Multi-tasking, Incentives & Short-termism

Extra Note

The modern theory of short-termism builds on two fundamental assumptions. The first is that the top management teams (TMT) in modern corporations face multiple tasks. A task is to maintain high stock prices in highly competitive markets. High stock prices require strong cash flows. Another task facing TMTs is investment in the firm, particularly investment in research and development, so that the firm continue to grow, maintain its long-term market position, and successfully deal with future technological disruptions. In theory, TMTs can divide their time to both tasks. In practice, several factors are likely to divert TMTs' attention more towards asset management / revenue creation. Attention to revenue creation can yield measurable results in short run. Or, in other words, attention to revenue creation can boost stock prices in the short run. In contrast, investment in research and development is a long-term exercise, risky, and most often fail to produce short-term measurable results. Research and development projects may begin to yield results only when the TMT have left the firm. Market pressure is unlikely to offer incentives for investment in long term projects.

Common compensation schemes link the fortune of the top management team to observable measures of firm performance including stock prices, revenue or profits. Such a link can further divert attention / resources from investment in long term projects / R&D investment and exacerbate short-termism. To put it explicitly, modern incentive schemes are designed to align TMT's interests with those of corporate shareholders. Such alignment can direct attention towards revenue creation, give rise to lower R&D investment, and lead to failure in the long run. A combination of multi-tasking challenges and high powered incentives underpins modern thinking on corporate short termism, where high-powered incentives refer to incentives linked to observable measures of performance.

The literature proposes several approaches to deal with short termism. An approach is to hire TMTs who are intrinsically interested in firm growth, research and product development. Such managers are less likely to be influenced entirely by financial incentives, and will devote resources to long term projects. Another approach is to redesign common incentive schemes by including elements that link the TMT's fortune with the long term firm performance – such long term future growth. Firms, for example, increasingly reward TMTs with stocks and performance-based restricted stocks. Stocks turn TMTs into owners, linking their wealth to the firm performance in the short term. Performance-based restricted stocks tie TMTs' wealth to the long term firm performance. A package of both stock and restricted stocks has the power to generate powerful incentives while minimising short-termism.