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Saving Capitalism From Short-Termism: How to Build Long-Term Value and Take Back Our Financial Future (Professional Finance Investment)

Alfred Rappaport, John C. Bogle
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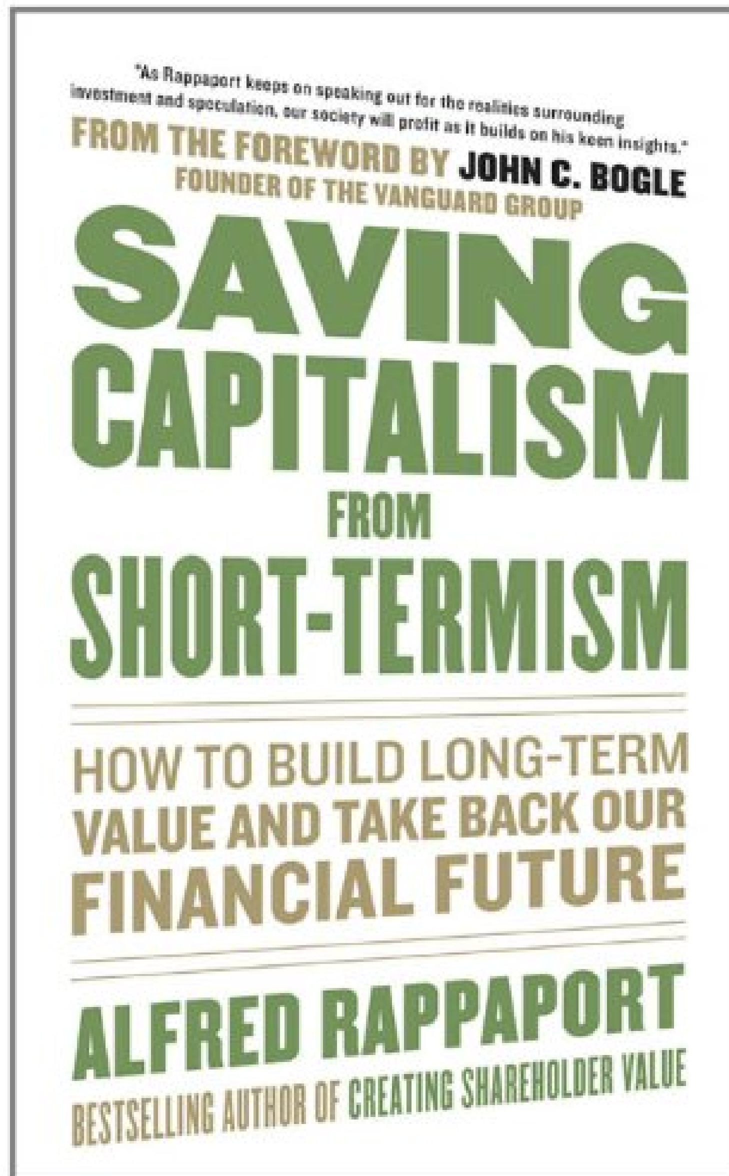

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Alfred Rappaport, John C. Bogle : Saving Capitalism From Short-Termism: How to Build Long-Term Value and Take Back Our Financial Future (Professional Finance Investment) before purchasing it in order to gage

whether or not it would be worth my time, and all praised Saving Capitalism From Short-Termism: How to Build Long-Term Value and Take Back Our Financial Future (Professional Finance Investment):

0 of 0 people found the following review helpful. Expose on short-termismBy xWhile this is an OK expose on short-termism I find the suggested solutions to be somewhat Pollyannaish.1 of 2 people found the following review helpful. Temptations, Incentives and Self-RegulationBy Andrea M. ScharaAlfred Rappaport in his new book, Saving Capitalism From Short-Termism: How to Build Long-Term Value and Take Back Our Financial Future, takes a look at what happens when economic common sense is eroded, principles forgotten and decisions driven by incentives. I found myself cheering as Rappaport used his analytic prowess to penetrate the nature of these overlapping factors, pointing to how vulnerable we humans are to the temptation to achieve quick results in social systems. He would like to realign incentives to refocus on better outcomes for society and suggests thoughtful ways to understand and alter structural problems, which currently reward investors for short-termism. Without deep understanding of the downside of the focus on quick results, there is little hope that a consensus can be built to alter policies and nudge people towards more rational behavior. This is not a small problem.Recall when Alan Greenspan, an intellectual powerhouse, confessed to Congress and the American people that his model for managing the economy was broken. "Badgered by lawmakers, former Federal Reserve Chairman Alan Greenspan denied the nation's economic crisis was his fault on Thursday but conceded the meltdown had revealed a flaw in a lifetime of economic thinking and left him in a `state of shocked disbelief'." [...].Obviously no one has found a new model for managing the economy, but Rappaport makes a solid case for refocusing on feedback loops and the nature of our interlinked system to understand what is plaguing our ailing capitalist world. He highlights the importance of principled behavior and suggests that among other problems, short term trading has spawned a multitude of unintended consequences that are not trivial. High frequency trading still accounts for roughly 50 percent of all transactions in the United States. The way incentives work for investing capital via the market is to drive management focus to the short term. Jobs are at stake and careers are damaged if short-term (e.g., quarterly, or even annual) results are not met. In both corporate America and on Wall Street, today's profits matter and the long term focus on compounding capital by investing in great companies has become old fashioned.This short-termism has crept into all of our lives during the last credit rampage. Many ordinary people found it impossible to self regulate and resist the temptation of easy money. It is not so far off to consider the current problems plaguing capitalism to be a problem of self-regulation, occurring at many levels.The question, if Rappaport's points are valid, is how many will be willing to alter their behavior to address the ways that businesses, boards, investors and consumers behave? And finally if they do alter their behavior, how will we the investors, know which companies are self-regulating? For even if we can find solid ways to alter the impact of short-term incentive driven behavior, we also have to consider if such a long-term focus will lead to investment successClearly, expectations and results vary from time to time and it is rare to find those with the skills needed to achieve investment success over any long-term period. Some of the problem has to do with how long it takes an economy, a company, or even a family to recover from downward spirals. The pressures and expectations for short-term results can create dysfunction in many kinds of social systems from the stock market to the family.In addition, even if the incentives encourage thoughtful investments with companies that have incentives aligned for longer-term performance, markets will still misprice stocks providing opportunities and traps. In an earlier book, Expectations Investing, Rappaport and Michael J. Mauboussin, considered ways to explain the gap between how the stock market prices businesses and the intrinsic value for those businesses.Investing success requires more than seeing clearly how incentives drive behavior. Rappaport also notes that luck itself may produce what might look like investment success over the short term. He makes the case that differentiating skill from luck is crucial in measuring investment outcomes. One take away is that investors may be taking unknown risks and heading over a long term cliff when they follow the short-term and/or lucky investors.Markets are almost impossible to predict so discovering which companies will be worthwhile investment vehicles is a challenge that few have been successful at over the long term. For example, only a small percentage of mutual funds beat their benchmarks over the long haul. These few investors find ways to identify companies that are able to return capital to investors despite the surrounding economic conditions. What is their secret? What do these investors look for? Or are they guided by principles similar to the ones that Rappaport identifies? Would it be possible to develop a computerized sorting mechanism that could identify the risks he notes along with the surrounding changes in the economy?Rappaport's common sense, principle-driven ideas are, as of now, left up to individuals to implement in their investing or their business. We as investors have to find ways to identify these principle driven companies and take a guess at how the pressures in society will impact investments. Is it possible that if more of these indicators were easily identifiable that we too as investors could drive change in corporate behavior?Currently, creating this kind of change is slow. It takes a long time for one company or mutual fund at a time to see how poor the outcomes are when the incentives of their own firms or the firms they invest in, or indeed the economic conditions for the market place are signaling warnings or just going in the wrong direction. Perhaps large-scale change can take place but I would hazard a guess that it will take a significant number of people to become more aware of how short-termism is a perceptual bias leading to emotional blindness.Rappaport's position

seems to be that those who are aware of these incentive-based traps can make more rational choices. His analysis further clarifies how the financial system has become a biased betting machine not an investing machine. Short term investors/traders reward companies for making the "accounting" look good for this quarter, often sacrificing the future by cutting research or jobs.As John Bogle notes in his foreword to the book, "When Wall Street's role of providing funding for the most promising projects... takes a back seat to countless waves of trading activity, we have to be concerned about whether the best interest of our society are being served." Rappaport makes the case that the faith of investors has been betrayed and that their voices are barely heard as short term, irrational thinking sways the herd.Capitalism will always face shortsighted traders with sharp knives. However by clarifying the measurements of financial statements, (cash flow, bonuses for managers, insider buying or selling, options and expirations, amount of debt carried forward, these and other measurements may make it possible to tie the tenure and rewards of company officers, and board members, to long term performance. Can clarifying important linkages between incentives and performance keep short-term traders from undercutting the stock price of the more solid and transparent companies? Is it significant to focus on returning value to shareholders in the age of the quick short?Rappaport has confidence that the problems that bedevil capitalism are not found in the cognitive limits of decision makers but rather from the use and abuse of incentives. His hope is that, "if we change incentives, in the above mentioned areas, we should expect a change in behavior."My concern is that we need more clarity and focus on the corporate and or Wall Street people who are willing to change towards a longer-term perspective. It is a difficult discipline for mutual fund and other financial managers and corporate leaders to shun a short-term orientation and return to a long-term focus, when short-term traders can undercut the future of their companies. As long as the short-term music continues to play, in this game of musical chairs, who will find a seat for the long term? Will understanding the feedback loops driving Mr. Market allow us to grasp a long term out look sustaining our companies and markets?Rappaport notes that from the nineteen-twenties on, managers were enabled, by "diffuse and mostly passive investors" to maintain high degrees of autonomy, along with limited accountability. This historical trajectory, along with habit, makes it harder to self regulate and change the incentive driven relationship between investors and managers. Clearly incentive-driven behavior is based in our evolutionary roots, where we see the winner takes all strategy as highly influential in the competition for mates and resources.People are highly influenced to win through the brain's reward system. A study by Georgio Coricelli appearing in the Proceedings of the National Academy of Sciences, measured activity in the regions of the brain associated with rewards and with social reasoning while participants in the study entered lotteries. The researchers found that the striatum, a part of the brain associated with rewards, showed higher activity when a participant beat a peer in the lottery, as opposed to when the participant won while alone. The medial prefrontal cortex, a part of the brain associated with social reasoning, was more activated as well. Those participants who won in a social setting also tended to engage in more risky and competitive behavior in subsequent lotteries. These findings suggest that the brain is equipped with the ability to detect and encode social signals, make social signals salient, and then, use these signals to optimize futurebehavior. As Coricelli explained, in private environments, losing can more easily be life-threatening. With no social support network in place, a bad gamble can spell doom. [1]The gambler is driven by an automatic preference to win, despite risks, when in social groups. Of course this can lead to increasing risky behavior and poor outcomes. Will being aware of these dynamics help us to decide when to risk and when to cooperate and perhaps even let others win?Both family and economic systems are driven by mechanisms that are out of awareness. The increasing anxiety in society, the competition for declining resources, and threats of all kinds, drive short-term behavior. To the degree that social systems, and the individuals in them and leading them, have an alerting mechanism about when they are following short-term incentive prizes, they may be able to think more clearly and function with more stability and principle-driven behavior during anxious times.Short-term thinking leads to behavior that sabotages families too. We hear short-termism threaten to dominate in such statements as: "Why can't I stay out with my friends," "Everyone is doing it", "I need a drink," "You make me mad" and "All this is your fault." Just as parents need to self regulate during times of great pressure so too our leaders have to understand which of their behaviors lead to failure, especially in the longer term.Social research backs Rappaport, making the point that the wiring of the brain is what makes us vulnerable to risky behavior in social settings. Human nature itself is tilted to reward people who take risks, the end result being big organizations and capitalism itself failing to rationally use rewards to incentivize productive behavior.It may be that just as in a family, where one person has to separate from the anxiety-driven behavior of the group, leaders in one company after another will have to step up to demonstrate that they are willing to reorganize their accounting methods and to demonstrate more clearly to investors the power of cash flow analysis. Perhaps investors will be more interested in looking at the accounting methods and the principles of corporate officers and board members. And perhaps mutual funds' investment criteria will include rigorous cash flow analysis and analysis of the extent to which the companies they invest in are led by principle-driven boards and corporate leaders.Will changing the incentives and behaviors of corporate leaders result in more viable organizations and a more adaptable society? Will expectations for investors be on solid footing with better analytic skills devoted to the measurements? Will this allow people to make long-term investments and thereby compete with short-term traders looking to make an even faster buck?Humans have the ability to self regulate and to some extent control emotionally

driven short-term thinking and action. But not all individuals are able to control reactivity. Rappaport's book notes that controlling the rush to "short termism" will give capitalism a new life. The bottom line is that investors have to be able to see the reasons for self-regulating as they consider the role of incentives in driving behavior. Those systems driven by short-term incentives will have a different, and less positive outcome than organizations run with a more long-term focus.Rappaport follows the money, warning us of the long-term problems when responsibility is lost in a rush to collect the short-term (trading) incentives rather than follow the principles of sound investing. It does take time to discover how incentives drive behavior and can corrupt both companies and people. But this is a necessary discipline for investors to undertake.Investors who read this book will have a different take on the "tells" of mutual funds, companies, and managers plus ways to support capitalism itself. People will want to read this book to know how to clarify their own thinking about human behavior and how they go about placing their bets on the various forms of investment vehicles while understanding the vulnerability of capitalism.Andrea Scharasee my other reviews[...][1] "Medial Prefrontal Cortex and Striatum Mediate the Influence of Social Comparison on the Decision Process" Proceedings of the National Academy of Sciences, viewed September 7, 2011Read more at Suite101: Research Explains Why People Give in to Peer Pressure Suite101.com [...]1 of 2 people found the following review helpful. Rappaport's Best Book Yet; Compelling Prescriptive Analysis of Corporate / Investor MyopiaBy DonL2507I believe this is Alfred Rappaport's best book yet. Although the ideas in large portions of the book are found in previous works by Rappaport, e.g., shareholder value, expectations investing, "Short-Termism" represents a lucid integration and compelling advocacy of financial ideas that he's been discussing for over 30 years. At the corporate level, he discusses managing for long-term value creation rather than near-term earnings goals; at the investor level, he reviews the possibilities for identifying investments whose long-term intrinsic value exceeds the market price that may be influenced by short-term results; and at the investment management level he considers the prospects for fund managers to create long-term value for investors by being willing to hold investments that have potential for long-term value creation but whose short-term impact makes for an unfavorable comparison with the fund's benchmark. Rappaport integrates his ideas into a cogent comparison of what really drives shareholder value versus the pressures and constraints that force executives, investors, and investment managers into decisons that are too often focused on short-term results and accounting considerations. Finally, he applies the unwarranted focus on short-term results as a contributor to the sub-prime mortgage debacle associated with the recent financial crisis (2007 - 2009) by its sustaining of earnings results amid overvalued assets.Why do major agents in our economy, e.g., corporate executives and strategic / financial planners, and investment managers and advisors, substitute short-term considerations for long-term value creation? "Short-Termism" suggests the major reason is the incentive structure which I believe is correct. Too many cash bonuses in corporate America are based on meeting near-term earnings (i.e., accounting) results, and thus capital investments and RD are postponed / cancelled although they may offer the prospects of long-term value creation. Furthermore, too many firms provide "earnings guidance" that further deters firms from managing for long-term value creation if near-term accounting results may be jeopardized. As Rappaport cogently points out, its the "magnitude, timing and riskiness" of a firm's long-term cash flows that ultimately (i.e., over the long-term) create value. The supplementing of cash bonuses with stock options was supposed to lift an executive's eyes toward the creation of long-term value and more closely link the interests of shareholders with executives, but their impact has been disappointing as the book indicates. The discussion of their imperfections is good and Rappaport makes a strong argument, in my view, for indexed options (although the realist in me says good luck getting them adopted in corporate America!).I particularly liked the chapter on an overhaul of corporate financial reporting, and the associated recommendation that investment analysts replace the mechanical application of multiples to near-term earnings with the admittedly more difficult, but more rewarding, task of evaluating the strategic and market position of a firm and thereby projecting long-term cash flows. Yes, many analysts use multiples to value securities, and many a growth stock is immediately discounted, say 25%, if a sizable near-term earnings shortfall materializes; but Rappaport shows through "expectations investing" that most of a firm's value is derived from expected cash flows in future years, and the market's reaction to an earnings shortfall, if properly evaluated, often reflects a substantial downward re-estimation of a firm's expected long-term cash flows. "Short-Termism's" discussion of the uncertainties of various accrual items is good and its recommendations, to me, are compelling. (Personal Anecdote: I worked for a corporation where a major accounting initiative one year was to deconsolidate a money-losing venture to "grow" our earnings that year.)Probably the most interesting portion of the book to me was Rappaport's extension of the short-term malady to the investment management business (the book got an excellent Forward from John Bogle). While corporate executives are reluctant to deviate from their near-term earnings guidance, investment managers are similarly reluctant to deviate in investment results from their respective benchmarks. In the interests of not lagging too far behind their benchmark, too many of them select a portfolio that sufficiently resembles the benchmark to warrant the label "closet indexer". Why pay the steeper investment costs of a managed fund when it resembles a cheaper index fund? The investment manager who wants above-market returns must select a portfolio that appreciably differs from the benchmark, but then he (or his investors) must be able to endure periods of returns below the benchmark if his long-term assessment of value creation is not recognized in market prices. Will he lose assets, or worse, his career, because of this period of below-benchmark

returns? Then, perhaps, we can come full circle when a corporation's pension fund, whose executives have just eliminated a promising RD program because it would have lopped $0.05 off this quarter's earningss, have also dropped this investment manager from their pension portfolio because he's underperformed his benchmark for 3 reporting periods in a row.

Conquering the obession with short-term profits is critical to the future of business, society, and capitalism itselfmdash;Alfred Rappaport presents a game plan every business leader should read ldquo;As Rappaport keeps on speaking out for the realities surrounding investment and speculation, our society will profit as it builds on his keen insights.rdquo; John C. Bogle, founder of The Vanguard Group (from the Foreword) About the Book: Alfred Rappaport, who first introduced the principles and practical application of "shareholder value" in his groundbreaking 1986 classic Creating Shareholder Value, reiterated the basic message in his 2006 Harvard Business Review article: Focusing on Wall Street quarterly earnings expectations rather than on creating long-term value is an invitation to disaster. Rappaport shows how deeply flawed short-term performance incentives for corporate and investment managers were an essential cause of the recent global financial crisis. In Saving Capitalism from Short-Termism, Rappaport examines the causes and consequences of ldquo;short-termismrdquo; and offers specific recommendations for how publicly traded companies and the investment management community can overcome it. Whether you're a corporate manager, money manager, public policymaker, business-school student, or simply concerned about your financial future, Saving Capitalism from Short-Termism provides valuable insights and practical ideas to change the course of your organization mdash;and contribute to a healthier economy that benefits all.

About the AuthorAlfred Rappaport is the Leonard Spacek Professor Emeritus at Northwestern Universityrsquo;s J. L. Kellogg Graduate School of Management. He is the author of the business classic Creating Shareholder Value and coauthor with Michael Mauboussin of Expectations Investing. Rappaport has been a guest columnist for The Wall Street Journal, The New York Times, Fortune, and BusinessWeek. He created the Wall Street Journal Shareholder Scoreboard, an annual ranking by total shareholder returns of the 1,000 most valuable U.S. corporations, published annually from 1995 to 2008.