Buffett: “Short-termism” harmful to economy and investors

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INVESTING

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In a recent commentary in *The Wall Street Journal*, “Short-Termism is Harming the Economy,” CEOs Warren Buffett (Berkshire-Hathaway) and Jamie Dimon (JP Morgan) urged public companies to cease issuing quarterly earnings-per-share guidance, which they cited as a major contributor to financial markets becoming increasingly focused on the short-term.

In conjunction with Business Roundtable, an association of nearly 200 major company CEOs, they wrote “in our experience, quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability.” Further, “companies frequently hold back on technology spending, hiring, and research and development to meet quarterly earnings forecasts that may be affected by factors outside the company’s control.”

Publicly-owned companies in the U.S. are required to report earnings quarterly (i.e. about every 13 weeks or 65 business days) and annually. Wall Street analysts create models to project a company’s revenues and expenses to develop estimates of future earnings per share (“EPS”), which are then used to calculate price targets for the company’s stock. For instance, there are about 30 analysts who publish research on Cummins and the average of their EPS estimates is the “consensus estimate.”

Management teams work feverishly to beat, or at least meet, consensus estimates. Stocks can soar on a significant “beat,” while a company missing by even a penny of EPS can see its stock crushed. Thirteen weeks goes by quickly, so you can see why CEOs can feel like they’re perpetually on a hamster wheel.

Earnings reports are backward-looking, but are vital for providing transparency and holding management accountable. The quarterly reporting requirement isn’t going anywhere and neither is investors’ obsession with short-term EPS “beats” and “misses.”

However, a shrinking but still significant population of public companies provide quarterly “guidance” to analysts (Cummins does not), which is essentially management’s own estimate of future earnings. While bad to miss analyst expectations, it’s disastrous to miss your own.

Buffett and Dimon believe companies providing guidance 1) perpetuate investors’ focus on short-term results (to their detriment), thus continuing to feed the short-termism beast and 2) put undue pressure on themselves to bring home a “good report card” every thirteen weeks, which can lead to decisions counter to long-term best interests or accounting shenanigans.

A better alternative was provided by FCLTGlobal (Focusing Capital on the Long-Term) in “Moving Beyond Quarterly Guidance: A Relic of the Past” which argues companies should stop giving quarterly EPS guidance and instead provide investors “with a long-term roadmap focused on the fundamental economic drivers of the business tied to management’s outlook on critical key performance indicators (“KPIs”).

According to the report, companies should 1) select the appropriate metrics for their specific business and explain how KPIs advance long-term goals 2) provide guidance for metrics that will help investors understand and track the company’s long-term strategy and 3) resist the urge to alter metrics, introduce new ones or abandon targets when expectations are not met.

Further, the KPIs should be put in context by 1) offering a three- to five-year outlook for each KPI, as well as key risks and outside factors relevant to this outlook and 2) if offering annual guidance on KPIs, connect that to the progress toward longer-term goals and contextualize interim results within the frame of long-term objectives.

In his 2017 shareholder letter, Buffett also advised investors to avoid short-term noise and focus on the long-term when he said," Charlie (Munger) and I view the marketable common stocks that Berkshire owns as interests in ***businesses***, not as ticker symbols to be bought or sold based on their "chart" patterns, the "target" prices of analysts or the opinions of media pundits. ***Instead, we simply believe that if the businesses of the investees are successful (as we believe most will be) our investments will be successful as well. Overall – and over time – we should get decent results. In America, equity investors have the wind at their back."***

Regarding ***short-term*** price randomness, Buffett cited four "truly major dips" in Berkshire's shares over the past 53 years (ranging from -37.1% to -59.1%), saying "your mind may well become rattled by scary headlines and breathless commentary…an unsettled mind will not make good decisions." While Berkshire's stock has performed spectacularly over the ***long-term***, "in the next 53 years our shares (and others) will experience declines resembling (those four declines)." Further, "***no one*** can tell you when these will happen…the light can at ***any time*** go from green to red without pausing at yellow."
