Wachtell Lipton discusses Short-Term Investors, Long-Term Investments, and Firm Value

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A January 2016 study, *Short-Term Investors, Long-Term Investments, and Firm Value*, by Martijn Cremers, Ankur Pareek and Zacharias Sautner, provides substantial "empirical" evidence for the fact that, in the current corporate governance environment, short-term investors possess the undue ability to pressure companies into maximizing near-term gains at the expense of long-term growth.

The study finds that after short-term investors become shareholders of companies, those companies tend to decrease spending on R&D, and tend to experience temporarily increased earnings and stock prices. The results further indicate that when the short-term investors leave, these trends are all reversed, "so that only long-term shareholders suffer from the reduction in long-term investment and firm value."

The authors conclude that the evidence supports a causal interpretation of these results—i.e., that short-term investors are able to pressure managers to cut long-term investments with the objective of generating near-term earnings, which in turn leads to temporary stock price increases. The study notes that R&D expenditures are "particularly susceptible to myopia," as management generally has the ability to quickly reduce or postpone R&D expenditures in order to boost current earnings. Moreover, the authors posit that, as a result of having asymmetric information about a company's long-term plans, shareholders are unable to immediately and accurately measure the impact of the R&D cuts. As such, shareholders will trade based on the impacted earnings, without fully realizing that the R&D cuts are destroying long-term value.

These results show yet again that short-termism presents a serious, systematic threat to sustainable economic growth and is likely to destroy, rather than create, long-term shareholder value. So too will these results—like all "empirical" studies that are based on stock prices and operating statistics—be rejected by the academic supporters of activist hedge funds, who will turn the methodological problems they ignore or deny in their studies to use in rejecting these results. However, these results will resonate with those who are familiar with the intense focus on whether new shareholders of a company are short-term or long-term oriented. The stock-watch firms that advise companies on the comings and goings and holdings of large shareholders divide their reports into red teams and green teams and advise based on whether the investors are short-term oriented or long-term oriented. The client company then takes that advice into account reviewing its portfolio and formulating strategy.

The preceding post comes to us from Wachtell, Lipton, Rosen & Katz. It is based on a memorandum circulated by the firm on February 3, 2015.