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Envestnet Edge
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The End of Short-Termism is Long Overdue

For the past forty years, Wall Street and corporate boards increasingly have focused on short-term profits. Quarterly earnings determine the fate of a company's share price, and demonstrating a robust trajectory of short-term earnings growth is rewarded above all else. Signs suggest that this trajectory is shifting, and if it does, that will bolster a long-term approach to investing and managing money.

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The times they are a changin'

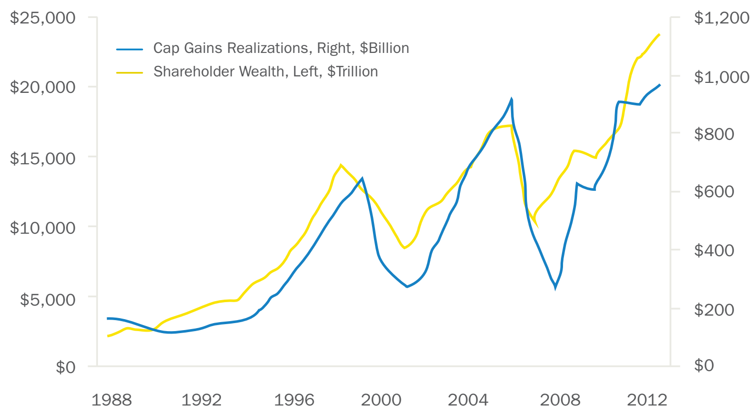
Larry Fink, the CEO of BlackRock, the world's largest asset manager, recently penned a letter urging a fundamental shift. Dispatched to the CEOs of the world's largest companies, Fink's letter criticized the relentless pressure of "activist" shareholders who push for immediate returns. He said, "More and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." While there may be nothing inherently wrong with buybacks (which have totaled more than $1 trillion this year), Fink warned that such short-term focus was harming long-term growth.

Notable for its candor, Fink's letter marks the latest sign that the very way companies approach their mission is changing. Wall Street's prevailing orthodoxy for more than forty years has been that the primary responsibility of companies is to maximize shareholder value. Variants of that view so dominate both the boardroom and the trading floor that some corporate boards fear being charged with violating their fiduciary responsibility if they consider other factors.

It was not always so. In fact, it was only recently so, starting with the now legendary (or infamous, depending on your perspective) essay by the legendary (or infamous) Milton Friedman in *The New York Times* in September 1970 titled, "The Social Responsibility of Business is to Increase its Profits." Pushing back against the tide in corporate America to attend to issues such as impact on communities and higher wages for employees, Friedman forcefully argued that the only duty management and boards have is to their employers: the shareholders who own the business. And those shareholders own businesses to increase profits (Figure 1).

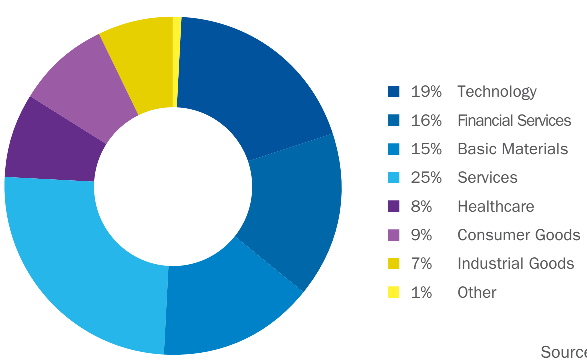
Not overnight, but soon enough, that was how most companies articulated their mission, and it certainly became the metric for investors who narrowly defined shareholder value in terms of the stock price. As we know, that mantra's most extreme form was recited by generations of activist investors, formerly known as corporate raiders, who used their ownership of shares to pressure management to restructure or divest parts of a business to unlock value so share prices could soar (Figures 2 and 3). Sometimes those activists exerted constructive discipline on inept and misguided management. But another result, as Fink stated, was that a generation of managers increasingly made decisions geared to sate the demands of activists. Short-term value was unlocked when share prices jumped, but long-term investment and societal consequences were neglected.

Figure 1:
Total Shareholder Wealth & Capital Gains Realizations



Source: Strategas

Figure 2:
Distribution of Activism, Publicly Targeted Companies, Dec 2014



Source: Strategas

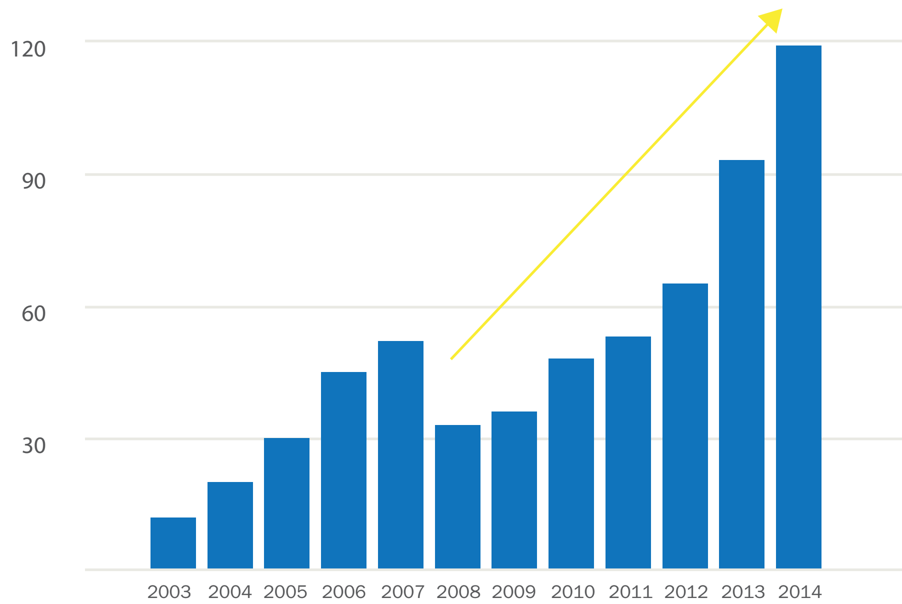
Going beyond the boardroom

Until recently, this debate was waged largely between left and right: those who called on businesses to attend to social issues such as the environment and women in the workforce versus those who adhered to the Friedman orthodoxy that such issues are best addressed, if at all, outside the boardroom. If Fink's letter is an indication—and it is—this debate is moving beyond the partisan and into the realm of the pragmatic. That is already true in large swaths of Europe, where many companies have rejected quarterly earnings and now report only twice a year, or even less frequently.

Evidence of similar shifts is apparent in the United States. Money for innovation and investment to cultivate intellectual property is a vital facet of future growth, but one that many companies are finding difficult to justify. Even with the Bureau of Economic Analysis's re-characterization of spending on intellectual property development as an output rather than a cost, companies are spending less on developing new products. Outliers such as Google, Microsoft and other big-tech companies notwithstanding, spending on research and development has shrunk, as managers shy away from explaining why quarterly earnings are being sacrificed to amorphous long-term prospects.

The cuts have been not only in innovation. Wages also have fallen or stagnated. The global wage arbitrage of the 21st century expanded not only the efficiencies of new information technologies but also the avenues for cost-cutting. But now, separate from the political and social debates about the moral merits of higher minimum wages, a swath of larger companies has unilaterally decided to raise wages in recent months, most

Figure 3:
Too Much Activism? Global Activist Hedge Funds (AUM, $Billions)



Source: Strategas, *The Wall Street Journal*, *IR Magazine*

Figure 4:
Walmart, Target, McDonald's Increase Minimum Wages

	Minimum Wage	% Over Federal Min. Wage ($7.25/hour)
Walmart	$9 (as of April 2015) $10 (planned Feb 2016)	24% 38%
Target	$9 (as of Spring 2015)	24%
McDonald's	$9.90 (as of July 2015)	37%
Washington (highest state minimum wage)	$9.47	31%

Source: *The Wall Street Journal*, *NY Times*, CNBC

notably Walmart, Target, and McDonald's (Figure 4).

The reasons are remarkably similar to the rationale behind Fink's letter: shaving wages may be good for earnings, but they dampen morale, make it challenging to retain good employees, and undermine the purchasing power of consumers whom those companies depend on to buy their products. Said the CEO of Walmart to the company's employees in announcing the raise, "It starts by making sure we're setting you up for success."[1]

Cynics might note that each of the major companies to announce pay hikes faces headwinds to its business model. True. But it might be equally true that those challenges stem from the same short-termism that pushed wages so low that the business model began to crack.

Further evidence that the narrow, short-term vision of shareholder value is nearing an end are proposals with the SEC that activist investors must disclose their attempts to gain more than 5% of a company within one day, rather than ten, and must

Emphasizing long-term sustainable business means less attention to quarter-over-quarter and more to year-over-year performance.

[1] Source: "In Letter to Associates, Walmart CEO Doug McMillon Announces Higher Pay", Walmart.com, February 19, 2015.

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slow down their pace of buying[2]. The intent is greater transparency, making it considerably more difficult simply to game the stock under the guise of "unlocking shareholder value."

What this means for investors

It's not that the fundamental goal for companies has changed. But the path to prosperity soon may look different. Higher corporate profits is still the goal, but the road to it includes higher pay for workers, greater concentration on long-term sustainable growth, and a more nuanced understanding of what constitutes success.

For investors, that spells an emphasis on the intrinsic viability of a business and management's ability to build a company for the long haul. For sure, bond investors must always consider such factors, but bond-rating agencies are no less susceptible than equity analysts to the lure of short-term metrics. Shifting the emphasis to long-term sustainable business means paying less attention to quarter-over-quarter and more to year-over-year performance. It also means rewarding companies for investing or paying workers in a way that might decrease short-term earnings and cash flow but increase them over time.

If this trend does prove to be transformative, it will be yet another factor that focuses markets and investors on investing rather than trading, on fundamentals rather than momentum, and on managements who view their task as stewards of a company's future. ■

[2] Source: "Congress Asked to Act on Activist Investor Disclosures", *The Wall Street Journal*, April 15, 2015.

Advisor Take-Away:

Corporations and investors are redefining what constitutes shareholder value after decades of being at the mercy of activists and narrow-mindedness on short-term earnings, dividend increases, and share buybacks to drive stock prices higher. In the past, management decisions may have conflicted with building and sustaining long-term growth. Now the tide is shifting, as corporations realize that investments in research, product development, and paying workers a livable wage are equally important. Similarly, investors who make decisions based on short-term performance metrics may need to reassess their own strategies. Higher corporate profits and investor returns are still fundamental goals, but the path to achieving them may look different.