The reasoning over short-term orientations is deeply flawed, writes Alfred Rappaport

Why do companies obsess over quarterly earnings and fail to invest adequately in long-term growth? And why would a company such as Volkswagen lie to its customers and government emission testers? Conventional wisdom places the blame squarely on the pursuit of shareholder value which, it is claimed, has fuelled pernicious short-term thinking and irresponsible behaviour.

That is wrong. The culprit is not shareholder value but rather corporate executives, investment managers and the business press who incorrectly believe that the governing
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8/15/16

objective of shareholder value is to boost a company’s near-term stock price by meeting the market’s quarterly earnings expectations. This misguided thinking has hijacked the good name of “shareholder value”. Consequently, companies commonly “talk” shareholder value but “walk” quarterly earnings in their everyday operations.

Let us be clear what managing for shareholder value really means. It means focusing on cash flow, not earnings. It means managing for the long-term, not the short-term. And it means that managers must take risk into account in their capital allocation decisions. Properly implemented, there is no better cure for short-termism than managing for shareholder value with its long-term orientation.

Critics also contend that shareholder value encourages the exploitation of other stakeholders. Quite the opposite is true. Shareholder value companies recognise that their long-term success depends on a solid relationship with each of their stakeholders. Customers expect high-quality products and services at competitive prices. Companies that charge too much will lose customers. Those that charge too little will have happy customers today but will find it difficult to fund the investments needed to provide better products and services tomorrow. The challenge is to find the price that adds value for both customers and shareholders.

Likewise, employees seek competitive remuneration and a satisfying work environment. Paying employees too little ensures that a company will have a substandard workforce. Paying too much, as the US car industry discovered, damages a company’s ability to remain competitive. Companies risk their viability if any one stakeholder gets too much or too little for an extended period.

The shareholder value concept also draws fire from critics who claim that it fails to address social issues such as the environment, global warming, poverty, and public health. Everybody wins when investments in socially responsible projects create shareholder value as well. But when companies invest in social initiatives at the expense of shareholder value, shareholders bear the cost through lower returns. The cost is ultimately borne by consumers through higher prices and employees via lower wages and fewer jobs.

Companies can prioritise the interests of stakeholders or the public rather than those of their shareholders. However, to honour their fiduciary duty to their investors they should disclose the circumstances under which they would invest in social initiatives that are expected to yield returns below the minimum return required to create value.

Finally, many executives claim they have no choice but to adopt a short-term orientation given that the average holding period for shares in managed funds is only about one year. They do not feel compelled to consider the interests of long-term shareholders because there are none. This reasoning is deeply flawed. What should matter is not portfolio turnover but the time horizons of the beneficiaries, typically individuals who are saving to meet long-term needs.
Because companies have not done shareholder value right, critics have concluded that it is flawed. Such thinking is backward. Shareholder value has not failed management. Management has failed the true principles of shareholder value.

*The writer is professor emeritus at the Kellogg School of Management and author of ‘Creating Shareholder Value’*