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# Is the stock market short-term oriented?

This is certainly the perspective of the popular press. Rarely does a day pass when some journalist, in a major business publication, does not rant and rave at the short-term nature of investors and the stock market. A company misses earnings and the stock drops 25%, or 50%. The reporters comment that clearly the market is over reacting to the shortfall, many times of which the miss is a small one at that. Just look at the "standard" reaction to news in the market; clearly investors are focused on the short-term. Why else would stocks react so violently to these seemingly temporary corporate events?

In 1988, a Blue-Ribbon commission formed to analyze the causes of the 1987 stock market crash concluded that one of the primary reasons for the crash was the overly short-term orientation to the stock market. The commission was staffed with significant business leaders and academics, and the final analysis was coordinated by Michael Porter from Harvard Business School. The commission published their findings in a book called "Capital Choices." In addition to concerns about the short-term nature of US capital markets, the commission was also impressed with the capital structure of both the leading European and Japanese companies. The commission found these countries to provide significantly more "patient" sources of capital than the US which allowed companies to invest for the long-term. The characteristics of these patient investors would give these countries a significant competitive advantage over the US. This conclusion was not just a mild concern in the report of the commission, but a major damnation on the US capital markets. Sixteen years later, one interesting question arises: Who thinks either the Japanese or the European capital structure is superior to the US and what evidence would one use to support the notion that somehow companies from these countries have had a significant competitive advantage as a result of the local capital markets?

Most people seem to think the answer to the above question is clearly yes.

A few confounding facts seemed to detract from the simple answer, however. If the stock market is short-term oriented, why are long-lived projects financed? Why are there publicly-held biotech companies? How did the cable industry get financed in its early life? All of these investments produce significant loses in the early years of their development with the positive cash flows only materializing well into the future. If the market was exclusively short-term oriented, none of these projects/companies would exist.

Other evidence that seems to counter the notion that the market is short-term oriented:

If one uses a dividend discount model to value the stock market in the aggregate, or even individual stocks, one would need to look well beyond a five year time horizon to justify current valuations. In fact, with dividend yields below 2% for most companies, the stock market suggests that investors are looking well beyond the near-term dividends to value these stocks. Even looking out 7-10 years, the valuation problem does not go away as even 10 years of dividends cannot support current stock market valuations. Making matters worse, fewer than 20% of all listed companies even pay a dividend, suggesting that valuation based on a DDM would require forecasting far enough into the future to when the company began paying dividends to investors let alone needing many subsequent years of actual dividends.

The most important new source of corporate ownership to emerge in the US in the past 25 years is the LBO funds (private equity). Once feared for their aggressive behavior, the LBO funds remain a concern for underperforming companies. Interestingly, LBO firms generally value companies based on a DCF model with a forecast period well beyond the near-term. Many times, these funds are forced to forecast cash flows 5 to 10 years into the future to justify the acquisition of the corporate assets. Keep in mind that private equity investors are generally locked up for many years and do not have the luxury of public market liquidity. Therefore, all private investments carry significant liquidity penalty for incorrect forecasts. To be competitive and successful, private equity firms must forecast many years into the future (to win) <u>and</u> be right in their forecasts (to make money from the investment). For most publicly held companies, cash flows from the next five years represent less than 40% of the current market value. Therefore, even with a five year forecast period more than 60% of the current value resides in the terminal value of the forecast, a further forward looking set of estimates. Pushing the forecast period to ten years helps reduce the importance of the terminal value as more of the current value is represented in annual cash flows. However, the terminal value remains an important source of value, which essentially pushes the market's "implied" forecast period to well beyond a decade!

Almost every company publishes "proforma" financial results with the goal of presenting the financial results for the ongoing operations, singling out the "one-time" and "non-operating" events during the period. The empirical evidence suggests that analysts, investors and the stock market cue their investment decisions to the results of the ongoing operations rather than reported GAAP results. If the market were short-term oriented, the focus would be on the actually reported results in the period including all of the non-operating charges.

An additional exercise would be to value a 10-year government note. We know the cash flows from the investment and use them to value the security. The recent yield on the 10-year note is roughly 4.25%, therefore trading at par the note would have a "P/E" of roughly 23. This "P/E" ratio is within the historical range for the stock market, yet investors are clearly looking to the cash flows from the entire 10 year period to justify the valuation. Even with a government note, investors appear to look well beyond the near-term.

All of these considerations would suggest that the stock market sometimes looks beyond the near-term in valuing companies/stocks. But how could one even suggest that the market is long-term oriented when stock prices seem to change everyday and some of the moves are quite significant? If the evidence is that the stock market is not short-term oriented, then what causes the often-times significant near-term reaction?

A more satisfying answer to this apparent conundrum is to realize that the market is merely reacting to the long-term impact of the new information released. The new information is an indicator of future financial performance, therefore the new information forces the "market" to revise all long-term forecasts. The market is not penalizing the company for the single event, but for what that event signals about what to expect in the future.

The new information almost always changes future expectations and the new information can have an enormous effect of the investor expectations. Even when a company misses expectations by only a penny, the long-term impact can be quite substantial. Therefore, the fact that the market dramatically changes the overall valuation of the company on the release of new information is, in fact, overwhelming evidence that the market is actually long-term oriented. If the market were truly short-term oriented, the stock would recover quickly as the market's short-term focus shifted from the current disappointing news to the prospects of the next set of events.

The periodic nature of earnings announcements and investors reactions to the announcements leads many people to believe there is a causation from one to the other and therefore the market must be short-term oriented. However, just because stocks move up and down does not mean the market is short-term oriented. In reality, investors are merely adjusting long-term expectations.

There appears to be overwhelming evidence that investor holding periods continue to shrink as more professional investment managers feel pressure to deliver short-term investment profits. Because the holding periods of institutional investors have decreased dramatically during the past 20 years, it is tempting to think that stock prices also reflect this short-term outlook. Although there are clear institutional forces that affect the trading behavior of many professional money mangers, these forces do not speak to the market's discounting mechanism. It is easy to show that if the market were systematically mis-pricing securities because of the short-term focus of funds, then smart investors could, and would, arbitrage away the error. But what about the short-term nature of traders in the market? Individual investors are irrelevant even if there are many (but not all) following a similar trading strategy. As we know, it is the collective wisdom of all participants that determine stock market prices. Any systematic error that these traders bring to the market are quickly arbitraged away by other long-term oriented investors.

The key insight to resolving this seeming paradox may be in understanding the difference between the market's discounting mechanism (clearly long-term) and the holding periods of investors (getting shorter). The conclusion that the market is short-term orient does not hold up to scrutiny. Although it is tempting to think the market is short-term oriented, in fact, it must reflect investors' long-term expectations.

One interesting conclusion from this analysis emerges.  If the market is, in fact, long-term oriented, as we have argued, then it is the economics of the underlying business that ultimately determines the value of the company.  Over time, the company's ability to create value for shareholders will become the most critical driver of valuation and will become the most important metric as the holding period of the investment increases.  As a direct consequence, a company's value creation potential will become critical to evaluating its investment merit.