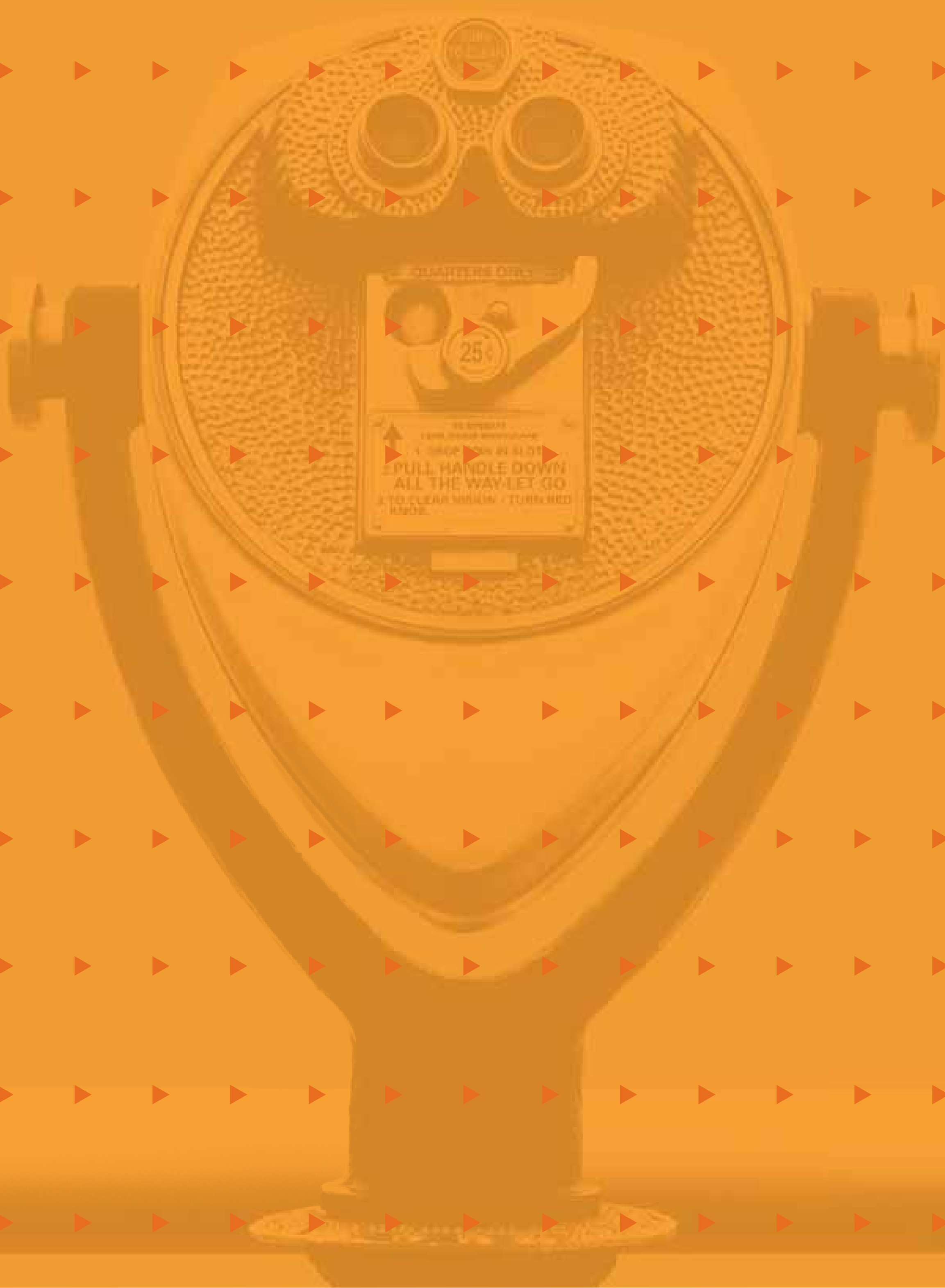
Business Council of Australia

2004 ANNUAL REVIEW

SEEING BETWEEN THE LINES LOOKING BEYOND THE HORIZON

BUSINESS COUNCIL OF AUSTRALIA

Creating lasting value, sustained growth and quality of life require Australia to extend its vision and time horizons



SHORT-TERMISM PAPER

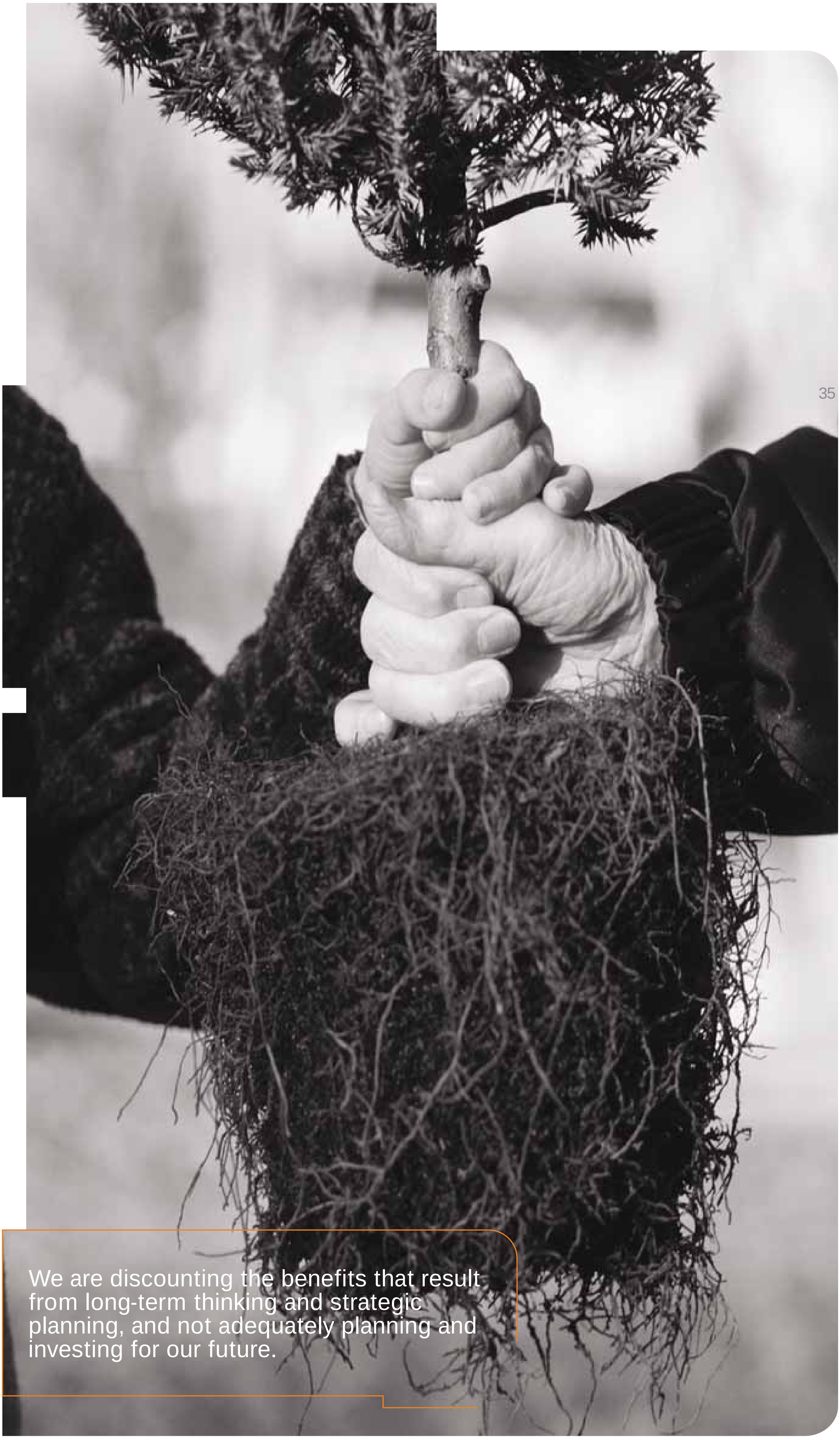
Creating lasting value, sustained growth and quality of life require Australia to extend its vision and time horizons.

Beyond the Horizon

Short-Termism in Australia: a call to think into the future

PREPARED WITH
THE ASSISTANCE OF

L.E.K. CONSULTING



We are discounting the benefits that result from long-term thinking and strategic planning, and not adequately planning and investing for our future.

Executive Summary

In recent years, growing concern has been expressed about the effect of short-termism on value creation within corporate Australia and its implications for continuing economic growth.

This Paper – *Beyond the Horizon: Short-Termism in Australia* – examines the drivers and dynamics of short-termism and how it might be manifesting in Australia. In particular, the Paper looks at whether institutional investors and shareholders are driving corporate leaders to focus excessively on short-term performance at the expense of long-term strategic planning:

- Institutional investors attract new funds under management according to performance against quarterly benchmarking. Accordingly, institutional investors are seen to be driven by incentives that over-emphasise short-term fund performance at the expense of support for corporate investment in projects that deliver returns over the longer term. These factors see institutional investors trading frequently, adding to market/share price volatility.
- Individual shareholders, on the other hand, look for high liquidity and security in investments, favour near-term returns, and overlook the benefits of long-term investments.

The Paper finds that due to the growing complexity of markets and their influences, the evidence that defines and quantifies short-termism, here and overseas, is ambiguous. Notwithstanding this, interviews with leading corporate managers, investors and other major participants suggest that short-termism is increasingly a driver of market behaviour and a potential constraint on longer-term value creation.

Finally, the Paper examines the trend to short-term decision-making in public policy and explores some possible ways of extending the policy vision.

Introduction

Short-termism is used to describe a range of concerns about the rationale and functionality of political, corporate and individual decision-making.

The term has become shorthand for perceptions that there is an increasing economic, social and cultural bias toward short-time horizons. It is argued we are discounting the benefits that result from long-term thinking and strategic planning, and, as a result, not adequately planning and investing for our future.

These perceptions have gathered increasing resonance in recent years. Rapid technological change, increased connectivity between global markets and ready access to real-time information have meant the inputs into decision-making and actions at all levels have become both more complex and immediate, and are often seen as reactive.

The Business Council of Australia (BCA) has a strong interest in the causes of, and solutions to, short-termism. The BCA was established in 1983 to provide a forum for Australian business leadership to contribute directly to public policy debates in order to build a better and more prosperous Australian society. As this Paper illustrates, concerns about short-termism have particular resonance among the Business Council's CEO Members who face pressure to adopt short-term value creation strategies and deliver strong returns within a relatively short period of time, or put their tenure at risk.

At a more general level, there is also concern among BCA Members that if the dynamics of change are forcing individuals, investors, business and Government to develop shorter time horizons in their decision-making, this could have significant implications for the adequacy and composition of public and private investment. As a result, Australia's ability to sustain economic growth, and thereby sustain individual well-being and quality of life over time is likely to be compromised.

Therefore, it is important to examine perceptions of short-termism and the consequences and implications for policy making. What impact do these perceptions have on behaviour and decision-making? What are the causes of short-termism? How and where are pressures to deliver short-term outcomes and performance being seen?

This Paper aims to explore these issues and highlight areas where further investigation or policy action or advocacy might be required. The focus of the Paper is on the nature and scope of short-term pressures facing business and Government, with particular emphasis on the key areas of interest to the BCA.

1 A SURVEY OF CORPORATE PERCEPTIONS OF SHORT-TERMISM AMONG ANALYSTS AND FUND MANAGERS, C.L. MARSTON AND B.M. CRAVEN, THE EUROPEAN JOURNAL OF FINANCE, 4, 233-256 (1998).

What is Short-Termism?

Short-termism may be defined, from a business, investment and policy perspective, as the excessive preoccupation with projects, activities and investment designed to deliver improved near-term returns and outcomes at the expense of those that could deliver higher returns and outcomes over the long run. A more technical description of short-termism – or investment myopia as it is sometimes known in business and commercial terms – is that it represents inflating the value of near-term returns or, alternatively, the excessive discounting of future returns.

Short-termism has been a matter of concern in the corporate sector for some time. It is an issue that has been raised and discussed in Australia and in the US and UK since the late 1980s. At the time, it was held to present particular problems for economies (such as the US, UK and Australia) which rely heavily on stock exchanges to price securities and allocate resources and capital.[1] In the late 1980s and into the 1990s, short-termism was seen as a key factor contributing to the low level of investment in many of the major Western economies compared with that undertaken in the then highly-performing economy of Japan, the newly industrialising Asian economies, and Germany.

We have moved on from the circumstances and recommendations of those earlier debates. Few would now argue, for example, that Australia should adopt closer relationships between the banking and corporate sectors to more closely mirror the Japanese system, as was advocated in the mid-1990s. Nonetheless, even though investment levels and economic performance have improved markedly in Australia, short-termism remains an important issue of concern in the corporate sector and for many in the investment community.

Short-termism & the Private Sector

An excessive focus on short-term results in private investment and corporate decision-making has important implications for the optimal allocation of investment and the creation of value throughout the economy. The aim of this section is to identify and examine the factors that may lead to short-termism in private sector decision-making and to evaluate the evidence of its occurrence in Australia.

Possible causes

At the heart of the short-termism debate is the rationality of decisions that are focused excessively on short-term considerations and returns. A core tenet of economic and finance theory is that individuals are rational – that is, when confronted with full and complete information, individuals will make the right choices in terms of maximising their own well-being over time.

Yet evidence on individual decision-making shows individuals often do not make sound judgements or decisions even when presented with relatively simple choices and information.[2] This research shows that individuals demonstrate greater sensitivity to losses than gains, are averse to uncertainty and place more weight on certain outcomes.[3] When faced with a choice, individuals will opt for a smaller amount of money they are certain to get, than hope to receive a larger amount that is more uncertain, even though the expected return of the latter would clearly be higher.

It may be, however, that short-termism is the result of rational decisions made within an incentive framework that skews the decision-makers' focus towards the achievement of short-term rewards, even to the detriment of long-term returns. The structure of the funds management sector, the shortening of media/reporting cycles, and increasing levels of media scrutiny are often cited as examples of incentive frameworks which affect the behaviour of fund managers and corporate decision-makers.

Research

There has been little analysis within Australia of the implications of short-termism for Australian markets and public policy.

Short-termism has been the topic of academic analysis in the US and in the UK in particular, although not as a major body of research.[4]

Research undertaken in the US and UK on the topic has predominantly focused on:

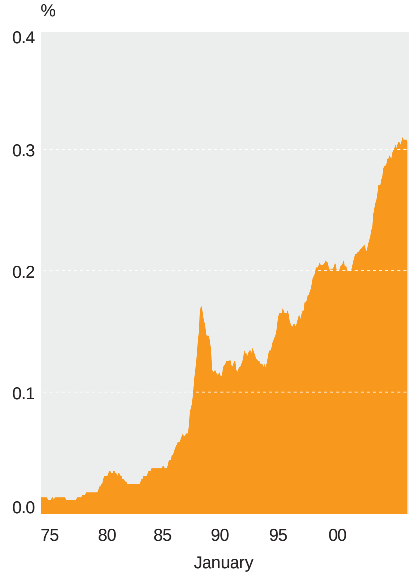
- share market volatility;
- whether share prices correctly price future earnings; and
- the relationship between share prices, investment plans and long-term capital spending.

Market volatility

In principle, it would be reasonable to expect short-termism to show up in greater market volatility as investors increasingly react to short-term factors.

Research into mutual funds bears out the idea that short-termism is at work. The average holding period for mutual funds in the US fell from 15 years to 2.5 years between 1950 and 2000, and the average rate at which funds turn over their entire portfolio has risen from 59 per cent a year in 1980 to 112 per cent in 2001. One in 10 US funds turned over its portfolio more than twice in 2001 (an admittedly hyperactive year, as the tech boom burst).[5]

RATIO OF TURNOVER TO MARKET CAPITALISATION



Source: Reserve Bank of Australia data

2 A SURVEY OF BEHAVIOURAL FINANCE, NICHOLAS BARBERIS AND RICHARD THALER, IN HANDBOOK OF THE ECONOMICS OF FINANCE, EDITED BY G.M. CONSTANTINIDES, M. HARRIS AND R. STULZ, 2003.

3 BARBERIS AND THALER (2003)

4 THIS PAPER INCORPORATES RESEARCH PREPARED FOR THE BCA BY VALUE ENHANCEMENT MANAGEMENT: 'IS SHORT-TERMISM A PROBLEM FOR AUSTRALIAN INVESTMENT MARKETS?' A PAPER FOR THE BUSINESS COUNCIL OF AUSTRALIA, DAVID UREN, VALUE ENHANCEMENT MANAGEMENT, AUGUST 2003

5 THE CONSILIENT OBSERVER: STRESS AND SHORT-TERMISM, CREDIT SUISSE FIRST BOSTON, VOL.1, ISSUE 9, 7 MAY 2002.

However, while key international markets do not show a sustained trend in volatility over the long run, individual share prices have become more volatile. Moreover, the average turnover relative to market capitalisation has increased significantly. A study by Campbell et al[6] showed that the relative stability of overall market volatility masks a rise in the volatility of individual share prices, with individual share price volatility in the US more than doubling between 1962 and 1997.

In Australia, a trend toward rising market volatility is less evident. Monthly data since the 1980s shows Australia does not display the volatility of share prices experienced in the US, although market turnover relative to market capitalisation has risen significantly. Anecdotal evidence suggests that individual share prices have also become more volatile.

Research by Malkiel and Xu (1999) suggests that the rapid rise in stock turnover which has accompanied the rise of institutional investment has contributed to the volatility of individual company share prices. In particular, they have shown that the volatility of a share price can be forecast on the basis of the level of institutional ownership.[7]

These findings are consistent with the experience and perceptions of CEOs that their companies' share prices are extremely vulnerable to the day's news. It is one of the key factors that leads companies to believe that the short-termism of institutional investors is having an adverse impact.

The increased movement of the price in response to news may also reflect that there is more news about. Information circulating about companies has increased dramatically, as a result of their disclosure and the attention of the media and investment analysts, supported by the widespread availability of information online.

In less developed economies, such as the Asian markets, overall market indexes correlate much more closely with the movement of individual stocks.

Valuations of long-term earnings

In examining whether markets correctly price future earnings,[8] and therefore whether short-termism is a reality, one study by Black and Fraser found that British markets consistently undervalue future earnings.

Another study by the same authors examined whether markets correctly price future earnings, and therefore whether short-termism is a reality. Black and Fraser (2002) were interested in whether the German and Japanese markets, in which companies have traditionally relied more upon bank finance than equity, would value long-term returns more highly than the market-based economies of Australia, the US and the UK.

The study showed mixed results. Australia, Japan and Germany produced almost full valuations of five-year returns while there was a small discount in the US. British markets consistently undervalued future earnings. That said, there was more evidence of short-termism in the non-financial market in Australia, particularly over a longer horizon.[9]

6 HAVE INDIVIDUAL STOCKS BECOME MORE VOLATILE: AN EMPIRICAL EXPLORATION OF IDIOSYNCRATIC RISK, JOHN Y. CAMPBELL, MARTIN LETTAU, BURTON G. MALKIEL AND YEXIAO XU, WORKING PAPER, HARVARD BUSINESS SCHOOL, FEBRUARY 2000.

7 THE STRUCTURE OF MARKET VOLATILITY, BURTON G. MALKIEL AND YEXIAO XU, WORKING PAPER, PRINCETON UNIVERSITY, 1999.

8 INTERNATIONAL COMPARISONS ON STOCK MARKET SHORT-TERMISM: HOW DIFFERENT IS THE UK EXPERIENCE? ANGELA J. BLACK AND PATRICIA FRASER, THE MANCHESTER SCHOOL SUPPLEMENT, 2000.

9 STOCK MARKET SHORT-TERMISM – AN INTERNATIONAL PERSPECTIVE, ANGELA BLACK AND PATRICIA FRASER, JOURNAL OF MULTINATIONAL FINANCIAL MANAGEMENT 12, 135-158 (2002).

Market response to long-term investments

The existence of short-termism would suggest that if institutional investors and financial markets are excessively focused on the short term, they would be expected to react adversely to long-term investment announcements. Equally, a higher dependence on equity finance might adversely impact longer-term investment. More specifically, excessive investor pessimism/conservatism may cause firms with a high reliance on equity financing to forego attractive investment opportunities because it is too costly to finance them with undervalued equity.

There is a large amount of literature looking at the influences on capital investment decisions. Samuel (2001) specifically explored whether a short-term approach in the market would have an influence upon investment decisions. He examines how important stock market perceptions are in shaping the capital spending decisions of managers.[10] This study found that although there is some relationship with stock prices, there is a much tighter connection with operational income. The conclusion Samuel drew was that managers base decisions about capital spending much more upon their own operational performance than upon how they are being perceived in the market.

However, a recent study by researchers at Duke University and the University of Washington of 401 senior financial officers of major United States companies found that 78 per cent of those surveyed would give up economic value in exchange for reporting smooth earnings growth.[11] Fifty five per cent of respondents would delay the start-up of profitable investment projects to avoid missing an earnings target while four out of five executives said they would defer maintenance and research spending to meet earnings targets.

“I was shocked by the honesty of the executives’ responses. There was no cover-up – they are telling it like it is,” said Campbell R. Harvey, an international business professor at Duke. “Perhaps they see this research paper as the first step in defusing the cycle of short-termism.”[12]

10 STOCK MARKET AND INVESTMENT: THE SIGNALLING ROLE OF THE MARKET, CHERIAN SAMUEL, APPLIED ECONOMICS 33(10), 1243-52 (2001).

11 THE ECONOMIC IMPLICATIONS OF CORPORATE FINANCIAL REPORTING, JOHN R. GRAHAM, CAMPBELL R.HARVEY AND SHIVA RAJGOPAL, DUKE UNIVERSITY, NATIONAL BUREAU OF ECONOMIC RESEARCH AND UNIVERSITY OF WASHINGTON, 2004.

12 THE JOHN R. GRAHAM, CAMPBELL R.HARVEY AND SHIVA RAJGOPAL REPORT (SEE NOTE 11) WAS PROFILED BY ASSOCIATED PRESS WRITER EMERY P. DALESIO IN AN ARTICLE ENTITLED ‘EXECUTIVES SACRIFICE SHAREHOLDER VALUE TO PLEASE STREET’ ON 10 FEBRUARY 2004. THE ARTICLE ALSO QUOTED KARL J. SCHULZE, A FORMER CORPORATE CHIEF FINANCIAL OFFICER AND NOW HEAD OF THE LOS ANGELES FORENSIC ACCOUNTING FIRM OF SCHULZE HAYNES & CO., AS SAYING THAT THE “ATTITUDES EXPRESSED IN THE SURVEY ARE PREVALENT IN THE BUSINESS WORLD.” MR SCHULZE ALSO SAID THAT “LONG-TERM SHAREHOLDER VALUE HAS TRADITIONALLY BEEN SACRIFICED FOR SHORT-TERM EARNINGS, ESPECIALLY SINCE MOST EXECUTIVE COMPENSATION PACKAGES HAVE BEEN, AND CONTINUE TO BE, WEIGHTED TOWARD NEAR-TERM PERFORMANCE RATHER THAN CREATION OF LONG-TERM VALUE.”

SHIVA RAJGOPAL STATED IN THE ARTICLE THAT “THE EXECUTIVES RESPONDING TO THE STUDY RESORT TO MANAGING EARNINGS BECAUSE THEY FEAR RUNNING AFOUL OF THE SARBANES-OXLEY ACT, PASSED IN 2002 AFTER REVELATIONS THAT ENRON CORP. MANIPULATED EARNINGS WITH ACCOUNTING TRICKS.”

Reconciling perceptions & evidence

While the above research indicates that some signs of short-termism can be measured, it does not appear to provide conclusive proof of a short-termism problem. There are, however, a number of reasons why quantitative evidence of short-termism will be difficult to find. These include:

- the use in the research of aggregated market-wide data, which may obscure the responses of companies and the market to individual investment decisions;
- the reliance in the research on reactions to actual long-term investment decisions, which therefore fails to take account of the opportunity costs of projects not adopted for fear of an adverse market reaction; and
- the countervailing effects of investors looking for short-term gains with those seeking long-term returns.

Market averages versus case-by-case analysis

Much of the academic analysis addresses the behaviour of the market as a whole – that is, it deals with averages. Limited evidence of short-termism in the aggregate data does not preclude the possibility that short-termism may be a problem for individual companies or even for sectors of the market, or that it may be more of a problem at different points in time (for example, when there is greater macroeconomic or political uncertainty). This may explain the research noted previously that showed volatility for individual shares has risen, while overall market volatility has remained the same.

In the same way, examination of investment spending tends to focus on aggregate investment. It may be the case that some types of capital spending are more susceptible to the impact of short-termism. For example, highly observable projects, where progress is easier to demonstrate, may be less susceptible than large-scale investment in less tangible projects, such as in human capital or certain types of R&D.

Actual verses opportunity costs

The research and analysis focuses on the reaction to projects actually undertaken, not the opportunity costs of projects foregone. Based on their own perceptions of short-termism, executives may select projects which they believe are more easily defended and explained in the short term and which are less likely to attract adverse market reaction. In short, external pressures, whether real or perceived, create incentives to play it safe. Evidence of this may be seen in research which suggests that institutional shareholders are increasingly communicating their concerns and views regarding proposed corporate strategies and decisions directly to the companies concerned (eg letters to executives, Boards, etc).[13] This suggests that the impacts of short-termism are felt before major investment decisions are made and will therefore not show up when market reactions are analysed.

The market combines both short & long-term views

Markets comprise two general groups – risk seekers and risk minimisers. The first group are largely short-term in their focus. They provide liquidity to the market and their marginal movements in and out of a stock set short-term pricing. The second group, the hedgers, are long-term in their focus. They provide the function of allocating capital as they seek to distribute their risk and, in turn, shape the long-term price.

”Short-termism is a serious problem and is encouraging risk-averse behaviour.”
CHAIRMAN, ASX TOP 20 COMPANY

“There is no doubt whatsoever that the investment industry has become more short-term focused.”
LEADING AUSTRALIAN STOCKBROKER

“CFOs do not like the system, but they are forced to play the game or risk losing their jobs.”
SHIVA RAJGOPAL, QUOTED IN ASSOCIATED PRESS, 10 FEBRUARY 2004.

The American investment sage, Warren Buffet, has stated many times that: “In the short term, the market is a voting machine. In the long term it is a weighing machine.” A company announcement receives an immediate popularity vote from the market, which may reflect true value or alternatively may reflect risk aversion or short-sightedness. In theory, the long-term weighing machine of the market assesses the true worth of the news and gets it right. Given the evidence of increased individual company volatility, the more rapid churning of investment would also suggest the noise of the short-term voters is growing louder. While the challenge for Boards and management is to hold to their true course in the expectation that the market will get it right eventually, the tendency for fund managers to herd and shape shorter-term market momentum suggests that the reaction of the voters can hold sway in determining value for some considerable time.

13 SEE FOR EXAMPLE SHAREHOLDER ACTIVISM AMONG FUND MANAGERS: POLICY AND PRACTICE, IFSA (2000 & 2001).

“The focus in the investment industry is too short-term and is exacerbated by the media.”
ASSET CONSULTANCY MANAGING DIRECTOR

“Managers have three-year share schemes and may not even be in the job that long – of course they are focused on the short term.”
FUND MANAGER

Examples of short-termism

Despite the inconclusive nature of the quantitative research undertaken to date, there are examples that suggest short-termism is occurring in Australia and is having significant implications for investors and company decision-makers. These examples include:

- the structure of the funds management market;
- issues relating to CEO decision-making and tenure; and
- perceptions of short-termism by market participants in Australia.

Funds management in Australia

The rapid growth of the institutional funds management industry has been propelled by the advent of compulsory superannuation.

The structure of the funds management sector has changed markedly in recent times. There are new and increased levels of intermediation with the development of consultants to advise on asset allocation against industry benchmarks and new distribution channels through financial planners and banks. The industry has also developed a global dimension, with significant flows, both inbound and outbound, of portfolio investment.

Of the $719 billion under funds management in Australia, 79 per cent is invested through superannuation products. The range of these products continues to grow, from corporate funds, public sector funds, industry funds and retail public offer funds to self-managed funds.

Superannuation funds are trusts with their trustees typically elected or appointed to represent members. Two-thirds of all superannuation assets are placed by their trustees with fund managers. Larger funds will diversify their assets among a number of fund managers and change them according to performance. The trustees usually select the funds on the advice of asset consultants, who assess the performance of funds against a benchmark performance, typically judging it over terms including the past quarter, year, three years and five years.

While the three to five year range is an important gauge of performance, it is a lagging indicator and in practical terms gives little guide to future performance. As the only way to climb the fund manager league tables is currently one quarter at a time, there are strong competitive pressures to achieve results on a short-term basis. In circumstances where fund performance has been poor, quarterly performance can take on a heightened significance.

Performance measurement of fund managers is most commonly expressed in terms of a relative performance against a benchmark. The incentive for the fund manager is therefore to outperform the index, which can create incentives to hug the benchmark and/or to mimic higher performance, particularly when performance has been relatively poor. In other words, investment decisions can be driven by short-term performance issues.

There is more than perception at stake. For the industry as a whole, fees are largely determined on the basis of the size of funds under management – the greater the size of the fund, the greater the profit. As a result, the role of the asset consultant, playing the gatekeeper’s role in dictating where funds will flow, is influential.

The importance of size can make established managers more conservative in hugging market indices and reluctant to take risks, in order to avoid below benchmark performance and fund outflow. This process of continual benchmarking is seen as a problem because it encourages group herd mentality – that is, decision-making on the basis of short-term movements in the market and among competitors.[14]

There is evidence of herd behaviour, including that active fund managers are more likely to herd particularly when selling down stocks. Herding has also been shown to be more prevalent where stocks exhibit lower levels of information transparency and when there is more concentrated share ownership by institutions. Broker participation has also been shown to result in a much higher level of herding.[15]

Moreover, research on executive turnover in the funds management industry shows that even though the objective of investment managers is to deliver returns over a three to five year time horizon, the average tenure of the head of an Australian equity team in the Australian funds management industry is a fraction under three years – a feature which is described as being unique to Australia. Within this context, short-term trading strategies become more overtly important and portfolios are rebalanced on the strength of daily market information and news.

14 WHILE THE INITIAL TRADE OR SHARE PRICE MOVEMENT THAT TRIGGERS HERDING OR MOMENTUM IN THE MARKET MAY BE BASED ON AN ASSESSMENT OF THE LONGER-TERM IMPLICATIONS OF NEW INFORMATION (AND HENCE HERDING COULD SIMPLY RESULT IN THE MORE RAPID ADJUSTMENT OF THE SHARE PRICE) IT IS NOT CLEAR THAT THIS IS ALWAYS THE CASE, NOR THAT THE INITIAL ASSESSMENT IS CORRECT, AND HERDING CAN RESULT IN AN OVER-SHOOTING OF SHARE PRICES. IN ADDITION, HERDING CREATES A PERCEPTION THAT MARKET MOVEMENTS ARE FEEDING ON THEMSELVES IN THE SHORT TERM RATHER THAN REFLECTING UNDERLYING FUNDAMENTALS.

15 FOR DISCUSSIONS OF HERDING BEHAVIOUR AND TENURE OF FUND MANAGEMENT EXECUTIVES SEE (RESPECTIVELY) FONG, K., GALLAGHER, D.R., GARDNER, P., AND SWAN, P.L., A CLOSER EXAMINATION OF INVESTMENT MANAGER HERDING BEHAVIOUR, UNSW SCHOOL OF BANKING AND FINANCE WORKING PAPER SERIES 2004-03; AND GALLAGHER, D., AND NADARAJAH, P., TOP MANAGEMENT TURNOVER: AN ANALYSIS OF ACTIVE INVESTMENT MANAGERS, UNSW SCHOOL OF BANKING AND FINANCE WORKING PAPER SERIES, 2003-13.

The diverging, and in some cases, short-term incentives and motivations for different players in the sector serves to reinforce concerns about short-termism in the market more broadly. For example, it can be difficult to develop effective long-term incentives for equity managers (and chief investment officers) who have an average tenure of just under three years, face frequent performance monitoring, and are under pressure to attract fees on the basis of total funds under management.

In addition to differing incentives, irrational biases can also affect the behaviour of institutional investors. Like individuals, institutional investors also exhibit loss aversion – in fact to a greater extent.[17] This, combined with excessive monitoring of investment portfolios by fund managers, has important implications for investment decision-making.

These issues do not imply criticism of the role or actions of any one group in the market, but rather serve to highlight the potentially differing incentives and motivations now impacting on the various players that make up that market and the potential flow-on effects.

To illustrate, consider the following funds management participants, performance incentives and time horizons:

- Super Trustees are motivated by achieving stable and satisfactory fund performance, fiduciary responsibilities and avoiding legal liability. Access Economics argues that Super Trustees tend to adopt relatively defensive strategies because they are focused on impacts of short-term fluctuations in returns and the implications for the fund reputation.[16]
- Fund Managers are motivated to maximise assets under management (and hence their fees). They are sensitive to frequently monitored performance, individual remuneration (usually influenced by 1-3 year performance), and tenure (on average a fraction under 3 years).
- Stockbrokers are motivated to maximise revenue earned through trades. They are obviously an important conduit for information and have a clear incentive to present new information as being significant enough to warrant a decision to trade.

AUSTRALIAN FUNDS PERFORMANCE & BEHAVIOUR

Participants	Incentives	'Rational Behaviour'
Super fund members	Total shareholder returns	- Diversify portfolio. - Take long-term perspective. - Invest in well-run assets with sound strategy in advantaged markets.
Super trustees	Fees/fund performance/ fiduciary responsibilities/ avoiding legal liability	Loss aversion: approve advisers' recommendations, avoid legal liability.
Implementation consultants	Fee for service	Loss aversion: recommend brand name advisers.
Asset consultants	Fee for service or assets under advice	Bias towards action/change to reinforce value. Produce performance data to support decisions.
Master trusts	Assets under management	Loss aversion. Maintain a bias towards fund managers with good recent performance.
Fund managers	Annual performance bonus, quarterly ratings	Trade shares or pressure CEOs to increase quarterly returns that Fund Manager will rate highly; stay on mandate lists; retain job, achieve bonus, etc.
Listed companies	EPS growth, TSR	Focus on short-term earnings. Deliver consistent forecasts. Achieve smooth earnings. Manage share price.

Source: LEK Consulting

"CEOs recognise that announcing a long-term investment in growth can hit the share price and open the door to predators."
FUND MANAGER

"Super Trustees, who now have greater sums invested, greater responsibilities and higher public profiles, are exposed to increasing levels of media-fed information on short-term performance and will clamour for action…"
SENIOR EXECUTIVE, FUND MANAGEMENT FIRM

16 ACCESS ECONOMICS VIEWPOINT 5: LONG-TERM INVESTING, JULY 2004

17 DO PROFESSIONAL TRADERS EXHIBIT MYOPIC LOSS AVERSION? AN EXPERIMENTAL ANALYSIS, HAIGH, M. AND LIST, J.A., WORKING PAPER 18, UNIVERSITY OF MARYLAND (2002).

> "It's very hard to look past management pay to explain the pressures on the short-term – annual bonuses, short-term share schemes and low tenure is bound to have an impact."
>
> FUND MANAGER

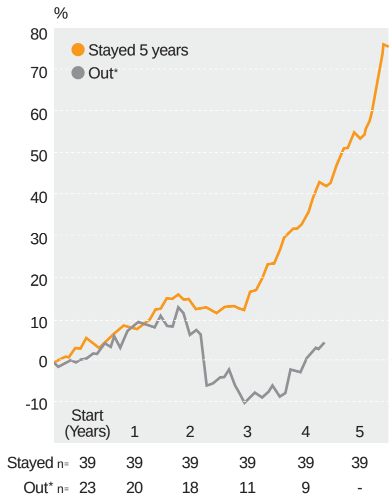
> "Short tenure of CEOs means there are definitely projects that are left behind."
>
> SENIOR EXECUTIVE, FUND MANAGER

Individuals who monitor their investments more frequently are more likely to incur short-term losses, which they weigh more heavily than their gains. It is not surprising therefore, that in the context of investment decisions, it has been concluded that the more frequently investors evaluate the returns of an uncertain investment, the lower is their average level of investment in risky assets.[18] Frequent monitoring makes it harder to stay the course with investment strategies.

Furthermore, it has been found that institutional investors exhibit persistent over-confidence which contributes to excessive trading because individuals are overly confident that new information obtained is significant enough to justify a trade even when it is not. People who are over-confident trade often on the basis of new information, contributing to excessive volatility and lower returns.[19]

This analysis of the funds management sector raises serious issues about short-termism in Australia. In particular, frequent performance monitoring, particularly by institutional investors, and incentives to maximise short-term performance (related to fund inflows, tenure and remuneration) can exacerbate underlying biases and preferences among investors. In such an environment it is argued that company executives will favour investment projects that will deliver more certain, highly observable and shorter-term outcomes at the expense of riskier, long-term projects. These pressures are then compounded by the short tenure of CEOs in Australia.

CUMULATIVE RETURNS OF ALL CEOs AGAINST INDUSTRY SECTOR



Source: LEK Consulting

CEO turnover & the impact on value creation

A major focus of short-termism at the corporate level is the turnover of CEOs, who face unprecedented levels of market and media scrutiny and pressure. No doubt part of this is cyclical and related to high-profile corporate collapses over recent years. But a fair portion of this pressure and scrutiny is ongoing. From interviews with CEOs, there is a strong consensus that Australian business leaders, particularly the CEOs of Australia's largest companies, face higher levels of media scrutiny than elsewhere. This reflects the relatively small Australian market, with a small number of high-profile companies and CEOs.

A study by Booz Allen Hamilton (BAH) with the BCA last year[20] showed that CEO turnover rates for Australian CEOs are higher than overseas, and that the average tenure of CEOs in Australia, at 4.4 years, is nearly half the global average of 8.6 years. Based on data from 2002, the BAH study showed that more than one in ten of the ASX 200 companies experienced a change in CEO in that year.

The shorter tenure of Australian CEOs means they have less time to devise and execute their corporate strategies. In particular, the average tenure of CEOs who leave because of underperformance is just 3.6 years. This suggests that local CEOs have just two to three years to deliver concrete results before their jobs are at risk. A corporate strategy that delivers negative returns during this period, even if it will deliver strong longer-term results for the company, can be fatal to the CEO's tenure. Put simply – the pressure is on to deliver more within shorter timeframes. BAH also concluded that Boards are becoming increasingly sensitive to performance, driven by investor expectations, and therefore more ready to dismiss a CEO who does not deliver strong short-term returns.

18 DISCUSSED IN THE RISK PREMIUM FOR EQUITY: EXPLANATIONS AND IMPLICATIONS, SIMON GRANT AND JOHN QUIGGIN, DISCUSSION PAPER, TILBURG UNIVERSITY, NOVEMBER 2001, AND BARBERIS AND THALER (2003).

19 BARBERIS AND THALER (2003).

20 CEO TURNOVER IN 2002: TRENDS, CAUSES AND LESSONS LEARNED, BOOZ ALLEN HAMILTON/BUSINESS COUNCIL OF AUSTRALIA (2003).

As part of its global CEO turnover research, BAH also found that Chief Executives are being fired for short-term performance shortfalls that may have previously been tolerated. CEOs who were dismissed in 2002 generated returns only 6.2 per cent less than Chief Executives who voluntarily retired, compared to a difference of nearly 12 per cent in 1998.

Within this context of increasing performance expectations and turnover, management consultants LEK, undertaking work for the BCA, examined how value creation in Australian listed companies may be linked to CEO tenure. In summary, the LEK research found that decreasing executive tenure can result in the departure of senior executives prior to the period in which their leadership can deliver the greatest value.

The analysis shows that the relationship between total shareholder return of CEOs relative to their industry sectors is such that performance and returns increase in step with the tenure of the company's lead executive. While the analysis does not purport to claim that executive leadership is a defining factor in shareholder performance, the correlation is nevertheless strong and supports anecdotal concerns among leading CEOs that decreasing tenure acts as a counterweight to their capacity to deliver long-term value.

Certainly, the fact that Australia is expending its executive talent – as a key input into company performance and value creation – at a much faster rate than its overseas competitors is an issue of concern which warrants further investigation.

Perceptions of market participants

The evidence outlined above is backed up by the perceptions of market players.

The BCA, through LEK, conducted interviews with a range of participants in the Australian business and investment sectors, including CEOs of leading companies, to determine their perceptions of short-termism and whether they believed short-termism was constraining their ability to plan and act on the basis of longer-term considerations and objectives.

In interviews, fund managers frequently identified the increasing pressure and scrutiny from asset consultants, master trusts and superannuation trustees as a result of a few poor quarters.

"The benchmarking of funds and the power of the asset consultant over mandate turnover places enormous pressure on the fund manager to work to a shorter timeframe on investments…" FUND MANAGER

While the aim of such scrutiny may be to determine whether there are issues at play that could undermine longer-term performance, short-term pressure to turn performance around is nonetheless acutely felt.

Furthermore, the interviews revealed that fund managers were placing increasing pressure on corporate managers to deliver short-term results.

"If EPS is under threat, we try to influence management to abandon the strategy…" FUND MANAGER

"Fund managers are talking more with CEOs, but it's not about strategy – it's about the next results announcement." MANAGING DIRECTOR, INVESTMENT FUND

This pressure also seems to be making an impact on decisions by corporate managers.

"Australian Boards are becoming risk-averse, focusing only on short-term performance. In our industry with very long-term assets, this is value-destroying for all participants." CEO, ASX TOP 20 COMPANY

"You would never get a ten-year growth project up today in Australia." LEADING CEO

In summary, the clear messages from many market participants is that increasingly frequent performance monitoring, particularly by institutional investors, and incentives to maximise short-term performance (related to fund inflows, tenure and remuneration) can exacerbate underlying biases and preferences toward short-term results among most participants in the value-creation chain. In such an environment, company executives believe the market is more disposed to favouring investment projects which deliver more certain, highly observable and shorter-term outcomes at the expense of riskier, longer-term projects.

The overriding interest of policiticans is to remain in or attain office by reacting to immediate electoral issues and concerns or to those constituencies that are important to their re-election.

Perceptions of increasing short-termism in Australia are consistent with views expressed by market participants overseas, particularly in the US, UK and Europe, as the following quotes illustrate.

"Many executives feel that they are unhappily locked into a situation where the short-term focus of the market has affected their behaviour." [21]

"Many finance directors from large UK companies are short-termist in their perceptions and (this) is positively associated with their beliefs about the level of emphasis placed by the capital markets on figures of reported earnings." [22]

"Fund managers believe that the quarterly relative performance monitoring, to which many funds and fund managers are subject, results in the adoption of a more short-termist attitude and approach to the management of the funds in question." [23]

As the comments illustrate, no one party appears to be the driver of short-termism. Instead, the dynamic of short-termism appears to derive from a complex web of actions, relationships and expectations.

"Fund manager short-termism does produce herd-like behaviour within corporate Australia. Boards do not want to fall behind the pack and so relative performance is more important than overall performance."

SENIOR EXECUTIVE, FUND MANAGEMENT FIRM

"The emphasis from equity analysts is on short-term outlooks and trading – that is their incentive."

INVESTMENT ANALYST, ASSET CONSULTANT

Short-Termism & the Public Sector

Short-termism is not only restricted to private-sector decisions about investment but can be related to policy decisions by Governments. The pressure for short-termism in Government can arise in much the same way as it might in business. The power and ability of Governments and politicians to determine policies and influence the national agenda depends on remaining in Government – that is, on the ongoing approval or satisfaction of the electorate. Accordingly, just as company executives might be motivated by the expectations of investors to adopt strategies aimed at delivering highly visible short-term results to protect their positions, so too might elected Governments and politicians.

Possible Causes

Highlighting these short-term pressures is not intended to suggest that politicians or Governments are driven exclusively by this focus or that it is the sole focus throughout an entire term in office. However, the overriding interest of politicians is to remain in or attain office by reacting to immediate electoral issues and concerns or more specifically to those constituencies that are particularly important to their re-election.

This is obviously no bad thing. After all, Governments are elected to represent the interests and preferences of voters. In reality, however, there is no such thing as a perfectly functioning democracy and there is not complete certainty of outcomes – for voters or politicians – in elections. Policy choices can be highly complicated and difficult to convey, and often politicians and the bureaucracies that support them tend to have a monopoly on information about the relative long-term costs and benefits of different policies.

Taking these factors into consideration, and against the backdrop of the political realities, Governments may exhibit public policy short-termism in the following ways:

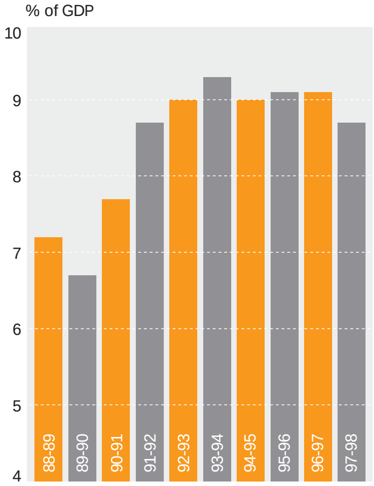
- avoiding policies that have significant and clear short-term costs and/or less visible benefits that flow over the longer term;
- cutting spending in areas where it is difficult to observe the consequences of those cuts (especially over the short term);
- adopting policies for which winners are concentrated and losers dispersed;
- adopting short-term policies around elections that are not part of, or are inconsistent with, their broader long-term, policy strategy, including some which can be recouped after the election (eg spending that can be wound back or met by higher taxes once a Government is re-elected); and/or
- neglecting to address issues for which the costs of avoidance are not easily observable.

21 CORNER OFFICE THINKS SHORT-TERM, JUSTIN LAHART, ASIAN WALL STREET JOURNAL, 15 APRIL 2004.

22 EVIDENCE OF MANAGERIAL SHORT-TERMISM IN THE UK, JOHN GRINYER, ALEX RUSSELL AND DAVID COLLISON, BRITISH JOURNAL OF MANAGEMENT, VOLUME 9, 13-22 (1998).

23 FUND MANAGERS' ATTITUDES TO RISK AND TIME HORIZONS: THE EFFECT OF PERFORMANCE BENCHMARKING, MAE BAKER, THE EUROPEAN JOURNAL OF FINANCE 4, 257-278 (1998).

PERSONAL BENEFITS PAYMENTS



Source – Access Economics and Department of Finance

Over time the simplification of issues and debate can produce unintended consequences.

Public Policy Examples

There are clearly many examples of Governments taking long-term policy decisions, including many that have involved significant short-term political and economic costs and adjustment. For example, successive rounds of trade liberalisation, financial deregulation, workplace relations reform and the introduction of the GST have all been directed at long-term economic competitiveness. At the same time, most can also recall examples of policies that have sub-optimal public policy outcomes and appear to be aimed largely at appeasing or pleasing certain elements of the electorate.

Any analysis of individual policy decisions carries a good deal of subjectivity. Governments may legitimately argue that policies implemented around elections would have been implemented regardless and are an integral part of a broader long-term strategy. However, there are a number of examples that point to the existence of short-termism in public policy formulation which are of concern from the perspective of sustaining economic growth and prosperity in Australia.

Transfer payments

On a general level, it has been argued that a rising share of transfer payments is a sign that Governments are increasingly pursuing policies that deliver more tangible and observable benefits to voters. Data from the late 1980s to the late 1990s (see chart opposite) suggests that Federal personal benefits payments rose by the equivalent of two percentage points of GDP over that period at a time when economic conditions would tend to point to a cyclical decline in such payments. At the same time, there was a steady trend down in capital spending.

Simplistic policy messages

Another form of short-termism that can have adverse implications in the longer run is the adoption of simplistic messages and rules about policies as a way of getting consensus around complex policy issues. While such an approach might enable a constituency of support to be built for important policies, over time the simplification of issues and debate can produce unintended consequences.

For example, the need to cut public debt from unsustainably high levels has been achieved effectively through the adoption of a policy goal that any debt is bad. While such a simple message undoubtedly assisted in gaining public support for fiscal consolidation, we are now in a situation where it is difficult to conduct a sensible public debate about sustainable use of debt financing that might be appropriate to support investment and long-term economic activity.

Superannuation

In common with most Western countries, the ageing of our population has given rise to an important set of public and fiscal policy challenges going forward. A key issue is the funding of retirement for Australians over the next 50 years.

Compulsory superannuation was introduced for industrial employees in 1986 and extended for all Australians in 1992 in response to concerns about the declining Australian rate of household savings, which had dropped to a low point of 15 per cent of GDP during the 1991-92 recession, and the implications for the sustainability of Government-funded aged pensions.

Although the superannuation debate was not couched in the language of short-termism, it was based upon an assumption that only a compulsory scheme would encourage people to set aside savings for their long-term retirement. But while public policy has placed significant emphasis on superannuation to fund retirement incomes, the outcomes it has sought to deliver appear to have suffered from short-term political timeframes.

The problem of the superannuation shortfall has been exacerbated in recent years as consumer debt has increased, accompanied by a decline in the household savings ratio from 5.9 per cent in the December quarter 1996 to a historic low of 0.90 per cent in the June quarter 2002 (‘Prices and Income Saving’, ABS, April 2004).

Since its introduction, successive Governments have introduced a three-tier system of taxation on superannuation, taxing contributions, investment income and benefits. This taxing maximises tax revenue in the short term at the expense of long-term savings and retirement incomes.

In administering this tax burden, Governments have also changed the tax mix to maximise near-term tax revenues by moving the tax burden to contributions (including the surcharge) and investment earnings and reducing the tax on lump sums. This further reduces capital available for future retirement income.

“Australia is the only country in the world that taxes retirement income three times – at the contributions stage, on earnings, and on final benefits.”
ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA (ASFA)[24]

The Investment and Financial Services Association (IFSA)[25] recently estimated that at current super contribution rates, a $600 billion shortfall in Australians’ retirement savings has already opened up. Tax on superannuation currently amounts to $6.8 billion a year, and is forecast to grow to $7.1 billion by 2007-08. While reducing or removing the current tax burden would not address this shortfall, the impacts of these short-term fiscal decisions are huge. If total taxes on superannuation in this current financial year were invested as long-term retirement savings and allowed to grow at a compound rate of 6 per cent, it would be worth $93.6 billion to the national savings pool by 2050.

SUPERANNUATION TAX IN AUSTRALIA

Country	Contributions	Investment/Income	Benefits
Australia	T (plus S)	T	T
Canada			T
Chile			T
Denmark		T	T
Ireland			T
Netherlands			T
New Zealand	T	T	
Singapore			
UK		T	T
US			T

T=taxed, S=surcharge

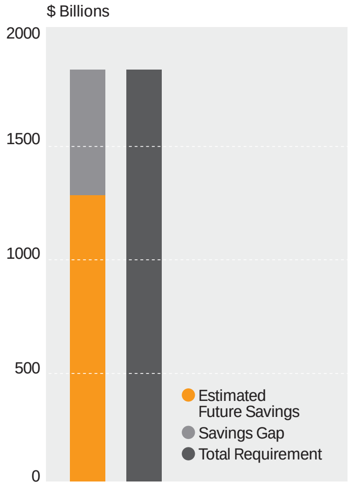
LEK Consulting, sourced from Association of Superannuation Funds of Australia, January 2004

24 ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA, FACT SHEET NO.2, JANUARY 2004.
25 RETIREMENT SAVINGS GAP, INVESTMENT AND FINANCIAL SERVICES ASSOCIATION (2003).

Research on private savings suggests that saving is something that people often prefer to defer. Studies show that people consistently underestimate the savings they will require for their retirement.[26] Therefore, confidence among savers in the integrity of the system is important to achieving its objectives.

The impact of superannuation taxes, however, appears to be a contributing factor in the loss of confidence in the adequacy and control among ordinary Australians about their retirement savings. According to public polling by the Association of Superannuation Funds of Australia in 2002 – commissioned at a time when many funds were experiencing negative returns – tax and not funds' performance was seen as the single biggest negative for super.[27] A more recent ASFA opinion poll showed half of respondents do not believe their current level of superannuation will be sufficient for retirement, and reducing super contributions tax and the provision of greater savings incentives should be priorities for Government.[28]

THE SAVINGS GAP



Source: Investment and Financial Services Association

Regulation

Creeping re-regulation of economic and corporate activity is another clear example of short-termism in public policy. The introduction of new regulations often has hidden costs which accrue over time. Accordingly, it is relatively easy for Government to introduce new regulation in response to community concerns, even though the costs of such regulation, including in terms of longer-term growth and investment, may be significant. For example, regulation introduced in response to short-term losses in the share market by investors can be counter-productive if it makes companies risk averse and consequently impairs their competitiveness and decreases shareholder returns over the longer term.

Pressures on Governments to marry short-term political action with corporate regulation have increased over time, particularly due to a rapid increase in the number of shareholders in Australia. Australia now has 5.7 million direct shareholders, compared to 1.1 million in 1991, an increase due to a series of major floats, privatisations and demutualisations. The rise of Australia as a shareholder society over the past decade has led to increasing shareholder activism and a powerful new voice which is able to greatly influence Government policy.

The 'Corporate Regulation' table (page 52) outlines recent legislative changes to Australian corporate regulation as a direct response to high-profile malfeasance such as HIH and Enron. While each of the responses may be valid in terms of strengthening core corporate values, such as accountability and disclosure, collectively they represent a significant new and restrictive compliance burden on companies. Indeed, a good deal of anecdotal evidence from senior managers and Board Directors points to this newest raft of regulation having a constraining influence on strategic planning and long-term value creation.

26 NATIONAL SAVINGS: TRENDS AND POLICY, MALCOLM EDEY AND LUKE GOWER, RESERVE BANK OF AUSTRALIA ANNUAL CONFERENCE PAPER (2000).

27 'SO FAR, SO GOOD FOR SUPER' – RESULTS OF TWO NATIONAL ATTITUDE SURVEYS OF THE AUSTRALIAN WORKFORCE, ANOP RESEARCH SERVICES FOR THE ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA (2002).

28 NATIONAL SURVEY ON COMMUNITY ATTITUDES TO SAVING FOR RETIREMENT, ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA, AUGUST 2004.

Regulation and economic growth

The BCA is currently undertaking a major study to provide empirical evidence on the costs of regulation, both directly and indirectly to companies and the economy, building on research overseas which correlates light-handed and consistent regulation with sustained business and economic growth.

Overseas research suggests there is a strong relationship between excessive regulation and economic performance.

OECD research showed that the least regulated countries tended to show the greatest improvements in their rates of multifactor productivity growth.[29]

World Bank research showed that labour productivity and employment are positively correlated with less regulation, and that countries that have performed well have five common elements to their approach to regulation:

- simplifying and deregulating in competitive markets;
- focusing on enhancing property rights;
- expanding the use of technology;
- reducing court involvement in business matters; and
- making reform a continuous process.[30]

29 GIUSEPPE NICOLETTI, THE ECONOMY-WIDE EFFECTS OF PRODUCT MARKET REFORM, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PARIS, 2002.

30 DOING BUSINESS IN 2004: UNDERSTANDING REGULATION, WORLD BANK, 2004.

CORPORATE REGULATION

Characteristic	Trend	Time scale	Examples
Frequency of reporting/disclosure	More often	Post 2000	- Companies now only have 75 days to submit growth statements - Companies required by ASX to make official announcements when stock is subject to market/press rumour that could affect share price
Scope of disclosures	Wider	Post 2000	- Companies required to disclose labour policies and practices, environmental, social and ethical factors, as well as superannuation and managed funds information
Number of stakeholders	More bodies scrutinisting corporate disclosure	Steady increase since 1989	- ASX Corporate Governance Council formed in 2002 - Australasian Investor Relations Association was established in 2001 to address corporate disclosure issues
Enforcement	Introduction of fines and prosecutions taking place	Last 24 months	- ASIC receives increased funding ($30 million over two years) to organise civil prosecutions - ASIC given power to fine companies breaching disclosure requirements - Review of audit practices in wake of American corporate scandals
Individual accountability	Greater accountability of senior management	Last 24 months	- CEOs and CFOs now required to certify financial results of the company in annual reports - Maximum fines for Directors rise from $200,000 to $1 million

Source: LEK Consulting

Potential Responses & Issues for Future Consideration

Private Sector

There are a number of important issues that have been raised in the discussions regarding short-termism in the private sector.

The high frequency of performance monitoring for fund managers and the benchmarking of performance are two areas that raise potentially important adverse implications for investment decision-making. In addition, there is a case for greater awareness of the roles of the various intermediaries in the superannuation industry and the incentives applying to each so that super fund members can better understand how, and how well, their investments are being managed. The advent of greater choice in superannuation makes these issues more important.

From the perspective of CEOs and the corporate sector, increased visibility and clarity about investment strategies and their expected outcomes, including interim and long-term goals, can be important in reducing investor uncertainty and scepticism. This is reinforced by evidence that greater impacts from short-termism can be found in markets and sectors for which information is less available or less reliable. More specifically, multi-country research has shown that increasing disclosure of key information reduces stock price volatility.[31] However, disclosure is not costless and frequent disclosure of lower-order information, the context of which is not clear, may simply add noise to the market.

There also appears to be a growing recognition that focusing on narrow indicators of performance and the announcement of specific earnings targets by companies may contribute to a shortening of time horizons and an excessive focus on short-term performance by the market, media and individual shareholders. This is a welcome development and should be supported.

31 DISCLOSURE, VOLATILITY AND TRANSPARENCY: AN EMPIRICAL INVESTIGATION INTO THE VALUE OF BANK DISCLOSURE, U. BAUMANN, AND E. NIER, FEDERAL RESERVE BANK OF NEW YORK, AVAILABLE AT HTTP://WWW.NY.FRB.ORG/RESEARCH/EPR/FORTHCOMING.HTML

The influence of the media on market behaviour and particularly individual investors is very strong. The most recent profile of Australian retail shareholders by the Australian Stock Exchange found that 40 per cent of retail investors gained the majority of their market information from the media.[32] The objective and timeframe of the vast majority of media coverage is short-term. Media outlets operate predominantly in a 24-hour news cycle, and therefore continuity of information on a specific issue or company is often not practical, let alone marketable. The extent to which the media influences its readership, or in turn responds to the issues and perspectives readers find most appealing, is an ongoing debate. What is clear is that in making the news of the day the overriding focus for its consumers, the media can serve to fragment attention away from an understanding or acknowledgement of long-term planning and action.

Added to this, the mushrooming number of investment advice and services and chat rooms on the Internet has accelerated the tendency for household investors to engage in rapid-turnover trading activity on the share market. As evidence, typing the search string 'share market investment' into Google reveals almost 130 sites covering Australia alone.

More broadly, while much of the above discussion has focused on the interaction between institutional investors and the market, it seems clear that there needs to be a better and wider understanding within the broader community of the nature of investment, risk and long-run returns.

Recent survey work by the ANZ on financial literacy in Australia showed that 37 per cent of adult Australians holding insurance or investments did not understand that good investments can have short-term fluctuations in market value.[33] In other words, over one-third of Australians believe that investing is a one-way bet, even in the short run. In addition, the survey found that around 60 per cent of adults have a low level of understanding about long-term investment options.

While some might be inclined to push for stronger measures to address concerns about short-termism, simple solutions are not readily available or even desirable. Before more concrete measures are advocated, there is a need for more research, including a better understanding of trends and market characteristics in Australia, given that much of the current research focuses on experiences in the US and UK.

Public Sector

In relation to addressing issues around public policy short-termism, the following are some areas for further consideration.

Institutional reforms and policy rules such as Reserve Bank independence and fiscal policy targets can be important in attempting to limit short-termism in public policy formulation. However, it is important that these policies are reviewed to ensure that the nature of the target and implementation in practice remain relevant and effective. The risk is that such policies, once implemented, become entrenched and taken for granted and lose their effectiveness over time.

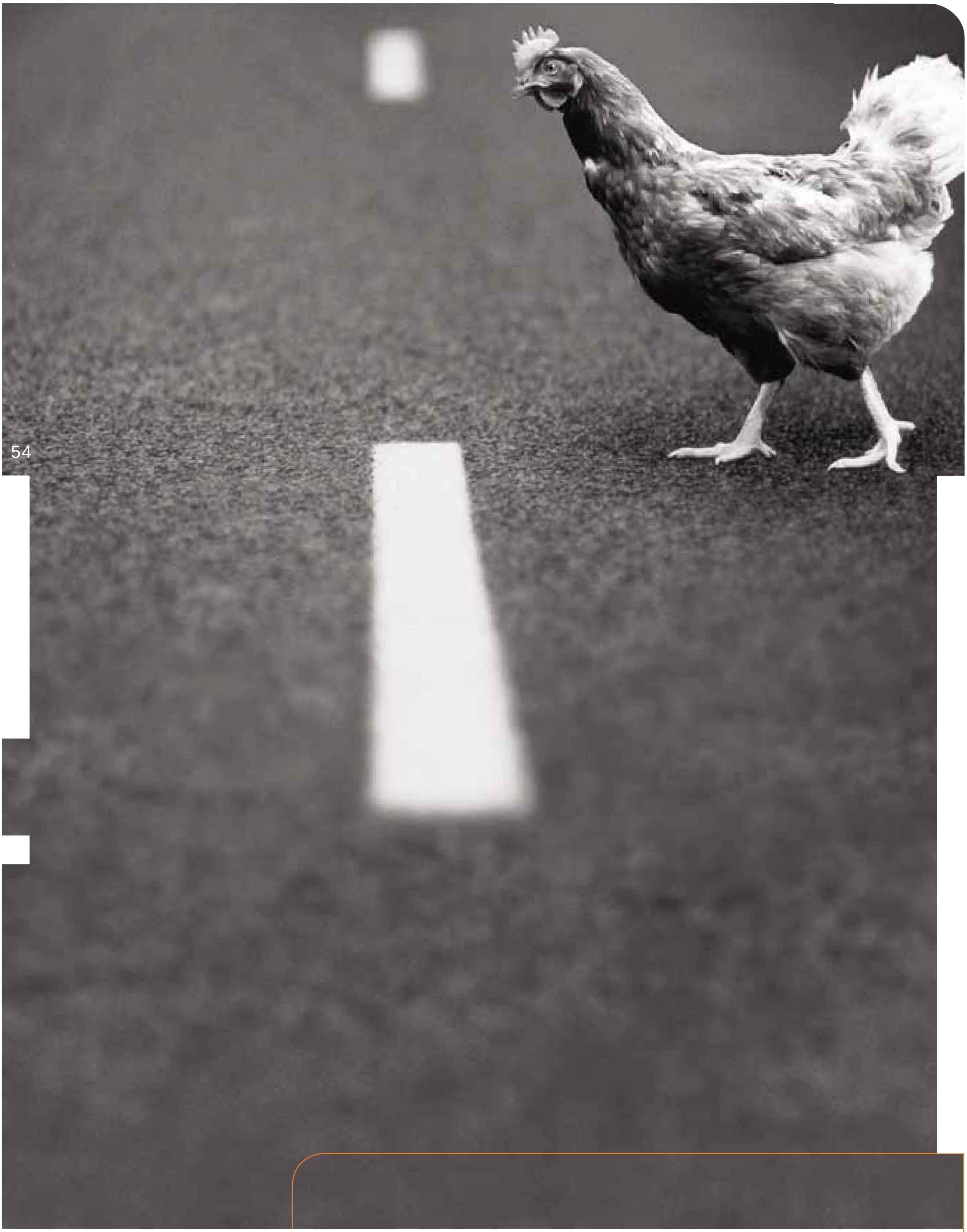
While the aim to achieve a balanced fiscal position over the course of an economic cycle has supported responsible fiscal policies and debt reduction, it may be time to give consideration to the longer-term appropriateness of that goal and how it interacts with election cycles, in light of the intergenerational fiscal challenges confronting Australia.

Regulatory impact statements and cost-benefit analyses of new regulations and how they interact with the current regulatory structure and policies are also fundamental to avoiding short-termist policies, which over the long run can undermine potential growth.

For those outside Government, the aim should be to highlight the otherwise hidden costs and benefits of policies, and to draw attention to the opportunity costs of policies that are neglected or ignored through the push for greater transparency and disclosure, including through infrastructure audits and the like.

32 ASX 2003 SHARE OWNERSHIP STUDY

33 ANZ SURVEY OF ADULT FINANCIAL LITERACY IN AUSTRALIA, ROY MORGAN RESEARCH, MAY 2003, WWW.ANZ.COM.AU



Risk and reward: Company executives believe the market is more disposed to investment projects which deliver more certain, highly observable and shorter-term outcomes at the expense of riskier, longer-term projects.

Recommendations

Some possible areas for advocacy include:

Companies

- measure and communicate performance that is linked to achieving long-term strategy and intrinsic value and critical success factors, and not just EPS/market value;
- recognise and remunerate executive performance in line with longer-term indicators (eg five to ten years) and not just short-term indicators (eg quarterly);
- encourage companies to frame their reports with increased emphasis on strategic direction and longer-term objectives; and
- create heightened awareness of the value of longer-interval reporting by fund/investment managers, and establish associated contract and remuneration strategies that reflect this approach.

Public Sector/Government

- investigate if continuous disclosure and corporate regulation is creating an excessive focus on the short term;
- mandate effective regulatory impact statements and cost-benefit analyses to assess new regulatory proposals;
- review the triple tax on superannuation;
- lengthen electoral cycles (eg introduce fixed four-year Federal Election terms as previously advocated by the BCA) to lengthen public policy-making timeframes;
- review, evaluate and articulate policy in the context of key long-term trends and challenges including population ageing; and
- introduce benchmark reporting and reviews of the appropriateness of longer-term policy objectives and regular infrastructure audits.

Finally, further research and case studies are required to better highlight the disadvantages of short-termism and the advantages of long-term strategy/actions to participants in the business, investment, Government and broader communities.

"Financial markets together with the major players in them, investment analysts, fund managers and institutional investors, are too short-term oriented. As a result, the stock market places too much weight on current profits and dividends. This in turn causes companies to be managed according to the same short-term horizons as their investors."[34]

Conclusion

The Business Council seeks to play a key role in making sure that due consideration is given to policies and decisions that support the long-run sustainability and competitiveness of businesses operating in Australia, as well as alerting policy makers and the community to potential barriers in achieving that objective.This reaches into all areas of economic activity and our lifestyles and warrants prominence as a point of public debate.

The empirical evidence to prove or disprove the negative aspects of short-termism in Australia remains inconclusive, similar to previous studies in other OECD countries. However, what is evident is a strong perception among key market participants and CEOs that there is more pressure to deliver in the short term than ever before. Reconciling perceptions with evidence that short-termism is an inhibitor to sustainable value creation is a central issue to the debate. A key tenet of behavioural theory states that 'situations that are defined as real become real in their consequences.' In other words, it does not always matter if something is true or not. If it is defined as such it becomes true. Many of the participants who play a key role in Australia's business and commercial sectors consistently express concerns about an increasingly myopic focus of decision-making. Therefore, short-termism warrants further discussion, research and scrutiny.

34 STOCK MARKET SHORT-TERMISM – AN INTERNATIONAL PERSPECTIVE, ANGELA BLACK AND PATRICIA FRASER, JOURNAL OF MULTINATIONAL FINANCIAL MANAGEMENT 12, 135-158 (2002).

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