Strategic Outlook: Pushing Markets to Take the Long View

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I've been asked several times recently how the stock market could be rebounding in the face of such bad news, and in particular what appear to be large long-term imbalances. Out-of-control health care and military spending are driving up government borrowing, and consumers are awash in debt backed by the mirage of million-dollar, three-bedroom homes.

The markets have joined the politicians and become hooked on short-termism, with the election cycle being compressed into the four-times-per-year earnings report. None other than William Donaldson, outgoing Chairman of the Securities and Exchange Commission (SEC), highlighted this problem in a May speech to the leading society of investment analysts:

For companies, the short-term outlook has given rise to the disturbing syndrome of trying to force earnings into an artificial model of uninterrupted quarter-to-quarter growth..."Making the numbers" often results in unsound corporate strategies, which pay no regard to the cost of postponed investment. Such a goal is often achieved only by bending accounting standards.

Highlighting the breadth of the problem is the finding contained in a National Bureau of Economic Research working paper. The authors surveyed 401 financial executives and 78% said they would sacrifice an initiative they expected would create economic value if it would affect their ability to realize smooth earnings.[1]

If company and analyst behavior is going to change, the vanguard will be owners of stock, who have the ultimate power to shape management behavior. A good example of investor leadership for the long term is in the area of global warming. The Investor Network on Climate Risk (INCR) is devoted to raising climate risk awareness among institutional investors. It includes 45 participating members with $2.7 trillion in assets. These investors realize that climate change is not simply a public policy issue, but also a long-term investor issue with fundamental impact on regulation, liability and the very structure of the underlying economy that drives sustainable investment returns.

At the INCR conference at the UN in May, a group of state treasurers, state and city comptrollers, public and labor pension funds, foundations and religious institutional investors signed a call for action, including commitments to 1) deploy $1 billion of capital to achieve attractive long-term investment returns in alternative energies, 2) develop investor proxy voting policies around this issue, and 3) create a reliable global standard for company disclosure on climate risk.

As investor money focuses on the long term, both Wall Street analysts and the companies themselves will react. Climate change proxy resolutions, which received less than 5% of shareholder votes a decade ago, are now achieving more than 30% approval at energy companies like Anadarko and Apache. After a process of shareholder engagement Cinergy, which is the country's largest emitter of greenhouse gases and is in the process of merging with Duke Power, has agreed to cut emissions by 5% by 2012, and has advocated for an end to the regulatory uncertainty on climate change.

In the long run, stocks have shown themselves to be an excellent source for wealth building in a diverse set of countries. It is on a multi-decade view, not a quarter-to-quarter basis, that the society and its corporations are dependent on sustainable policies that ensure a healthy, balanced economy. A true investment horizon goes beyond short-term speculation to encompass our lifetimes and those of our children and grandchildren. As such, the big-picture issues like government finance, international relations, consumer debt and climate change policy will be the ultimate drivers of market returns. The more that owners of capital demand a focus on the long term, the better these returns will be.

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[1] CFA Institute Annual Conference, Philadelphia, May 8, 2005.