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Taking Short-Termism Seriously: A Response to Charles Nathan

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday, September 13, 2016

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here).

In a recent blog post on the *Conference Board Governance Center*'s website, "Activists Are Not the Culprit: So Don't Shoot the Messenger", Charles Nathan argues that criticism of short-termism is simultaneously misguided and hopeless. We agree with his ultimate practical advice—that companies have to engage more effectively with their major institutional shareholders to persuade them of the merits of long-term strategies—but he is wrong to dismiss concerns about short-termism and to surrender to its inevitability.

Nathan acknowledges both that "the bulk of institutional investors—the mutual fund complexes (whether actively managed or indexed) and managers of public and private pension funds and foundations—are long-term investors" and that "the institutional investment managers who manage the overwhelming majority of funds invested in the stock market, are motivated by a single over-riding imperative—gathering funds to manage and retaining those funds" and thus may have a "bias towards shorter-term alternatives." However, having observed this fundamental misalignment between the interests of the ultimate beneficial owners of corporations—ordinary working people who are looking for their retirement savings to grow steadily over the course of decades—and the incentives of the intermediaries who invest on their behalf, Nathan simply surrenders to its inevitability: "Inveighing against quarterly capitalism and its hand maidens, no matter how impassioned, is just not going to change the stock market's behavior." In other words, all money managers are short-termist, so get over it.

We disagree that we should resign ourselves to short-termism as the "unalterable bottom line." After three decades of turbulence in the corporate governance arena, we believe we are nearing an inflection point, as an increasing number of investors, stakeholders, academics, advisors, politicians and policymakers are recognizing the far-reaching and damaging effects of short-termism. Short-termism and activism are significant contributors to diminished GDP and to economic decline. They reflect a systematic failure to harness and cultivate the value of human capital and strategic investments, and they accelerate social inequality and concomitant political tensions. To the extent that individual money managers are biased towards the short term for self-interested reasons, notwithstanding the damage to the long-term economy as a whole, this is all the more reason to bring attention to the problem and combat it.

Recognizing the financial, social and political effects of short-termism and activism, during recent years, a growing number of institutional investors have publicly renounced financial engineering to achieve short-term results at the expense of long-term investment and have encouraged corporations to develop and pursue long-term strategies and reject short-termist demands by activists. These investors, led by BlackRock, State Street and Vanguard, have called on corporations to resist financial engineering, to pursue long-term strategies and to embrace transparency and engage with their investors on a regular basis to cultivate an understanding of their performance and strategy. Corporations that implement the governance "best practices" advocated by these investors, with an amplified emphasis on engagement, transparency and ongoing collaboration with investors, to demonstrate that they are diligently pursuing well-conceived strategies developed with the participation of independent and engaged directors and executed by a competent management team, should be assured that, in exchange, these investors will be patient and support the corporation in resisting short-term pressures.

We expect that, contrary to Nathan's expectation for the unrestrained continuance of short-termism and activism, the major institutional investors, which in the aggregate control most of the significant publicly held corporations, will follow through on their assurances to corporations that they will support them in their long-term strategies and in their resistance to short-termism and activists. The increasing membership by institutional investors in organizations such as Focusing Capital on the Long Term, and the endorsement by a number of institutional investors of the Commonsense Principles of Corporate Governance announced in July, are concrete support for our optimism.

If these private sector initiatives fail to gain real traction, we expect there will be a number of regulatory actions designed to discourage short-termism. This regulatory impetus is evident in recent legislation introduced in Congress, the policy statements by Hillary Clinton in the U.S. and Theresa May in the U.K. and pending regulations in the EU. In the absence of, or in addition to, new regulation, long-term shareholders may seek injunctive relief and monetary damages from investors and activists who overtly or tacitly cooperate to force a corporation to produce short-term gains at the expense of long-term, sustainable investment. Such litigation might be brought on the grounds that the investors and the activists have effective control of the corporation and therefore have a fiduciary duty to the corporation and shareholders who are long-term investors.

Major institutional investors have the capability and responsibility to restore a long-term approach. Indeed, the ultimate beneficial owners they serve will be principal beneficiaries of a governance regime that is calibrated to produce long-term value creation and sustainable economic prosperity. One way or another, we believe they will be successful in rebalancing the relationship between corporations and shareholders to facilitate rather than undermine this objective.