Are U.S. Companies Too Short-Term Oriented? Some Thoughts

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Overview

- Much criticism of U.S. economy / companies as too short-term oriented.
- Long history.
- What do corporate earnings tell us about short-term orientation overall?
- Current P/E Ratios?
- Venture Capital investments and returns?
- Private Equity investments and returns?

Criticism of U.S. economy / companies as too short-term oriented.

- "Short-term thinking pervades our most important institutions, from government to households... The effects of the short-termist phenomenon are troubling... In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth.
  - Laurence Fink, CEO, BlackRock, Spring 2015.

Criticism of U.S. economy / companies as too short-term oriented.

- "An additional reason for the absence of inclusive prosperity is the ***changing nature*** of corporate behavior. Business leaders, government officials and academics have pointed out that corporations have shifted their traditional focus on long-term profit maximization to maximizing short-term stock-market valuations. One reason that economists have advanced for this transition to corporate short- termism is the overwhelming shift to stock-market-based compensation for CEOs and other highly compensated executives at publicly traded corporations…
  - Report of the Commission on Inclusive Prosperity (Co-chaired by Larry Summers).
- "The goal is to cause companies and their shareholders to operate on longer time horizons and to more generously share the fruits of corporate success with their workers, customers and other stakeholders." Summers

But, long history.

- “By their preference for servicing existing markets rather than creating new ones and by their devotion to short-term returns and management by the numbers, many of them have effectively forsworn long-term technological superiority as a competitive weapon. In consequence, they have abdicated their strategic responsibilities.”

- “It would not be unfair to pose the policy issue as: Whether the long-term interests of the nation’s corporate system and economy should be jeopardized in order to benefit speculators interested . . . only in a quick profit . . . ?”

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  - Hayes and Abernathy (1980).

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  - Lipton (1979)

But, long history.

- “The U.S. system of allocating investment capital is failing, putting American companies at a serious disadvantage and threatening the long-term growth of the nation's economy… Many American companies invest too little, particularly in those intangible assets and capabilities required for competitiveness – R&D, employee training and skills development … The U.S. system, first and foremost advances the goals of shareholders at the expense of the long-term performance of American companies. In global competition, where investment increasingly determines a company's capacity to upgrade and innovate, the U.S. system does not measure up.”

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  - Michael Porter (1992).

But, long history

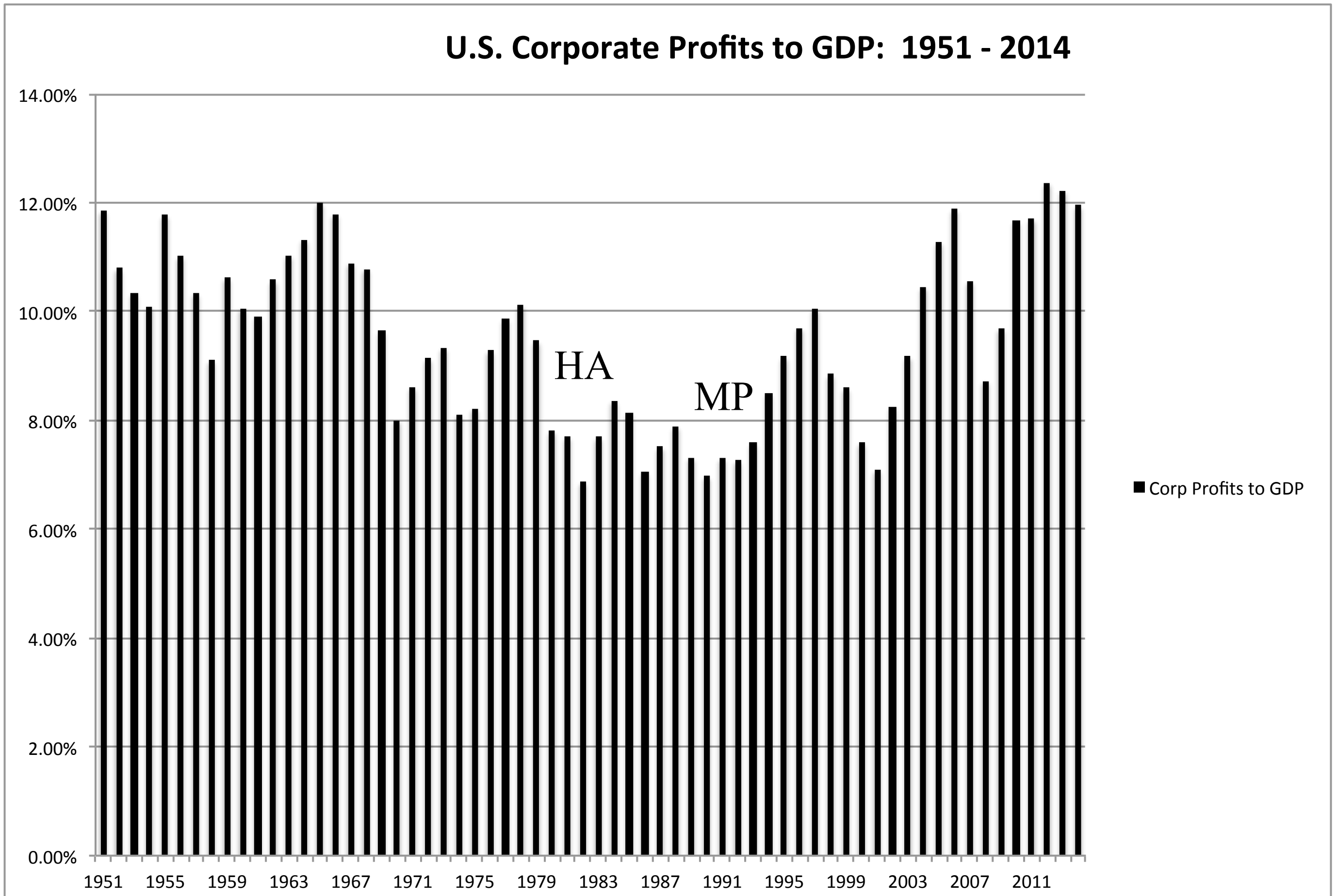
- Critiques of U.S. business as short-term have been with us for at least 35 years. [Mark Roe (2013) also describes some of this.]
  - Lipton (1979)
  - Hayes and Abernathy (1980)
  - Porter (1992)

- If they had been right, shouldn't we be in the long-term today?
  - The short-termist view clearly implies that U.S. businesses should be doing horribly today.
  - Today is the long-term that U.S. companies supposedly underinvested in in the 1980s and 1990s.

- How are U.S. companies doing?

What does corporate performance tell us?

- Corporate profits are at historically high levels and at historically high % of GDP.



What does corporate performance tell us?

- Timing is odd.
  - Corporate performance has been extremely strong relative to GDP since 1992.
  - Where is predicted decline?

- Other observations not consistent with short-termism:
  - Internet Boom.
  - Fracking Revolution.
  - Biotech Boom.

What does corporate performance tell us?

- Labor economists and others point to technological change as the reason for the increase in corporate profits (as well as the lower labor share of GDP and the increase in income inequality).
  - Didn't this have to come from investments in technology?

Current P/E Ratios?

- What do P/E ratios tell us? Short-term arguments imply that P / E ratios should be low! Yet!
  - Read every day that P / E ratios are historically high in the U.S.
  - S&P 500 P/E is roughly 20 versus historical median of 15.
  - Shiller P/E is roughly 25 versus historical median of 16.

- Recall:
  - P = E / (R – g)
  - P / E = 1 / (R – g)

- So, R – g must be low.

Current P/E Ratios?

- So, $R - g$ must be low.

  $R - g \quad = \quad R_f + RP - \pi - g_r$

  $\quad\quad\quad = \quad (R_f - \pi) + (RP - g_r)$

- For $R - g$ to be low, either
  - real risk-free rates are low: $(R_f - \pi)$
  - or real growth risk premiums are low: $(RP - g_r)$
  - or both.

- Neither is consistent with a short-term market, particularly the latter.
  - In particular, hard to see that g_r can be low.

What do Venture Capital returns and investments tell us about early stage innovation

- If U.S. companies underinvest in innovation, shouldn't there be huge opportunities for others to invest in innovation?
- Shouldn't the amount invested in VC increase and the returns to VC firms be terrific?
- What is the evidence for that?

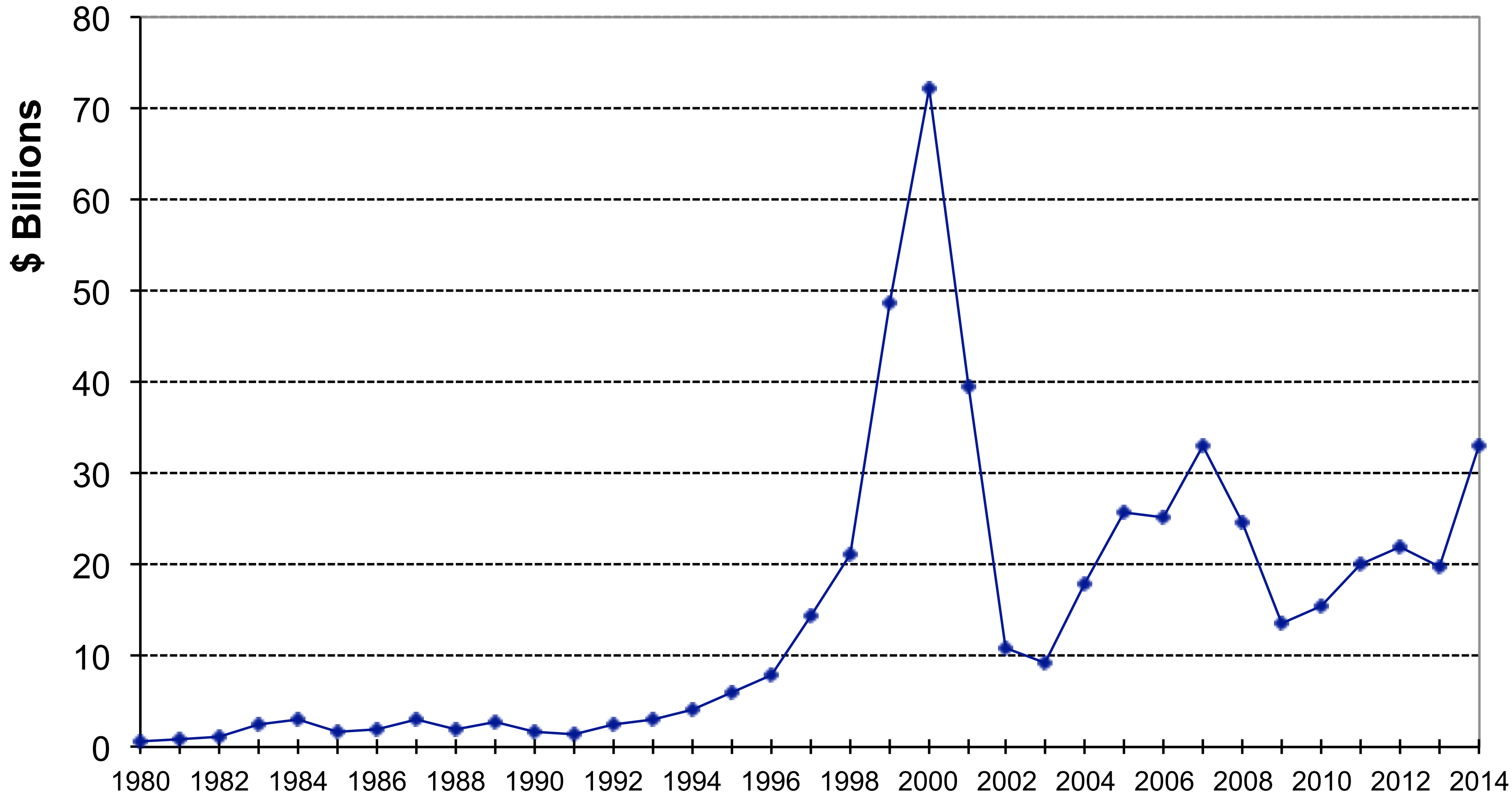
What do Venture Capital returns and investments imply for early stage innovation?

- Summarize results from
  - Harris, Jenkinson, Kaplan, Journal of Finance.
  - Harris, Jenkinson, Kaplan, Journal of Investment Management (forthcoming).
  - Harris, Jenkinson, Kaplan, Stucke.

Capital Invested In VC?

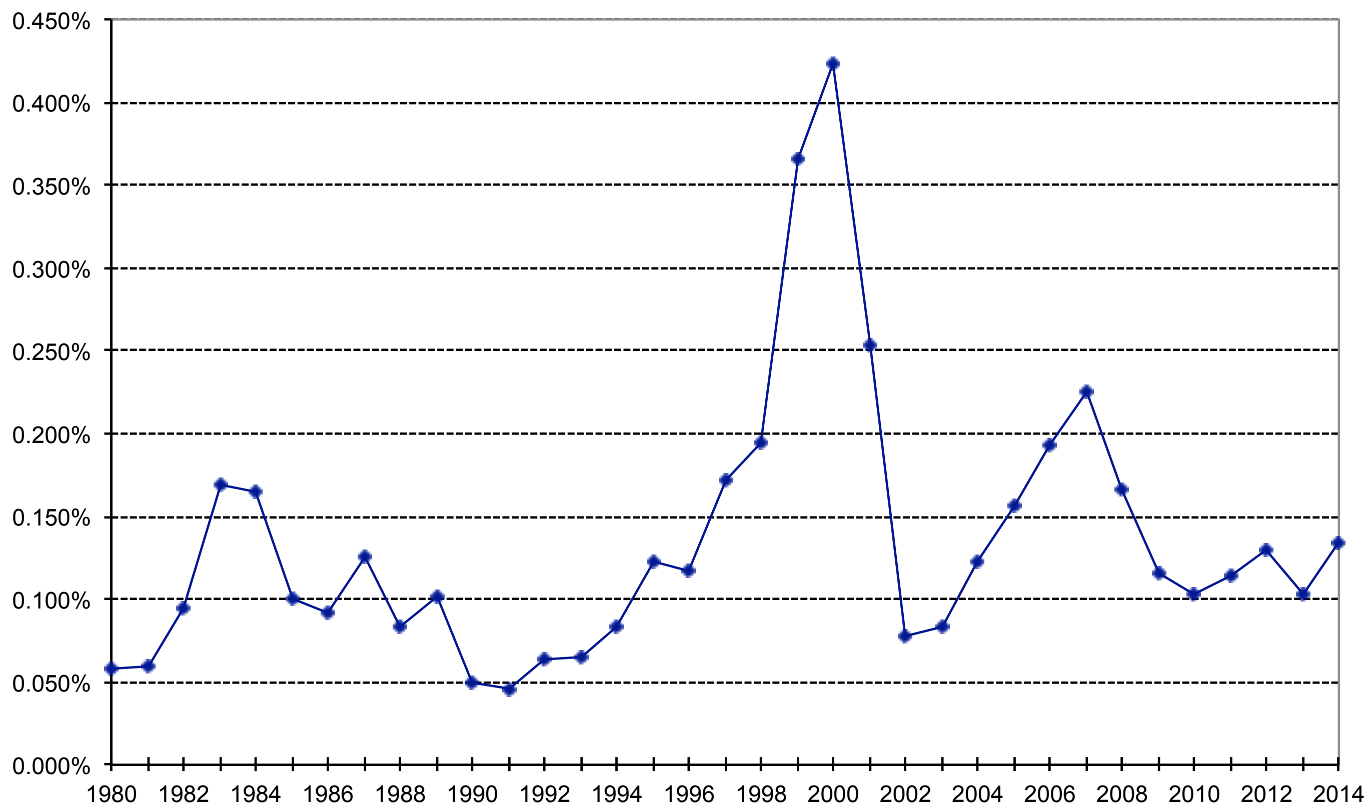
- Capital committed to VC – nominal.
- Capital committed to VC – as a fraction of total stock market value.

Commitments to U.S. Venture Capital Partnerships 1980 - 2014 (in $ billions)



Source: Private Equity Analysis, Steven N. Kaplan

Commitments to U.S. VC Partnerships as Fraction of Stock Market Capitalization 1980 - 2014



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Capital Invested In VC?

- Capital committed to VC (as a fraction of total stock market) has averaged 0.13% over last 35 years.
  - In 2014, it was exactly equal to the average at 0.13%.
  - Innovation opportunities, while cyclical, seem to be roughly constant over longer periods.

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- Capital committed to VC (as a fraction of total stock market) has averaged 0.13% over last 35 years.
  - In 2014, it was exactly equal to the average at 0.13%.
  - Innovation opportunities, while cyclical, seem to be roughly constant over longer periods.

- Also suggests that we are nowhere near the VC bubble we saw in 1999 / 2000.
  - Whatever one thinks about valuations and unicorns, nowhere near the capital and activity of the dotcom boom.

In fact, regular claims that there is too much money in VC (not too little).

- "Dramatic inflows of cash weaken the 'fragile ecosystem' of the venture capital industry by forcing some to 'shove' money into deals… The answer is to discourage more money from coming in and to suppress what goes out."
  - » *Venture Capital Journal*, December 1993.

- "It seems inevitable that venture capital must shrink considerably. While there is no question that venture capital can facilitate some forms of high-growth entrepreneurial firms, its poor returns make the asset class uncompetitive and at risk of very large declines in capital commitments as investors flee this underperforming asset."
  - – Paul Kedrosky, Kauffman Foundation, June 2009.

Performance?

- How did VC perform relative to the public markets?

- Kaplan and Schoar (2005) introduced PME.
  - = market-adjusted multiple.
  - PME = Public Market Equivalent.
    - $$\frac{\Sigma(\text{S\&P 500 discounted value of cash outflows})_t}{\Sigma(\text{S\&P 500 discounted value paid in capital})_t}$$
    - Compares fund to investment in S&P (including dividends).
    - If PME > 1, then LPs did better than S&P 500.

Question

- Have VC funds beaten the S&P 500?
  - 1990s vintages?
  - 2000s vintages?

Use Burgiss Data

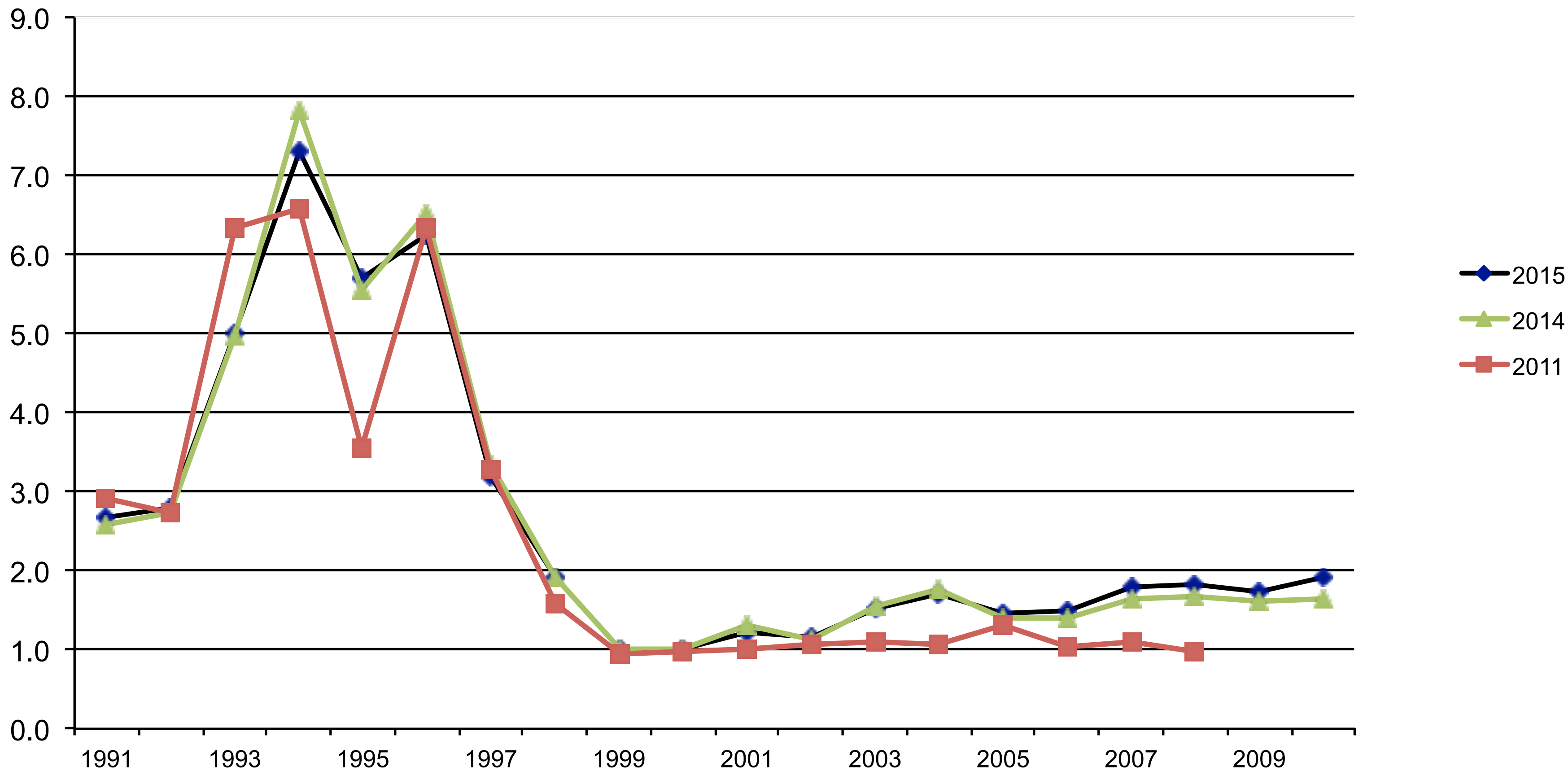
- Sourced exclusively from LPs.
  - Include all funds and cash flows from LPs that provide the data.
    - » More than 2/3 of Burgiss' clients have allowed access.
- Data come from "over 200 investment programs and represent over $1 trillion in committed capital." Of these,
  - 60% are pension funds (a mix of public and corporate); and
  - 20%+ are endowments or foundations.
- LPs use Burgiss products for their internal processes:
  - record keeping and fund investment monitoring.
- The data are essentially LP records.
  - Cash flow data likely to be very accurate because Burgiss systems used by LPs for record keeping and fund investment monitoring.
  - Data are up to date – given need for quarterly reporting by most LPs.

Burgiss

- For a given LP, unlikely to be any reporting / backfill / selection bias.

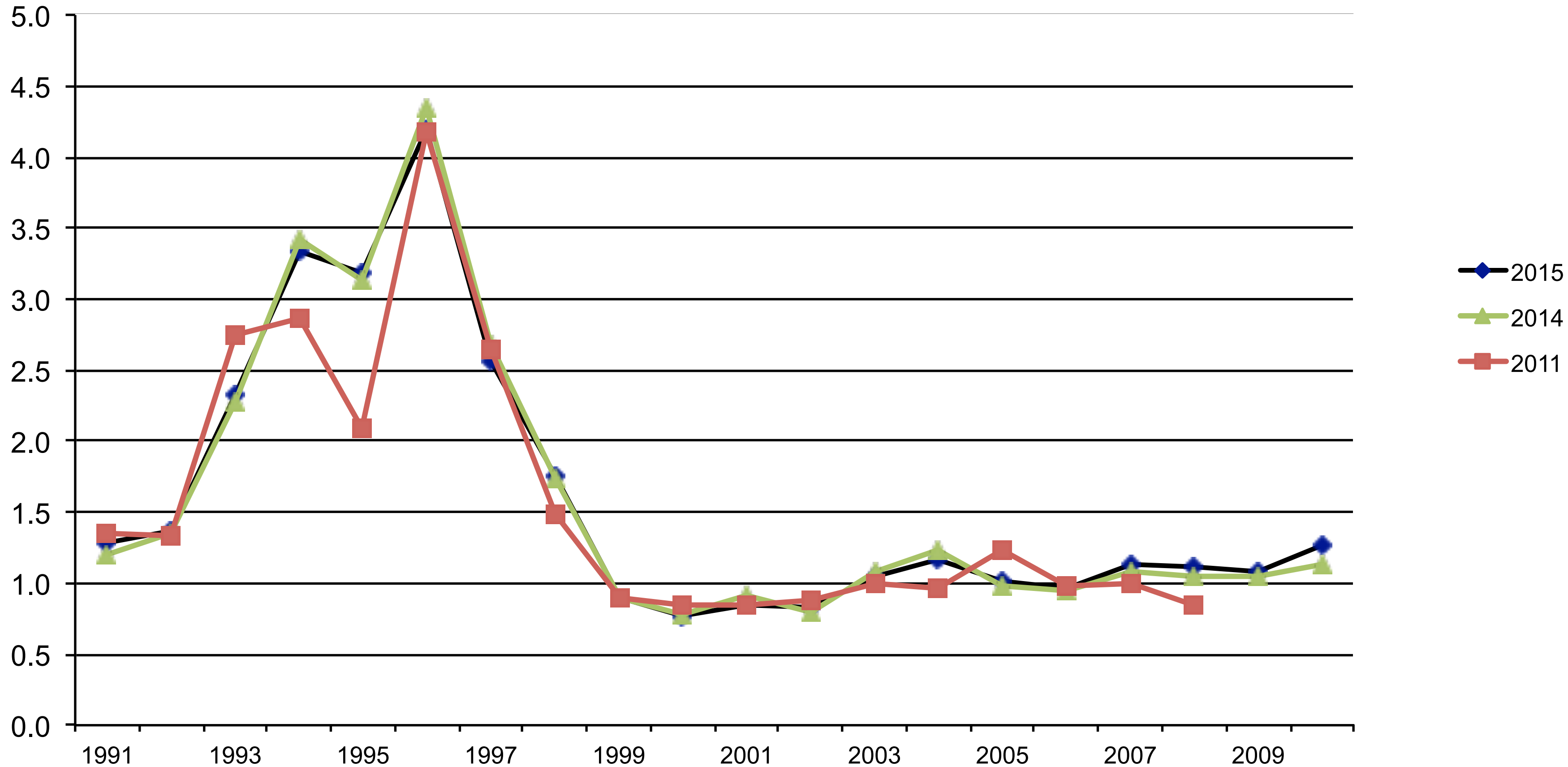
- Primary potential bias– which it shares with the other commercial databases – is how representative the LPs (and resulting GPs) are.
  - Possible, but very unlikely that LPs in the Burgiss sample have had better than average experience with private equity which is why they use Burgiss and allow Burgiss to aggregate their results.

U.S. VC MOIC by Vintage Year



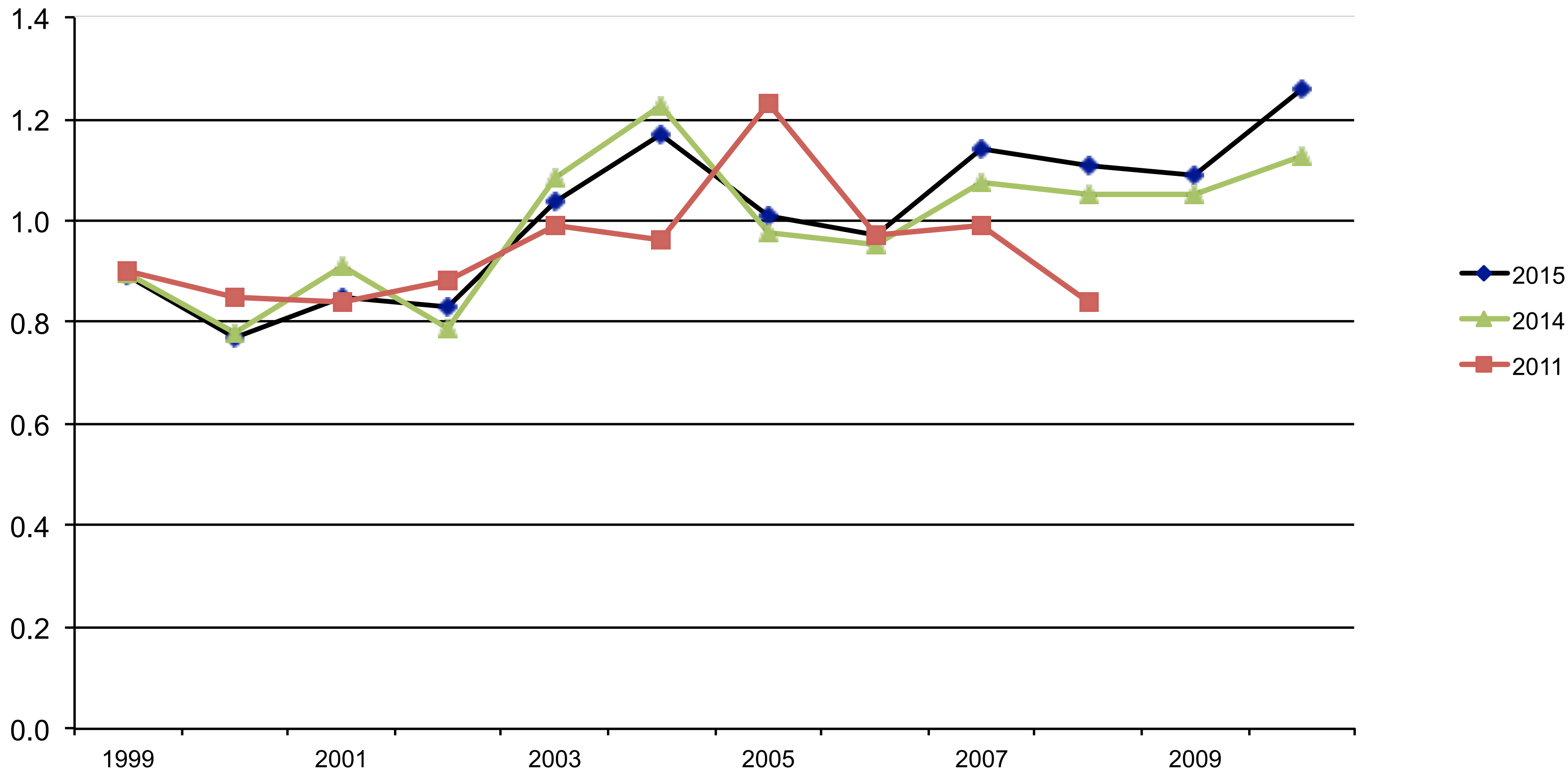
Source: Burgiss

U.S. VC PME by Vintage Year



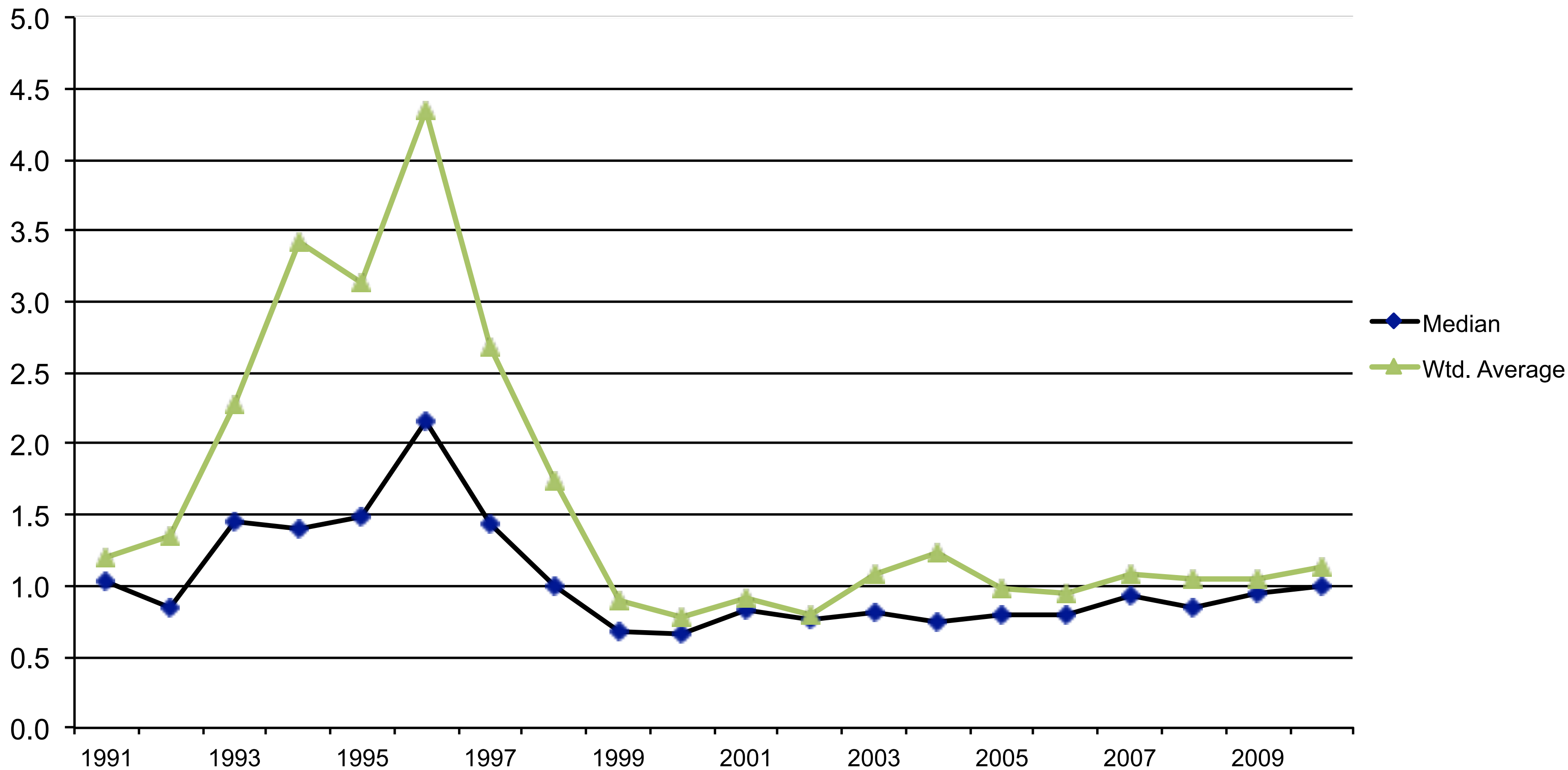
Source: Burgiss

U.S. VC PME by Vintage Year Since 1999



Source: Burgiss

U.S. VC PME by Vintage Year Wtd. Average Versus Median



Source: Burgiss

Overall Performance Evidence

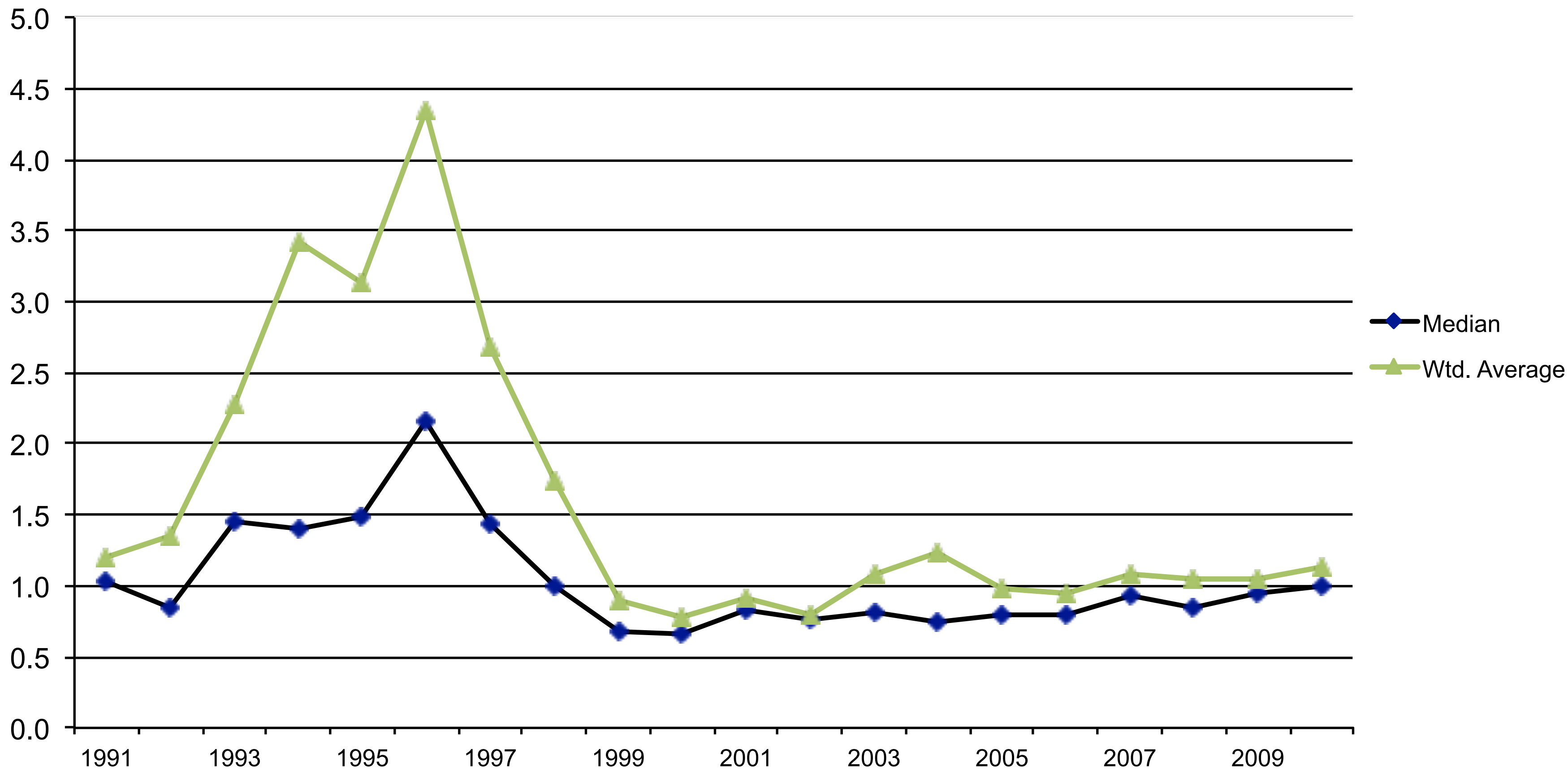
- PMEs (MOICs and IRRs) vary substantially across vintage years.
  - PMEs well above 1.0 through 1998.
  - PMEs below 1.0 in the from 1999 to 2002.
  - PMEs modestly above 1.0 from 2003 to 2010.

- Does not seem to be “huge” opportunity for excess returns.
  - VC investing is difficult.

Overall Performance Evidence

- Performance results may overstate opportunities.
  - Medians always well below means.
  - Cannot just invest in VC and succeed.

U.S. VC PME by Vintage Year Wtd. Average Versus Median



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Overall Performance Evidence

- Performance results may overstate opportunities.
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  - Cannot just invest in VC and succeed.

- Is there some specialized skill / ability value-added required?

Persistence in Performance: Are there good GPs? Historically yes.

- There is persistence in overall sample:

B.1 Total Sample

Previous Fund Quartile PME	Current Fund Quartile PME 1	2	3	4	Total	Average Current Fund IRR	Average Current Fund MOIC	Average Current Fund PME
1	48.5%	16.7%	24.2%	10.6%	100.0%	33.1%	3.28	2.26
	64	22	32	14	132	132	132	132
2	28.9%	34.2%	20.2%	16.7%	100.0%	14.6%	1.84	1.30
	33	39	23	19	114	114	114	114
3	22.0%	29.4%	29.4%	19.3%	100.0%	10.4%	1.74	1.19
	24	32	32	21	109	109	109	109
4	14.8%	17.3%	29.6%	38.3%	100.0%	-0.3%	1.00	0.79
	12	14	24	31	81	81	81	81
NA, not 1st Time	22.0%	21.2%	27.3%	29.5%	100.0%	7.6%	1.53	0.98
	52	62	72	74	260	260	260	260
1st Time	23.6%	22.1%	24.4%	29.9%	100.0%	9.7%	1.86	1.26
	40	39	33	44	156	156	156	156

Persistence in Performance: Are there good GPs? Historically yes.

- Strong in both sub-periods.

B.2 Pre-2001 Funds

Previous Fund Quartile PME	Current Fund Quartile PME 1	2	3	4	Total	Average Current Fund IRR	Average Current Fund MOIC	Average Current Fund PME
1	48.7%	14.1%	23.1%	14.1%	100.0%	47.7%	4.41	2.79
	38	11	18	11	78	78	78	78
2	33.3%	27.0%	27.0%	12.7%	100.0%	22.0%	2.35	1.48
	21	17	17	8	63	63	63	63
3	26.8%	35.7%	17.9%	19.6%	100.0%	18.2%	2.33	1.40
	15	20	10	11	56	56	56	56
4	8.7%	19.6%	26.1%	45.7%	100.0%	-0.3%	1.00	0.71
	4	9	12	21	46	46	46	46
NA, not 1st Time	19.9%	21.9%	30.1%	28.1%	100.0%	10.9%	1.78	1.00
	30	43	50	44	167	167	167	167
1st Time	24.3%	23.0%	24.3%	28.4%	100.0%	16.0%	2.36	1.40
	25	20	20	23	88	88	88	88

Persistence in Performance:
Are there good GPs? Historically yes.

- Strong in both sub-periods.

B.3 Post-2000 Funds

Previous Fund Quartile PME	Current Fund Quartile PME 1	2	3	4	Total	Average Current Fund IRR	Average Current Fund MOIC	Average Current Fund PME
1	48.1%	20.4%	25.9%	5.6%	100.0%	12.1%	1.65	1.49
	26	11	14	3	54	54	54	54
2	23.5%	43.1%	11.8%	21.6%	100.0%	5.5%	1.21	1.07
	12	22	6	11	51	51	51	51
3	17.0%	22.6%	41.5%	18.9%	100.0%	2.2%	1.11	0.96
	9	12	22	10	53	53	53	53
4	22.9%	14.3%	34.3%	28.6%	100.0%	-0.3%	1.01	0.90
	8	5	12	10	35	35	35	35
NA, not 1st Time	25.9%	19.8%	22.2%	32.1%	100.0%	1.9%	1.08	0.94
	22	19	22	30	93	93	93	93
1st Time	22.6%	20.8%	24.5%	32.1%	100.0%	1.6%	1.21	1.08
	15	19	13	21	68	68	68	68

Persistence in Performance:

- Strong persistence.
- Does not scale.
- Cannot just invest more in VC and earn excess return.

What do PE returns and investments tell us about innovation?

- If U.S. companies underinvest in innovation, shouldn't there be huge opportunities for others to invest in innovation?
- Shouldn't the amount invested in PE increase and the returns to PE firms be terrific?
- What is the evidence for that?

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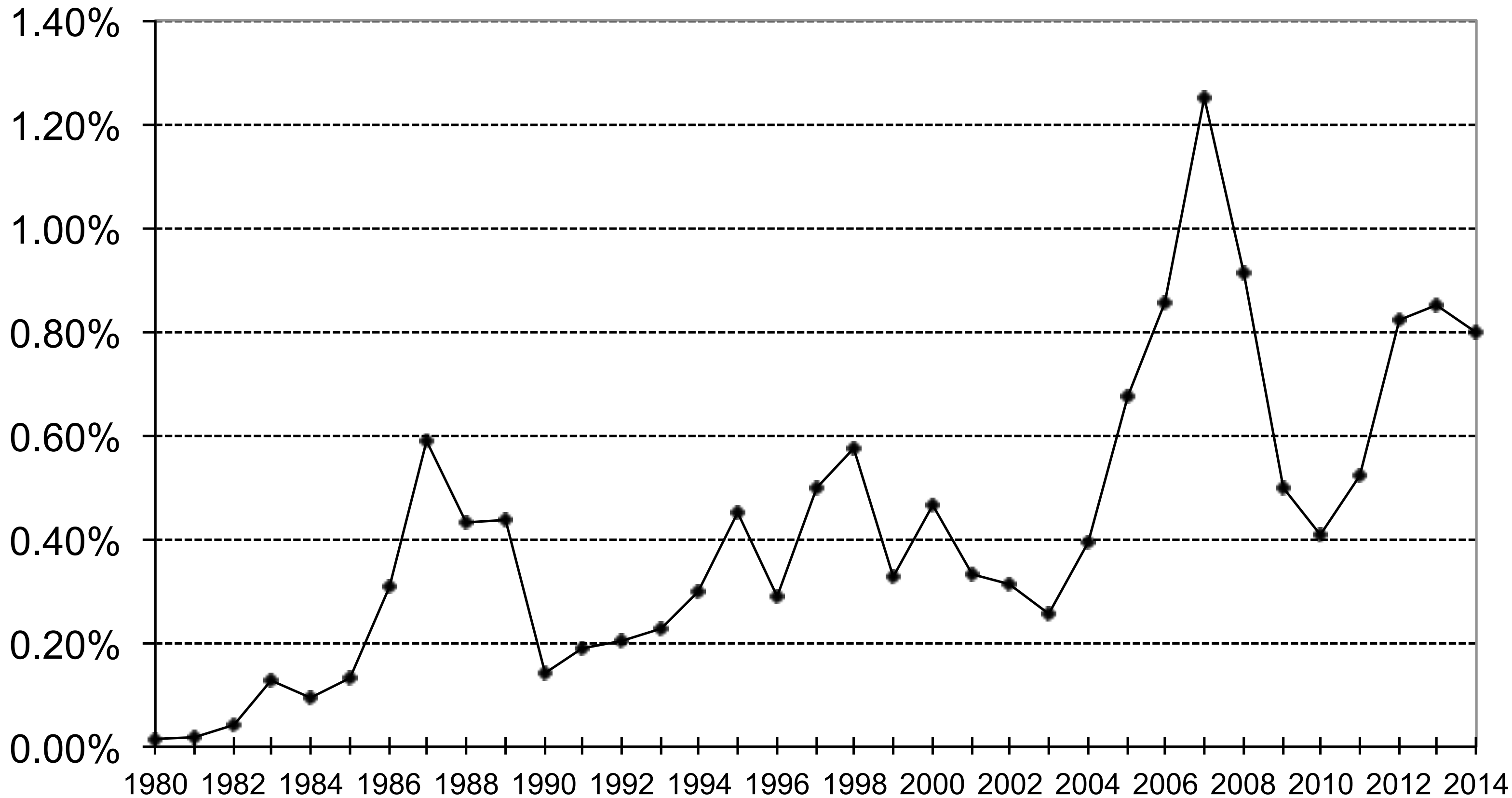

Source: Private Equity Analyst, Steven N. Kaplan

What do PE investments tell us about innovation?

- Capital invested has increased markedly over time.
  - Suggests there may have been an opportunity?
  - Market forces worked without regulation?
  - Of course, Democrats (and a number of Republicans) criticized PE.

Question

- Have PE funds beaten the S&P 500?
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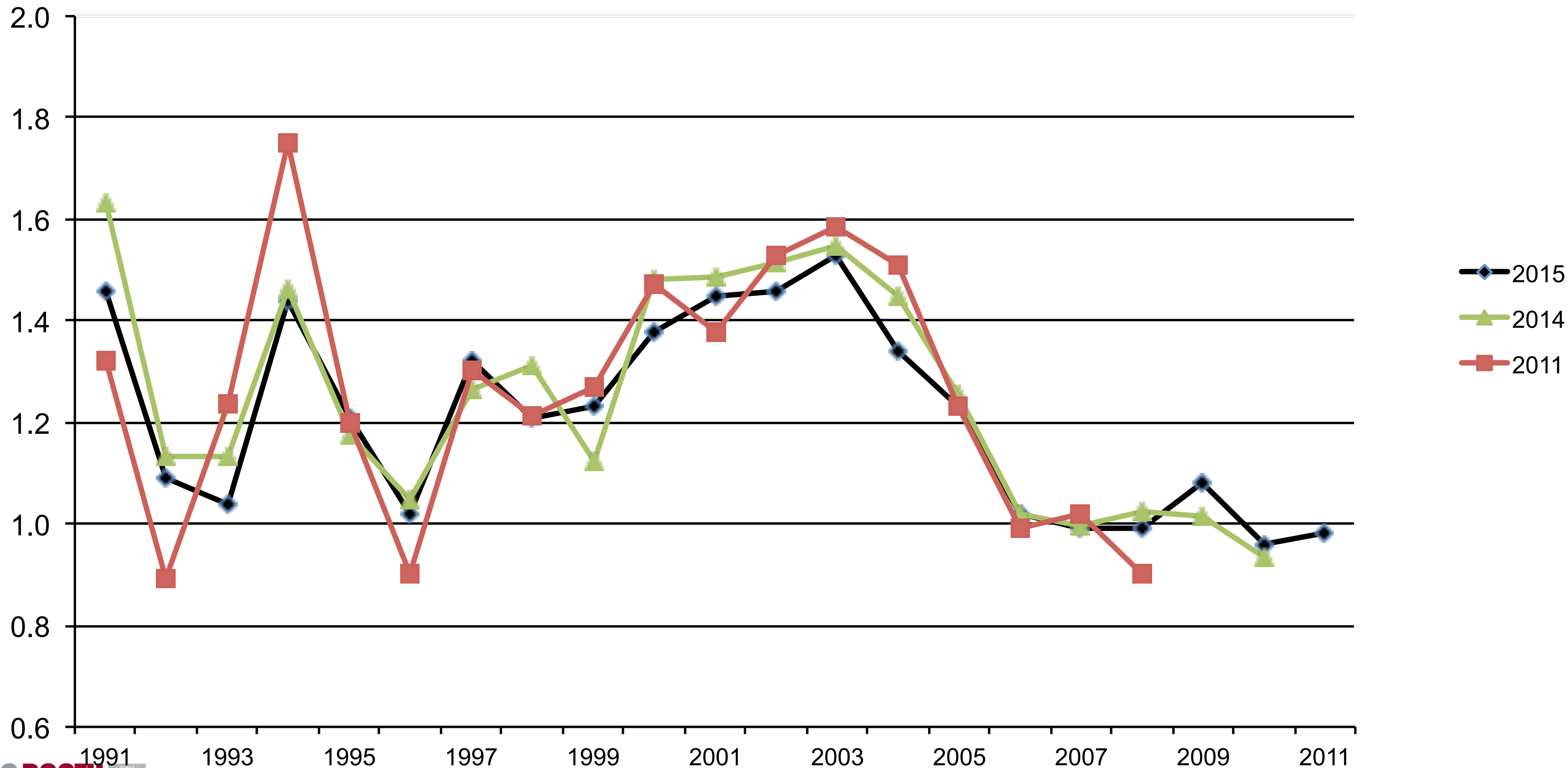
What has performance been on average? PMEs

U.S. Buyout PMEs by Vintage Year, 1991 - 2010



Source: Burgiss

What do PE returns tell us about innovation?

- PE firms outperformed public markets through 2005.
  - Suggests there may have been an opportunity?
  - Market forces worked without regulation?
  - Of course, Democrats (and a number of Republicans) criticized PE.

- Since 2006 vintages, no outperformance on average, net of fees.
  - Suggests opportunities, if that hypothesis is true, have now been captured?

Summary / Implications

- Much criticism today of U.S. economy / companies as too short-term oriented.
- But, this is not new. There is a long history.
- If the short-term orientation is such a bad thing, it should have shown up by now. But:
  - It has not shown up in (lower) corporate profits.
  - It does not show up in (lower) current P/E Ratios.
  - It has not shown up in (higher) VC investments and returns.
  - It may have shown up in higher PE investment and returns in the past, but now we appear to be close to market returns.

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Summary / Implications

- My policy recommendations?
  - There does not appear to be an obvious "short-term" problem.
  - Do not do anything.

- What about other proposals?
  - Increase capital gains tax on shorter holds? Silly.
    - » Small effect on margin.
      - Most trading done by intermediaries, tax exempt institutions.
    - » On the margin, makes investing more expensive.
  - Curb buybacks?
    - » Increase special dividends.
  - Increase the minimum wage?
    - » Will get more investment, but will get fewer jobs?