishing 78% admit they would sacrifice a small, moderate or large amount of value to achieve a smoother earnings path."

Short-Termism and Macroeconomic Productivity

● The problems discussed above have larger implications than simply the performance of individual firms. In his 2012 book, Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies, Pavlos Masouros used macroeconomic data to show that the shift in corporate governance toward shareholder interests and increasing short-termism in France, Germany, the Netherlands, the UK and the US have contributed to low GDP growth rates in those countries since the early 1970s. Masouros outlined the unfolding of a "Great Reversal in Corporate Governance" whereby the primacy of shareholder value in the corporate governance pecking order was established, as well as a "Great Reversal in Shareholdership" where the average holding period of shares rapidly decreased, both of which contributed to a dramatic increase in the average equity-payout ratio of firms and a decrease in the average capital retention and reinvestment of profits by firms. Masouros' prescription for ameliorating this trend away from capital reinvestment is what he calls "Long Governance" – moving toward a system where shareholders are infused with incentives that would allow them to develop long-term horizons that would align their interests with other constituencies and increase companies' incentives to invest in future productivity.

● In "The Kay Review of UK Equity Markets and Long-Term Decision Making," published by the UK Department for Business Innovation and Skills in July 2012 (the "Kay Review"), John Kay examined how the structure of the UK equity markets encourages short-termism and discussed the impact on UK businesses and investors. Kay started with the observation that "[a]s a percentage of GDP, research and development expenditure by British business has been in steady decline" and proceeded to explore why this was the case. He then identified a fundamental misalignment of the interests of the UK asset management industry and the ultimate principals, the companies which use equity markets and the individual UK "savers" who provide funds to them: "Returns to beneficial owners, taken as a whole, can be enhanced only by improving the performance of the corporate sector as a whole. Returns to any subset of beneficial owners can be enhanced, at the expense of other investors, by the superior relative performance of their own asset managers. Asset managers search for alpha, risk adjusted outperformance relative to a benchmark. But savers collectively will earn beta, the average return on the asset class." This misalignment exists because "the time horizons used for decisions to hire or review investment managers are generally significantly shorter than the time horizon over which the saver, or the corporate sponsor of a pension scheme, is looking to maximize a return." Kay pointed out that "[c]ompetition between asset managers to outperform each other by anticipating the changing whims of market sentiment … can add nothing, in aggregate, to the value of companies … and hence nothing to the overall returns to savers." Predictably, the short-term incentives of asset managers flow down to corporate managers, many of whom are incentivized "to make decisions whose immediate effects are positive even if the long run impact is not" and "whose consequences are likely to be apparent within a short time scale." After describing the problem in great detail, Kay presented a series of recommendations that he believed "will help to deliver the improvements to equity markets necessary to support sustainable long-term value creation by British companies," including the recommendation that "regulation must be directed towards the interests of market users – companies and savers – rather than the concerns of market intermediaries." The applicability of Kay's analysis to American equity markets is obvious.

The Evidence of Experience

No matter how much Professor Bebchuk attempts to denigrate what he calls "anecdotal" evidence, the experiences of those with "boots on the ground" must be taken into consideration in combination with the empirical evidence sampled above. Take, for example, some of the statements below from leaders who have firsthand experience with the short-term pressures faced by public company managers and directors.

● Bill George, a professor at Harvard Business School, former chief executive of the medical device company Medtronic, and currently a director of Goldman Sachs and Exxon Mobil, recently said in his August 2013 *New York Times* article, *Activists Seek Short-Term Gain, Not Long-Term Value*: "While activists often cloak their demands in the language of long-term actions, their real goal is a short-term bump in the stock price. They lobby publicly for significant structural changes, hoping to drive up the share price and book quick profits. Then they bail out, leaving corporate management to clean up the mess. Far from shaping up these companies, the activists' pressure for financial engineering only distracts management from focusing on long-term global competitiveness."

● Warren Buffet and 27 other highly regarded businesspeople, academics, investment bankers and union leaders expressed concerns about short-termism in "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management," a 2009 Aspen Institute policy statement. In this paper, these leaders voiced concern that "boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation," and that this trend toward short-term objectives has "eroded faith in corporations continuing to be the foundation of the American free enterprise system." In particular, they noted that "the focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managements and boards pursue strategies simply to satisfy those short-term investors," which "may put a corporation's future at risk."

● Dominic Barton, global managing director of McKinsey & Company, described the problem in "Capitalism for the Long-Term," a 2012 McKinsey publication: "[E]xecutives must do a better job of filtering input and should give more weight to the views of investors with a longer-term, buy-and-hold orientation. . . . If they don't, short-term capital will beget short-term management through a natural chain of incentives and influence. If CEOs miss their quarterly earnings targets, some big investors agitate for their removal. As a result, CEOs and their top teams work overtime to meet those targets. The unintended upshot is that they manage for only a small portion of their firm's value. When McKinsey's finance experts deconstruct the value expectations embedded in share prices, we typically find that 70 to 90 percent of a company's value is related to cash flows expected three or more years out. If the vast majority of most firms' value depends on results more than three years from now, but management is preoccupied with what's reportable three months from now, then capitalism has a problem."

● Daniel Vasella, former chairman and CEO of Novartis AG, spoke firsthand about the pernicious effects of the pressure created by such short-term expectations in a 2002 *Fortune* article: "Once you get under the domination of making the quarter – even unwittingly – you start to compromise in the gray areas of your business, that wide swath of terrain between the top and bottom lines. Perhaps you'll begin to sacrifice things (such as funding a promising research-and-development project, incremental improvements to your products, customer service, employee training, expansion into new markets, and yes, community outreach) that are important and that may be vital for your company over the long term."

A Proposal for Effective Shareholder Engagement

In laying out the evidence above, I do not mean to say that all forms of investor engagement are bad. To the contrary, I believe that collaborative interaction between boards and long-term shareholders can help increase the effectiveness of boards. Consider the observations of John Kay in the Kay Review. Kay encouraged "effective engagement" between asset managers and the companies they invest in. However, he did not hold all forms of engagement equal, arguing instead that all participants in the equity investment chain should act according to the principles of what he calls "stewardship": "Our approach, which emphasizes relationships based on trust and respect, rooted in analysis and engagement, develops and extends the existing concept of stewardship in equity investment. This extended concept of stewardship requires that the skills and knowledge of the asset manager be integrated with the supervisory role of those employed in corporate governance: it looks forward to an engagement which is most commonly positive and supportive, and not merely critical." Kay recommends that company directors "facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives." But, importantly, he also emphasizes that directors should "not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy."

I support Kay's views on what constitutes "effective engagement" and believe shareholder collaboration with management and directors along these lines could be a value-enhancing development for many companies both in the short-run and long-run.

Standing Firm, Not Running Away

As to Professor Bebchuk's allegation, I think it is clear that, far from "running away" from the evidence, my views and my colleagues' views are supported by many highly respected academics, policymakers, investors and business leaders whose empirical analyses and real-world experiences show that most activist interventions contribute to managerial short-termism and harm the innovation and growth potential of American companies. It is also clear that empirical evidence must be considered in context with other forms of evidence, including macroeconomic analysis, real-world experience and common sense, to determine if it tells a story that makes sense in the real world.

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