

Why Short-Term Trading Can Be Long-Term Stewardship

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Stewardship by investors – actively improving the long-term performance of the companies they own, rather than passively receiving dividends – is central to ensuring that capitalism works for all of society. Accordingly, stewardship codes around the world emphasise the need for investors to engage with companies – voting in an informed manner, acting as a sounding board for executives, or holding them to account for diversity and climate change.

But most codes make the mistake of equating stewardship with engagement. While engagement can create substantial value, it's not the only stewardship mechanism. Selling shares, even in the short-term, can be an effective form of stewardship.

This view seems heresy. Common wisdom is that selling shares is the antithesis of stewardship – walking away from a troubled company rather than sticking around and fixing its problems. The mere threat of selling allegedly forces a company to prioritise investors over customers, employees, and the environment.

These concerns have sparked several policy proposals to lock in investors for the long-term. France's *Loi Florange* doubles investors' voting rights after two years. Hillary Clinton proposed a sharply higher capital gains tax on shares held for fewer than two years. Toyota has a class of shares that gives investors "loyalty dividends" if they hold onto them for five years. Other proposals go further. Arguing that shareholders are irremediably short-term, they advocate reducing shareholder influence by putting other stakeholders on boards, or giving stakeholders equal priority with shareholders in directors' fiduciary duties.

These arguments are fundamentally flawed, because they confuse the holding period of a shareholder with her orientation. The *holding period* is how long an investor holds shares before she sells. The *orientation* is the basis – long-term value or short-term profits – that triggers an investor to sell. Critically, *short-term selling can be based on long-term information*.

Take a company that's thinking about cutting investment to boost earnings, hoping to inflate its stock price. An informed shareholder, who looks beyond earnings and analyses the company's intangible assets, would notice that the firm has mortgaged its future. She would sell her shares, pushing the stock price down. Anticipating this, the company will decide not to cut investment in the first place. As a result, short-term selling by shareholders need not encourage short-term behaviour by managers. Instead, it disciplines it, which is it's a stewardship mechanism.

For example, Ford announced record profits in 2015 followed by its second-highest profits in 2016. But investors weren't fooled. The stock price fell 21% over those two years due to concerns that Ford was investing insufficiently in electric and self-driving cars, which led to Mark Fields being fired as CEO in May 2017. More generally, large-scale evidence shows that short-term trading improves long-term value.

So the crux isn't whether shareholders hold for the long-term, but whether they trade on long-term information. How do we ensure it's the latter? By encouraging investors to take large

stakes. Gathering information on a firm's intangible assets is costly, and not worth it if an investor owns only a small amount. She'll instead base her trading decisions on short-term profits, because they're freely available. Large shareholders – blockholders – do have incentives to gather intangible information. Doing so not only deters earnings inflation, but also encourages long-term investment. If earnings are low, “the market sells first and asks questions later” as the saying goes. Blockholders, due to their large stakes, have the incentive to ask questions first. If they find out that low earnings are due to investment, rather than mismanagement, they won't sell – and may even buy more. Blockholders thus shield firms from the vagaries of uninformed investors.

Shareholders who rarely sell are praised as “loyal” and providing “patient capital” – loaded language as loyalty and patience are seen as unambiguous virtues. But *unconditional* loyalty – staying with a firm, regardless of whether it is destroying long-run value – is poor stewardship as it simply entrenches management. Indeed, Volkswagen's patient shareholders were happy to sit tight and do nothing while it was cheating emissions tests. The praise of patience is surprising since it's generally accepted that customers and employees should walk away from an irresponsible firm, even if it's offering low prices and high wages. Investors should do the same if executives are unresponsive to engagement.

Instead, the best form of loyalty is *conditional* loyalty: staying with a firm, even if short-term earnings are low, but only if the firm is pursuing long-run value. It's the combination of loyalty if the firm continuously innovates for the long-term, plus the threat of selling if it coasts or pursues the short-term, that will help build the great companies of the future.