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It is essential that investors look to the long term

By David Blood and Al Gore
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As Abraham Maslow, the psychologist, once said: "If the only tool you have is a hammer, you tend to see every problem as a nail." This rings true of the financial markets using short-term financial measures to drive investment decisions regardless of time period.

The recent speech by William Donaldson, the former Securities and Exchange Commission chairman, to the CFA Institute, the financial analysts body, was a wake-up call for the investment community to put an end to this trend: "I hope that investors will begin to change, particularly when they see the value of an investment in a company that is managed for the long term."

Numerous studies show that most of a company's value is determined by its long-run performance. The best investors have understood this. And yet, the majority of the investment community now act as though the long term simply does not matter. The average mutual fund in America turns over 100 per cent of its portfolio every 11 months and quarterly earning targets are an obsession with analysts.

In a recent paper by the US National Bureau of Economic Research, 78 per cent of the financial executives surveyed said they would give up economic value in exchange for smooth earnings, and 55 per cent of managers would not initiate a project with a very positive return if it meant falling short of consensus earnings.

This short-term orientation has significant negative repercussions for the global economy - in essence, the market is short on long. If businesses are forgoing value-creating investments to manage short-term earnings, this will damage our economic vitality. A short-term perspective hinders innovation and research and development, diminishes investment in human capital, encourages financial gymnastics and discourages leadership.

How do we reverse this trend towards the dominance of short-termism? First, the investment community must embrace genuine long-term thinking. This means managing portfolios with an investment horizon of roughly five years, or through a business cycle. To do this, portfolio managers and analysts need to take account of factors that are not routinely monetised on balance sheets - including sustainability issues - as opposed to solely focusing on short-term returns. This means analysing the implications for shareholder value of long-term economic, environmental and social challenges. They include future political or regulatory risks, the alignment of management and board with long-term company value, quality of human resources management, risks associated with governance structure, the environment, restructurings/mergers and acquisitions, branding, corporate ethics and stakeholder relations.

Second, management must move away from the obsessive focus on meeting quarterly earnings per share targets and instead concentrate on what McKinsey, the consultancy, refers to as the "healthy company".

Third, the research community must address long-term issues. These extra-financial matters provide an opportunity for the sell side to differentiate itself and add value. In support of this trend, The Enhanced Analytics

Initiative (EAI), a consortium of fund managers and asset owners, encourages sell-side research into important

extra-financial issues. Furthermore, many executives are keen to have their shareholders aligned with their long-term thinking and are communicating their value-creation strategies to Wall Street and the City.

Capital markets and capitalism are at a critical juncture. The domination of short-termism will stifle innovation, damage our economies, further impair our pension systems and ultimately erode our standard of living. We are not against hedge funds; they have a role to play in capital markets. However, the long-term investment community, which represents the majority of total investable assets, must adopt truly long-term thinking. Company management and the research community must also look to the long term. Our livelihoods and those of our children and grandchildren depend on it.

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