April 29, 2010

Mr. Chairman and Members of the Committee:

I am Judith Samuelson, Executive Director of the Business and Society Program of the Aspen Institute. The mission of the Business and Society Program is to align business with the long-term health of society.

Thank you for the opportunity to present ideas about curbing short-termism in business and capital markets. These ideas come out of dialogue that we began in 2003, building on the findings of a Blue Ribbon Commission convened by The Conference Board in 2002 that probed the rapid demise of Enron.

My father passed away last year at the age of 93. He spent his career at Pacific Telephone but he always loved the market and spent many hours a day in his retirement years pouring over the stock pages and his subscription to Value Line. I tried once to explain what I did for a living; I tried various terms and buzz words to explain the work we do that is aimed at influencing business—corporate social responsibility, environmental consciousness, stakeholders, leadership, ethics, values—but nothing was sticking. After a long and awkward pause, he finally said, bluntly, “Aren’t you just trying to say that business ought to take a long term view?”

He was right, of course. It took me a few more years to change the mission statement of our organization, but I have come to believe it is all about time frame. It's also about balance, judgment, and restoring trust in business. It's about recognizing the reality that the system is perfectly designed for the results we have now. If we want a different result, we need to change the rules that govern business decision-making.

Initially, the focus of the Aspen dialogue was on whether market short-termism exists, and if so, why it is a problem. It then moved to examine the sources of the behaviors and the solution space. Finally, a series of working groups were formed to build consensus across trade groups and individuals—including entities that rarely work together and don't often agree—to develop the ideas for extending time horizons that have the greatest potential leverage. The Aspen Corporate Values Strategy Group continues to tackle the problem through dialogue, research and education. Both Duke Energy and the AFL-CIO are among the signatories of two rounds of recommendations, released in 2007 and 2009, and I am pleased to present with them today.

I personally believe the issue you are beginning to explore is critical for our country and, for the globe. In fact, I cannot think of anything more important. I am not trying to be dramatic here; but having spent about ten years building this dialogue with hundreds of individuals and leaders across business, investment, academia, labor and other trade associations and partners, I remain convinced that extending time horizons in business and capital markets is worthy of our time and resources, and of yours. And, importantly, there is opportunity now to make a difference.

What do we mean by market short-termism? The UN Brundtland Commission in 1987 coined what has become the most common definition of sustainable development: *meeting the needs of the present without compromising the ability of future generations to meet their own needs.* Short-termism is the antithesis of sustainable development: it's about making decisions to meet some benchmark today without regard for the needs of, or the costs imposed on, the future. Most often, the metrics employed are the narrowest of financial measures, like short-term changes in return on equity and share price, which fail to capture the more complex impacts of business and investment as they play out over a longer term. For the purpose of the Aspen dialogue, we eventually settled on a five-year time frame to constitute "long term," but clearly, it depends on the nature of the decision or context.

Is there a problem with market short-termism?

Here is some of the evidence that short-termism is growing—and creating real problems[1]:

- The number of firms offering the market short-term or quarterly forecasts grew from a handful—92 in 1994, according to one McKinsey study, to over 1,200 by

[1] See the "Compelling Case for Change," a publication of the Aspen Institute Corporate Values Strategy Group, for a summary of relevant research

the time of the Enron implosion in 2001. The fact that Enron and other firms with fraudulent financials began their fall from grace by managing earnings in order to "beat" these same quarterly earnings forecast is evidence of the pernicious effect of this practice.

- A significant stream of academic literature suggest deferred or cancelled R&D and Net Present Value (NPV) positive projects within firms as a consequence of an excessive focus on Earnings Per Share (EPS) as the most important metric for judging firm performance and/or response to a large block of short-term holders in a firm's shareholder base.[2] One stunning statistic from a survey of 400 CFOs suggests that 80% will cut discretionary spending—for R&D, maintenance, advertising, etc.—to avoid missing a quarterly forecast.

- Professor Lawrence Mitchell at GWU School of Law has found that from 2004 to 2007, 270 (or 54%) of S&P 500 companies spent more money on stock buy-backs than on productive investments.

- A January 2010 working paper by Filippo Belloc, researcher at the University of Siena, found that "countries with stronger shareholder protection tend to have larger market capitalization but also lower innovation activity."

- Finally, participants in our dialogue talk about a growing aversion to being a public company at all, at least in part because of short-term pressures, although not exclusively for that reason.

- And, we are not the only organization concerned with market short-termism. We began collaborating with the CFA Institute, Committee for Economic Development (CED), US Chamber of Commerce, and the BRT-funded Institute for Corporate Ethics in December 2007, as all five organizations had published reports on the issue in the prior two years.

Although the fallout from Enron offered the hook to begin this conversation about curbing short-termism, and the financial crisis that continues to play out globally is certainly a convincing reason to stay at this work, it is not just about avoiding another financial catastrophe. Instead we began this work out of respect for the both ordinary,

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[2] See the work of Graham, Harvey and Rajgopal; Subramanyan, Chen and Zhang; and Bushee

and extraordinary, capacities of business and how critical that capacity is to our success as a nation and in globally connected markets. We have all heard statistics that compare our largest business organizations to nation states. Behind that scale of operation lie remarkable reach and distribution systems, research and management talent, and problem-solving skills—not to speak of financial wealth and other resources. It is hard to imagine solving our most important problems as a country or a world without business at the table in a big way. But whether we are talking about climate change or poverty, it's equally hard to imagine harnessing this same capacity of business for the public good, as long as managers move from 90 day calendar—to 90 day calendar.

In spite of examples to the contrary of which we are all aware, most businesses naturally think long term. Long term focus is inherent in the process of building and guarding the unique contributions and reputation of any enterprise. Companies with any degree of resilience are mindful of the myriad relationships that feed its success, from retention of top talent to the quality of relationships with customers and suppliers and the host communities that offer up the license to operate. But it is also true, that the world we now inhabit has changed as a result of investment, finance and financial services representing a larger and larger share of GNP—growing steadily from less than 16% of corporate profits in the 70s and 80s, to over 40% this decade[3]. And the pressures to think

[3] "From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent. Pay rose just as dramatically." Cited by Simon Johnson of MIT, "The Quiet Coup," *The Atlantic*, May 2009.

and act short term in this sector are abundant, and are deeply influenced by fees and compensation systems driven by financial metrics and share price, as the financial crisis has ably demonstrated.

The statistics are pretty clear on this point. Even if you correct for technology enabled "flash trading" and day-trading, the average holding period of stock continues to fall. In 1960, the holding period for equities averaged about nine years; by 1990, it had fallen to just over 2 years, and today, it is less than a year. And corporate managers often focus on short term performance because that's what many of their most powerful investors want them to do.

Indra Nooyi, CEO of PepsiCo, in a recent speech to the Economic Club of Chicago[4] talks about the influence of "real-time global news and financial updates" and "24/7 media that amplifies the smallest missteps forcing corporate leaders to be constantly on guard—with precious little time to pause and think." The attention span of investors is playing out in the tenure of CEOs—which continues to fall: 40% of CEOs now last two years or less on the job. (No wonder they command outsized contracts that promise rewards on an early departure.) I quote Ms. Nooyi: "Attention spans are short, time is money, and there is a premium on speed."

[4] "Short vs. Long-Term: Getting the Balance Right," Indra Nooyi, April 12, 2010

In her speech she goes on to propose a number of important changes, including, the need to identify internal management metrics to reward what she calls "sustainable performance"—that speaks to a broader definition of business success and intangible value that financial markets seem to ignore, or at least, undervalue in their obsession with quarterly results.

In this vein, a set of **Guiding Principles**[5] for business practice were released by the Aspen Corporate Values Strategy Group in June 2007. They speak to voluntary measures that operating companies and investors can take to focus greater attention on long-term value creation and to create a defense against short-term financial pressures. The so-called Aspen Principles were drafted and endorsed by business, investors, labor, and corporate governance gurus. These include the Business Roundtable, the Council of Institutional Investors, the AFL-CIO and Change to Win labor federations, the Center for Audit Quality representing the accounting industry, and pension funds CalPERS, CalSTRS, and TIAA-CREF. The Principles focus on companies having the right metrics for judging success, driving a higher quality of communication with investors and long-term orientation in compensation of investment and business managers. It is not rocket science, but the agreement across this set of signatories was remarkable in itself. Six public companies added their names to the document as a signal to their peers and to their internal constituencies of the importance of moving in this direction, including Duke

[5] "Long-Term Value Creation: Guiding Principles for Corporations and Investors"; released by The Aspen Institute Corporate Values Strategy Group, June 2007

Energy, PepsiCo, and also Pfizer, Xerox, Apache Corporation and Office Depot. There is much more to be done that is well within the control of managers and boards.

However, two years later in September 2009, a working group took the additional step of recommending public policy changes to support the actions of companies working to stay long, and to focus attention on "shareholder short-termism." Much attention has been paid of late to the rights of shareholders, but many in the working group believed it also important to recognize that with rights should come responsibilities.[6]

Both of these documents are available publicly and are incorporated here as part of my testimony.

The principal recommendation of that working group, which has now been endorsed by 30 leaders from business and investment in a widely circulated **Call to Action**[7], is to create market incentives that reward long-term investment. For example, this might be accomplished by imposing an excise tax on trading, or by skewing the capital gains tax to greatly favor long-term holdings. Individual signers have proposed moving the cap gains to 0% after ten years, with a high tax at the short end of the investor continuum. These taxes could be revenue generators or revenue neutral; neither tax is a new idea and both are controversial for different reasons. The drafters of the "Overcoming Short-Termism"

[6] For example, in January 2010 TIAA CREF released "Responsible Investing and Corporate Governance" that highlighted lessons learned over the past decade and among other things, encouraged investors to take a long-term orientation. Also see Benjamin Heineman, Jr., "Shareholders: Part of the Solution or Part of the Problem?" *The Atlantic*, October 28, 2009.

[7] "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management" released by the Aspen Institute Corporate Values Strategy Group, September 2009

statement did not offer specifics, except to say that non-taxable entities also needed consideration, which might come in the form of modifications to ERISA.[8]

Other recommendations in the Call to Action address the need for better definition of fiduciary duty, as it applies to financial intermediaries and also to strengthen investor disclosures to illuminate the borrowing and lending of shares in order to make the actual position—short or long—of large holders transparent.

The range of signatories behind these ideas and recommendations, again, defies the usual alliances—Warren Buffet signed, but so did Richard Trumka of the AFL-CIO. Long time investors Felix Rohatyn, Peter Peterson, John Bogle, Lester Crown, Jim Crown and James Wolfensohn signed, as well as Steve Denning, current head of General Atlantic Partners, a $15 billion private equity firm. The former CEOs of IBM, Cummins Engine, Medtronic signed, but so did the current CEOs of Alcoa, Duke Energy, and TIAA-CREF.

And this is not the only thing that needs attention.

Last year some 150,000 students graduated from this country's MBA programs—roughly the same number as those seeking teaching credentials—and far out-pacing professional

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[8] ERISA managers need reassurance they are free to act in the long term interests of their investors; that no legal mandate to maximize short term returns exists. Further, given that ERISA investment gains are not taxed, it is necessary to apply a similar tax on gains, or on trading at the fund level of pension assets, in order to align incentives with long term. For example, managers that hold for less than 24 months could be subject to a modest transaction tax or penalty on the gains.

degrees in law, medicine and engineering. Twice that many are choosing undergraduate majors in business, economics and commerce each year—challenging colleges and universities to examine what constitutes a liberal arts education. Students, both men and women, are choosing business because that is where the best paid jobs are, but also because they have grown up in an era that values the skill set offered. Even if a student is planning a career in nonprofits or government, they want to learn the language of business and enjoy the networks that business education offers to them.

Unfortunately, given the dominance of finance and the "job train" to Wall Street in many business schools, the narrative about business purpose is stuck in the 1970s when Milton Friedman penned his famous article. The result is a curriculum that emphasizes the technical skills of analysis over judgment and long-term vision. The curriculum in too many schools teaches students to externalize costs and discount the future. Innovators and visionaries in business schools are starting to be heard and changes are beginning to take place, but much more work is needed.

Thank you again for the opportunity to address the Subcommittee on Economic Policy.

Judith Samuelson
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