

# **Breaking the Short-Term Cycle**

**Discussion and Recommendations on  
How Corporate Leaders, Asset Managers, Investors,  
and Analysts Can Refocus on Long-Term Value**

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**Proceedings of the CFA Centre for Financial Market Integrity  
and Business Roundtable Institute for Corporate Ethics  
Symposium Series on Short-Termism**

**July 2006**

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## ***About the Symposia***

Beginning in September 2005, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics co-sponsored the “Symposium Series on Short-Termism” to address the issue of “Short-Termism”—corporate and investment decision-making based on short-term earnings expectations versus long-term value creation for all stakeholders—from a unique cross-group perspective.

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# Breaking the Short-Term Cycle

## Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value

*Proceedings of the CFA Centre for Financial Market Integrity  
and the Business Roundtable Institute for Corporate Ethics  
Symposium Series on Short-Termism*

### EXECUTIVE SUMMARY

Beginning in September 2005, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics co-sponsored a “Symposium Series on Short-Termism.” The purpose of these symposia was to address the issue of “short-termism”—corporate and investment decision making based on short-term earnings expectations versus long-term value creation for all stakeholders—from a unique cross-group perspective.

The insights of our symposia participants (“the Panel”)—thought leaders from the corporate issuer, analyst, asset and hedge fund manager, institutional investor, and individual investor communities—confirm what the academic research suggests: namely, that the obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.

### SUMMARY OF RECOMMENDATIONS

Corporate leaders, asset managers, investors, and analysts should:

1. **Reform earnings guidance practices:** All groups should reconsider the benefits and consequences of providing and relying upon focused, quarterly earnings guidance and each group’s involvement in the “earnings guidance game.”
2. **Develop long-term incentives across the board:** Compensation for corporate executives and asset managers should be structured to achieve long-term strategic and value-creation goals.
3. **Demonstrate leadership in shifting the focus to long-term value creation.**
4. **Improve communications and transparency:** More meaningful, and potentially more frequent, communications about company strategy and long-term value drivers can lessen the financial community’s dependence on earnings guidance.
5. **Promote broad education of all market participants about the benefits of long-term thinking and the costs of short-term thinking.**

The Panel asserts that our broad set of recommendations—focused on the issuer, analyst, institutional investor, asset manager, and hedge fund manager communities—could mitigate the current overemphasis on short-term performance.

The CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics thank the many commentators and participants for their contributions.

## RECOMMENDATIONS

### Recommendations

The Panel encourages corporate leaders, asset managers, institutional investors, and analysts to:

#### **Earnings Guidance**

1. End the practice of providing quarterly earnings guidance.
2. However, companies with strategic needs for providing earnings guidance should adopt guidance practices that incorporate a consistent format, range estimates, and appropriate metrics that reflect overall long-term goals and strategy.
3. Support corporate transitions to higher-quality, long-term, fundamental guidance practices, which will also allow highly skilled analysts to differentiate themselves and the value they provide for their clients.

#### **Incentives and Compensation**

1. Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests. Compensation should be structured to achieve long-term strategic and value-creation goals.
2. Align asset manager compensation with long-term performance and with long-term client interests.
3. Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.
4. Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.

#### **Leadership**

1. Endorse corporate leadership in communicating long-term strategic objectives and related performance benchmarks rather than in providing quarterly earnings guidance.
2. Support analysts and asset managers in using a long-term focus in their analyses and capital investment decisions.
3. Promote an institutional investor focus on long-term value for themselves and when evaluating their asset managers.

#### **Communications and Transparency**

1. Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting that reflects a company's operations.
2. Encourage greater use of *plain language* communications instead of the current communications dominated by accounting and legal language.
3. Endorse the use of corporate long-term investment statements to shareowners that will clearly explain—beyond the requirements that are now an accepted practice—the company's operating model.
4. Improve the integration of the investor relations and legal functions for all corporate disclosure processes in order to alleviate the current bifurcated communications that confuse, rather than inform, investors and analysts.
5. Encourage institutional investors to make long-term investment statements to their beneficiaries similar to the statement the Panel is asking companies to make to their shareowners.

#### **Education**

1. Encourage widespread corporate participation in ongoing dialogues with asset managers and other financial market leaders to better understand how their companies are valued in the marketplace.
2. Educate institutional investors and their advisors (e.g., consultants, trustees) on the issue of short-termism and their long-term fiduciary duties to their constituents.
3. Support education initiatives for individual investors in order to encourage a focus on long-term value creation.

## INTRODUCTION AND CALL TO ACTION

In 2003, former U.S. Securities and Exchange Commission (SEC) Chairman William H. Donaldson called upon business leaders at a corporate governance forum “[to] manage the business for long-term results and to get away from the attitude that you’re managing the business out of a straight jacket that has been put upon you to create earnings per share on a regular basis.” He further encouraged these leaders to “present to investors exactly how you are going to manage that business.”<sup>1</sup> Expanding his concern at the 2005 CFA Institute annual conference, Donaldson cited “short-termism” as a critical issue facing the financial industry.

Similar concern is noted by corporate executives. In research conducted by the Business Roundtable Institute for Corporate Ethics, chief executive officers (CEOs) at many of the largest U.S. corporations were asked to identify the most pressing ethics issues facing the business community. “Effective company management in the context of today’s short-term investor expectations” was among the most cited concerns.<sup>2</sup>

In a recent survey of more than 400 financial executives, 80 percent of the respondents indicated that they would decrease discretionary spending on such areas as research and development, advertising, maintenance, and hiring in order to meet short-term earnings targets and more than 50 percent said they would delay new projects, even if it meant sacrifices in value creation.<sup>3</sup> These results demonstrate that short-termism is a larger issue than companies simply using *accounting* actions to meet quarterly earnings expectations. These are *real* actions—asset sales, cuts in research and development, and forgone strategic investments—that corporate managers use to hit “the quarterly earnings number.” Although the creation of long-term company value is widely accepted as management’s primary responsibility, this research suggests that managing predominantly for short-term earnings expectations often impairs a manager’s ability to deliver such value to shareowners.

These collective concerns mirror the views of the Panel gathered for the symposium series on short-termism. The Panel agrees that an obsession with meeting short-term expectations of varying constituencies too often hinders corporate managers and all types of investors from focusing on long-term value creation. The causes of this short-term fixation are multifaceted, which necessitates reforms that involve many stakeholders, including those who participated in the symposium (corporate issuers, analysts, asset managers, shareowners, institutional investors, regulators, and media representatives).

To be sure, the introduction of new information that is material to a company’s health demands that investors and other market participants respond quickly. Such short-term actions actually promote market efficiency. The short-termism issue addressed in this paper, however, focuses on instances in which long-term investment decisions are made on the basis of short-term information, the most prominent of which is the “hit or miss” of quarterly earnings guidance. The Panel believes that where long-term planning and investment is called for, short-term information should factor into decision-making primarily in the context of supporting such long-term strategy.

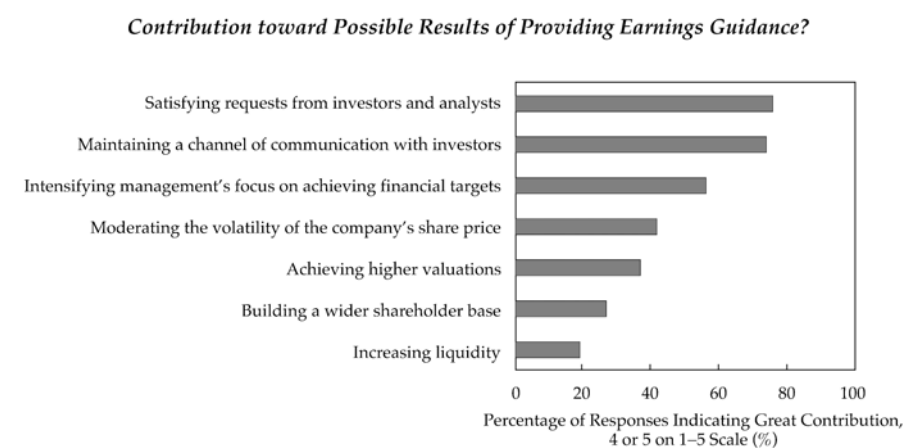
*Short-termism* refers to the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation. An excessive short-term focus combined with insufficient regard for long-term strategy can tip the balance in value-destructive ways for market participants, undermine the market’s credibility, and discourage long-term value creation and investment. Such short-term strategies are often based on accounting-driven metrics that are not fully reflective of the complexities of corporate management and investment.

Warren Buffett, the widely respected and emulated CEO of Berkshire Hathaway Inc., addressed the issue in his letter to shareowners in 2000 by encouraging management teams to place their attention and focus on long-term strategy, not quarterly earnings. Subsequently, companies representing significant Berkshire holdings, including Coca-Cola, Gillette, and The Washington Post Company, ceased providing quarterly earnings

guidance and, instead, opted for annual projections. More recently, Intel, McDonald's, Motorola, and Pfizer joined the growing group of companies signaling their plans to scale back focused earnings guidance. This movement away from earnings guidance reflects a growing sentiment summarized by John C. Bogle, founder and former CEO of The Vanguard Group, that "[t]he role of management should not be beating abstract numeric estimates but improving the operations and long-term prospects of organizations."<sup>4</sup>

Why do many companies continue to issue earnings guidance? In a March 2006 survey conducted by McKinsey & Company, a worldwide group of business executives identified the three most significant benefits of earnings guidance as (1) satisfying requests from investors and analysts, (2) maintaining a channel of communication with investors, and (3) intensifying management's focus on achieving financial targets (see Figure 1).<sup>5</sup> The Panel's recommendations provide a better roadmap to achieve these objectives.

**Figure 1: Perceived Benefits of Issuing Guidance**



*Source:* The McKinsey Quarterly, March 2006.

The McKinsey survey further indicates that the most demanding groups calling for earnings guidance are sell-side analysts, mutual/pension funds, and internal (within the company) sources—groups that were represented in our symposia. Each group does indeed share responsibility, and ultimately, each must contribute to a better model. Continuing to follow the rules of “the earnings guidance game” runs counter to the research suggesting that these behaviors can have unintended and detrimental consequences, such as destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.

In recognition of the magnitude of short-termism and its impact, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics conducted a unique series of symposia on the topic that brought together a broad cross-section of stakeholder groups. The groups initially convened individually. Subsequently, a meeting of all participants was held to discuss and agree upon suggested principles and recommendations for broadly addressing the issue of short-termism. The Panel identified five broad categories of recommendations in response to the short-termism issue: (1) earnings guidance practices, (2) compensation and incentive practices, (3) leadership that refocuses on long-term metrics, (4) communication and transparency of long-term valuation data, and (5) improved education for all market participants.

The following pages detail each issue and describe the Panel's recommendations for breaking the short-term cycle and refocusing corporate leaders, asset managers, investors, and analysts on long-term value.

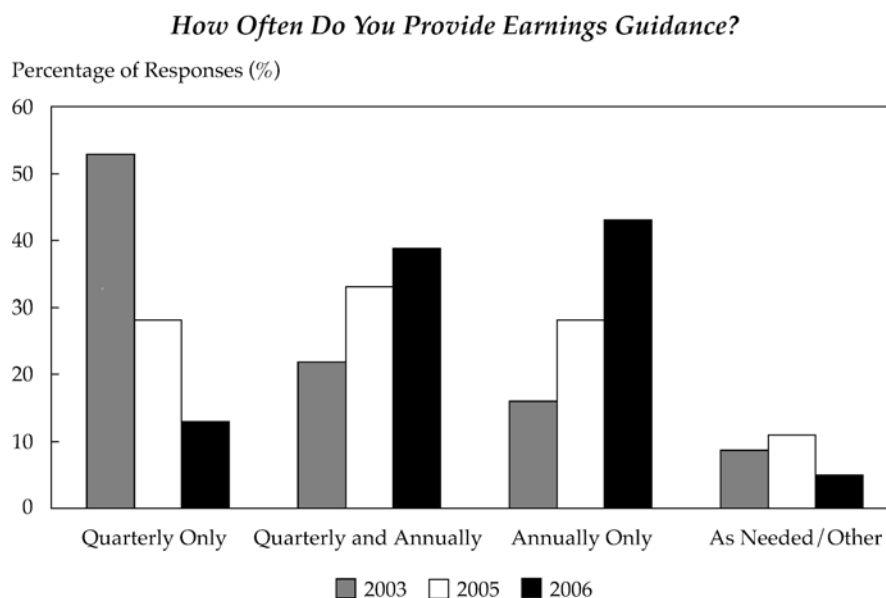
## EARNINGS GUIDANCE

In a 1998 article, financial historian Peter Bernstein gently chastised the capital markets for focusing too much on measures of central tendency, such as consensus earnings estimates, as a way to measure and mitigate risk. Bernstein observed, “Simplification lures us into the trap ... we set for ourselves with our demand for the ‘essence’ in preference to the variation, for simplification is impossible without the averages and the other measures of central tendency.”<sup>6</sup> Indeed, the current earnings guidance landscape tends to crowd out “variations” in an effort to boil a company’s complex future prospects down to its “essence,” a practice Bernstein surmised might perpetuate the kind of risk market participants seek to avoid.

Although there may be certain benefits to providing earnings guidance, the costs and negative consequences of the current focused, quarterly earnings guidance practices are significant, including (1) unproductive and wasted efforts by corporations in preparing such guidance, (2) neglect of long-term business growth in order to meet short-term expectations, (3) a “quarterly results” financial culture characterized by disproportionate reactions among internal and external groups to the downside and upside of earnings surprises, and (4) macro-incentives for companies to avoid earnings guidance pressure altogether by moving to the private markets. Corroborating research identifies the most significant costs of issuing guidance to be management time (which 53 percent of respondents identified as very costly), a focus on short-term earnings (42 percent), and employee time (35 percent).<sup>7</sup> Additionally, earnings guidance contributes to an illusion of complete business predictability, a faulty premise for both companies and their investors.

Recent evidence suggests that companies are indeed addressing the shortcomings of the current earnings guidance landscape. The trend is to shift from quarterly to annual guidance and, in some instances, to withholding guidance entirely. According to research conducted by the National Investor Relations Institute (NIRI), the number of companies providing quarterly guidance decreased from 75 percent in 2003 to 52 percent in 2006. The number of companies providing annual guidance has increased to 82 percent from 38 percent over the same period, and the percentage of companies that now provide *only* annual guidance is 43 percent (see Figure 2).<sup>8</sup>

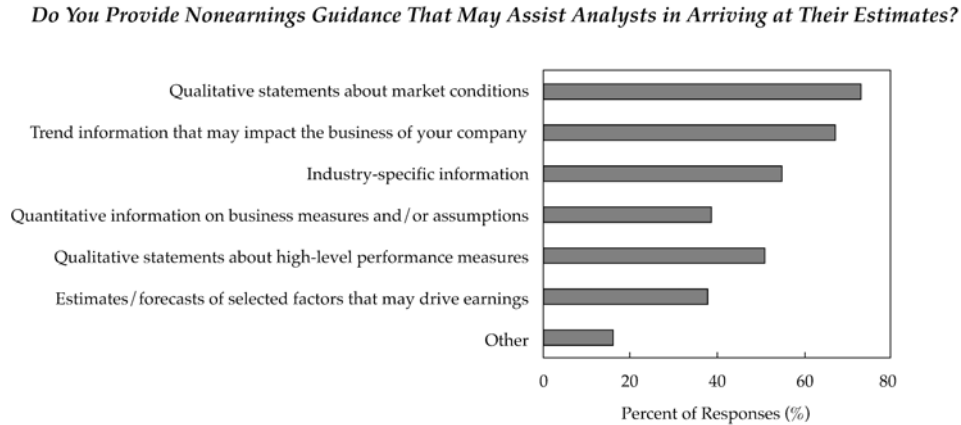
**Figure 2: NIRI Survey on Earnings Guidance Practices**



*Source: National Investor Relations Institute.*

Discontinuing the practice of earnings guidance does not imply discontinuing communication. Indeed, the NIRI participants who do not provide earnings guidance note a lengthy list of quantitative and qualitative information that they do provide to assist analysts and the broad investment community (see Figure 3).

**Figure 3: NIRI Survey on Earnings Guidance Practices**



Source: National Investor Relations Institute.

These survey results should encourage corporations to examine their own guidance practices and consider whether they are indeed following “leading practices” for informing shareowners and others about their businesses.

Although a majority of panelists supported a recommendation for companies to discontinue providing quarterly earnings guidance, there was recognition that such a bold step might not be appropriate for all companies. Accordingly, one framework suggested by the Panel (the second recommendation in this section) is a matrix of evolving practices based on both company size and industry life-cycle characteristics.

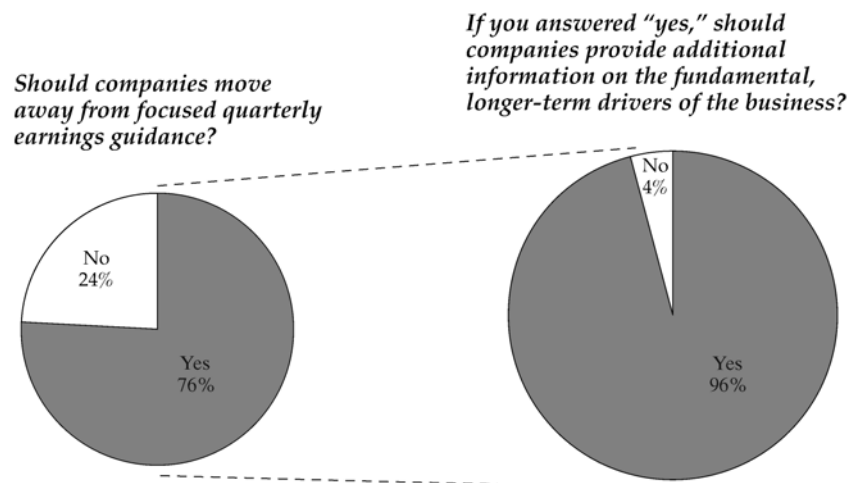
Efforts by corporations to adjust earnings guidance practices will require significant cooperation and communication with the analyst and asset manager communities to gain support for reforms. Analysts are increasingly recognizing that earnings guidance “creates an echo chamber that drowns out investor debate and distills what should be a complex message about a company’s operations and performance into a single number—dictated by the company itself,” according to the head of global securities research at Merrill Lynch & Company. The Merrill Lynch position, she added, is that “it would be in the best interests of investors if companies dropped quarterly earnings guidance.”<sup>9</sup>

A broad base of financial professionals is also supportive of such a change. In a CFA Institute survey of its membership, which includes a large contingent of asset managers and analysts, 76 percent of respondents supported companies moving away from quarterly earnings guidance. Of those supporters, 96 percent further agreed that companies should provide additional information on the fundamental, long-term drivers of the business (see Figure 4).<sup>10</sup> Discontinuing earnings guidance would offer skilled analysts and asset managers an opportunity to differentiate themselves and add value by conducting insightful research and building superior valuation models for their clients.

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**Figure 4: CFA Survey of Earnings Guidance**


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Source: CFA Institute (2006).

Earnings  
Guidance

The recommendations made by the Panel for reforming earnings guidance aspire to refocus attention on the reality of business complexities. Focusing on key assumptions, business drivers, and overall strategic objectives will lead to more valuable and insightful disclosures, analysis, investment, and decision making.

## EARNINGS GUIDANCE RECOMMENDATIONS

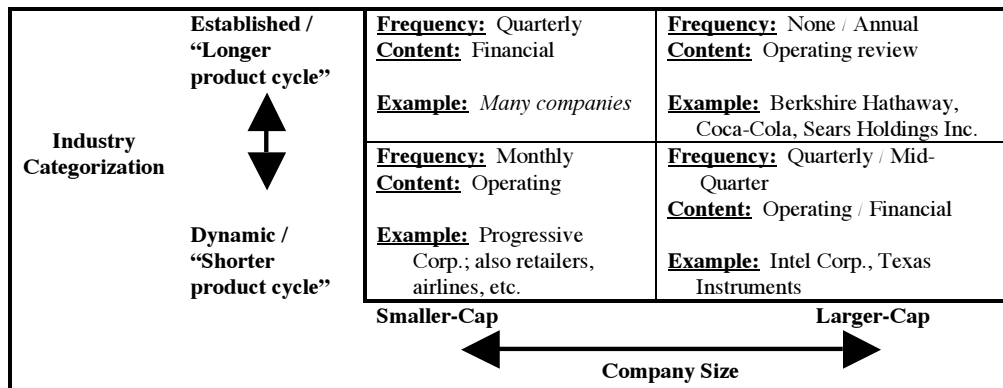
### 1. End the practice of providing quarterly earnings guidance.

The widely held consensus of the Panel is that publicly traded companies should end the practice of providing quarterly earnings guidance. The Panel believes that such guidance inadequately accounts for the complex dynamics of companies and their long-term value drivers.

By proactively moving to change a culture that has become overly obsessed with meeting a quarterly earnings number, companies would also motivate analysts to effectively differentiate themselves and their analyses, thereby encouraging a long-term outlook by both the institutional and individual investment communities.

### 2. However, companies with strategic needs for providing earnings guidance should adopt guidance practices that incorporate a consistent format, range estimates, and appropriate metrics that reflect overall long-term goals and strategy.

In recognition of the difficulty some companies may encounter in abruptly ending quarterly earnings guidance, the Panel introduced the concept of an “earnings guidance life cycle” as a method to replace the current “one-size-fits-all” quarterly guidance model and allow companies to improve the quality of their disclosures on the basis of company-specific and industry characteristics. The “earnings guidance life cycle” is depicted in Figure 5.

**Figure 5: Guidance Practices Framework**

The life-cycle concept also supports a process for companies to ultimately end focused earnings guidance. For example, an early-stage, small-capitalization company with a shorter-term product/service cycle is likely to be covered by few analysts and may need to raise capital from the financial markets over a regular time frame (e.g., every two to three years). In today’s capital markets, such a company may not have the strategic option of providing less than quarterly guidance. As the company grows and/or diversifies its products, services, and markets, however, it can tolerate potential fluctuations in volatility and investor sentiment that may occur with less frequent earnings guidance. Still later in the corporate life cycle, the company may have matured to the point of focusing on managing the business for the long term and have little need to provide earnings guidance to outside sources.

From a tactical perspective, a company could notify users of its financial data of a planned change in what guidance it considers appropriate according to the earnings guidance life-cycle model by stating, for example, “... when we meet the current guidelines we have communicated [perhaps including market-cap, market share, yearly revenue, and sales targets], we intend to begin providing less earnings guidance [or will cease to give quarterly earnings guidance]. We intend to provide monthly operating data on our website to help investors understand our business and provide them the information necessary to value our company.”

Our panelists noted that several companies that have stopped providing quarterly earnings guidance now offer *more* information (such as monthly operating data) that is also of a higher quality and less susceptible to manipulation than earnings. These companies thus still provide analysts with the information they need to complete their analyses and run their valuation models.

**3. Support corporate transitions to higher-quality, long-term, fundamental guidance practices, which will also allow highly skilled analysts to differentiate themselves and the value they provide for their clients.**

Asset managers, institutional investors, and analysts should use their increasing influence to support reformed corporate earnings guidance and communications practices directed at long-term performance. Highly skilled analysts and asset managers should view a decrease in corporate earnings guidance as an opportunity to differentiate themselves and to add value by doing more direct research and creating superior valuation analyses and models.

## INCENTIVES AND COMPENSATION

Much attention is currently directed at corporate executive compensation, but a more thorough approach to addressing short-termism requires appropriate incentive policies and practices for corporate executives, asset managers, analysts, and others.

Although the current median tenure for CEOs of Fortune 500 companies is approximately five years,<sup>11</sup> the actions and decisions of these CEOs often have much longer consequences. To be properly structured, incentives should reflect the upside potential *and* downside risk of management actions and should align management interests with those of shareowners. One way companies can encourage long-term value creation is by basing the *majority* of executive compensation on long-term performance measures, even if such terms extend beyond the tenure of the executives themselves. (The definition of “long term” varies largely by industry, and therefore, incentive measures should reflect specific industry operating characteristics. Typically, in this context, long-term is considered to range from three to five years and should not be less than two years.)

Progress in long-term “pay for performance” is being made. In 2006, 57 percent of Business Roundtable companies indicated that the use of performance criteria has increased as a component of overall executive compensation. This is a notable increase from 49 percent in 2005 and 40 percent in 2004. Moreover, among the companies placing greater emphasis on performance, 20 percent use primarily long-term goals, 73 percent use a mix of long-term and short-term goals, and only 7 percent emphasize only short-term targets.<sup>12</sup> The Panel’s recommendations seek to advance this progress.

In January 2006, the SEC proposed new guidelines for executive compensation that would greatly enhance the disclosures U.S. listed companies must make concerning the compensation of their highest paid executives. Greater disclosure should allow asset managers and all investors to better understand whether corporate executive compensation packages provide the proper incentives to manage for the long term. The Panel encourages asset managers and institutional investors to develop rigorous processes for the thorough review of corporate executive compensation packages.

Similarly, evaluating the performance of asset managers against a quarterly benchmark is counterproductive to conditioning them as long-term investors. When asset managers are evaluated and compensated primarily on the basis of quarterly metrics, they may pressure companies into the same short-term thinking or increase volatility by regularly trading in and out of company securities in an effort to capture short-term profit. The Panel thus believes that a significant portion of incentive pay for asset managers should be measured by long-term (three to five years) metrics similar to those used at the companies in which they invest. To confirm this longer-term focus, asset management firms should provide investors with more information about their incentive structures.

### INCENTIVES AND COMPENSATION RECOMMENDATIONS

- 1. Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests. Compensation should be structured to achieve long-term strategic and value-creation goals.**

Although proposed SEC requirements on executive compensation will provide shareowners with greater transparency as to the components of management compensation, it is ultimately up to the companies themselves, their boards, and their shareowners to make sure that the interests of management are aligned with those of shareowners. All three panels identified executive incentives that focus disproportionately on short-term objectives as a key driver of short-termism.

Additionally, stock ownership guidelines should require all executives and directors to hold a *meaningful* amount of equity in the company at which they serve. “Meaningful” in this context can be defined as an amount that makes it economically material to the individual that a company succeed in the long-term.

**2. Align asset manager compensation with long-term performance and with long-term client interests.**

Evaluating asset managers quarterly almost ensures that many will fall short of the benchmark because of unpredictable short-term events, near-term stock market swings, and transaction fees that ultimately penalize returns to investors.

As much as possible, incentive pay for asset managers should be measured by long-term metrics in order to promote a long-term investment horizon. The Panel recommends that asset managers investigate ways to link asset manager pay to performance—in much the same way the Panel encourages corporations to rethink corporate executive pay to better reflect long-term performance. An example would be tying manager incentives to multi-year performance. By creating more transparent links between asset manager pay and long-term performance, asset management firms will help ensure fund shareowners that asset managers are paid for performance, not asset gathering.

Asset managers should also be encouraged to commit a *meaningful* portion of their own wealth to the funds they manage in order to tie their compensation directly to the wealth they create for fund shareowners.

**3. Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.**

Asset managers and investors have long called for more transparency from the companies they evaluate and in which they invest, especially in the areas of executive compensation. Similar incentive disclosures are severely lacking in the managed funds industry.

The Panel calls on asset management firms to more closely link incentive compensation to long-term performance. Because most investors in mutual funds have a long-term investment horizon, asset management firms should strive to provide investors with more information concerning asset manager incentive metrics and incentive structures. Greater transparency concerning the incentive structures of asset managers will go a long way toward reassuring investors that the interests of asset managers run parallel to their own.

Although hedge funds do not fall under the same regulatory rubric as mutual funds, hedge fund managers should strive to assure long-term investors (e.g., those that agree to lock up their funds for a prolonged period of time) that the fund managers are fairly compensated on the basis of long-term results through use of incentive fees and other methods of tying fees to long-term performance.

**4. Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.**

The new SEC guidelines for executive compensation disclosures should provide all shareowners with better tools for evaluating whether corporate executive compensation packages properly link pay to performance and provide executives with the incentives to manage for the long term. The Panel encourages asset managers and institutional investors to closely examine corporate pay packages to ensure that incentive plans are aligned with the long-term interests of shareowners.

## LEADERSHIP

Several panelists claimed that the short-termism mindset among certain investors is correlated with an overall loss of trust in corporate leaders. Those investors who have become distrustful of business leadership and its commitment to long-term value creation may have opted to seek short-term profits instead of long-term growth in value.

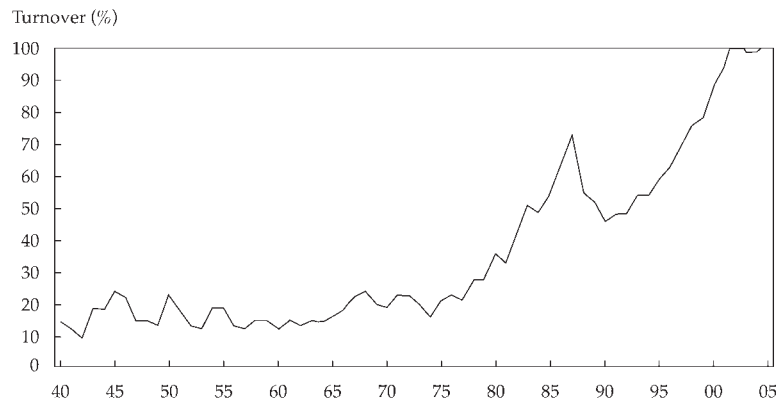
TIAA-CREF, one of the largest financial services organizations in the United States, has published a principle that “sound corporate governance contributes significantly to long-term corporate performance.”<sup>13</sup> Believing that reform efforts should be focused throughout the business and investor community on regaining the public trust, the Panel endorses a similar philosophy. Companies as a group, as well as their investors, would better demonstrate corporate leadership by concentrating their attention on the long-term business strategy of their companies.

One symposia participant summarized, “Companies get the shareowners they deserve.” The corollary is also true: Shareowners get the companies they deserve. In other words, long-term shareowners need to act like the owners they are and demand proper long-term stewardship of their capital assets. This is a two-way relationship. Investors should expect greater influence but must exhibit true ownership behavior and generally commit to acting like *owners* (e.g., holding longer, trading less). Similarly, companies should expect longer capital commitments—but only if they provide investors with high-quality communications and a fair voice in governance.

A company can make an active effort to seek a base of shareowners whose investment horizons mirror the company’s strategy for long-term economic growth by focusing its communications and disclosures on the long-term strategy, operations, and viability of the business. Moreover, the company should resist the pressures of shareowners who simply clamor for short-term results (see the following section on “Communications and Transparency” for further discussion). Put another way, leading companies and their shareowners need to coalesce around the appropriate long-term value creating strategies.

Currently, many companies encounter significant short-term pressures from a more transient investor base. The annual turnover (“churn rate”) for shares of New York Stock Exchange-listed companies has increased dramatically from a range of 10 percent to 30 percent during the 1940–80 period to more than 100 percent in 2005 (see Figure 6). Certainly, such a churn rate imposes costs on companies and their investors, not the least of which are higher transaction fees and possible internal company trade-offs against long-term strategic investments.

In contrast, a group of *Fortune* magazine’s 2006 Most Admired Companies specifically recognized in the category of “Long-Term Investment” had an average turnover rate of approximately 60 percent in 2005.<sup>14</sup> These results suggest that, instead of short-term shareowners or speculators applying undue pressure, a core base of long-term shareowners allow these companies to make sound long-term investments.

**Figure 6: NYSE Turnover Rate**

Source: New York Stock Exchange Fact Book, 2006.

Corporate directors are one influential group that must take a leadership role in engendering a longer-term focus. In March 2006, *Directors & Boards* magazine asked its *eBriefing* subscribers, “Should companies end the practice of giving earnings guidance?” Almost 74 percent of respondents answered “Yes.” Equally intriguing was the overall interest in the question, which resulted in “the highest response rate and additional comments [of any question] to date,” according to the magazine’s editor.<sup>15</sup> Recently, the directors of Coca-Cola addressed shareowner concerns about short-termism in a unique manner. The board adopted an “all-or-nothing” compensation plan in which all director pay consists entirely of equity-based share units payable only when longer-term company performance targets are met. The initial performance period is three years.<sup>16</sup>

Leadership can also come from institutional investors willing to make a long-term commitment to strategy. Institutional investor equity holdings increased to \$8 trillion in 2005, representing 60 percent of outstanding equity in the United States.<sup>17</sup> With such influence, institutional investors have the opportunity to become a major advocate for supporting long-term, value-creating corporate strategies.

Leadership commitments from public companies, asset managers, and institutional investors to long-term strategy, investment, and ultimately, value creation will contribute to improved long-term performance for all market participants.

## LEADERSHIP RECOMMENDATIONS

- 1. Endorse corporate leadership in communicating long-term strategic objectives and related performance benchmarks rather than in providing quarterly earnings guidance.**

The Panel believes that companies gain little from participation in the current practice of providing quarterly guidance and can better serve themselves and their shareowners by concentrating attention on the long term.

Companies that discontinue providing earnings guidance can take the lead in demonstrating the long-term benefits of devoting less of their valuable resources to providing guidance.

Leading companies can focus attention on the long term by embracing enhanced reporting that concentrates on cash flows and a broad range of operating metrics. These companies can take the lead in “changing the conversation” to a focus on the long-term growth prospects that are ultimately more important to continued success than pennies per share in a quarterly earnings forecast.

## **2. Support analysts and asset managers in using a long-term focus in their analyses and capital investment decisions.**

It will take leadership from analysts and investment firms to focus more on the long term and align their incentive structures with a long-term mandate. But without such leadership, it is doubtful that such changes will happen.

Such panelist comments as “the quality of analysts has declined in recent years” support the need for CFA Institute to continue emphasizing long-term measures, including discounted cash flow (DCF) valuation models, over short-term asset valuation models in its curriculum. CFA Institute will continue to espouse the virtues of such long-term valuation models and will revisit its curriculum to determine if and where undue emphasis is being given to short-term investment strategies that are detrimental to the creation of long-term shareowner value.

Additionally, the current “consensus earnings” culture places significant pressure on analysts whose estimates differ from company guidance, thereby promoting analyst conformity. CFA Institute supports bringing about a market in which the hard work, expertise, and independent assessment of the best analysts are rewarded.

Leadership

## **3. Promote an institutional investor focus on long-term value for themselves and when evaluating their asset managers.**

Some panelists cited the actions of institutional investors and pension funds as part of the short-termism problem. Members of our institutional investor panel stated that many pension funds are focusing too closely on the same quarterly performance data that they criticize companies and analysts for following. These pension funds sometimes evaluate asset manager performance based heavily on quarterly results—thereby exacerbating the very short-termism issue they bemoan and reinforcing the short-term-driven quarterly rating cycle.

The Panel encourages pension fund managers to evaluate their asset managers on a long-term basis and develop incentives based on a long-term measurement period (three to five years). The Panel believes that institutional investors would be better served by focusing their efforts on asset allocation and cost containment to meet their long-term return goals.

Institutional investors ultimately control an influential proportion of global equity and are in a position to encourage long-term thinking by supporting resolutions dealing with compensation, corporate planning, and other corporate actions that foster a long-term perspective.

## COMMUNICATIONS AND TRANSPARENCY

All investor groups that participated in our symposia called for meaningful communication and performance reporting that goes beyond the current calls for transparency and understandable language in disclosures. When the SEC approved Regulation Fair Disclosure (Regulation FD, adopted in August 2000), the explicit intent was to ensure that analysts, asset managers, and institutional investors would no longer receive privileged corporate information. Our symposia discussions suggest that an unintended consequence has been a decrease in the quality of information exchanged between companies, investors, and analysts. The Panel recommends bridging the gap between the information that companies believe is being requested and the information that investors, analysts, and other stakeholders really need.

A recent PricewaterhouseCoopers survey of business executives illustrates the gap between the quality of information companies provide and what their key stakeholder groups seek (see Figure 7). According to those surveyed, only the shareowner and analyst groups are being provided the information they consider important for understanding the company's overall strategy. However, even the group whose needs are best met—shareowners—are receiving only 62 percent of the information they need.<sup>18</sup> This research supports panelist recommendations for improved communication of information that allows all investors and analysts to better understand companies' long-term value drivers.

**Figure 7: Analysis of Stakeholder Information Needs**



Source: PricewaterhouseCoopers, 2006.

Clearly, companies need to focus efforts on meeting the unsatisfied information needs of their most important stakeholder groups—customers, employees, shareowners, suppliers, and analysts. Perhaps one of the most important responsibilities of company executives is to communicate and act on their corporations' values and to embed those values in the long-term strategy and "value proposition" of the company. Short-term earnings goals are inherently volatile and susceptible to significant fluctuations and are a hurdle to corporate leadership in communicating a company's long-term value prospects. An executive overly focused on and driven to respond to short-term objectives may diminish and discourage long-term commitment from employees, investors, and other important groups.

For shareowners and analysts, such communications should occur predominantly in plain language (not accounting or legal language) to encourage accurate analysis and a clear understanding of the business. These groups will rely less on the quarterly earnings guidance from companies if appropriate, high-quality performance metrics are provided on a frequent basis.

Public companies that wish to step off the earnings guidance treadmill may be able to do so by sharing more of the high-quality performance metrics they themselves use for internal planning. One panelist indicated that his company does not provide quarterly

earnings guidance but, instead, discloses on its website the same monthly operating data used internally for long-term planning. The company managers can then focus their efforts on educating analysts as to the business drivers of both the industry and the company. This communication strategy removes the drain on resources required by providing separate earnings guidance, and it provides more frequent information focused on how the company is managing for the long term.

## COMMUNICATIONS AND TRANSPARENCY RECOMMENDATIONS

### 1. **Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting that reflects a company's operations.**

The Panel believes that companies should strive to increase the understanding of their businesses by those in the financial community. A company can engender a long-term outlook in the financial markets by providing highly transparent financial statements that clearly communicate that company's financial position and long-term, value-creating prospects.

For example, by including both a condensed balance sheet and statement of cash flows in each quarterly earnings release, companies allow shareowners to easily reconcile the income statement items, always included in a quarterly earnings announcement, with the directly related balance sheet or cash flow statement items. Regular quarterly earnings releases should also provide expanded discussions of the balance sheet and cash flow impacts so that shareowners are given a clearer sense of companies' long-term value drivers.

In addition, the Panel believes it would be beneficial for companies to provide supplemental shareowner value information for investors. A large body of literature on shareowner value attempts to provide ways to improve communications with investors through robust tools that measure changes in shareholder value. An example discussed by symposia participants is the "Corporate Performance Statement" developed by Alfred Rappaport of Northwestern University's Kellogg Graduate School of Management, which would provide shareowners with more meaningful corporate performance measures than they currently receive and help the markets move away from over-reliance on earnings-based valuation models.<sup>19</sup> Rappaport argues that, although many market participants agree that DCF is the correct model for equity valuations, such models are more time-consuming than are the immediate share price reactions offered by earnings-based models. Unfortunately, both corporate managers and short-term investors often forget that earnings-based valuation models are, in reality, DCF models with a large number of implicit assumptions, including future growth rates, margin trends, and reinvestment rates. These assumptions should be explicitly stated through a DCF-driven model, where accounting that may obscure true performance must be clarified.

### 2. **Encourage greater use of *plain language* communications instead of the current communications dominated by accounting and legal language.**

One panelist spoke for many in suggesting that "... currently, the proxy statement is looked upon as a legal document, as a liability document. It should be a communications document."

The Management Discussion and Analysis (MD&A) narrative that accompanies financial statement filings is widely perceived to not meet the broad purpose of informing investors as originally intended. A study by the SEC in 2001 of the agency's review of annual reports filed by Fortune 500 companies revealed that "[the SEC] issued a significant number of comments generally seeking greater analysis [where] companies simply recited financial statement information without analysis or presented boilerplate analyses that did not provide insight into ... business prospects."<sup>20</sup>

Financial documents and other corporate communications should not be written predominantly in boilerplate or legal language. The Panel believes that investor uncertainty would lessen if such documents were written in plain language.

**3. Endorse the use of corporate long-term investment statements to shareowners that will clearly explain—beyond the requirements that are now an accepted practice—the company’s operating model.**

In each Berkshire Hathaway annual report, CEO Warren Buffett does a great service to Berkshire’s investors by providing insight into the state of the company and its long-term outlook. Over the decades, Buffett has also educated his shareowners about the virtues of long-term investing and helped create a long-term investor base—in part, because their CEO focuses his company and communications on the long term.

The Panel encourages company managers to follow this example and communicate more about the long-term investment outlook for their companies. Currently, the typical letter to shareowners spends a significant amount of time describing what the company did *right* in the past year and gives limited space to miscalculations or disappointments. The rest of the letter is likely to address expectations for the coming year, with vague references to a long-term mandate for “building shareowner value.”

Investors would be better served by this letter if it discussed with shareowners why the company should serve them well as a long-term investment. The Panel acknowledges that not everyone can write on the virtues of long-term investing as well as Buffett (although this is a hard proposition to prove because so few have tried.) Nonetheless, company managers owe it to shareowners to make the effort.

**4. Improve the integration of the investor relations and legal functions for all corporate disclosure processes in order to alleviate the current bifurcated communications that confuse, rather than inform, investors and analysts.**

Our panelists noted that the corporate communications process has become split between investor communications created and distributed by a company’s investor relations (IR) department and a large number of communications, including the annual report and proxy statement, that consist largely of boilerplate and legal language.

The Panel believes that by serving on a company’s corporate disclosure committee, an executive from a company’s IR department can help develop disclosure language that communicates the company’s corporate message better than the current boilerplate/legalese writing that dominates disclosure-related communications.

**5. Encourage institutional investors to make long-term investment statements to their beneficiaries similar to the statement the Panel is asking companies to make to their shareowners.**

Although several of the improvements to communications the Panel recommends pertain to *corporate* communications, the institutional investors on the Panel admitted that they also need to do a better job of communicating their long-term investment strategies to their beneficiaries.

This recommendation originated when a panelist observed, “Maybe one answer (to the lack of long-term vision by fiduciaries) is to have fiduciaries make a long-term investment statement so that beneficiaries have a better understanding of how their money is being managed for the long term.” Such a statement should focus on long-term liabilities faced by the institution and on that institution’s strategic investing plan to match long-term assets to those liabilities.

Additionally, the Panel encourages institutions to use this long-term investment statement to educate their beneficiaries about the costs of short-term thinking (turnover, trading costs, and manager replacement costs) that can erode long-term returns.

## EDUCATION

Some panelists in the asset manager group stated that too many corporate managers misinterpret how the market values their companies, and therefore, they focus too much attention on short-term valuation measures such as earnings per share. These panelists suggested that many public companies overestimate the influence of hedge funds, perhaps because of the heightened coverage these funds receive in the business media. Our panelists agreed that greater education of all significant parties—corporate leaders, investors, analysts, regulators, and the media—is a necessary element to address the complex nature of short-termism.

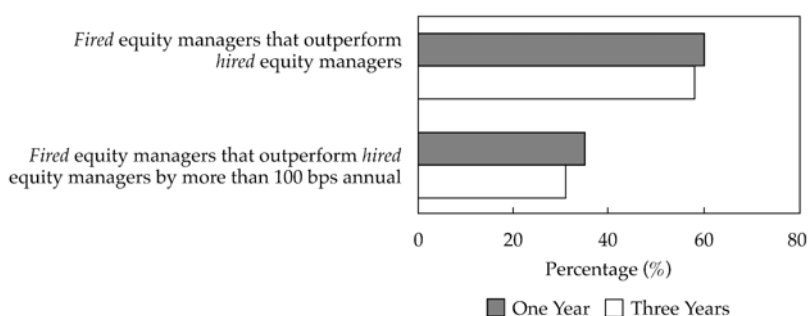
Institutional investors on the Panel specifically noted the need for better education of pension fund plan sponsors and pension fund trustees. This perspective was endorsed by a pension fund consultant, who suggested that some pension fund trustees may not possess the financial background necessary to adequately fulfill their fiduciary duties to fund beneficiaries in relation to a number of issues, not only short-termism.

Panel participants voiced concern that the true costs of hiring and firing asset managers may not be adequately understood by all pension funds and their trustees. They noted that an over-reliance on recent past performance may be indicative of a short-term mindset that ill serves the interests of the pension funds and their ultimate beneficiaries.

In an analysis of their clients, Cambridge Associates, an investment consulting firm to foundations, endowments, and other large institutions, found that 92 institutions in the period from 1996 to 2001 indicated that the decision to switch asset managers, often on the basis of short-term criteria, usually resulted in the destruction of value.<sup>21</sup> This analysis found that the *fired* equity managers outperformed the *hired* equity managers in 58 percent of the switches in the next year and in 60 percent of the switches over the next three years. Furthermore, the study found that if companies required new equity managers to beat their replacements by at least 100 basis points annually (to justify the costs and disruptions associated with switching managers), only 35 percent of the changes would be labeled a success after one year, and only 31 percent after three years.

Education

**Figure 8: Performance of Hired and Fired Equity Managers**



Source: Cambridge Associates (2003).

A similar study published in 2006 by Watson Wyatt, a worldwide consultancy, reinforces these findings. The report found that pension funds and insurers often fire asset managers just before performance improves and often hire managers immediately before performance declines.<sup>22</sup>

Finally, panelists observed that more financially educated individual investors who better understand the consequences of focusing on the short term to the detriment of the long term would help alleviate the short-termism problem. A more knowledgeable investor would be better equipped to understand long-term business and investment strategy and could reinforce a focus on long-term horizons by corporate leaders, fund managers, and institutional investors.

Unfortunately, the overall financial education level in the United States and around the world is low. Only 8 of 50 states currently require a course with personal finance content to be taught in high school, and only 9 states test personal finance knowledge.<sup>23</sup> The Panel thinks that investor education efforts such as requiring more financial literacy programs in schools would help, although simply requiring such courses would be but one step in addressing the short-termism problem. A population armed with practical personal finance knowledge is likely to make for more patient future investors who are not as easily swayed by short-term influences.

## EDUCATION RECOMMENDATIONS

### **1. Encourage widespread corporate participation in ongoing dialogues with asset managers and other financial market leaders to better understand how their companies are valued in the marketplace.**

The disconnect between perception and reality regarding how investment professionals value companies causes many corporate managers to focus on short-term metrics, such as earnings per share, instead of focusing on running their businesses for the long term.

Influential organizations, including CFA Institute and the Business Roundtable Institute for Corporate Ethics, can play a role in providing publicly traded companies with better information about how they are valued by sponsoring educational seminars for company executives or by bringing the asset management and corporate issuer communities together in forums to facilitate understanding. Such meetings would comply with Regulation FD because company managers would be listening to their asset management and hedge fund counterparts—a role reversal the Panel suggested many company managers would welcome.

### **2. Educate institutional investors and their advisors (e.g., consultants, trustees) on the issue of short-termism and their long-term fiduciary duties to their constituents.**

The need for pension fund trustee education came up on multiple occasions in the symposia discussions. Trustees who understand the market forces that produce short-termism will be better equipped to do their part to stop it.

The Panel encourages pension funds to make use of educational programs and materials already available to their trustees so that trustees can gain the knowledge required to adequately serve the long-term interests of beneficiaries.

### **3. Support education initiatives for individual investors in order to encourage a focus on long-term value creation.**

Individual investors would make fewer decisions that are counter to their long-term investing goals and would be less tolerant of behavior destructive to long-term value (by executives or investment professionals) if the individuals were better students of the financial markets and better long-term investors.

CFA Institute will work with appropriate partners to expand its educational efforts and aid in financial educational initiatives that serve the investing public. CFA Institute will also work to facilitate investor education through the sponsorship of investor forums and other events that aim to educate the investing public.

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