The 'Elephant in the Room' is Getting Bigger:

SHORT-TERM BIAS in a POST-COVID WORLD

Judicial trends are guiding directors to the long term.

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Directors&Boards

Short-term bias in corporate thinking is still the "elephant in the boardroom." Everyone knows it is there. And everyone knows that, in the post-COVID world, short-termism in corporate decision making is as problematic as relying on a 3-mile radar for a supertanker. Yet most corporations have a strategic focus of three to five years at the most.

Companies that manage a long-term strategic plan outperform peers on almost every financial measure that matters.

However, several major trends are converging that could finally provide strong reason to confront this elephant:

• Reputable empirical business research showing dramatically that long-term strategic assessment can improve the bottom line.

• Recent trends in the Delaware courts recognizing corporations' obligation to maximize profits in the long term and broadening the fiduciary duty obligations of directors to think long-term.

• Strong public commitments by mainstream business leaders from the Business Roundtable and others, like BlackRock, to long-term investment goals.

• The mainstreaming of the "sustainable investment" movement.

• COVID itself, which has shaken up traditional business models.

We do not lack for metrics or techniques to focus more on the long term. Business schools have taught these principles for decades. The power of applying such techniques is that they are a win-win: They accomplish the goals of better long-term profitability and address broader social goals as well.

How long-term strategic planning improves performance

Empirical research by McKinsey and others shows the dramatic difference between a short-term accounting bias and long-term strategic accounting:

• 85% of S&P 500 companies use only strategic planning horizons of less than five years — shorter than a typical business cycle.

• 75% of the S&P 1500 have no long-term measures of capital efficiency.

• 85% of S&P 1500 companies use long-term incentive compensation plan performance periods of less than three years.

• A subsequent October 2020 survey by McKinsey and Focusing Capital on the Long Term (FCLT) identified an increase in short-term company behavior between 2015 and 2019.

On the other hand, the small minority of companies that manage a long-term strategic plan outperform peers on almost every financial measure that matters. A 2017 *Harvard Business Review* article by McKinsey and FCLT reported that, from 2001 to 2014, average revenue and earnings growth of companies managed for the long term were respectively 47% and 36% higher than their peers. Average company economic profit was 81% greater, and market capitalization grew at 58% more. A follow-up study reported in the April 2019 *McKinsey Quarterly* added findings that revenue growth of companies focused on long-term management was less volatile.

McKinsey and FCLT research published in 2017 concluded that if companies had managed with a longer-term strategic plan rather than a short-term bias, they could have created an additional 5 million jobs and added $1 trillion in asset wealth for investors when coming out of the Great Recession. Those numbers are likely to garner support for long-term planning beyond corporate law.

Nevertheless, fear of taking on "first mover" risk by diverging from the safety of herd behavior has locked companies and investors into a game of "chicken," in which each player expects someone else to make the first move.

Trends in Delaware courts

Delaware courts — the arbiter of the rules of the game for most corporate directors — have also become increasingly frustrated with short-termism. This is the natural result of being forced to preside over major lawsuits stemming from corporate short-termism, as reflected in the meltdowns of Enron, WorldCom and others.

For example, in a 2017 case involving ODN Holding Corporation, the Delaware Chancery Court confirmed that "the fiduciary relationship requires that the directors act prudently, loyally and in good faith to maximize the value of the corporation over the long-term…" It added, "The fact that some holders of shares might be market participants who are eager to sell and would prefer a higher near-term market price likewise does not alter the presumptively long-term fiduciary focus."

In the 2019 Marchand v. Barnhill case (involving listeria-infected Blue Bell Ice Cream), the Delaware Supreme Court strengthened corporate board obligations to proactively monitor company compliance functions. It held that the board's failure to make a good-faith effort to exercise its fiduciary compliance oversight duties constituted breach of the duty of loyalty. Application of this principle to the corresponding fiduciary duty to generate long-term value for long-term shareholders could be a "game changer" for directors, creating "rules of the game" that require board focus on long-term thinking. Corporate boards that recognize the benefits of long-term thinking appear to have their backs protected by the Delaware courts.

Mainstream endorsement of sustainable practices

In 2019, 185 Business Roundtable CEOs pledged to commit to long-term strategies. In addition to endorsing stakeholder capitalism, the Business Roundtable's "Statement on the Purpose of the Corporation" included, "Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders."

On the mainstream investor side, Larry Fink's 2021 letters to BlackRock clients and corporate CEOs demonstrate how mainstream investors have embraced sustainable investing.

"From January to November 2020, investors in mutual funds and ETFs globally invested $288 billion in sustainable products, a 96% increase over the whole of 2019…," he wrote. "This is fueling a global reallocation of capital towards more sustainable companies that will continue over many years.

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"During 2020, 81% of a globally representative selection of sustainable indexes outperformed their parent benchmarks. This outperformance was even more pronounced during the first quarter downturn, another instance of sustainable funds' resilience that we have seen in prior downturns. Investment returns can and will fluctuate over specific periods, but this evidence is helping to end the misconception that investing sustainably has to come at the cost of lower returns."

Fink also addressed the implications for companies.

"The trust our clients place in us, and our role as the link between our clients and the companies they invest in, gives us a great responsibility to advocate on their behalf…This is why I write to you each year, seeking to highlight issues that are pivotal to creating durable value — issues such as capital management, long-term strategy, purpose and climate change. We have long believed that our clients, as shareholders in your company, will benefit if you can create enduring, sustainable value for all of your stakeholders."

On the regulatory level, the SEC's investor advisory committee last year recommended an agency focus on updating reporting requirements to include "material, decision-useful ESG factors." The Biden administration has given clear signals that it will prioritize improvement of corporate reporting on ESG/sustainability factors. In addition, a petition from investors with more than $5 trillion in assets under management was submitted in 2018 asking for development of a standardized ESG reporting requirements for public companies and remains pending before the SEC.

Internationally, the E.U. and U.K. have already taken the lead in efforts to standardize current inconsistent private sector ESG reporting frameworks. The E.U. commission is considering modifications to its Non-Financial Reporting Directive, which already requires large companies to make ESG policy disclosures. The E.U. also mandates reporting by banks and other financial institutions under a Sustainable Finance Disclosure Regulation. The U.K. also has several disclosure mandates and reviews underway. Over the long term, it is unlikely U.S. regulators will be exempt from this international momentum toward sustainability and longer-term thinking.

And of course, COVID may have forever altered a worldview of business as usual. Many business models have been destroyed, and that may allow long-term strategic thinking to be more easily introduced.

"Uncertainty" is no excuse for avoiding long-term strategic accounting. To the contrary, it is in a world of uncertainty and diminishing resources that long-term thinking is central — so that corporations have an early alert to fatal long-term risks and future business opportunities.

Transitioning the bottom line to the long term

No director can achieve a good balance between short-term and long-term strategic planning goals if there are no metrics, no incentives and no accounting built into corporation decision making that focusses on the long term.

It is time to immediately transition to longer-term strategic thinking and build performance metrics and incentive compensation around long-term strategic plans. There is no time like the present. And in the 21st-century world, this is no longer even an option — from a profitability perspective, legal perspective, investor perspective and social perspective. ■

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