Chapter 4

Short-termism in Capital Markets

4.1 Introduction

Academicians and the industry experts are generally of the opinion that businesses are formed for wealth creation for the owners over the long term. Rappaport (2005)\(^1\) aptly summarises this when he states “a company’s value depends on its long term ability to generate cash to fund value-creating growth and pay dividends to its shareholders”. He goes on to suggest “maximizing long-term value means that management’s primary commitment is to continuing shareholders rather than to day traders, momentum investors, and other short-term oriented market players. To maximize value to continuing shareholders, managers must develop and effectively execute strategies that maximize the company’s long-term cash flow potential.” Mizik (2009)\(^2\) describes the objective of effective management as requiring long-term focus. Kay (2012)\(^3\) states the primary duty of the board is to promote the success of the company for the benefit of its members over the long-term. Salter (2013)\(^4\) assets “managing for the long term is the only way for public companies to create durable economic value for shareholders and other stakeholders”.

Short-termism involves deviation from this objective.

The phenomenon of ‘short-termism’ is also referred to as ‘myopia’ or ‘myopic behaviour’. A few researchers have attributed different meanings to the terms ‘short-termism’ and ‘myopia’ by distinguishing between finer aspects that are represented by the two terms.

Several studies have been conducted on the phenomenon of short-termism. Some of these studies confine themselves to one or two specific aspects of short-termism while others examine a number of different aspects in one study. Research papers and articles that discuss a number of aspects of short-termism and either find further evidence from earlier researches or give different perspectives of aspects discussed by

There are also a few studies, among those who have commented on different aspects of short-termism, that refute the causes attributed for short-termism. For example, Roe (2013) vehemently argues against many accepted theories of causes of short-termism. There are also those who claim that short-termism is not all that pervasive as it is perceived to be (Maubossin and Callahan, 2015). In another research paper, Kaplan (2017) argues that short-termism as propounded by researchers and others during the past thirtyfive years or so is not supported by empirical evidence. To prove his point, he refers to growth of firms over the years and continuing rise in their profits.

Before studying the various aspects of short-termism, it will be useful to understand the relevant aspects of capital markets. In the following sections, a brief description is given about capital markets.

4.2 Role of Capital Markets in an Economy

Capital Markets play an important role in channelising savings of the domestic sector in an economy for productive purposes (Malhotra, 2015). According to Rappaport (2005), capital markets allocate scarce resources to enterprises with most promising long-term prospects. In an economy, there are those who require funds for various purposes. These include Governments for funding infrastructure and other projects and business houses for production purposes. And, there are those who can provide funds. These include individuals who have savings to invest and institutions that have surplus funds that can be invested. Capital markets provide the means to meet the requirements of long-term funds of the former class by mobilising resources from the latter class.

IFC (2017), a report by the International Finance Corporation of the World Bank Group, states that capital markets provide an alternate source of funding for business firms. The report draws attention to the fact that it may be possible to raise funds for riskier projects from the capital markets rather than from banks which may be reluctant to finance such projects. Business firms issue shares and bonds in the capital
markets to individuals to raise funds for deployment in productive purposes. Business firms use both equity and debt for their funding requirements (Marimuthu 2009\textsuperscript{14}, Chaudhari, Raje and Singh 2014\textsuperscript{15}). Governments issue bonds to raise funds for infrastructure projects. Individuals invest their savings in these shares and bonds. Thus, there is productive use of idle funds from the domestic sector.

\textbf{4.2.1 Share Capital of Firms}

Firms require money to buy assets like land, buildings, plant & machinery, vehicles and furniture to produce products or to provide service to their customers. This money is known as capital. The person who conceives the idea of setting up the business, known as the promoter, brings in part of the capital. The remaining capital is raised from those who are interested in investing in a business and to own a business. The total capital is known as the share capital. The term share capital has its origin in the fact that there are several owners of a business firm and that each owner has a share in the profits of the firm. The total capital of the firm is divided into ‘shares’ and those who invest in the capital of the firm get ‘shares’ in the firm’s capital (Dhar 2008\textsuperscript{16}). Each share has a denomination like Rs. 10 or Re. 1 per share. This denomination is known as the face value of the share.

Shares are of two types. They are equity shares or preference shares (Dhar 2008\textsuperscript{16}). Investors in equity shares have a set of rights that are different from those who invest in preference shares. Most firms issue only equity shares. Some firms issue both equity and preference shares. While issue of equity shares is necessary to raise share capital, preference shares may or may not be issued by a firm.

Shares can be traded in the markets. There are organised markets known as stock exchanges that facilitate the trading of shares. Equity shares may be traded at par i.e. at their face value or below or above their face value depending on the financial performance of the firm, the prospects of the industry in which the firm operates and many other factors that influence the market price of the shares. Preference shares are usually traded at a price close to the face value of the shares.
Equity shares are usually issued by the issuing firms in the country in which the firms are incorporated. However, it is possible to issue equity shares in other countries also. When such issues are made, an equivalent security known as Depository Receipt (DR) is used. According to Miller (1999)\(^{17}\), a DR is a negotiable instrument issued by a depository bank in one country to represent a number of underlying securities issued by a firm in another country that are held by a custodian in that country. Kumar (2006)\(^{18}\) describes a depository receipt as a negotiable instrument denominated in a currency other than the home currency of the issuer and issued to investors in countries other than the home country. The depository receipt represents one or more equity shares of the firm issuing the DRs. The DRs are issued in foreign countries instead of the equity shares of the firm issuing the DRs. These DRs are denominated in the currency of the country in which they are issued. DRs can broadly be classified into two types. Those DRs that are issued in the U.S.A. are known as American Depository Receipts (ADRs) and those that are issued in countries other than U.S.A. are known as Global Depository Receipts (GDRs). It is possible that different countries may have different terminology for DRs issued in those countries. For instance, DRs issued in India are known as Indian Depository Receipts (IDRs). The DRs may or not may be listed in the stock exchanges in the countries in which they are issued.

### 4.2.2 Borrowings by Business Firms

Firms may also raise funds to meet their requirements by borrowing. The firms may borrow from banks and other financial institutions in the form of loans or they may issue ‘bonds’ or ‘debentures’ (Chaudhari, Raje and Singh 2014\(^{15}\)). These bonds or debentures are issued to individuals and institutions who are interested in lending to the firms. The firms pay interest at periodic intervals to the persons who have lent the money to the firms by way of bonds or debentures. The bonds and debentures also have a face value similar to that of shares. Just like shares, these bonds and debentures can also be traded in the markets. Bonds and debentures are traded at market prices that are close to the face value of the bonds or debentures.
4.2.3 Government Borrowings

Bonds are also issued by Governments to raise funds for various requirements (Malhotra, 2015). Governments require funds for infrastructure projects like building dams, bridges, roads and for other purposes. These bonds are similar in structure to the bonds issued by business firms.

4.2.4 Securities

Equity shares, preference shares, bonds and debentures are known as securities or financial instruments.

The features that are common to all securities are:

1. All securities have a face value i.e. a denomination. An issuer of a security may issue it at par or at a premium or discount. If a security is issued at par it means that the security is offered at a price equivalent to that of its face value. If it is offered at a premium, it is said to be issued at a price higher than its face value. In the case of issue at a discount, the security is issued at a price lower than the face value of the security.

2. All securities are tradeable

3. The securities may be traded at par or at a premium or at a discount.

The differences among the securities are:

1. Equity shares may yield high returns while debt instruments and preference shares will yield only lower returns.

2. While the yields on debt instruments and preference shares are more or less fixed in nature, returns from equity shares are not fixed

3. Equity shares are perpetual in nature except in those regimes where buy-back of shares is permitted. Debt instruments usually have a fixed tenor but may be perpetual. Preference shares may or may not have a fixed tenor depending on applicable laws
4.3 Classification of Capital Markets

Capital markets perform a dual role (Malhotra, 2015\textsuperscript{12}, Juman and Irshad, 2015\textsuperscript{19}). The first function is to facilitate raising of capital and debt by business firms and raising of debt by Governments. Capital markets provide the necessary resources required for raising of capital and debt. Funds are raised by business firms and Government by issue of securities. The second function is that of facilitating trades in the securities issued by business firms and Governments. The second function involves ensuring liquidity for the securities issued.

Based on the above two functions, Capital Markets can broadly be classified into Primary Markets and Secondary Markets (Dhar 2008\textsuperscript{16}, Mishra 2011\textsuperscript{20}, Malhotra 2015\textsuperscript{12}). Primary Markets are those in which issuers of securities like the Governments, Corporates and other institutions issue their securities for the first time to be subscribed by investors. Secondary Markets are those that enable trading in the securities issued in the Primary Markets. One segment of the Capital Market cannot exist without the other. It is the harmonious blending of both the markets that give an economy vibrant capital markets.

While the primary markets provide the means for raising resources for productive purposes, the secondary market provides the much needed liquidity to the investors (Malhotra, 2015\textsuperscript{12}). The secondary market also supports in the process of information dissemination through the price discovery process. (Kay 2012)\textsuperscript{3}

Another classification of Capital Markets is based on the nature of securities dealt with in the markets. Markets in which ownership securities i.e. equity shares and preference shares are dealt with are known as the Equity Markets or Stock Markets and those in which debt instruments like Bonds and Debenture are dealt with are known as Debt Markets (Juman and Irshad, 2015\textsuperscript{19}). Both equity markets and debt markets deal with long-term financial instruments. They do not deal with short-term securities.
4.3.1 Issue of securities in the Primary Market

Business firms issue securities in the market through a public issue or other types of issues. Public issues involve issue of securities to the public i.e. any individual or institution can invest in these securities. When business firms issue equity shares to the public for the first time, the issue is known as an Initial Public Offer (IPO) and when the firms issue equity shares to the public again after the IPO, the issue is known as Follow-on Public Offers (FPOs). In IPOs and FPOs, the equity shares may be issued at par or at a premium or at a discount to the face value of the share. In practice, equity shares are issued either at a par or at a premium to the face value.

Other types of issues include Rights Issue, Private Placement and Bonus Issues. Rights issues are issues made exclusively to existing shareholders of the firm. Private placement refers to offer of securities to a select group of individuals or firms or institutions. Bonus issues are issued to the existing shareholders of the firm by capitalising the retained earnings in the firm.

Issue of bonds and debentures to the public by business firms is known as public issues. Concepts of rights issue and bonus issue do not apply to issue of bonds and debentures except for certain categories of bonds and debentures. Private placements of bonds and debentures are possible.

Governments issue bonds through an auction process. The terms associated with issues by business firms like public issues do not apply in the case of issue by Governments.

4.3.2 Trading in Secondary Markets

Secondary markets enable trading in securities issued by business firms and Governments. There are organised and well regulated secondary markets known as stock exchanges. There are also not-so-organised and less regulated secondary markets known as Over-the-Counter (OTC) markets. Those who own securities can sell them through the stock exchanges or through the OTC markets. Similarly those who want to buy securities can buy them through the stock exchanges or through the OTC markets. There are intermediaries known as stock brokers required to buy or sell
securities through the stock exchanges. In the case of OTC markets, one-to-one dealings in securities are possible. Use of the intermediary in the OTC market is optional.

4.3.3 Entities in Capital Markets

Lot of legal and procedural formalities are involved in both the primary and the secondary markets. These formalities are fulfilled by various entities acting as principals and as intermediaries to support the activities in these markets.

Entities that support in the issue and trading of securities in the primary and secondary markets include Investment Managers, Registrars & Share Transfer Agents, Stock Exchanges, Clearing Houses, Depositories and other intermediaries like Stock Brokers and Bankers to an issue. Each of these entities has a defined role to play in the Capital Markets.

The role of the investment manager, known as merchant banker in India, is to advise the firms that issue securities and to hand-hold the firms through the entire process of the issue from the initial stages till the end. The Registrars to an issue take care of all the formalities related to processing of applications received from investors for the securities. The stock exchanges have to give permission to the firms issuing the securities for the securities to be traded in the stock exchange after they are issued. This process is known as ‘listing’ of the securities.

The share transfer agents have the role of recording transactions in shares between investors after the securities are issued. The clearing houses have a role in clearing and settlement of trades in securities in the stock exchange.

Depositories have a dual role. They have a role at the time of issue of securities and when the securities are traded. They keep electronic records of all issue of and transactions in securities. The stock brokers also have a dual role. When firms issue securities, the stock brokers help in disseminating information about the issue to the investors and in procuring investments for the issue. In the secondary market, they are the intermediaries who facilitate trading in securities.
The bankers to an issue help in the process of receiving and collecting payments for the investments by the investors when the securities are issued.

In the case of issues by Governments, the central bank of the country and other designated departments of the Government will have specific roles to play. In India, the Reserve Bank of India, the primary dealers and the Public Debt Office are the entities / departments involved in issue by the Central Government or the State Governments.

4.4 Investors in Capital Markets

In the following paragraphs, the discussion is essentially about investors in equity shares as the subject of short-termism in the current study predominantly deals with equity share capital.)

Those who invest in the securities can be classified as (a) individual investors, (b) institutional investors and (c) traders and speculators, though the term ‘invest’ in the context of speculators is a misnomer.

Individual investors are typically considered to be patient investors in the sense that they remain invested for long periods of time and wait for their investments to yield high returns.

Institutional investors can be divided into two broad categories, namely, those that invest their surplus funds to earn returns and those that act like investment vehicles for others who entrust them with their monies to be invested in the equity and debt markets. Examples of the first category are manufacturing firms, trading firms and other such firms. Examples of the second category of institutional investors include pension funds and mutual funds. Those who entrust their monies with this category of institutional investors are individual investors.

The first category of institutional investors, namely, those who invest their own surplus funds, is normally expected to invest for the short-term. This is because they may need the invested surplus funds for their regular operations at short notice and cannot afford to invest the funds for a long period of time.
The second category of institutional investors, namely, those who invest monies entrusted to them by others, invest in securities in line with the expectations and mandates of whose funds they invest. These institutional investors invest for the long term or short term, for capital gains or dividends depending on the mandates of their clients. They are, in a sense, agents of their clients, acting on the broad mandates of the clients.

Traders typically look for profits in the short-term by buying when the prices are low and selling when the prices are high. Some traders resort to short-selling, where the regulations permit it. (Short-selling refers to selling securities without owning any in the hope of buying the securities later from the market and making delivery). Unlike the individual investors, the traders are not patient investors.

Speculators form a class of their own who differ from the other categories of investors in their approach. Their approach is more aggressive than that of traders. They invest in the hope of a rise in the market prices of securities within a very short span of time; a shorter time span than that in which traders operate. What distinguishes speculators from traders is that while the latter seize opportunities, the former actively look for opportunities.

4.4.1 Expectations of Investors

The equity share capital represents the funds invested in the firm by the shareholders i.e. the owners of the firm. Being owners of the firm, they are entitled to share in the profits of the business. Under normal circumstances, part of the profit earned by a firm in any year is distributed to the shareholders by way of dividend and the balance is retained by the firm for future requirements. In this process, over a period of time, the firm accumulates profits from many years. This accumulated profit is known as ‘reserves’ or ‘retained earnings’. It can be inferred that the retained earnings belongs to the shareholders of the firm. Thus, over a period of time, the total funds belonging to the shareholders in the firm comprises of the equity share capital and the retained earnings. This means that, theoretically, each shareholder is entitled to receive a higher amount than what he invested in the share capital of the firm, in the event of the firm returning the share capital and the accumulated earnings to the shareholders.
Thus, it can be seen that for every rupee invested by the shareholder in the firm, he is entitled to receive a higher amount from the firm.

As can be seen from the above discussion, the shareholders are entitled to a higher amount than what they had invested in the firm initially. In such a scenario, they would expect an equivalent amount if they were to sell the shares in the secondary market. This is one of the factors that determines the market price of the share. However, the market price of equity shares is determined by various other factors also. One of the most important factors is the financial performance of the firm that has issued the shares. Bhatt and Sumangala (2012)\textsuperscript{21} state that on an average, variation in 45% of the market price of shares can be explained by earnings per share of the firm. Mishra (2011)\textsuperscript{20} finds that dividend payout per share and earnings per share have a significant influence on the market price of a share.

An investor who invests in securities issued by a firm expects returns from the investment. The return on equity shares is usually expected to be much higher than the return on preference shares or bonds or debentures. This is because the equity shareholders, as discussed above, are entitled to the retained earnings of the firm while the other investors are entitled to receive back only the amount that they invested in the firm. In this scenario, the returns for equity investor comprises of dividend that is paid periodically and the increase in market price of the share. The returns for the preference shareholders are only the dividend paid at a rated fixed at the time of issue of the preference shares. This rate is usually similar to the rate of interest applicable on bonds and debentures at the time of issue of the preference shares. The returns for bondholders and debentureholders are only the periodical interest that is paid.

As discussed above, one of the major factors that determines the market price of a share is the financial performance of the firm reflected in its retained earnings after dividend payout. It is very clear that retained earnings can grow only over a period of time. The firm has to exist for a number of years before it can reap the benefits of accumulated profits. Thus, an investor who invests in equity shares of firm is a ‘patient investor’. Investors in equity shares should ideally not be concerned with
short-term growth of the firm but should look for indications for growth of the firm in the long term. This essentially means that equity investors should not react to periodical announcements of financial results by the firm nor react to movements in the market prices of the shares in the short term.

As the operations of the firms start yielding profits over a period of time, patient investors in these firms would also realise benefits from rising market prices of the equity shares. After having held the shares in a firm for a long period of time, if a patient investor decides to dispose off the shares, he could expect a high profit.

4.4.2 Expectations of Issuers of Securities

Issuers of securities essentially raise funds from the capital markets for the long term. They raise funds by issuing various financial instruments like equity shares (common stock), preference shares (preferred stock), debentures (bonds) and other tradeable securities. While equity shares are perpetual in nature, preference shares are not perpetual in all countries. In some countries, regulations require preference shares to be redeemed or converted into equity shares after a specified period and it is not permissible to have perpetual preference shares. (In India, preference shares can be issued for a maximum period of twenty years). Debentures may be issued without any specification as to tenure (perpetual debentures) or with a specified tenure.

Issuers of equity will ideally desire to have the investors remain invested for a long period of time. Firms that issue these securities in the capital market and raise funds expect the funds to remain with them for perpetuity or, at the least, for the long term. As funds raised from such securities are used for buying long term assets that are expected to yield results over the long term, the firms would prefer to have investors who have a long-term outlook. To this end, they try to attract investors who have surplus funds that the investors can keep invested for a long period of time.

4.4.3 Alignment of Expectations of Issuers and Investors

In the scenario discussed above, there is an alignment between the expectations of the firm for long-term funds and expectations of patient investors to reap higher gains by remaining invested for a longer period.
On the other hand, the expectations of a trader or a speculator would not be aligned to those of the firm. The trader or the speculator would expect returns within a short-term and would churn his or her portfolio at every opportunity to make a profit even if the profit margin is low.

The markets comprise of investors who look for both long term and short term gains and issuers of securities also recognise that not all their investors can be those who seek long term returns. It would be unrealistic to expect all investors in securities of firms to be patient investors. There has to be a section of the investors who would trade in the securities to provide the necessary liquidity in the markets for the securities. For various other reasons also, it is necessary to have a vibrant secondary market in securities of firms.

4.4.4 Mutual Trust between Issuers of Securities and Investors

Another facet of capital markets is the trust placed by the investors in the firms they invest. The capital markets work on basic trust. The investors entrust their monies to the issuers of securities in the hope that the latter would fulfil the mandates of the investors. They look for long term growth of both the firms and their investment in the firms. They reward the firms that perform well by higher valuations in the stock markets, especially in the long run. They are willing to wait for better performance in the future inspite of poor current performance, if they are convinced that the managements are taking the right decisions for the long-term benefit of the firms and that of the investors. There are instances of higher valuations in the current period, if the investors are convinced that the decisions and actions by the managements of firms are in the right direction, even if the current period earnings are low.

To this end, the investors look for periodic dissemination of information on the performance of the firms. The investors expect the management of firms that have issued equity to take the investors into confidence and share information about the prospects of the firms and any significant developments in this regard. This is important for the investors to assess the current performance in the right perspective. In the absence of adequate information being disseminated by the managers of firms, the risks of moral hazard and agency problem arise.
It will be pertinent to discuss the agency theory in this context. One of the important theories pertaining to firms that raise capital from the public is the agency theory. This theory was propounded by Michael Jensen and William Meckling (Jensen and Meckling, 1976). This theory states that the management of firms who are agents of the investors do not necessarily act in the best interests of the investors. They do not always go by the dictates of the investors and may have their own agenda. There is also information asymmetry because the managements of firms know more about the activities of the firm and consequences of the activities than the investors. Sappideen (2011) refers to this agency theory when he discusses short-termism. In this context, mention may also be made of ‘moral hazard’. It refers to the possibility that the managers of firms will take unwarranted risks in managing the affairs of the firms which will have an impact on the interests of the investors in the firm.

4.5 Investment Decisions by Investors

Investors require information for making their investment decisions also.

Investors may take a passive approach or an active approach to investments (Ang, Goetzmann and Schaefer, 2010). The passive approach involves adopting the same portfolio as that of an index. An index comprises of constituents in a defined proportion. An investor, by adopting the same portfolio structure, can hope to realise the same returns as that of the index, subject to differences due to cost of transactions.

The active approach involves research by the investors into the markets and basing their investment decisions based on their research. For this, they need information. Investors need information about the performance of firms, prospects for firms and other relevant details to make informed decisions about their investments. They may have many sources of information about the economy, the prospects of the industries and other factors external to the firms. As far as information about the firms are concerned they rely principally on three sources. These are:

1. Periodical financial performance reports disclosed by the firms
2. Earnings guidance given by management of firms and
3. Analysts’ forecasts

4.5.1 Periodical Financial Performance Disclosures

Firms disclose details of their financial performance on a quarterly or half-yearly basis depending on the mandates of law. Many countries have made this disclosure mandatory on a quarterly basis and some countries have made it half-yearly. Some firms also disclose performance details voluntarily. Investors in firms need information about the financial performance of the firms and other important aspects of the firms’ performance on a periodical basis. Periodical disclosure of information on quarterly basis reduces information asymmetry (Fu, Kraft and Chang 201225, Stoumbos 201726). The current system of disclosure of information aids in disseminating information about the financial performance but not about various other important aspects that affect the performance of firms. The reasons for increase or decrease in profits or sales or other significant parameters are disclosed only in general terms. The investors do not get to know the long-term implications of actions initiated by management of firms. To address this concern, some researchers have suggested better disclosure practices. (Bhat 201127, Jackson and Petraki 201128, Global Compact 201429 and Barton, Bailey and Zoffer 201630).

4.5.2 Practice of giving Earnings Guidance

As a measure of transparency and better communication with investors, many firms have the practice of giving earnings guidance for each quarter (Karageorgiou and Serafeim 201431). Earnings guidance is basically information about expected financial performance by firms in the next quarter. The investors should ideally treat the information in the guidance as expectations of management and plan their investments accordingly.

4.5.3 Analysts’ Forecasts

Investors are also aided in their investment decisions by forecasts about performance of firms given by analysts who track the performance of the firms. The investors rely on these forecasts because the analysts are knowledgeable and take into account
various parameters before making their forecasts. The analysts study the industry trends, prospects for the industry, the economic trends and various other factors. Based on these studies, they make their forecasts on the performance of individual firms. These analysts usually time their forecasts just before the announcements of the quarterly or semi-annual disclosure of financial performance of firms.

4.6 Reactions of Markets to Financial Performance Announcements

Over a period of time it has been proved through empirical studies that stock markets react to earnings announcements. Research studies indicate that when firms announce their quarterly financial results, the markets react by a rise or fall in market prices of the shares of the firms (Beaver 1968, Kiger 1972, Ball and Kothari 1991, Landsman and Maydew 2002). However, in the Indian context, it has been found that the reactions to quarterly earnings announcements are not pronounced (Das, Pattanayak and Pathak, 2008, Saravanakumar and Mahadevan, 2013, Babu and Kasilingam, 2013). Volumes of trade in the secondary market also witness a change when financial results are announced. (Beaver 1968, Kiger 1972, Bamber 1986, Landsman and Maydew 2001, Sankar 2014).

4.7 Stock Indices

Stock indices serve as barometers of price movements in stock exchanges. Securities of thousands of firms are listed in the stock exchanges and trading in these securities occurs on a daily basis in high frequencies. Trading volumes are to the extent of a few lakhs on each day in some of the equity shares. The market price of securities keeps fluctuating on a minute-to-minute basis. Given this high fluctuation in stock prices, stock exchanges use an index to represent the price movements of various securities. This index helps the investor to keep track of price movements at any point of time. These indices are known as stock indices.

A stock index indicates or measures change in the market prices of the underlying shares. A stock index comprises of a portfolio of equity shares whose price movements are reflected in the value of the index. An index is prepared as of a base date. The market prices of the shares in the underlying portfolio are taken as the base
and price movements are captured in the index value. Stock indices may include equity shares of firms from different industries or may comprise of only equity shares of firms from specific sectors. Other stock indices such as thematic or strategic indices are also available. When stock indices comprise of equity shares of firms from various sectors, they are known as broad market indices. When stock indices comprise of only equity shares from specific sectors, they are known as sectoral indices.

Selection of stocks in the indices is based on strict criteria specified by the stock exchanges. The criteria include volume of market capitalisation, trading frequencies, volumes of trade and other factors. The stocks comprising an index are reviewed on a periodical basis. It is possible that a particular stock is removed from an index and is replaced by another stock.

Examples of stock indices include S & P 500, Dow Jones Industrial Average (DJIA), FTSE 100, Nikkei 225, NIFTY and SENSEX.

Stock indices may be market capitalisation based or price based.

Stock indices may be prepared based on market capitalisation or market prices. In the former case they are known as market-weighted or capitalisation-weighted indices and in the latter case they are known as price-weighted indices. In a market-weighted index, the proportions of the constituent shares are based on the market capitalisation of the shares. In a price-weighted index, the proportion is based on the market price of the shares. S & P 500 is an example of market-weighted index and DJIA is an example of price-weighted index. In India, the stock indices are market-weighted.

4.8 Theories of Capital Markets

Many theories have been floated with respect to movement of market prices of shares. One of the most popular theories is the Efficient Market Hypothesis propounded in late 1960s by Eugene Fama (Fama 1970)\(^{41}\). This theory essentially states that the markets are efficient and the market prices reflect all known information. Hansen and Hill (1991)\(^{42}\) state that according to the efficient market hypothesis, investors base their valuation of a firm’s shares on a rational assessment of all publicly available information about the future cash flows of the firm. According to Mishra (2011)\(^{20}\)
“the efficiency of the capital market is often defined in terms of its ability to reflect the impact of all relevant information in the prices of securities”. However, there are counter-views that markets are not always efficient and they react to various other stimuli. According to the critics, the theory does not explain various anomalies in the markets. Another popular assumption in the markets is that investors behave in a rational manner while making investment decisions. But, this view has also been refuted. To explain the anomalies in the market and the irrational behaviour of the investors, behavioural finance theories were introduced. These theories tried to explain investor behaviour in the light of psychological theories.

4.9 Development over the Decades

Capital markets have undergone major changes over the decades, particularly, during the years following early 1990s. These changes are happening in all capital markets over the globe and are not confined to any specific regions. While many changes have happened, the following section highlights a few that are pertinent or related to the current study of short-termism.

These changes are:

1. Integration of global capital markets
2. Investments across capital markets
3. Introduction of exotic financial instruments
4. Demutualisation and corporatisation of stock exchanges
5. Merger of stock exchanges
6. Advent of online trading
7. Introduction of computer algorithms for trading
8. Increase in volumes and frequency of trading
9. Increased focus on corporate governance
10. Change in the composition of investors

4.9.1. Integration of Global Capital Markets

Capital Markets in different countries are now integrated with each other (Henderson, Jegadeesh and Weisbach 2003, Erdinc and Milla 2009, Subha and Nambi, 2010).
Sharma and Bodla (2010), through a study of literature, comes up with the finding that there is increased integration among capital markets in various countries. Trading hours and trading days in stock exchanges are beginning to be synchronised across capital markets. An example is that of the commencement of trading in Indian Stock Exchanges being advanced by one hour in 2009 to synchronise with trading hours in major Asian Stock Exchanges. An investor can invest in Initial Public Offers (IPOs) of firms in different countries. Trading in the same security simultaneously in different capital markets and trading in various stock exchanges by investors is possible today (Mukherjee, 2007). According to Henderson, Jegadeesh and Weisbach (2003), investors have the choice of diversifying their portfolio internationally. A firm can issue securities in different countries and get them listed in the respective countries through the medium of Global Depository Receipts (GDRs). The researchers state that firms now have the flexibility to decide on the nature of financial instruments to be issued to raise funds and the geographies in which they are to be issued. Majumdar (2007) refers to firms raising funds from foreign countries.

A common set of regulations called ‘Markets in Financial Instruments Directive’ (MiFID) is now applicable for all capital markets in countries forming part of the European Union (EU). A capital market intermediary registered in any one country in the EU can operate in all countries in EU. A firm that gets its prospectus for an IPO approved by the capital market authority in any one of the countries in the EU can issue the prospectus in all countries in the EU without further approvals.

### 4.9.2 Investments across Capital Markets

Investment in firms across countries is increasing in leaps and bounds. Foreign Direct Investments (FDI) are the order of the day. Most developing countries welcome investments from other countries to develop their equity and bond markets. Many firms are established in developing countries by firms from other countries. FDI is an avenue to bridge the gap in domestic savings and domestic investments (Adhana and Saxena (2016)). Governments in developing countries and private institutions rely on foreign sources for their fund requirements.
There has been a steep increase in issue of and investment in Global Depository Receipts over the years. The value of GDRs issued every year between 2011 and 2015 is more than USD 10 billion.

### 4.9.3 Introduction of Exotic Financial Instruments

New financial instruments have been and are being issued by firms and other entities. A notable example is the Mortgage-backed Security i.e. bond created through the process of securitisation of mortgage loans. STRIPS (Separate Trading of Registered Interest and Principal of Securities) is another innovation that was introduced for the first time in 1985 in the U.S.A. These new financial instruments are issued to meet specific requirements such as to mitigate a risk from a financial activity or to enhance the efficacy of some financial product. Inflation Indexed Bond is another innovation to link returns on bonds to inflation.

### 4.9.4 Demutualisation and Corporatisation of Stock Exchanges

Aggarwal and Dahiya (2005)\textsuperscript{50} discuss the concept of demutualisation of stock exchanges and trace its history. They also discuss the circumstances that led to demutualisation of stock exchanges and its related aspects.

One of the major changes witnessed from the 1990s was demutualisation and corporatisation of stock exchanges. Stock Exchanges traditionally had been mutual associations. The ownership and the management were not separated. The owners also acted as members of the stock exchange and they were the only ones entitled to carry out trades in the stock exchanges. In the 1990s, stock exchanges began to get corporatised. Stock Exchanges ceased to be mutual associations and became corporates with separation of ownership and management. While the erstwhile owners continued as shareholders in the exchange, management was entrusted to separate bodies. Membership of the exchanges was also thrown open to others for trading in the stock exchanges.

The formation of the National Stock Exchange of India in the mid 1990s, in a way, heralded the era of demutualisation and corporatisation in the Indian stock markets.
4.9.5 Merger of Stock Exchanges

A logical follow-up of corporatisation of stock exchanges was listing of the shares of the stock exchange. And, as a consequence, mergers and acquisitions of stock exchanges started taking place.

The period from around the mid 1990s to late 2000s saw mergers among stock exchanges. This was not confined to exchanges within a country but across nations. Leading examples are merger of New York Stock Exchange (NYSE) with Euronext to form NYSE-Euronext in 2007 and takeover of NYSE-Euronext by Intercontinental Exchange (ICE) in 2013. Euronext itself is an exchange born by merger of Amsterdam, Brussels and Paris Stock Exchanges in 2000. Closer home, merger of the Bombay Stock Exchange and the United Stock Exchange is an example.

4.9.6 Advent of Online Trading

Introduction of computerised processing in the stock exchanges brought about online trading or screen-based trading (Malhotra, 2015\(^{12}\), Juman and Irshad, 2015\(^{19}\)). Till the advent of computers, the exchanges had followed an open outcry system in which the members used to meet in a hall in the stock exchange premises and carry out trades. Introduction of computers facilitated online trading. As a result, dependence on physical presence in the trading hall diminished and the trades could be carried out from anywhere across the world with proper connectivity.

4.9.7 Introduction of Computer Algorithms for Trading

Use of computer algorithms has brought about automated trades. Human intervention is no longer required to place buy or sell orders. Algorithmic trading enables automatic trading through a pre-defined set of instructions. This process enables placing and execution of orders at speeds that cannot be matched by humans. (Zhang 2010\(^{51}\), Kay 2012\(^{3}\), Patelli 2012\(^{52}\))
4.9.8 Increase in Volumes and Frequency of Trading

Volumes of trade have increased manifold over the years. Drew (2009)\textsuperscript{53} states that average annual turnover rates for a period of 15 years till 1998 and till 2003 were 40\% and 70\% respectively in the New York Stock Exchange. He further states that the average annual turnover rate for the 5 year period ending 2003 was 100\%. With improved communication and connectivity and online trading facilities, investors invest and trade in much higher volumes than earlier.

Frequency of trading has also increased over the years. Holding periods of shares have come down over the years. Barker (2012)\textsuperscript{54} quotes Bank of England when he states that the average holding period of UK shares was down to less than eight months in 2008 as compared to five years in the 1960s. Quimby (2013)\textsuperscript{7} cites other researchers and states that the holding period in the New York Stock Exchange was down to less than one year in 2005. According to Maubossin and Callahan (2015)\textsuperscript{10} the average holding period of stocks has reduced from around seven years in the 1960s to around two years in the current times. Rappaport (2005)\textsuperscript{1} states that in professionally managed funds, annual portfolio turnover is 100\%. While Kay states that investors tend, in general, to hold shares for longer periods than traders, some researchers have expressed the opinion that investors behave like traders in the current times. (Kay 2012\textsuperscript{3} and Bushee 1998\textsuperscript{55})

4.9.9 Increased Focus on Corporate Governance

Another major change that has occurred during the last twentyfive years or so is the increased focus on Corporate Governance. Starting with the constitution of the Cadbury Committee in 1991 and submission of its report in 1992, Corporate Governance has been given a lot of importance in management of listed firms by both corporate executives and regulators in many countries. Capital Market and Company Law regulators in these countries have emphasised the role of the Board of Directors of a firm and have incorporated various additional measures in the laws to ensure effective Corporate Governance. Boards have voluntarily adopted many practices in the interests of the investors over and above those mandated by law.
4.9.10 Change in the Composition of Investors

The composition of investors in the capital markets has changed over the last few decades. There has been a distinct shift from individual investors to institutional investors (Kay 2012, Quimby 2013). The latter category of investors is primarily in the nature of investment vehicles. Individuals invest their surplus monies with these institutions and instruct the latter to invest such monies as per the mandate of the individual investors. This aspect of change in the composition of investors is discussed in more detail in the next section.

4.10 Indian Capital Markets

Capital markets in India reflect the trends of the markets in developed nations. There are a few specific aspects in which Indian capital markets are more advanced than others. To cite an example, the settlement cycle for trades in secondary trades in stock exchanges in India has been $T + 2$ for several years now whereas the stock exchanges in the U.S.A. will move to a settlement cycle of $T + 2$ from $T + 3$ only now. A press release from the Securities and Exchange Commission of the U.S.A. dated 22$^{nd}$ March, 2017 announces this change. Settlement cycle refers to the time required to settle trades effected through the stock exchange. ‘$T + 2$’ refers to settlement on the third day from the day of trade. Another example will be the introduction of IPO grading in India. India is the only country to have grading for IPOs (Khursheed, Paleari, Pande and Vismaro 2008). IPO grading is a process similar to that of rating of debt instruments. It assesses the fundamentals of the equity issuing firm and gives a grade for the IPO.

Capital markets in India have aligned themselves to the markets in developed countries. New financial instruments that are introduced in the foreign markets are introduced in India also within a few years. Examples include the introduction of STRIPS (Separate Trading of Registered Interest and Principal of Securities) and inflation indexed bonds. U.S.A introduced the concept of STRIPs initially in 1961 and then discontinued it in 1974. It revived the securities in 1985. The Reserve Bank of India introduced STRIPS in India in 2010. The first developed nation to introduce
inflation indexed securities was U.K. in the early 1980s. The U.S.A. introduced the securities in the late 1990s. India issued its first version of the security in the late 1990s and later improved its features in 2013. Gourav (2016) lists innovative financial instruments introduced in the Indian Capital Markets. The list includes Triple Option Convertible Debentures, Deep Discount Bonds, Floating Rate Notes, Inflation Linked Bonds and others.

The introduction of screen based trading in Indian stock exchanges to replace open outcry system also happened around the same time it happened in other countries. National Stock Exchange of India was the first exchange in the country to introduce screen based trading (Senthilkumar and Murugesan 2016).

Indian capital markets attract foreign investments. According to Adhana and Saxena (2016) India has topped the list of favoured nations for FDI. Foreign Direct Investment (FDI) in India has increased manifold over the years. The handbook of statistics released by SEBI shows the latest figure for the year 2015-16 at USD 44,907 million. According to reliable reports (India Brand Equity Foundation, www.ibef.org), during the period April to June, 2017, total FDI in India was to the tune of USD 14.55 billion.

Indian firms continue to raise capital from abroad by issue of Depository Receipts. History of Indian firms raising capital through the depository route goes back to the early 1990s. After the advent of IT companies, issue of American Depository Receipts (ADRs) by Indian IT companies and listing of these DRs in stock exchanges in the U.S.A. saw an increase. According to the handbook of statistics released by SEBI for the year 2016, Indian firms had issued GDRs and ADRs to the tune of USD 1271 billion in 2014-15.

4.11 Effects of Developments in Capital Markets

There is no doubt that the developments discussed above are for the better and are in line with technological changes and societal changes. However, it cannot be said that all these changes are uniformly beneficial to the various players in the capital markets.
According to researchers, some of these changes in the capital markets have led to the phenomenon of short-termism in capital markets.

For instance, the higher frequency of trading among investors and shorter holding periods of securities are considered to be indications of short-termism. While these are indications, they are also causes and effects of short-termism. They are causes because higher churning of portfolios leads to expectation of profits at every churn. They are effects because higher churning is caused by unsatisfactory performance by firms.

Short-termism is not perceived as a welcome phenomenon by many academicians, Government authorities and industry experts.

### 4.12 Short-termism

The subject of short-termism can be studied from the following aspects:

1. Understanding short-termism
2. Manifestation of short-termism
3. Causes of short-termism
4. Measures to curb short-termism
5. Contrary arguments on short-termism

#### 4.12.1 Understanding Short-termism

Short-termism can be understood from two viewpoints. One viewpoint is to describe short-termism in terms of its features. The other is to understand short-termism from the point of view of its source.

The following paragraphs discuss descriptions of short-termism based on its features.

The main attribute of short-termism is a defined preference for the short-term *vis a vis* the long term. This aspect of short-termism can be seen reflected in the following definitions or descriptions.
For Laverty, short-termism is about “decisions and outcomes that pursue a course of action that is best for the short-term but suboptimal over the long run” (Laverty 1996).^59^ 

Marginson and McAulay (2008)^60^ describe short-termism as “a preference for actions in the near term that have detrimental consequences for the long term”.

Mauboussin and Callahan (2015)^10^ describe short-termism as “the tendency to make decisions that appear beneficial in the short term at the expense of decisions that have a higher payoff in the long term”.

The report by Prof. Kay describes short-termism in terms of nature of activities undertaken as a consequence of short-termism. It describes short-termism as (a) under investment in physical assets or intangibles and (b) focus on restructuring or other means to improve performance of firms rather than undertaking inherent business improvement measures. (Kay 2012)^3^ 

Patelli (2012)^52^ describes short-termism as “the excessive focus on short-term results which manifests itself as myopic management of operations and manipulation of earnings”.

Short-termism, from the point of view of its source, is discussed below. One school asserts that short-term originates from investors and another school asserts that the originators are managers of firms (Thakor 2016)^61^.

Duruigbo (2011)^5^ suggests that short-termism originates from investors and influences managers of firms. According to him, short-termism can be described as the “investment approach in which investors push managers to invest in short-term projects in order to keep earnings high”.

Contrary to the above view, another description of short-termism seems to suggest that the phenomenon originates with the managers of firms. Dent (2010)^62^ vehemently argues that shareholders are not the cause for short-termism but it is the managers of firms who are the cause. Grinyer, Russell and Collison (1998)^63^ define short-termism as “a phenomenon which is demonstrated by managerial preferences
for short-term gains over economically superior long-term returns”. They believe that the attitudes of investors are relevant only if managers of firms are influenced by them.

Closely related to the above description is the one by Polsky and Lund (2013)\(^ \text{64} \). According to them, short-termism is “the tendency of public firms to overweight short-term results relative to long-term consequences when making decisions”. This description stems from research findings that managers were willing to forego long-term value to meet short-term targets and that earnings is considered to be the most important measure of performance. (Graham, Harvey and Rajgopal, 2005)\(^ \text{65} \). A similar view that managers of firms and analysts consider earnings as the most important of financial performance followed by revenue and free cashflows is expressed by Jong, Mertens, Poel and Dijk (2013)\(^ \text{66} \).

The following description attributes short-termism to all stakeholders.

It states that short-termism is “the excessive focus of some corporate leaders, investors and analysts on short-term, quarterly earnings and a corresponding lack of attention to strategy, fundamentals and long-term value creation”. This description is from the report prepared by Global Compact LEAD and Principles for Responsible Investment (Global Compact, 2014)\(^ \text{29} \).

Jackson and Petraki (2011)\(^ \text{28} \) also explain short-termism in terms of all stakeholders. According to them, short-termism involves situations where corporate stakeholders show a preference for strategies that add less value but have an earlier payoff relative to strategies that would add more value but have a later payoff.

As seen above, there are convincing arguments that short-termism originates from investors. There are equally convincing arguments that managers of firms are the originators. (Jackson and Petraki 2011)\(^ \text{28} \). It is quite possible that one reinforces the other and, as a consequence, the phenomenon of short-termism takes on serious dimensions.
It may be pertinent to note in this context the view of Duruigbo (2011). He opines that investors have two choices. Either they can ‘pressure’ the managers of firms to take a particular course of action or ‘walk’ i.e. sell off their shareholding in the firm.

A few other discussions on short-termism are based on psychological factors such as cognitive abilities and inter-temporal choices for managers and investors. (Laverty 1996, Marginson and McAulay 2008, Drew 2009).

The conclusion that can be drawn from various descriptions above is that when investors, managers of firms and other stakeholders have a short-termist attitude, they focus on current earnings at the expense of long term earnings. The key point is that the focus of these stakeholders is on current earnings ignoring or neglecting the long term. If there is a balance between the short-term and the long-term, it would not be short-termism.

A term that is very often used to denote short-termism is ‘myopia’. It may be worthwhile to note the finer distinctions between the terms short-termism and myopia, though used synonymously many times. Marginson and McAulay (2008) while describing short-termism on the same lines as discussed above, describe managerial myopia as the difficulty of managers of firms to foresee the future consequences of their current actions. According to them, it is not deliberate ignoring of or indifference to future consequences. The same logic could be extended for investor myopia also i.e. the investors are not able to assess the long-term consequences of their preference for the short-term.

Summing up the discussions on the descriptions of short-termism, it could be said that short-termism is a preference for the present as compared to the future.

4.12.2 Manifestation of Short-termism

Short-termism manifests itself in different forms. This topic is discussed under the following headings:

1. Focus on Quarterly Financial Results

2. Reliance on Earnings Guidance
3. Earnings Management

4. Removal of CEOs

4.12.2.1 Focus on Quarterly Financial Results

The opinions of various researchers, academicians, industry leaders and authorities, seem to point to the importance given to current earnings by the investors, whether for a quarter or for a year. According to finance executives, the only financial measure that the market focuses on is earnings per share (Graham et al., 2005)\textsuperscript{65}. This in turn results in focus on quarterly earnings announcements so much so that the term short-termism has been described as quarterly capitalism (Bhat, 2011\textsuperscript{27}, Lubber 2012\textsuperscript{67}).

Many financial analysts publish their earnings forecasts for firms before the firms announce their quarterly financial results. Investors form their expectations about the quarterly results based on these forecasts. When the firms announce the actual quarterly results, if the results are not on the lines of the forecasts, the stock prices of the firms are impacted. The impact may be positive or negative depending on whether the actuals are higher or lower than expectations formed. The above reality has been expressed by researchers like Bartov, Givoly and Hayn (2002)\textsuperscript{68} and Kasznik and McNichols (2002)\textsuperscript{69}. Markets reward firms that meet or beat expectations. The reward is in the form of higher stock prices. On the other hand, if a firm does not meet expectations, the firm is penalised by a fall in the stock prices.

In the Indian context, it has been seen that stock market reaction is pronounced when the quarterly results are announced by some of the Information Technology (IT) firms. Khatua and Pradhan (2014)\textsuperscript{70}, based on their research, find that stock markets in India react to quarterly financial results and that the reactions are more severe when the results convey bad news as compared to good news. Sankar (2014)\textsuperscript{40} finds that there is a significant change in the volume of trades around the time of announcement of quarterly financial results by firms in India. Nevgi (2016)\textsuperscript{71} states that stock prices react to earnings announcements.

This form of manifestation of short-termism is at the core of short-termism. All studies on short-termism, one way or the other, relate to this form of manifestation.
The studies may relate to any aspect of short-termism but the undercurrent will be meeting investor expectations from quarter-to-quarter. The Managing Director of State Bank of India, Ms. Arundhati Bhattacharya, in an interview to the Economic Times (August 19, 2013) stated that the bank needed to get out of the quarter-to-quarter culture. She said that all the future actions of the bank will have a long-term effect and not a short-term outlook.

4.12.2.2 Reliance on Earnings Guidance

Investor expectations are also shaped by earnings guidance given by management of firms apart from analysts’ forecasts. Many firms have the practice of giving earnings guidance for the succeeding quarter. This practice is followed by firms in many countries including a few firms in India. According to Karageorgiou and Serafeim (2014)\(^{31}\), an average of 40% of the firms in most countries have the practice of giving earnings guidance. They list out 35 countries in which firms give earnings guidance. The proportion of firms giving earnings guidance in various countries ranges between 5% and 65%. This list includes Indian firms and the proportion of firms in India giving earnings guidance is around 15%.

Practice of giving earnings guidance can be seen as a measure of transparency. However, most times, the investors believe that the managements of firms have set these guidance figures as targets to be achieved for the period and that the firms will meet or beat the earnings guidance. The CFO of a diversified firm in India echoes this opinion when he states “A guidance is not a commitment but markets take it as a commitment” (Seetharaman 2013)\(^{72}\). The analysts also base their forecasts on these earnings guidance. Instead of basing their forecasts on their own independent research, the analysts also rely on the earnings guidance given by firms. This opinion is also expressed in the Indian context by the Chief Investment Officer of a mutual fund in India (Basu 2003\(^{73}\)). When both the investors and the analysts depend on earnings guidance given by firms, the impact of earnings guidance on investor expectations is magnified.
4.12.2.3 Earnings Management

The combined effect of focus on quarterly results and practice of giving earnings guidance results in yet another practice. This practice is known as earnings management. Earnings Management can be described as affirmative actions by managers of firms to help achieve desired financial results for a period. The desired financial results may be better or worse than the financial results that would be realised if no earnings management actions were to take place.

Graham et al. (2005) find that the managers of firms believe in having smooth earnings period-after-period rather than having volatile earnings. According to the researchers, in the opinion of the managers, smooth earnings convey a sense of stability and better future prospects for the firms among investors. Many researchers have studied earnings management in the context of short-termism. These include studies by Verbruggen, Christaens and Milis (2008), Gunny (2010) and Ernstberger, Link and Vogler (2011).

Schipper (1989) defines earnings management from a disclosure perspective. She defines earnings management as “a purposeful intervention in the external financial reporting process with the intent of obtaining some private gain”. In her view, this is a limited description of earnings management and does not take into account its entire gamut.

Earnings Management can be classified into two classes, namely, Accrual based Earnings Management and Real Earnings Management (Roychowdhury 2006, Gunny 2010, Ernstberger et al., 2011). The former class gives the flexibility to managers to adopt it towards the end or after the end of the accounting period. Managers can study the results for the accounting period and make modifications to the accounting accruals during the period. Real Earnings Management or Real Activities Manipulation, as referred to by some researchers, has to be effected during the accounting period, earlier than close to the end of the accounting period Athanasakou, Strong and Walker 2011). It cannot be adopted towards or after the end of the accounting period.
Zang (2012)\textsuperscript{80} brings out the difference between accrual based and real earnings management. As regards accrual based earnings management, he states that this involves changes to accounting methods or estimates in financial statements. He states that real earnings management involves purposeful action to modify earnings and these actions have suboptimal business consequences.

Accrual based earnings management (or Accounting based earnings management) involves making adjustments to accounting entries to increase or decrease the current earnings. Examples include under provisioning for bad debts and timing asset write-offs. While this practice was adopted by many firms in earlier times, with the increased scrutiny by authorities and auditors, the practice has come down. This practice is fraught with risk for the managers as they are liable to be questioned by the auditors and the authorities for making the adjustments (Graham et al. 2005\textsuperscript{65}, Gunny 2010\textsuperscript{75}). On the other hand, real earnings management involves increasing or decreasing actual expenditure, offering of discounts to increase sales, increasing spending on publicity and other such actions that would result in tangible results. These actions have an impact on the current earnings and the earnings can be adjusted by using these actions.

Roychowdhury (2006)\textsuperscript{78} describes real activities manipulation as management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings thresholds. Gunny (2010)\textsuperscript{75} describes real activities management as “actions that change the timing or structuring of an operation, investment, and/or financing transaction in an effort to influence the output of the accounting system”.

**4.12.2.3.1 Real Earnings Management and Discretionary Expenditure**

Real earnings management is usually adopted with respect to discretionary expenditure by the managers of firms. Discretionary expenditure, in this context, refer to those items of expenditure that reduce the earnings of the current period but whose benefit may accrue in the current or future periods. These real earnings management
actions are not subject to scrutiny and can be justified as business decisions. Moreover reducing some of the discretionary expenses does not reduce sales in the current period. Examples of such discretionary expenditure include expenditure on Research & Development, employee training expenses, travel, maintenance and capital expenditure (Graham et al. 2005, Ernstberger et al. 2011). Advertising & other publicity expenses is another discretionary expenditure that will impact current earnings. The effect of change in publicity expenses will depend on nature of product and nature of the expense.

4.12.2. 3.2 Reducing Expenditure on Research & Development


Expenditure on Research & Development is one of the areas that has been studied by many researchers in the context of short-termism. Many researchers have found through empirical and other studies that managers of firms reduce R & D expenditure to meet current period earnings targets or expectations or due to short-term earnings pressure from investors. (Baber et al. 1991, Dechow and Sloan 1991, Bange and DeBondt 1998, Shimada 2013, Guidara and Boujelbene 2015).

Sankar and Ramanathan (2017) study the effect of changes to research and development expenditure during a financial year in the subsequent two years. They find through an empirical study of 388 listed companies in India that profit before tax in any year is sensitive to changes in research and development expenditure incurred one year earlier.

The reason for managers of firms reducing R & D expenditure lies in the treatment required to be given to this outlay by firms according to the applicable accounting standards of the country (Lev 1999, Gunny 2010, Shimada 2013, Guidara and Boujelbene 2015). If the accounting standard requires firms to treat R & D Expenditure as an expense during the period in which expenditure is incurred instead
of capitalising it, current period earnings are impacted. If the current period earnings of the firms are likely to be low or if the firms are not likely to meet the earnings targets, reducing R & D Expenditure will help in increasing the earnings.

There are two views prevailing regarding investor perceptions about R & D. One view is that investors do not value the research and development initiatives of firms and so are indifferent to such initiatives or actively resist expenditure on R & D. The reason for this view may be information asymmetry between investors and the managers of firms. The other view is that investors recognise the value of such initiatives.

It is acknowledged by many researchers that R & D helps to improve innovativeness of firms, enables growth of firms and is for the long-term benefit of the firms. Lev (1999)\(^8\) refers to earlier research when he affirms that investors value high tech firms that invest in R & D. Powell, Moltchanski and Nagm (2012)\(^8\) assert that investors do not exert pressure on managers of firms to forego investment opportunities like R & D or other capital expenditure.

At the same time, Bange and De Bondt, (1998)\(^8\) are of the view that due to information asymmetry with respect to R & D efforts between the managers of firms and the investors, the managers of firms tend to reduce expenditure on R & D to maintain earnings. Gross (2009)\(^8\) adduces evidence of short-term pressure when he asserts that firms that have gone private are able to focus more on R & D and are able to obtain more patents which in turn helps them when they go public again.

### 4.12.2.3. 3 Selling Price Management

Another practice related to real earnings management is that of increasing the discounts on prices during a period when the managers would like to increase the sales for that period. However, this is not possible with all products and can be adopted only for certain types of products depending on the nature of demand for the product and shelf-life of the product. (Jackson and Wilcox 2000\(^0\), Roychowdhury 2006\(^7\), Chapman and Steenburgh 2010\(^1\), Cohen, Masraruwa and Zach 2010\(^2\))
4.12.2.3.4 Rejecting Positive NPV projects

The third practice related to real earnings management is the practice of rejecting positive net present value (NPV) projects (Graham et al. 2005). This may happen for reasons such as to increase current period earnings or increasing executive compensation. Dechow and Sloan (1991) state that such rejection of positive NPV projects will have an adverse impact on long-term cumulative earnings.

Another related form in which short-termism manifests is in the discount rate applied for evaluating projects. Poterba and Summers (1995) find from a survey of 228 CEOs, that the discount rates applied by firms for capital budgeting decisions were much higher than their cost of capital resulting in rejection of projects that would benefit the firm in the long run. Mizik (2009) states effective management requires adopting strategies that maximize the sum of the discounted future profits. Use of an appropriate discount rate is of importance while discounting future cash flows. The focus on current earnings makes managers of firms discount future cash flows from projects at much higher rates than warranted. This results in rejection of viable net present value projects. (Haldane 2011).

4.12.2.3.5 Other Real Earnings Management Measures

Firms resort to adjustment to various facets of publicity expenses with a view to increase current sales. Gunny (2010) refers to reduction in Selling, General and Administrative (SG&A) expenses to increase current earnings.

Firms also resort to overproduction to reduce the Cost of Sales as fixed cost is spread over a larger volume of production (Roychowdhury 2006, Athanasakou et al. 2011, DesJardine and Bansal 2015).

Yet another practice is postponing investment in Property, Plant and Equipment (PPE) as the initial depreciation for these would be high and would adversely affect current earnings. (Wahal and McConnell 2000, Mizik 2009). It is also possible that managers of firms change the timing of sale of assets to influence current earnings (Bartov 1993, Gunny 2010).
Graham et al. (2005) also refer to some of the above and other practices. These include reducing or postponing hiring of people to reduce employee cost, reducing R & D expenditure to avoid reduction in earnings, reducing expenditure on advertisement and postponing acquisition of new assets to avoid excessive depreciation, reducing travel budgets, delaying expenditure on maintenance, booking capital gains on investments, offering discounts during last quarter and announcing a price increase in the first quarter to increase sales in the quarter.

Most researchers concur with the view that real earnings management with respect to discretionary expenditure is the most widely adopted earnings management practice by managers of firms to manage current earnings. Examples of such researchers include Graham et al. (2005) and Patelli (2012).

Barker (2012) lists out some of the forms in which short-termism gets reflected. These are:

1. Reduced or inadequate outlay on research and development
2. Accrual based earnings management to inflate current earnings
3. Higher dividend payouts and share buybacks
4. Executive pay linked to short-term financial goals
5. Increased acquisitions of firms instead of organic growth

There are other incidental manifestations of short-termism. At the macro level, the competitiveness of the industries in an economy is adversely affected. At the micro level, the consequences include reduced innovative ability of firms, losing competitive position among comparable firms, frequent CEO turnover and others.

**4.12.2.3.6 Expectations Management**

A phenomenon related to earnings management is expectations management. (Bartov et al. 2002, Kasznik and McNichols 2002). Expectations management refers to the practice of managers of firms tempering the expectations of the analysts before announcing financial results. The practice particularly refers to the managers of firms.
lowering the expectations of analysts before quarterly financial results are announced so as to give a positive earnings surprise. This practice is associated with meeting or beating the earning expectations.

Related to earnings management, Athanasakou et al. (2011) discuss a process they refer to as earnings forecast guidance. They use this term to denote ‘guiding analyst forecasts down to make the final forecast more attainable’. They say that managers of firms may combine earnings forecast guidance and earnings management to achieve the desired results.

The aim of expectations management is ultimately to moderate the reaction of the investors that gets reflected in the stock price of the firms. When the analysts are prepared in advance, they, in turn, project earnings forecasts that are closer to what the actual results may turn out to be. Investors who are guided by these analysts’ forecasts will not be in for a negative earnings surprise when the actual results are announced.

4.12.2.4 Removal of CEOs

It is found that boards of firms are intolerant of CEOs not performing in the short-term. CEOs being removed for non-performance within a short span of time of their appointment is common today. As recently as May, 2017, CEO of Ford Motor Company, Mark Fields, was replaced because sales and profits of the company during the last two years had been reducing and the stock prices also decreased. Another example is the removal of the CEO, Andrew Mason of the U.S. based firm, Groupon, in 2013 when the company did not perform well for two quarters and the stock prices were much lower than the listing price two years earlier. Yet another example is the removal of CEO, Daniel Ustian, of the U.S. based Navistar in 2012 because he tried a new technology that failed and landed the company in financial distress. This happened despite the fact that he had been with the company for thirtyseven years and under his leadership the company’s revenue had almost doubled in earlier years. One more example is the removal of the CEO of the insurance giant, Generali, in Italy, in 2012 after 30 years when the company failed in its performance during recent years.
Gao, Harford and Li (2015)\textsuperscript{97} compare turnover of CEOs among public and private firms and come to the conclusion that turnover of CEOs in public firms due to performance related issues are higher than those in private firms and that such turnover is high in public firms with short-termist investors.

4.12.3 Causes of Short-termism

Causes for short-termism can be discussed in terms of its source or activities that lead to short-termism.

Sappideen (2005)\textsuperscript{23} summarises the former set of causes when he talks about short-termism as caused by investor pressure, managerial preferences and management systems in place.

Patelli (2012)\textsuperscript{52} summarises the latter set of causes of short-termism succinctly quoting evidence from various research papers. He refers to the practice of issuing quarterly earnings guidance, shift in shareholding pattern, increased turnover of shareholdings, reduced holding periods of shares, decreasing CEO tenure and the evolution of high-frequency traders using computer algorithms.

Gigler, Kanodia, Sapra and Venugopalan (2014)\textsuperscript{98} refer to price pressure from the capital markets as a possible source for short-termism among managers.

Causes for short-termism can be discussed as follows:

1. Shift in shareholding pattern of firms
2. Practice of announcing quarterly financial results
3. Executive compensation linked to short-term financial performance
4. Information asymmetry
5. Other Causes
4.12.3.1 Shift in Shareholding Pattern of Firms

There has been a fundamental shift in shareholding pattern of firms during the last few decades. As explained in an earlier section, the shift has taken place from a majority of shares being held by individual investors to a majority being held by institutional investors.

Kay (2012)\textsuperscript{3} states that insurance firms and pension funds in the U.K. became major shareholders during the 1990s as compared to individual investors holding most of the shares about fifty years earlier. According to him, in 1963 insurance firms and pension funds held around 16% of the total shareholding of listed firms in U.K. as compared to 54% holding by individual investors. In 1991 the trend was reversed with the former category holding around 52% and the latter category holding around 20%. (During the 2000s, the shareholding pattern in U.K. further changed with majority shares being held by investors from outside U.K. and the share of insurance firms and pension funds coming down.)

Quimby (2013)\textsuperscript{7} states that during 2010 the proportion of shareholding by institutional investors in U.S.A was nearly 70%. The corresponding figure was 8% in 1950. In 2010, the share of mutual funds and pension plans was 26% and 20% respectively. According to Frentrop (2012)\textsuperscript{99}, 80% of the listed shares in the American Stock Exchanges are held by institutional investors.

In the Indian context, according to a study by Value Research Online in July 2015 (Vardhan 2015)\textsuperscript{100}, nearly 51% of the total shareholding of the firms listed in the Bombay Stock Exchange is held by promoters and around 20% is held by Foreign Institutional Investors (FIIs). Domestic institutional investors hold around 10% and retail investors hold around 16%. According to the report, the retail shareholding has reduced to 16% in 2015 from 19% in 2005 while FII holdings have gone up from around 14% to 20% during the same period. Balasubramanian and Anand (2013)\textsuperscript{101} study the shareholding pattern of Indian firms over the period 2001 to 2011. While institutional shareholding increased from around 25% in 2001 to 29% in 2011, non-institutional shareholding declined from around 28% in 2001 to around 16% in 2011.
4.12.3.1.1. Effect of Shift in Shareholding Pattern of Firms

The shift in shareholding pattern is said to have brought about a fundamental change in the expectations of the investors with regard to performance of firms. The general argument is that while individual investors were long-term oriented and were patient investors, institutional investors are short-term oriented.

The discussions on institutional investors primarily revolve around institutions that are in the nature of investment vehicles for individual investors. Institutions like pension funds, mutual funds and other similar funds fall in this category. By their very nature, these institutions should be long-term investors and need to reward those who park their monies with the institutions (beneficiaries) with long-term returns. Global Compact (2014) brings out this point succinctly. Contrary to expectations, many arguments have been put forth regarding short-termism among asset managers in these institutions. As early as 1992, Porter (1992) commented on this aspect. He expressed the view that mutual funds and actively managed pension funds held on to their shareholding only for 1.9 years on the average. He also was of the view that institutional investors aimed to beat the stock indices and were interested in quarterly or annual increase in the value of their investment portfolio.

It has been said that the asset managers in these institutions are short-term oriented (Rappaport 2005) and look for opportunities to make profits in the short term rather than in the long term. Lubber (2012) refers to a report regarding investment horizon of asset managers and states that 55% of the asset managers responded that their average investment horizon is less than or equal to 3 months. Nevgi (2016) concurs with the view that fund managers in mutual funds have reduced their stock holding spans.

A report published in the Economic Times in October 2011 (Chadha 2011) states that the average holding period of equity investment by equity oriented schemes in India was 1.6 years. Rao (2010), in his study of nine mutual funds in India, reports that though the investment objective of these schemes was long-term appreciation, the average stock holding period by these funds was around 12 months during the period 2006 to 2009.
Kay (2012)\textsuperscript{3} expresses this idea when he states that beneficiaries are interested in long-term absolute performance while asset managers are concerned with short-term relative performance. Manjrekar and Sinha (2010)\textsuperscript{105} express a similar opinion in the context of asset managers in mutual funds in India. This view is also expressed in the report published in the Economic Times in October 2011 (Chadha, 2011)\textsuperscript{103} referred to earlier.

The asset managers expect the firms in which they invest to perform well quarter-on-quarter. One argument put forward for this short-termist approach of the asset managers is that their compensation is linked to short-term performance. (Jackson and Petraki 2011)\textsuperscript{28}. The other argument put forward is that the management of these institutions expects superior performance from the asset managers every quarter. Kochhar and David (1996)\textsuperscript{106} refer to this aspect of evaluation of performance of asset managers. Drew (2009)\textsuperscript{53} lays stress on this aspect when he talks about Universal Owners i.e. Pension Funds and Superannuation Funds. He quotes from relevant research studies and states that these institutions have a three year rolling performance objective and evaluate performance on a quarterly basis. Kay (2012)\textsuperscript{3} reiterated the view when he expressed that an asset manager cannot take a long term view when his performance is evaluated on a quarterly basis. The asset manager necessarily needs to measure his performance with respect to short-term benchmarks.

The asset managers on their part assert that they are dictated by the beneficiaries for short-term performance. (Li 2005)\textsuperscript{107}

The resultant effect of the short-term approach of the asset managers reflects on the management of firms in which they invest. (Rappaport 2005\textsuperscript{1}, Li 2005\textsuperscript{107}). They are pressurised because they fear that if the institutional investors sell off their holdings, the stock prices will drop and will reflect badly on their capabilities. When institutional investors sell their shares, the impact in the markets on stock prices will be quite high considering the volume of shareholding by these institutions in individual firms (Hansen and Hill 1991)\textsuperscript{42}. To avoid a steep decline in stock prices, managers of firms try to ensure sufficiently high levels of stock prices in the markets to withstand such downward pressures.
Thus, a combination of factors leads to short-termism among asset managers of financial institutions. This, in turn, leads to short-termism among managers of firms.

Another aspect is that asset managers who look for short-term superior performance churn their portfolios at a higher frequency to avoid holding on to stocks of losing firms (Hansen and Hill, 1991)\textsuperscript{42}. Kochhar and David (1996)\textsuperscript{106} cite earlier research to point out this factor. As a consequence, the holding period of securities is also reduced.

Yet another important aspect of short-termism exhibited by asset managers is that they discourage management of firms from investing in projects that yield returns in the long term but reduce the current earnings. Investment in Research and Development (R &D) is one such area. This attitude of asset managers is said to adversely affect the innovativeness of firms.

There are also counter-arguments that asset managers are not necessarily short-term oriented. There are some researchers, including those who express the opinion that asset managers have a short-term outlook, who assert that institutional investors are not necessarily against innovation. They argue that institutional investors support investments for long-term growth and that they discern between firms that add value in the long-term and firms that don’t. (Hansen and Hill 1991\textsuperscript{42}, Majumdar and Nagarajan 1994\textsuperscript{108}, Kochhar and David, 1996\textsuperscript{106} and Wahal and McConell, 2000)\textsuperscript{95}.

Rajgopal and Venkatachalam (1997)\textsuperscript{109} also put forward the view that institutional investors do not necessarily induce short-termist behaviour among managers of firms.

In spite of these researchers producing evidence to the contrary, the general opinion continues to be that institutional investors are short-termist in nature and do not support investments in R & D and other similar investments.

There is also a view that institutional investors cannot influence a firm because their holding is only a small proportion of the total shares issued by the firm. But this argument may not be sustainable if several such institutional investors hold shares in a firm and the cumulative shareholding is high.
In this context, Sahu and Chakraborty (2013) refer to the relatively smaller shareholding by institutional investors in Indian firms as compared to the corresponding figure among American firms. The researchers come to the conclusion, based on their study, that shareholding by Foreign Institutional Investors (FIIs) in Indian firms positively influences the financial performance of these firms inspite of the lower shareholding. The researchers are of the opinion that the FIIs monitor the performance of firms closely which has a positive effect. They also find that Indian mutual funds, though having a small proportion of the total shareholding, have a positive effect on the financial performance of firms in which they invest.

Bushee (1998) finds that institutional investors can be divided into two classes. In the first class fall those institutions that support long-term outlook by firms and the second class comprises of institutions that are short-termist in nature. Roychowdhury (2006) is also of the opinion that the institutional investors can influence managers of firms in both ways. They can induce short-termism among managers and they can also make managers more responsive to long-term needs. This depends on the outlook of the institutional investors. Based on his study, he comes to the conclusion that presence of institutional investors discourages managers of firms from resorting to real activities manipulation.

Jackson and Petraki (2011), in this context, differentiate between various types of institutional investors in the U.K. Capital Markets in 2007. They analyse the holding pattern and duration of holdings by venture capital funds, private equity funds, insurance firms, investments advisors, pension funds and hedge funds. They find that pension funds and hedge funds have a much higher turnover of holdings as compared to venture capital funds and private equity funds.

Gigler et al. (2014) in this context, while agreeing with the view that impatient traders exert pressure on managers of firms to perform in the short-term, point out that a cumulative effect comes into play when successive impatient traders buy and sell stocks. In their view, the short-term view of the impatient traders cannot sustain in the long term and even these traders need to ensure that firms perform well in the long run to satisfy the various traders in the chain.
The above studies seem to suggest that not all categories of institutional investors are short-termist. While one class of institutional investors exerts pressure on managers of firms, there are others who encourage firms to take a long term view also.

In the overall analysis, the argument for and against institutional investors influencing managers of firms to take a short-termist approach seems to tilt towards the ‘for’ arguments inspite of evidence supporting the ‘against’ view.

4.12.3.2 Practice of Announcing Quarterly Financial Results

It is mandatory in many regions to announce financial results of firms on a quarterly basis. Some regions have made half-yearly disclosures mandatory. There are also firms that give out results on a quarterly basis on a voluntary basis.

There is a widespread opinion that the requirement to announce quarterly financial results is one cause for short-termism. (Ernstberger et al. 2011, Gigler et al. 2014, Desjardine and Bansal 2015, Bhojraj and Libby 2005).

Two reasons are attributed for this. One is that more frequent financial reporting places more information in the hands of the investors resulting in a disadvantage rather than removing information asymmetry. The second reason is that quarterly financial results are interpreted in the light of quarterly earnings guidance given by managements of firms and analyst forecasts. As discussed in an earlier section, coupled with earnings guidance for the quarter and the analysts’ forecasts, the investors come to expect certain levels of performance by firms. The combination of quarterly results, earnings guidance and analysts’ forecasts contribute to short-termism among investors. If the investors do not get information about the performance of the firms at such frequent intervals, it is expected that they would also be long-term oriented.

The managements of firms are subject to pressure for meeting or beating the earnings targets every quarter due to the investor expectations as discussed above (Graham et al. 2005). This leads to the managers resorting to various measures to manage the earnings of the firms to meet targets.
During the early 2000s, many countries debated moving to quarterly mandatory reporting from half-year mandatory reporting (Bhojraj and Libby 2005\textsuperscript{111}) and rejected the proposal due to concerns of short-termism among managers of firms. (Gigler et al. 2014)\textsuperscript{98} Some Governments in Europe, that were considering introduction of mandatory quarterly financial reporting in place of half-yearly reporting, began rethinking their decision in the light of the widespread opinions that quarterly financial reporting leads to short-termism.

In this backdrop of researchers suggesting that quarterly financial results lead to short-termist tendencies among investors, there are counter-arguments also.

Proponents for quarterly financial reporting argue that one of the fundamental principles of capital markets is transparency. Timely and adequate dissemination of information by firms to their investors is of utmost importance. Kanodia and Lee (1998)\textsuperscript{112} put forward the argument that periodical dissemination of information has a disciplining effect on the managers of firms. They argue that such periodical reports are beneficial to the firm and the markets because the information asymmetry is removed and as a result the markets value the firm properly. Fu, Kraft and Zhang (2012)\textsuperscript{25} and Stoumbos (2017)\textsuperscript{26} also state, through empirical studies, that increased frequency of reporting reduces information asymmetry.

Bhojraj and Libby 2005\textsuperscript{111} also refer to these arguments by proponents in the context of frequency of mandatory financial disclosures. Timely and adequate information about the performance of firms is required by the investors to make informed decisions. Given this view, it would not be advisable to reduce the frequency of disclosure of performance-related information.

Inspite of counter arguments favouring quarterly financial reporting, while the European Union (EU) and the U.K. earlier required listed firms to report on a quarterly basis, both have now ended the requirement for mandatory quarterly reporting. The EU discontinued the requirement from 2015 while the U.K. introduced the change one year earlier.
The opinion against quarterly financial results was partly influenced by the fact that many firms discontinued the practice of giving quarterly earnings guidance. In the early 2000s, Coca Cola, AT & T and McDonalds discontinued the practice of giving quarterly earnings guidance. (Chen, Matsumoto and Rajgopal 2011, Call, Chen, Miao and Tong 2014, Kim, Su and Zhu 2016). Unilever also stopped the practice of giving earnings guidance in 2009 when a new CEO took over the reins. The new CEO wanted to bring about a fundamental change in the outlook of Unilever from being short-termist to long-term thinking.

Karageorgiou and Serafeim (2014) are of the opinion that earnings guidance shifts the focus of the management and the markets from long-term performance to short-term performance. This, in turn, gives rise to increase of proportion of short-term investors in the firm.

As regards firms discontinuing earnings guidance voluntarily, according to Chen et al. (2011) not all firms that stop giving earnings guidance do so because they want their investors to be long-term focussed. They discontinue the practice for other reasons also. For instance, the researchers find that firms that have performed poorly in the previous quarter stop this practice. They also state that those firms in which the investors are long-term oriented also stop this practice.

In India, IT major Infosys announced that it would not give quarterly guidance for the quarter July-September, 2012. The reason for this decision was prompted by uncertainty in the business environment.

To overcome the association of earnings guidance with earnings expectation, Fanning, Harris, Jackson and Stern (2015) suggest giving an earnings goal rather than an earnings expectation through the quarterly earnings guidance. They find that giving goals rather than expectations tempers the reactions of investors when the quarterly results are announced.

To conclude this discussion on quarterly financial disclosures leading to short-termism, the more prevalent view appears to be that quarterly disclosures, quarterly
earnings guidance and quarterly analysts’ forecasts do have a role to play in promoting short-termism among investors and managers of firms.

4.12.3.3 Executive Compensation linked to Short-term Financial Performance

Executive compensation may or may not be linked to the performance of firms. When it is linked, the link may be to current earnings or to long-term performance (Jackson and Petraki 2011). Dechow and Sloan (1991) suggest that top executive compensation may be linked to accounting earnings performance and to stock price performance. In the former case, the executives are compensated through an annual bonus plan and in the latter case, through stock options. This produces a balance between the short-term and the long-term.

Short-term performance based executive compensation is another cause for short-termism among managers of firms. (Dechow and Sloan 1991, CFA 2006, Gopalan, Milbourn, Song and Thakor 2014, Mauboussin and Callahan 2015). When compensation of managers of firms is linked to current year financial performance of firms, the tendency of managers to manage earnings is high. They resort to various earnings management measures like reduction in expenditure on research and development, increase in price discounts and other practices discussed in an earlier section.

According to Ghosh (2006), the current year financial performance of a firm has a significant impact on CEO compensation. As a result, CEOs would sacrifice long-term benefits for the firm to achieve current year earnings. This is evidenced by reduction in expenditure on R & D.

In the Indian context, Chakrabarti, Subramanian, Yadav and Yadav (2011) are of the opinion that CEO compensation is closely linked to the stock prices of the firms they manage.
There are studies that have come to the conclusion that CEOs, towards the end of their tenure, are inclined to boost earnings by resorting to expense containing measures if their compensation is linked to short-term performance. (Dechow and Sloan 1991)

4.12.3.4 Information Asymmetry

Researchers also put forward another cause for short-termism. This cause relates to information asymmetry between managements of firms and investors. The managements of firms are privy to internal information that cannot be nor is transmitted through quarterly financial results and quarterly earnings guidance to the investors. Consequently, investors are not able to assess the long-term effects of decisions taken by managements (Jackson and Petraki, 2011). This translates into wrong notions about the competency of managers when the results are not upto expectations (Polsky and Lund 2013).

This view is supported by Jong et al. (2013) when they express the opinion, based on a survey among analysts, that the analysts do not get to know the real reasons for a shortfall in earnings or the firm not meeting expectations; and as a result, this is taken as a negative indicator of future prospects and hidden problems in the firm.

Gigler et al. (2014) put forward the argument that when the investors have full information, scope for short-termism is limited. In the absence of complete information about the firm’s performance and future prospects, investors tend to exert pressure on managers of firms for short-term performance.

4.12.3.5 Other Causes

Roe (2013) is of the view that CEOs of firms would be short-term oriented because of human tendencies. While Roe estimates the average CEO tenure to be around 7 years, Lubber (2012) opines that the tenure is 4 years. Frentrop (2012) states that the average of tenure of CEOs in the mid 1990s was slightly less than 10 years, in the early 2000s it was slightly over 8 years and by the end of the decade the average tenure had reduced to 6 years. Given this scenario, CEOs would want to push poor results to a future date after their departure and would try to show strong financial
performance during their tenure. Executives in the next rung would also exhibit similar tendencies to improve their chances of being hired by other firms.

4.12.4 Measures to Curb Short-termism

Academics, industry leaders, industry bodies and authorities have come up with various suggestions to curb short-termism and to promote long-term thinking among investors, managers of firms and institutional investors (Patelli 2012, Polsky and Lund 2013). The most common measures suggested are:

1. Discontinuing the practice of earnings guidance
2. Delinking executive compensation from short-term performance
3. Delinking compensation of asset managers from short-term performance
4. Disclosure modifications to remove information asymmetry
5. Educating all stakeholders to be patient and to take a long-term view
6. Other measures like loyalty dividend and capital gains tax reforms
7. General Approach

The above measures are discussed below:

4.12.4.1 Discontinuing the Practice of Earnings Guidance

It has been suggested that firms should stop giving quarterly earnings guidance (CFA 2006, Salter 2013, Global Compact 2017). This will discourage investors and analysts from forming expectations about the results and make them accept the financial results announced at face value. Discontinuing the practice will also help the managers of firms to focus on the long term. Warren Buffet, Chairman and CEO of Berkshire Hathaway, was against the practice of giving earnings guidance in 2002 and continued to have the same opinion in 2016. (Countryman 2002, Belvedere 2016)
4.12.4.2 Delinking Executive Compensation from Short-term Performance

According to experts, executive compensation should not be linked to short-term performance of the firms. On the other hand, linking compensation to long-term performance will promote long-term view among the managers. Stock options that vest only after a specified number of years in the future will encourage managers to look at measures that will strengthen the firm financially in future.

In this context, Rappaport (2005)\textsuperscript{1} suggests offering discounted index options, with the index linked to the performance of the company’s competitors and not to a broad market index.

Romano and Bhagat (2009)\textsuperscript{124} suggest that incentive compensation plans for executives should comprise of restricted stock and restricted stock options. The restrictions will be that the stock cannot be sold before a defined period post-laying down of office by the executive concerned and the stock options cannot be exercised till a few years after resignation or retirement.

There is a strong argument for reforms to executive compensation to promote long-term view among managements. (CFA 2006\textsuperscript{117}, Drew 2009\textsuperscript{53}, Jackson and Petraki 2011\textsuperscript{28}, Kay 2012\textsuperscript{3}, Salter 2013\textsuperscript{4}, Pozen 2014\textsuperscript{125}, Barton, Bailey and Zoffer 2016\textsuperscript{30}) A general view expressed by academicians and industry experts is that executive compensation should be linked to both current financial performance and future financial performance.

However, there are counter views on the subject of reforms to executive compensation. Polsky and Lund (2013)\textsuperscript{64} are of the opinion that executive compensation reforms may not be a solution to short-termism. They argue that whatever the compensation structure, the managers of firms will continue to satisfy the demands of the investors.
4.12.4.3 Delinking Compensation of Asset Managers from Short-term Performance

On the lines suggested for executive compensation, suggestions are made for linking compensation of asset managers to the long-term performance of the funds. (Rapport 2005\(^1\), CFA 2006\(^117\), Drew 2009\(^53\), Kay 2012\(^3\), Pozen 2014\(^125\)).

4.12.4.4 Disclosure Modifications to Remove Information Asymmetry

Suggestions have been made to improve the information content in communications to the investors to remove information asymmetry. (Bhat 2011\(^27\), Jackson and Petraki 2011\(^28\), Global Compact 2014\(^29\) and Barton, Bailey and Zoffer 2016\(^30\)). The suggestions are that investors need to be informed of long-term plans of the firm and the effect of current actions on long term performance of the firms.

4.12.4.5 Educating all Stakeholders

It has been suggested all stakeholders concerned, namely, the investors, the asset managers, the top management of institutions that manage funds and the managers of firms should be educated to take a long-term view of the stock markets, performance of the funds managed by institutions and performance of firms (CFA 2006\(^117\), Jackson and Petraki 2011\(^28\)). Investors should be encouraged to be patient while asset managers should be educated to align their interests with that of the investors who invest in their funds. Managers of firms should be encouraged to take a long-term view for the benefit of the firms inspite of pressure from various quarters for short-term results.

Barker (2012)\(^54\) in this context suggests a stewardship approach by institutional investors. He recommends that institutional investors should engage with managements of firms rather than disposing off their holdings in case of under or non-performance by firms.
4.12.4.6 Loyalty Dividend and Tax Reforms

Proposals to curb short-termism include introduction of a Securities Transaction Tax, reforms in Capital Gains Tax for sale of shares and Loyalty Dividends for shareholders who hold shares for a specified long duration (Duruigbo 2011, Erasmus 2015).

Securities Transaction Tax is expected to discourage frequent trading in shares. Another suggestion made by many experts in the field is to incentivise investors by reducing capital gains tax as the period of holding increases. It may be pertinent to note in this context that India has a securities transaction tax. This tax was introduced in the year 2004. However, the purpose and the scope of the tax in India are different from the purpose suggested in literature.

Quimby (2013) suggests introducing loyalty shares for investors. These shares will carry higher voting powers and lower capital gains tax with increasing holding period.

4.12.4.7 General Approach

While the measures discussed above are specific to address various aspects of short-termism, a general approach to promote long-term thinking among all concerned in the capital markets has been suggested by Kay (2012). This approach advocates adopting a long-term outlook by all participants in the capital markets, including the regulators, and moving away from any practice that promotes short-termism.

The UK Stewardship Code (2012) suggests that the institutional investors should follow specific principles relating to stewardship of the firms in which they invest to adopt a long-term outlook.

4.12.5 Contrary Arguments on Short-termism

The academic world is not without those who claim that short-termism does not exist or that it is not so serious as it is made out to be.

Notable among these is the paper by Maubossin and Callahan (2015). In this paper, they express the opinion that short-termism does not exist in such serious proportions
as it is made out to be. There are other researchers who have also put forward the view that short-termism is not a serious phenomenon. There are yet others who are of the opinion that short-termism will actually lead to benefits in the long term because long term is made of a series of short terms. So, if results are positive in successive short terms, they need to be positive in the long term also.

4.13 Conclusion

This chapter gives a description of aspects of capital markets relevant to this study. The chapter also gives a description of short-termism as used in the context of this study. As can be seen, there are various facets of short-termism and many research studies have been conducted on the subject.
References


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