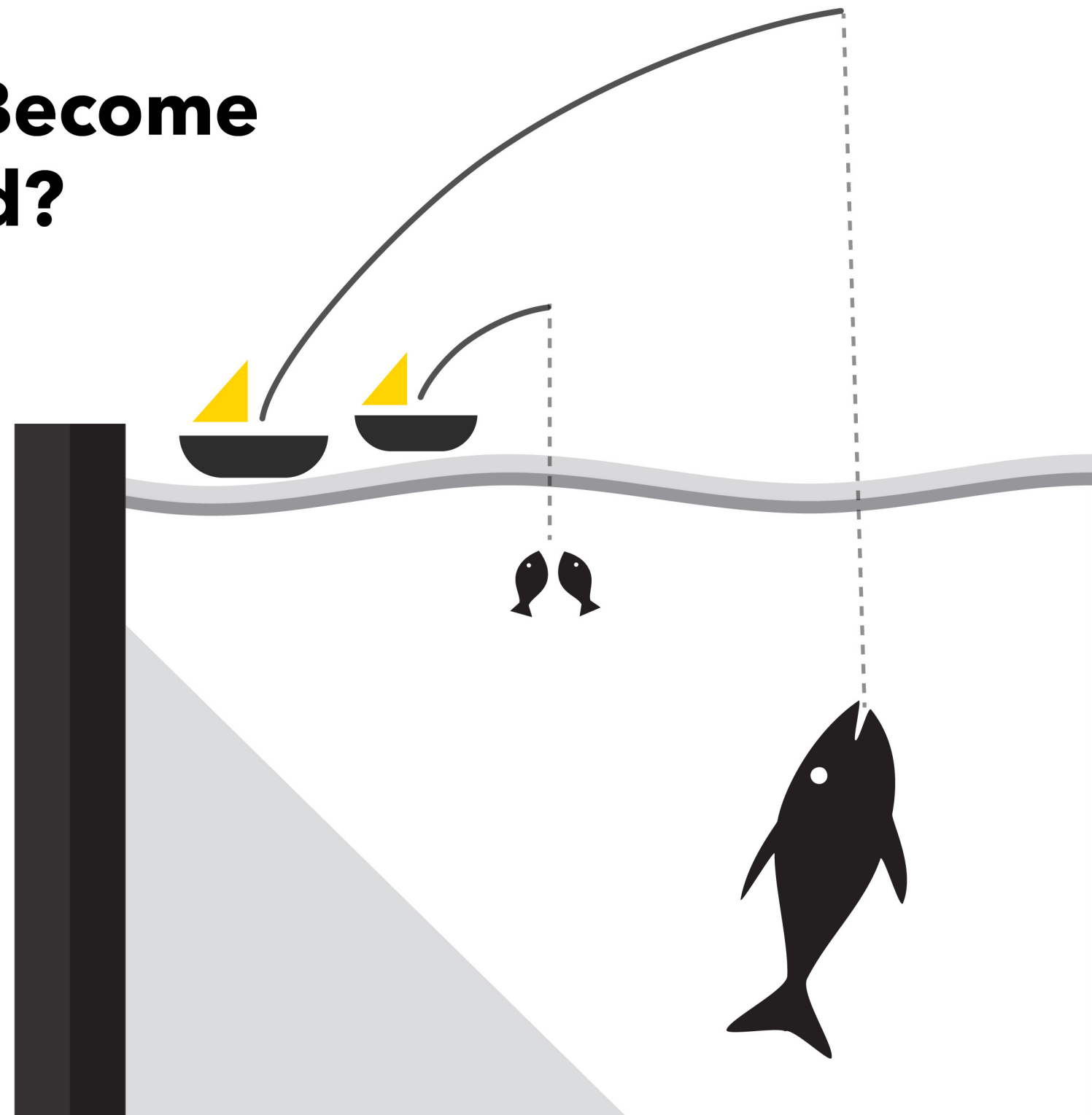


The Short-Termism Challenge:

How Can Organizations Become More Long-Term Oriented?

Jaimie Holland, Lauren Hwang, Dilip Soman and Kim Ly

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Correspondence

For questions and enquiries, please contact:

Dilip Soman / Melanie Kim
Rotman School of Management
University of Toronto
105 St. George Street
Toronto, ON M5S 3E6

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Email: dilip.soman@rotman.utoronto.ca or melanie.kim@rotman.utoronto.ca
Phone Number: (416) 978-6980
Twitter: @UofT_BEAR @dilipsoman
Website: www.rotman.utoronto.ca/bear



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People Are Myopic...Are Companies Too?

**People are myopic
- they plan for the
future well, but act
impulsively in the
present.**

**Are companies
myopic too?**

The Marshmallow Test: Mastering Self-Control

The marshmallow test is often used to illustrate the notions of temptation and willpower. The premise of the test is simple: you can eat one marshmallow now or, if you can wait, you can eat two marshmallows later.* Dr. Walter Mischel ran this self-control experiment in the early 1960s with preschoolers. The experiment set up an intense inner conflict in children between their desire for instant gratification and their desire for a delayed, but greater marshmallow reward. He found startling results. Dr. Mischel notes that the preschoolers who were able to wait for two marshmallows, over the course of their lives, "were already wired to conquer stress in pursuit of goals and were more able to sustain effort and deal with frustration."*

In essence, each preschooler's inner 'planner' intends to delay gratification for a larger, later reward. But the preschooler's inner 'doer' - the one responsible for executing on those plans - is impulsive and short-sighted, and must resist the temptation of eating the marshmallow placed in front of them. This intention-action gap, is a common occurrence people encounter throughout their lives.

The planner part of us has every intention of sticking to long-term goals and commitments. But when it comes time to taking the required action, the 'doer' self needs to manage various challenges such as visceral factors like stress and anxiety, staying motivated when encountering setbacks, and potentially getting waylaid by competing priorities.

To remain committed to long-term goals, one must find ways to close the intention-action gap. Just like preschoolers who successfully passed the marshmallow test, individuals need to develop strategies for themselves to resist short-term temptations and maintain their commitment and motivation to reaching their long-term goals.

Would Companies Also Choose One Marshmallow Today?

If individuals are prone to being myopic, could companies act myopic as well? Could the myopic behaviour of several individuals within a company escalate to an entire corporation exhibiting short-term myopia? And if so, what strategies could corporations develop to help them stay committed to their long-term goals? Alternately, is the behaviour of an organization a completely separate entity with behavioural traits that are independent of its members and leaders? This playbook is an exploration of these questions.

* Source: Mischel, W., & Ebbsen E. B. (1970) and Mischel, W., Shoda, Y., & Rodriguez, M. L. (1989).
Source: Thaler, R. (1981).
Source: Barton, D. (2011, March).

Methodology

Methodology



Research for this report was conducted over an 8 month period in 2018-2019. The following methods were used:

1. Synthesis and Summaries - of opinion pieces by the Brookings Institute, McKinsey Global Institute, Center for International Development at Harvard University, American Enterprise Institute, Aspen Institute, Economic Policy Institute, FCLT Global and Harvard Business Review.
2. Literature Reviews - of journal articles from various journals, including the Strategic Management Journal, Accounting Review and Management Science.
3. Expert Interviews - Interviewees included:

Roger Martin (Premier's Research Chair in Productivity and Competitiveness and Academic Director, Martin Prosperity Institute)

Karl Martin (VP Operations, Integrate.ai)

Anita McGahan (Associate Dean of Research, Professor and Rotman Chair in Management, Rotman School of Management, University of Toronto)

Richard Powers (National Academic Director, Directors Education Program and Governance Essentials Program and Associate Professor at the Rotman School of Management)

Jennifer Riel (Adjunct Professor, Faculty-at-large Managing Director, Knowledge Infrastructure Project, Rotman School of Management, University of Toronto).

Corporate Time Horizons

Short-termism is common and potentially problematic

The idea that companies face enormous pressures to deliver short-term results at the expense of long-term health has been around for a long time and is pervasive among executives and board members. McKinsey and FCLTGlobal have made the case for companies to be more long-term. Numerous articles have been published by the Harvard Business Review debating the topic. Scholars at the Brookings Institute, American Enterprise Institute and Aspen Institute have published warnings against short-termism in addition to executives such as Larry Fink from BlackRock and politicians such as Hillary Clinton and Joe Biden.

More recently, McKinsey published empirical findings linking long-term management to superior financial performance.

A McKinsey Quarterly survey of more than 1,000 C-suite executives and board members of 615 large and mid-cap US publicly listed companies from 2001-2015 found that **long-term companies with the highest Corporate Horizon Index (CHI) significantly outperformed other companies** on a range of key economic and financial metrics.*

How much money are short-term companies leaving on the table?

Corporate Horizon Index Methodology

Index	Hypothesis	Measurement Approach
1. Investment	Long-term firms will invest more and more consistently than short-term firms	Ratio of capital expenditures to depreciation
2. Earnings Quality	Long-term firms will generate earnings that reflect cash flow, not accounting decisions	Accruals as a share of revenue
3. Margin Growth	Short-term firms are more likely to grow margins unsustainably in order to hit near-term targets	Difference between earnings growth and revenue growth
4. Quarterly Management	Short-term firms will do whatever they can to hit short-term targets, whereas long-term firms are willing to miss them if needed	Incidence of beating EPS targets by less than 2 cents and incidence of missing EPS targets by less than 2 cents
5. Earnings-per-Share Growth	Long-term firms are less likely to over-index on EPS rather than true earnings and act to boost EPS (e.g. with buy-backs)	Difference between EPS growth and true earnings growth

* Adapted from Barton, D., Manyika, J., Koller, T., Palter, R., Zoffer, J., & Godsall, J. (2017, February).

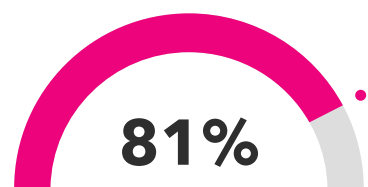


Corporate Time Horizons

Long-term companies seem to outperform short-term companies

Long-term companies have been shown to be more profitable, deliver more consistent and higher revenue growth, and produce higher earnings, even during the financial crisis, compared to short-term companies.

By being short-term, companies are therefore leaving money on the table and are less resilient over time.



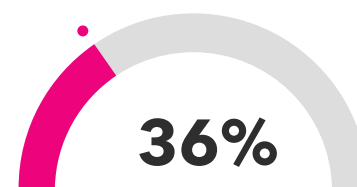
Economic Profits

Economic profits of long-term firms grew **81% more**



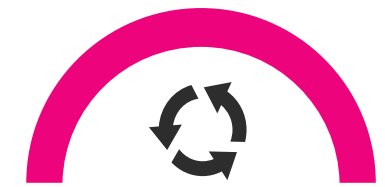
Market Capitalization

Long-term firms added **\$7 billion more** in market capitalization and delivered greater total returns to shareholders



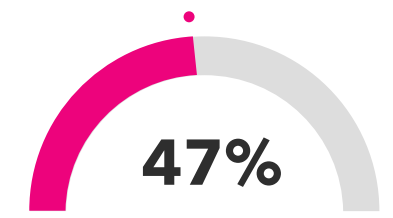
Earnings

Earnings of long-term firms cumulatively grew **36% more**



Recovery

Revenue decline of long-term firms was lower during the financial crisis and grew more rapidly after the crisis, along with their share prices.



Revenue

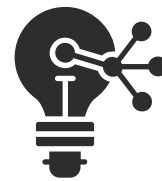
Revenue of long-term firms cumulatively grew **47% more** and was less volatile

Corporate Time Horizons

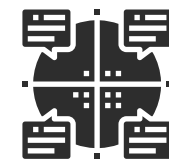
Long-term companies demonstrate **different behaviours** from short-term companies



Long-term firms hired more people, on average **12,000 more**.*



Long-term firms spent **50% more** on R&D.*



1. Long-term firms do not issue earnings guidance altogether**; or
2. Restructure quarterly earnings calls to remind investors of the company's long-term strategy and goals before diving into the short-term results***

* Source; Barton, D., Manyika, J., Koller, T., Palter, R., Zoffer, J., & Godsall, J. (2017, February).

**Source: Barton, D., Bailey, J., & Zoffer, J. (n.d.).

***Source: Linciano, N., Lucarelli, C., Gentile, M., & Soccorso, P. (2018).



Corporate Short-Termism is on the Rise

Despite long-term firms demonstrate stronger profitability and performance, companies continue to exhibit short-term behaviours.

01 "Short" is getting shorter

87% (up from 79% in 2013) of executives feel most pressured to demonstrate strong financial performance within 2 years or less.

Executives who felt that pressure over 7 years fell to zero from 2013-2016 while there was a simultaneous increase in those who felt that pressure over a period < 6 months from 26% in 2013 to 29% in 2016.

02 Short-term pressure is increasing

65% of executives in North America say short-term pressure has increased over the past 5 years.

Across geographies, executives from companies with headquarters in developing markets were significantly more likely to report increasing short-term pressure (82%).

03 Short-term vs. Long-term strategic decisions viewed as trade-offs

55% of executives at companies without a strong long-term culture indicate their company would delay a new project to hit quarterly earnings targets even if it sacrificed some value.

Trend of 'financialization' has incentivized companies to engineer their balance sheets and their bottom lines (corporate short-termism) to the detriment of real job creation, business investment, and long-term growth.

04 Executives report strategic planning horizons are too short

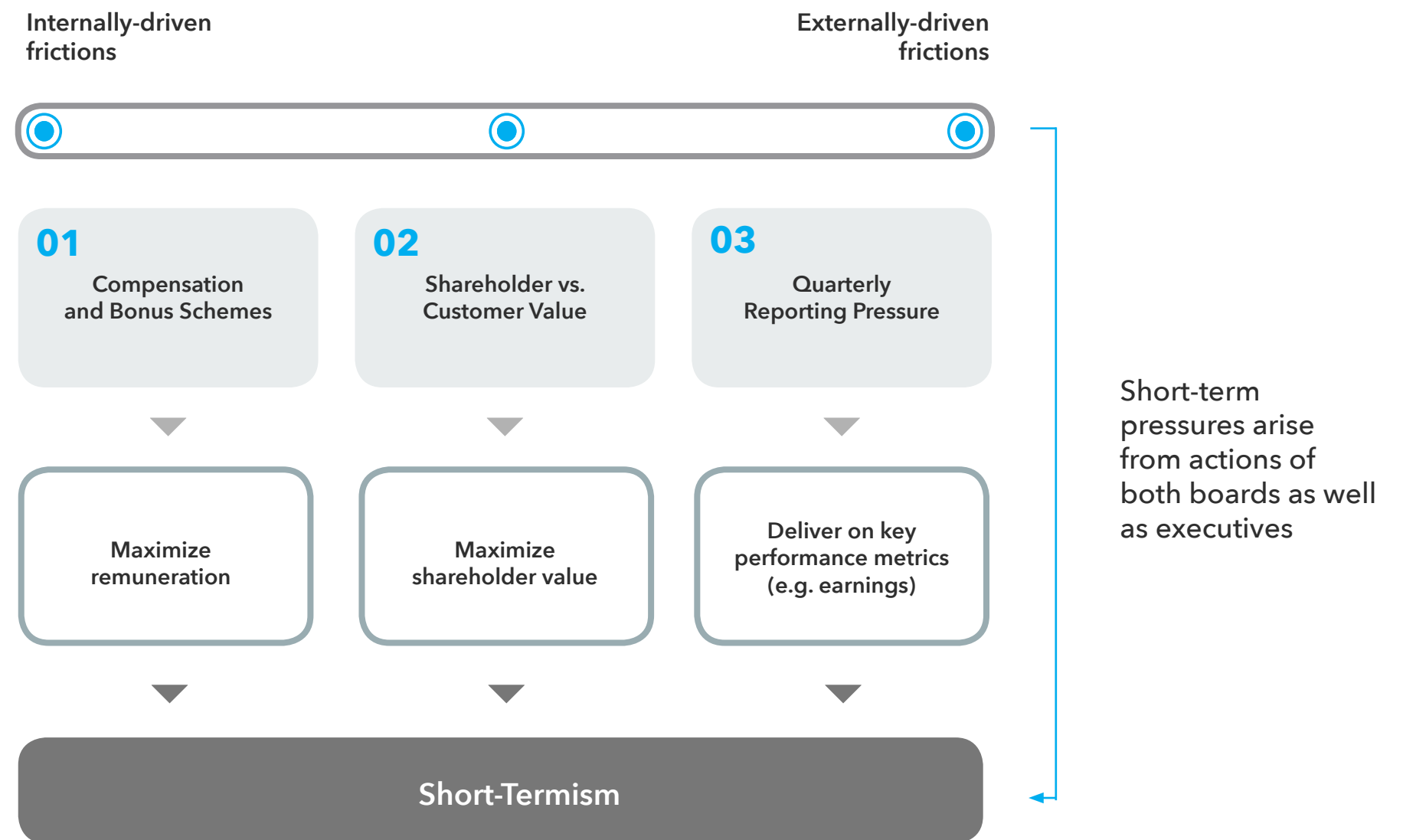
60% of executives say their management teams should use a time horizon of at least 3 years for formal strategic planning, but only 52% report using this timeline already.

Of executives who currently use time horizons of 2 years or less (44%), only 37% believe this is ideal.

Frictions to Long-Termism

Frictions to Long-Termism

Given the increasing trend in short-termism, there are three core frictions to long-term orientation that companies must work against. These frictions are placed along a spectrum of internally-driven pressures (from within the company itself) to externally-driven pressures (from the market):



01

Compensation and Bonus Schemes are Linked to Short-Term Outcomes

Executive compensation levels, particularly in Western economies, have been rising at a significant rate over recent years relative to the performance of their companies.

The Economic Policy Institute states that US executive compensation rose over 900% between 1978 and 2013.*

The risks of falling prey to short-term pressures is especially present when executive compensation is based primarily on "objective" accounting measures of performance. The saliency of these short-term measures encourage a myopic perspective as it allows executives to more "easily" manage and measure them.

Internally-driven frictions

Externally-driven frictions



*"Most pay packages contain a high amount of equity compensation (i.e. options or stock) and so CEOs (who's average tenure has historically averaged less than 10 years) look to maximize that value on their exit. **This volatility in leadership promotes more short-termism.**"*

- Richard Powers

* Source: Pepper, A. (2017).

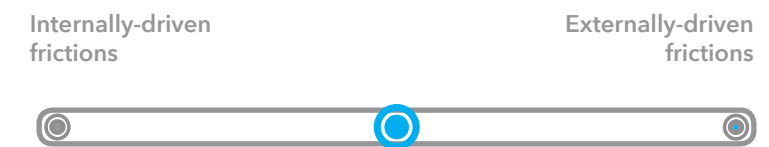


02

Shareholder Value is Valued More than Customer Value

There are conflicting interests between a company's Board of Directors and its executives, such that the former is responsible for representing the shareholder (market-led orientation), whereas the latter owns the responsibility of leading a long-term oriented organization (customer-led orientation).

When making the distinction between the two, **companies often adopt a 'market-led orientation'**.



*"The behaviours regarding the short-term appreciation of capital are not always in line with the long-term interest of the company's other stakeholders (that is, its customers and employees). Notionally, they should line up, but **it comes down to who you are prioritizing.**"*

- Jennifer Riel



02

Shareholder Value is Valued More than Customer Value

The Board of Directors' perspective

Board members are still seen to play a large role in their company's short-run decisions, in part due to the increased pressure of more vocal activist (short-term) investors. In fact, 25% of a company's shareholders are short-term investors who can create a lot of movement in the short-term.** Given that the board is responsible for representing the company's shareholders, in this way, they are pushing back against long-termism through an overreliance on short-term measures of earnings per share.

When asked to react to hypothetical trade-offs between short-term earnings and long-term value creation, nearly 40% of participating companies would make the short-term-oriented decision, despite undermining long-term value.*

The CEO's perspective

*"The best way to serve shareholders is to have a great company."
- Roger Martin*

...and it achieves this by making choices that are in the best long-term interests of all of its stakeholders, which includes its employees and customers, rather than through shareholder value maximization (SVM). Companies have a social license to operate, and this is a perspective commonly shared across executives.

In fact, 61% of executives at 'long-term companies' are more likely than others to take no action at all if their company were near the end of the quarter and it seemed they would miss their earnings targets.*

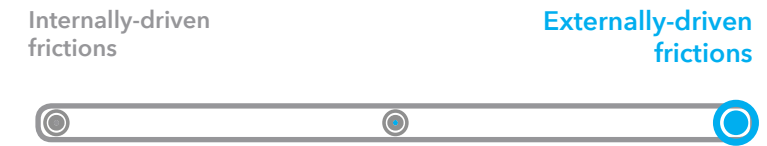
Key Takeaway

Elevating shareholder value maximization as the primary objective of the company is fundamentally misguided because it **creates a myopic focus on short-term earnings**, particularly quarterly earnings, that pushes management to neglect part of the organization, ultimately driving the decline in long-term investment.

* Source: Barton, D., Bailey, J., & Zoffer, J. (2016).

** Source: London, S., Useem, M., & Zempel, R. (2018, June).





03

Short-Term Losses Loom Larger than Long-Term Gains

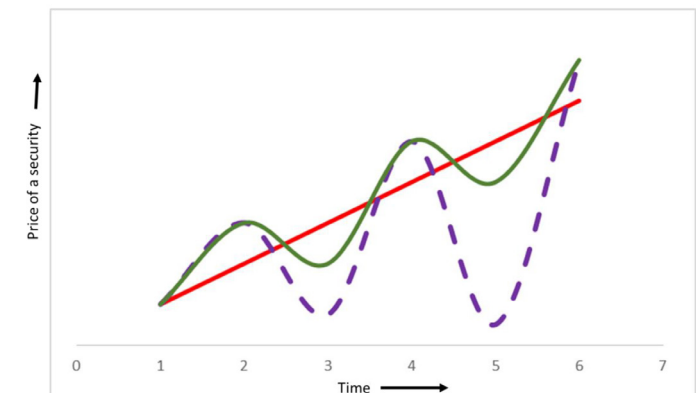
In a survey of 400 CFOs of large US public companies, almost 80% of them said that they would sacrifice economic value for the firm to meet their quarterly targets.*

There is a constant tension between the short-term and long-term objectives of the firm that has surfaced from the quarterly structure of the market. While serving as a reference point, if stakeholders know that they will fail to meet the quarterly target, they may exhibit more risk-seeking behaviour (being loss averse), compromising long-term performance for short-term gains. Ultimately, while companies may 'plan' and develop long-term investment strategies, the structure of quarterly reporting often drives myopic loss aversion, influencing their myopic "doers" to fall prey to short-termism. This phenomenon arises from the combination of two parts of prospect theory - mental accounting and loss aversion.**

Myopic loss aversion can best be illustrated through a simple example as illustrated in **Figure 1**. The **green** curve represents the price of a given security over time, while the **red** line represents the trend line that captures the same security over time. The latter is, in essence, the regression line that eliminates temporary "errors" - deviations from the trend.

In particular, the total area between the green curve and the red line is zero; or - there is as

Figure 1.



much area of deviation above the red line as there is below the red line.

However, one of the central tenets of prospect theory is the idea of loss aversion - the negative psychological impact of a unit loss is roughly twice as large as the positive psychological impact of a unit gain.*** As a result, the purple dotted curve in **Figure 1**, which outlines losses (negative deviations from the red line) with a greater weight, captures the effective (psychological) price of the same security. As is visually apparent, the area under the red line is now greater than the area above the red line.

* Source: Martin, R. (2015).

** Source: Gneezy, U., & Potters, J. (1997).

*** Source: Barberis, N. C. (2013).



Core Questions



Long-term companies seem to outperform short-term companies, however, short-termism is still on the rise...

01

How do you know if your company has a short-term problem?



02

How can your company leverage behavioural insights to become more long-term focused?



Goals of this Report

What Can I Get from this Report?

Do you want more clarity on what it means to be long-term vs. short-term focused?

▶ **Provides definitions of what it means to be short-term and long-term**

Are you interested in understanding if your organization might have a short-term problem?

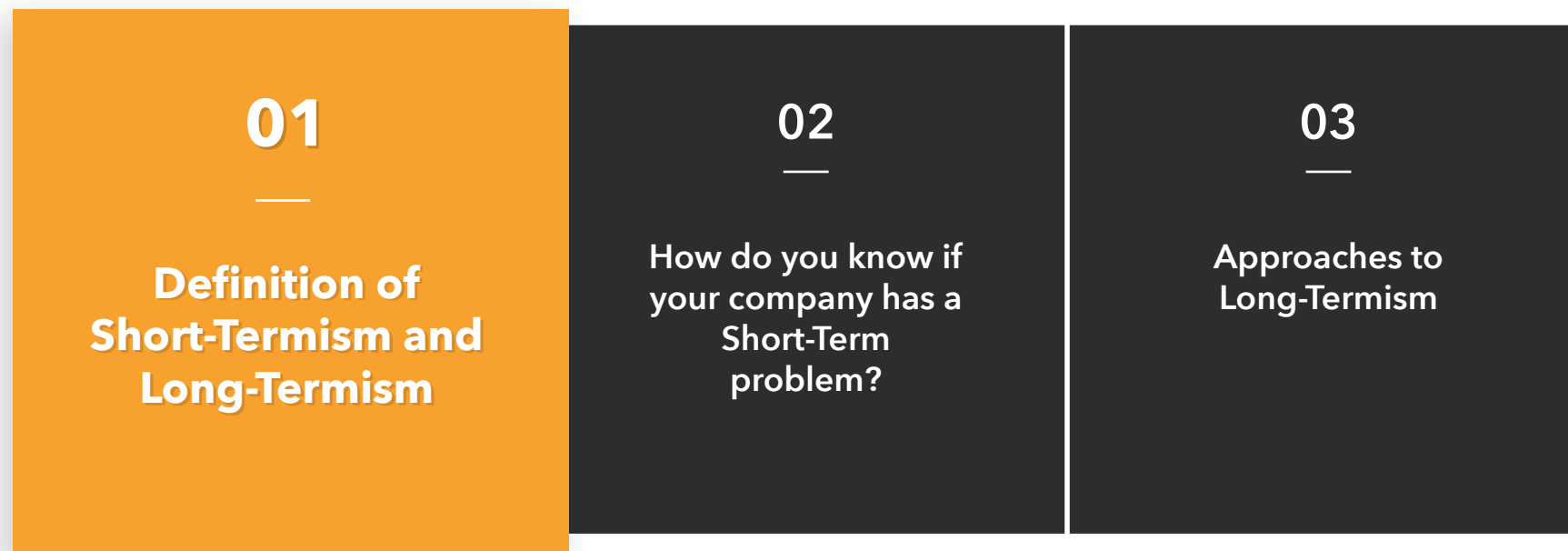
▶ **Highlights signs that your organization might have a short-term problem**

Are you wondering how to leverage behavioural insights to work against short-term frictions to be more long-term?

▶ **Suggests four approaches to be more long-term**

Are you curious about the beneficial impact being long-term may have for your organization?

▶ **Explores research findings on the performance and behavioural differences between long-term and short-term companies**



Pathways to Long-Termism

There are three core factors that may serve as stepping stones to drive a long-term orientation in companies.

Overall, companies should be aware of and leverage these factors to encourage long-term behaviour across stakeholders. These factors are explored in further detail in the following sections.

What is Short-Termism ?



Based on The Journal of Corporate Law, Institutional Investor, and work by the Brookings Institute and McKinsey, we define short-termism, also referred to as earnings management or managerial myopia, as an **excessive focus on short-term results at the expense of long-term interests and performance.**

More broadly, **short-termism encompasses the excessive focus of corporate executives, board members, managers, asset (portfolio) managers, investors and analysts on short-term results, whether it be quarterly earnings or short-term portfolio returns, and a rejection or avoidance of concern for long-term value creation and the fundamental value of firms.***

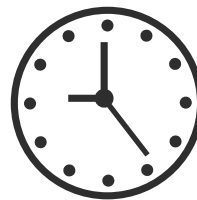
Short-termism is considered problematic due to its potential to undermine future economic growth resulting from a lack of long-term investment. A lack of long-term investment has the potential to lead to slowing GDP, higher unemployment levels, and lower future investment returns - implications that can hurt everyone.**

* Source: Long-Termism Versus Short-termism: Time for the Pendulum to Shift? (2016, June).

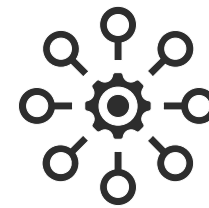
**Source: Dallas, L. L. (2012).

What is **Long-Termism** ?

We define long-termism based on 3 components



Time Horizon



Activities & Processes



Attitudes & Corporate Philosophy

Pathways to Long-Termism

Time Horizon

Long-Termism: Competing Time-Based Definitions

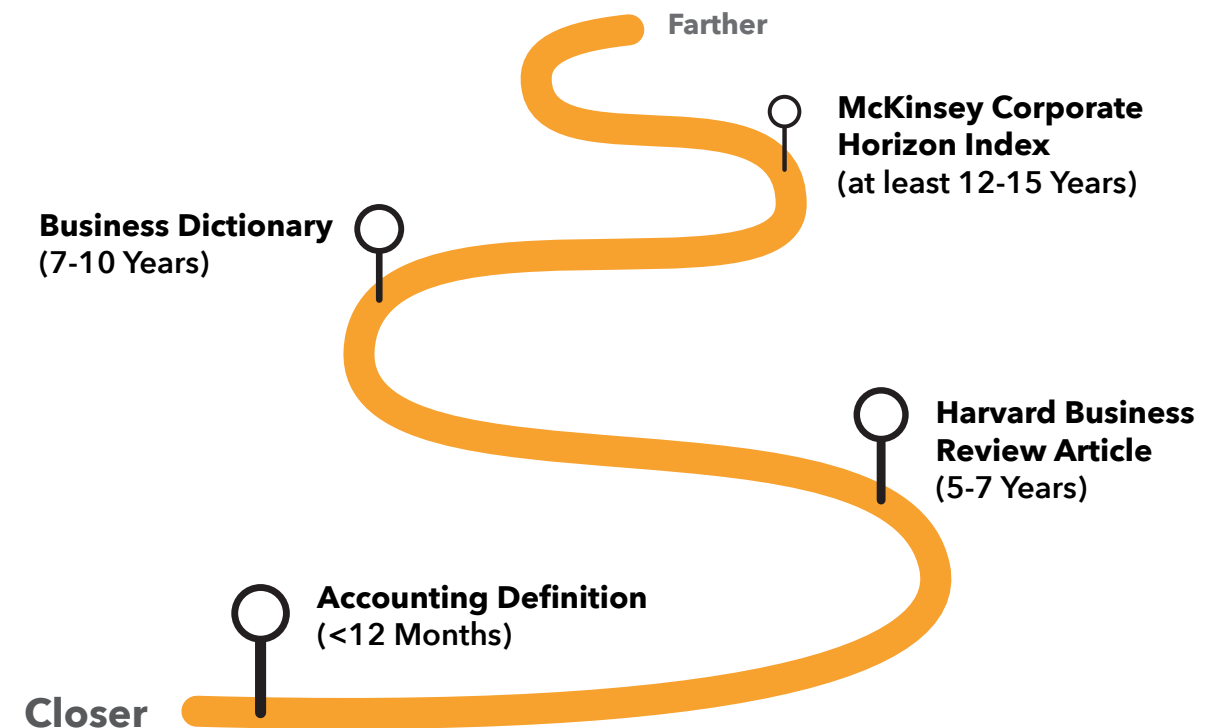
It is clear that there are multiple definitions for what it means to be long-term.

A Harvard Business Review article suggests that being long-term means at least a 5-7 year time horizon, as this is a rough estimate of the time required to invest in and build a profitable new business.

The Business Dictionary suggests that being long-term means a time frame for investing in which an asset is held for at least 7 to 10 years, and notes that the measure of a “long-term” time frame can vary depending on the asset held or the investment objective.

McKinsey defines firms that are long-term as those with Corporate Horizon Indexes (CHI) that are above the industry median for at least 12 years. Their CHI is based on 5 indicators: (1) the ratio of capital expenditures to depreciation, (2) accruals as a share of revenue, (3) the difference between earnings growth and revenue growth, (4) the incidence of beating EPS targets by less than 2 cents and of missing EPS targets by less than 2 cents, and (5) the difference between EPS growth and true earnings growth.**

Alternatively, in business accounting measures, long-term can be a period of time that exceeds 12 months.



* Source: Macpherson, C. (2018, July).

** Source: Barton, D. (2011, March).

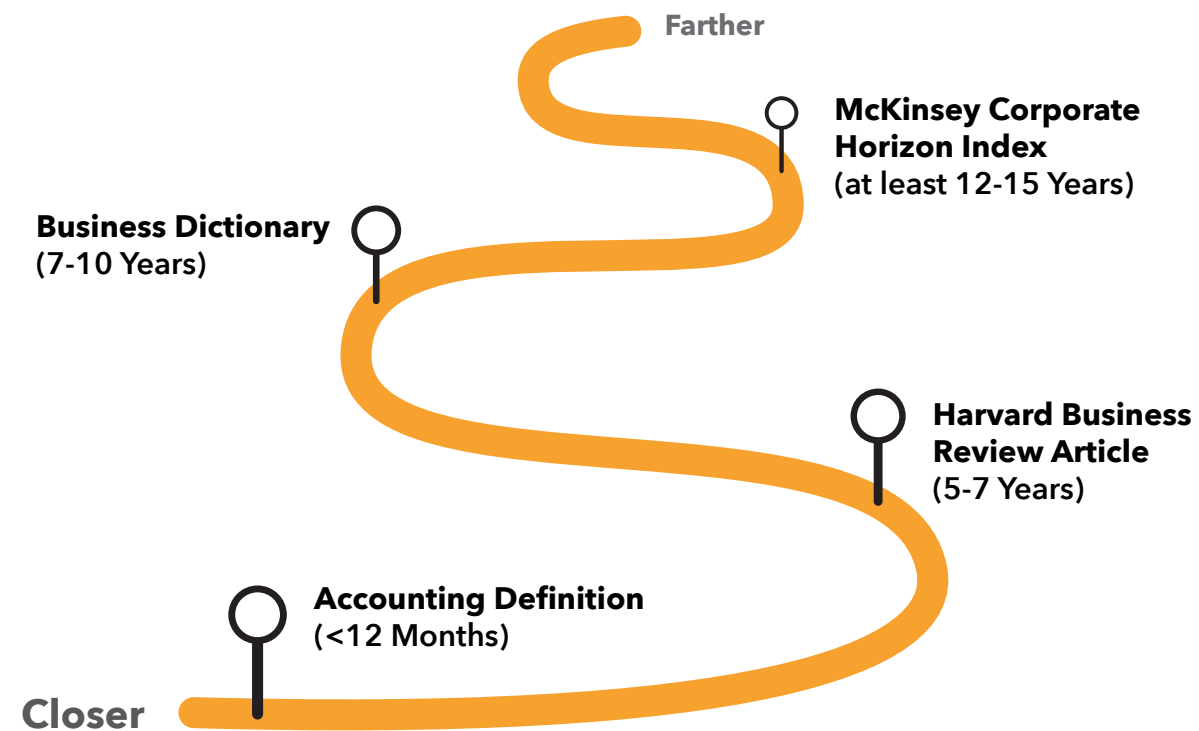
Source: Long-Term. (2019).

Source: Barton, D., Manyika, J., Koller, T., Palter, R., Zoffer, J., & Godsall, J. (2017, February).

Source: Balancing Act: Managing Risk across Multiple Time Horizons. (2018, December 21).

Pathways to Long-Termism

Time Horizon



Long-Termism: Time-Based Definitions (1/2)

Aside from the varying time horizons noted, there are striking global differences between the East and West in terms of the time frame leaders consider when making major decisions. Firms in Asia typically think in terms of at least 10-15 years, while in the US and Europe, nearsightedness is more pervasive and considered the norm.*

Altogether, the definition of long-term depends upon a number of factors, including but not limited to your investment horizon, cash flow requirements, and liabilities.

Being long-term is therefore more about attitude, not timeframes, and requires confidence grounded in clarity of purpose, clear research, and insightful analysis.**

Case Example

Apple iPod. The iPod, released in 2001, sold just 400,000 units in its first year. During this time, Apple's share price fell by roughly 25%. The board took the long view - a longer time horizon - and by late 2009 the company had sold 220 million iPods—and revolutionized the music business.*

* Source: Barton, D. (2011, March).
Source: Long-Term. (2019).
** Source: Macpherson, C. (2018, July).

Pathways to Long-Termism

Time Horizon

*"If you are truly building a strategy for the long-run, you need to **operate in the short-run in support of that long-term goal.**"*

*"Very few organizations have a productive way of navigating time horizons. In an ideal world, **short-run and long-run time horizons should be working simultaneously.**"*

- Jennifer Riel

Long-Termism: Time-Based Definitions (2/2)

In interviews, feedback we heard was that **leaders and organizations tend to treat short-term and long-term time horizons in decision making as a trade-off** because time is a relevant constraint.

However, should there really be a trade-off between being long-term or short-term?

In theory, **you can and should be able to do both.**

Pathways to Long-Termism

Activities & Processes



Long-Termism: Activities & Process-Based Definition

Long-term companies typically exhibit the following three behaviours:

01

Long-term companies continue to invest in difficult times

Long-term companies tend to invest more, and more consistently than short-term companies. They also continue to invest in difficult times.* This allows themselves to identify and maintain sustainable sources of growth - a key goal of long-term planning.

02

Long-term companies invest more in R&D expenditures

Long-term companies invest almost 50% more on average in R&D annually.*

R&D expenditures indicate the degree to which a company implements long-term planning for 2 reasons: it helps companies identify products or technology that could give a competitive edge in the future and indicates a commitment of resources that will bring them to life.*

03

Long-term companies focus on increasing corporate 'know-how'

Metaphor: Game of Scrabble**

"The average lifespan of an S&P 500 company is less than 18 years. That shows that you have to constantly regenerate yourself. There are many bad companies that have just a single product or a few products and don't re-engineer themselves; they don't look at the ecosystem and see how it's changing."
- Larry Fink, CEO of BlackRock

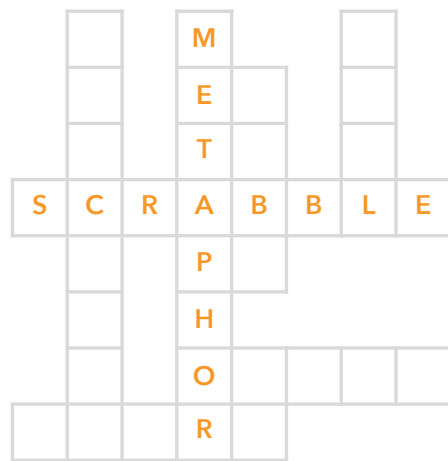
* Source: Barton, D., Manyika, J., Koller, T., Palter, R., Zoffer, J., & Godsall, J. (2017, February).

**Source: Hausmann, R., & Hidalgo, C. A. (2010).

Pathways to Long-Termism

Activities & Processes

What Does Increasing Corporate 'Know-how' Mean? (1/4)



Key idea: Capacity of a corporation increases with the addition of 'know-how', and this ultimately enables long-term corporate resiliency.

Ricardo Hausmann, Director of the Center for International Development and Professor of the Practice of Economic Development at the John F. Kennedy School of Government at Harvard University, created The Atlas of Economic Complexity with Cesar Hidalgo, Associate Professor at MIT and author of Why Information Grows, to explore global trade dynamics over time and help discover new growth opportunities for every country worldwide.* According to Hausmann and Hidalgo, "economic complexity is a measure of the knowledge ("know-how") in a society that gets translated into the products it makes. A country is considered 'complex' if it exports not only highly complex products, but also a large number of different products. The more complex a country's economy, the stronger its infrastructure and the more adaptable it is to market changes".

If we re-imagine Hausmann and Hidalgo's 2010 publication, Country Diversification, Product Ubiquity, and Economic Divergence, and the challenges of economic growth identified in Hausmann's 2015 publication, we can take the principles they espouse at a country-wide level and reimagine them at a corporate level to help companies be more resilient and thrive in the long-term through the following Scrabble metaphor.

Reimagining the Accumulation of Corporate 'Know-how' as The Game of Scrabble**:

In the game of Scrabble, you have to make words (reimagined as the products, goods, or services of a corporation) out of letters (the bits of 'know-how'). In order to make something (products, services or goods), corporations have to know how to string bits of know-how together.

If you only have 1 kind of letter (know-how), you are at most going to make one kind of word (product/good/service). If you have 4 kinds of letters, you can now make 9 words and up to 4 letter words; if given 10 letters, you can make 599 words. As you accumulate more letters (know-how), you, as a corporation, get an increasing number of words (i.e. a diversification of what you can do) and the ability to make longer words (i.e. create more complex products that are less easily replicated). Hausmann and Hidalgo suggest the process of corporate development and long-term planning can be re-described in this way.

Key Takeaway

More tangibly, short-term companies exhibit a tendency to cut investment in R&D when under pressure. However, in the long-term, investing in capabilities and firm 'know-how' through R&D spending should remain a priority.

* Source: Hausmann, R., & Hidalgo, C. A. (2010).

** Source: Atlas of Economic Complexity (n.d.).



Pathways to Long-Termism

Activities & Processes

What Does Increasing Corporate 'Know-how' Mean? (2/4)



Key idea: Capacity of a corporation increases with the addition of 'know-how', and this ultimately enables long-term corporate resiliency.

There is a relationship between how many letters you have, how rich you are, and how resilient you are in the long-term.

In 2015, Hausmann stated that, "in the economic growth process, countries in the developing world do not grow by making more of the same. In fact, more of the same is not the way rich countries grow either. In the process of economic growth, countries change what they do [and] evolve their comparative advantage. To analyze which industries are ripe for the next phase of growth in a country we look at how technologically close are those industries to the ones the country already has".* Hausmann uses the example of Germany: the most diversified country in the world. As the most diversified country in the world, Germany produces some of the least ubiquitous products, services and goods. This translates into Germany being able to do things that are more complex which results in a higher income per capita.

Therefore, the productive capabilities and know-how possessed by a country are strongly correlated with how rich the country is, and are predictive of future growth and of the complexity of a country's future exports.* Re-imagined at the corporate level, investing in capabilities and know-how will translate into less ubiquitous products, services or goods, future corporate growth and long-term profitability and resiliency.

How can the products or services you provide be less ubiquitous so you are more resilient in the long-term?

Hausmann and Hidalgo suggest that each of a company's products requires a potentially large number of non-tradable inputs, called 'capabilities', and a company can only make the products for which it has all the necessary capabilities.** Products differ in the number and specific nature of the capabilities they require, in the same way that companies differ in the number and nature of capabilities they have.

It therefore follows that products that require more capabilities will be accessible and producible by fewer companies (i.e. will be less ubiquitous), while companies that have more capabilities will be able to make more products (i.e. will be more diversified).**

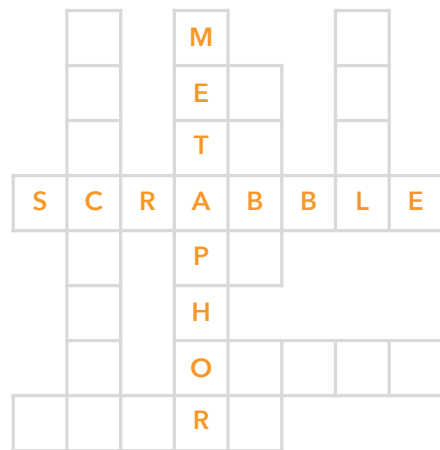
* Source: Hausmann, R., 2015.
** Source: Hausmann, R., & Hidalgo, C. A. (2010).
Source: World Economic Forum (March, 2013).



Pathways to Long-Termism

Activities & Processes

What Does Increasing Corporate 'Know-how' Mean? (3/4)



Key idea: Capacity of a corporation increases with the addition of 'know-how', and this ultimately enables long-term corporate resiliency.

If the diffusion of know-how underpins the capacity to know how to do more things, and more complicated things, does this mean the secret to progress is large companies?

Hausmann suggests it's not. His logic is simple: **the network of know-how to which you are connected also matters.**

Case Example

Boeing's Airbus 787. Boeing has over 150,000 workers that make less than 15% of the parts that go into making the airplane. The parts have to come from all over the place because Boeing has to source the know-how of making the parts in their whole network. Meaning, the know-how necessary to make one plane involves many people. Each worker and part contributes a different bit of know-how to make the whole plane. In essence, it's not what one person knows, it's the network of know-how to which Airbus is connected that allows the company to mobilize know-how and generate productivity.*

*Source: World Economic Forum (March, 2013).
Source: Hausmann, R., & Hidalgo, C. A. (2010).

Activities & Processes

What Does Increasing Corporate 'Know-how' Mean? (4/4)

Hausmann and Hidalgo's model implies, "the return on the accumulation of new capabilities increases exponentially with the number of capabilities already available in a company. Moreover, the convexity of the increase in diversification associated with the accumulation of a new capability increases when either the total number of capabilities that exist increases or the average complexity of products, defined as the number of capabilities products require, increases."*

* Source: Hausmann, R., & Hidalgo, C. A. (2010).

Difficulty

How do you coordinate the appearance of the letters with the demand of letters in an industry that needs them (chicken and egg problem)?

New activities always face a chicken and egg problem, according to Hausmann. For example, building a lawn mower in a country that has never created a lawn mower before. How do you source the bits of know-how and put them together to make lawn mowers? How do you know which bits of knowledge to source? How do you coordinate the need for a capability with the supply of the capability?

Re-imagining Hausmann's model suggests that companies should move from words that use certain letters to other words that use similar letters and add maybe a letter or two; companies should explore other products, services or goods that are nearby.

What does it mean to be nearby (i.e. for a product to be nearby another product)? Companies should start by mapping the product space, and identify products that are connected to others by the use of similar cognitive skills, materials or capabilities.* Key questions to consider include: how much can you use the letters from one word to produce another word? Where do you have a comparative advantage in something, and can export that know-how to produce another item (i.e. a longer word)? How do you build capacity as a company?

In Summary

As you become good at some things, you become good at many other things. The process of diversification is more about adding capabilities to capabilities (know-how) than adding value to raw materials.* Companies also need to be connected to networks that allow them to source and combine know-how and have channels to sell through to allow their efforts to be productive.* Using Hausmann's model, the challenge is to get more letters to allow you to create more words and longer words. This accumulation of know-how then allows companies to have a comparative advantage and produce things that are less ubiquitous to stand the test of time.

Pathways to Long-Termism

Attitudes & Corporate Philosophy

"It's a **competing mental model**: people tend to say I either need to do what's right for the quarter, or do what's right for the long-run, and they **consistently choose the short-run** because the incentives are more immediate and tied to the short-run, even if there is a notional long-term incentive."

- Jennifer Riel

"It's possible to be totally people- and customer-centric but still be short-term. **It is based on your mindset** - is your reason to be customer-centric so that you can sell a lot this quarter and turn an immediate profit, or is it about delighting your customer over the long-run and keeping them as a customer for life?"

Long-Termism: Corporate Philosophy-Based Definition

Performance always reflects leadership. Given this, what does leadership need to represent?

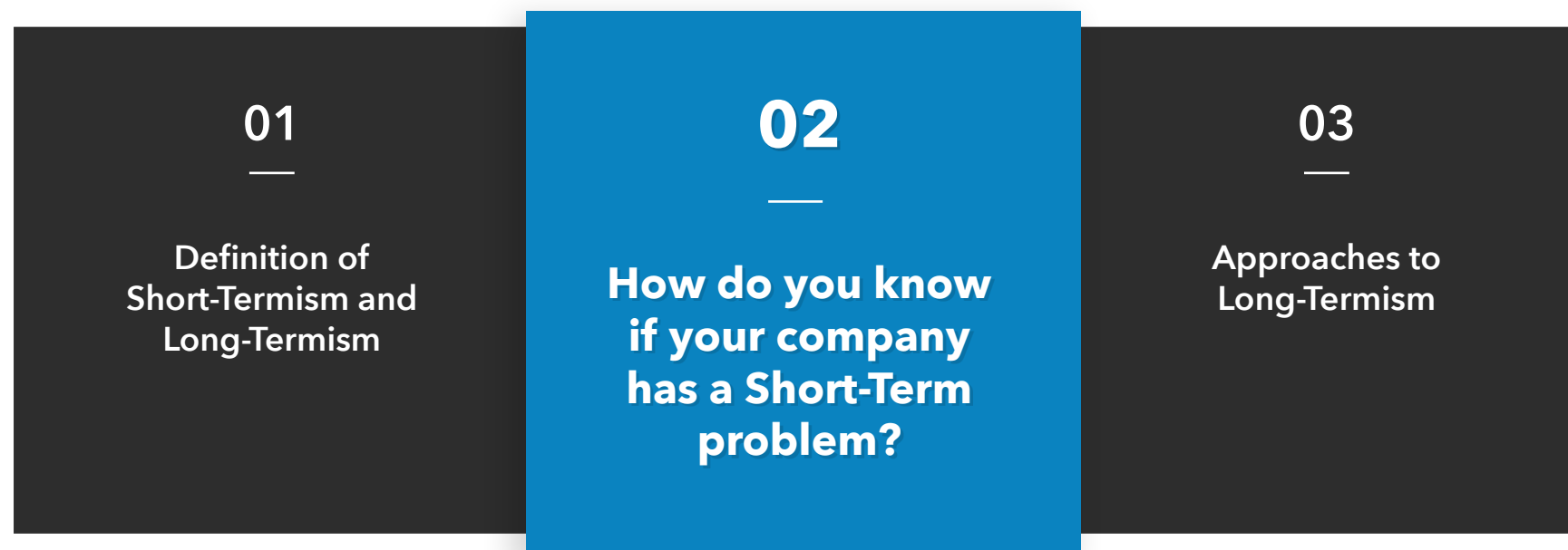
Other questions to consider include: is a company's risk management and governance appropriate? How does the company treat its employees, partners and suppliers? What about the societies in which it operates? Is it environmentally sound?

Culture is key, and an organization's culture is the one that its leaders create. To incentivize people to think, act and deliver like long-term investors, organizations need to bridge the gap between long-term investment performance goals and the relatively short-term nature of careers and annual compensation. It's incumbent upon leaders to ensure there is a long-term focus, not just a quarterly or annual focus. Leaders should be focused on building an organization that will outlast them, instead of meeting quarterly or annual capital markets performance goals.

Case Example

Estée Lauder's Philosophy. Long-term firms tend to embrace change and avoid complacency. Estée Lauder, for example, encourages its employees to 'imagine their own demise' knowing they will have a job with the company even if their own demise means their current role is obsolete.
- William P. Lauder, Executive Chairman of Estée Lauder Company

Pathways to Long-Termism



Pathways to Long-Termism

There are three core factors that may serve as stepping stones to drive a long-term orientation in companies.

Overall, companies should be aware of and leverage these factors to encourage long-term behaviour across stakeholders. These factors are explored in further detail in the following sections.

How Do you Know if Your Company has a Short-Term Problem?

99% of earnings for the S&P 500 are spent on dividends and on buybacks.*

More buybacks can be a sign of companies not having the confidence to invest in the long-term and instead handing the cash right back to their shareholders now.**

Investment Rates	Short-term firms invest less and less consistently.
Quality of Earnings	Short-term firms rely more on accruals and accounting methods to boost reported earnings.
Cost Reduction	Short-term firms rely more on cost reduction to increase profits, and are less likely to have consecutive years of increasing profit margins.
Earnings Management	Short-term firms are more likely to manage quarterly earnings to meet analysts' consensus estimates.
Financial Engineering	Short-term firms are more likely to use share repurchases and other non-operating methods to increase EPS.
High Fluctuation of Top Management	Short-term firms are more likely to decide to save on training budgets, new technology and human capital costs to meet goals like annual profits.

* Adapted from Barton, D., Bailey, J., & Zoffer, J. (n.d.).

** Source: Zempel, R., Useem, M., & London, S. (2018).



Pathways to Long-Termism

There are three core factors that may serve as stepping stones to drive a long-term orientation in companies.

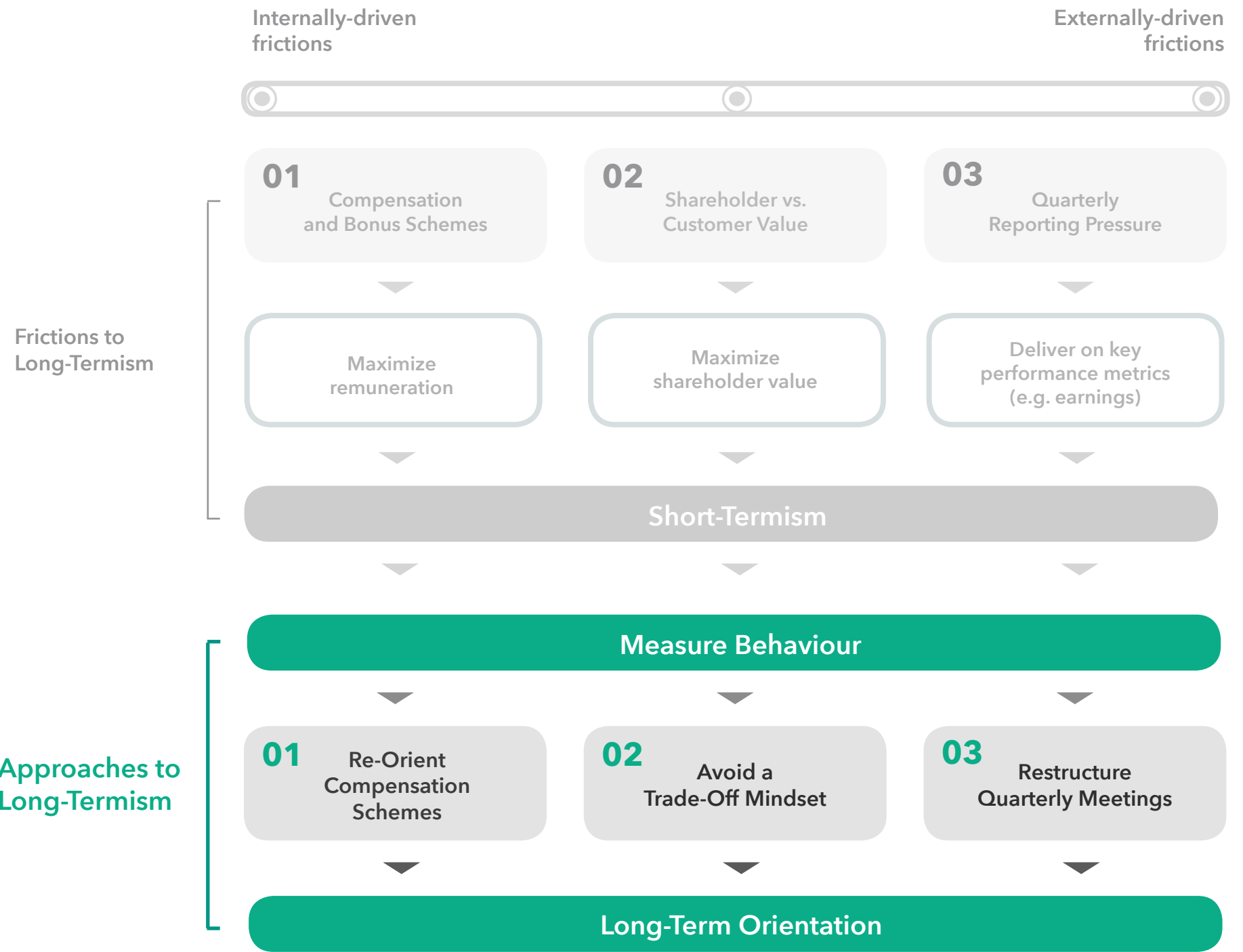
Overall, companies should be aware of and leverage these factors to encourage long-term behaviour across stakeholders. These factors are explored in further detail in the following sections.

Pathways to Long-Termism

Approaches

Approaches to Long-Termism

After understanding and determining if your company suffers from short-termism, there are three core approaches to address the frictions to long-termism, outlined as follows:



Pathways to Long-Termism

Approaches

Goals of the Dashboard

...Enable the tracking of time allocation across board meetings, types of industries, time of the year etc.

...Allow Boards to get a sense of their current time allocation to base decisions around whether they need to spend more or less time on certain types of tasks.

...Allow Researchers to design testable interventions that could encourage long-termism.

...Help the business community to better understand the behavioural foundations of short-termism; in particular, is decision-making short-term because Boards are not aware of their time allocation, or is it despite being aware?

Measure Behaviour (1/2)

Board of Directors often fail to allocate a sufficient amount of time on issues relevant to the future prosperity and direction of the business.*

Therefore, companies should develop a dashboard, or a measure, of the amount of time and resources across short- vs. long-term oriented activities, to ultimately drive the adoption of long-term behaviours.



* Source: The Board Perspective: A collection of McKinsey insights focusing on boards of directors (August, 2016).

Pathways to Long-Termism

Approaches

Measure Behaviour (2/2)

The dashboard should report how much time is spent on tasks or activities that fall across the following key dimensions:

01. Corporate control vs. shaping activities

Tasks classified under the corporate control category include fiduciary duties, whereas shaping activities refer to tasks related to corporate strategy, reviewing investment proposals, marketing

and competitive landscape reviews etc.

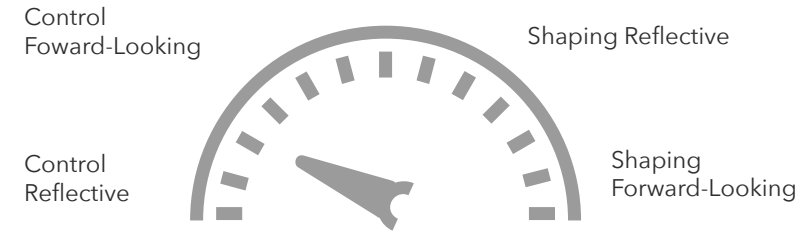
02. Reflective or forward-looking

This categorization is designed to help Boards understand whether they are spending time reflecting or evaluating the business' past performance in certain activities or whether they are looking towards the future and making decisions that create long-term impact.

Sample Dashboard

The dashboard should contrast the list of planned activities for the year with those that were actually completed, along with the amount of time spent on each. Ultimately, this serves as an indicator to Boards where the majority of the time has been spent.

Intended Allocation



Actual Allocation



Perceived Allocation



Example: All dials are low. This is a case where boards need to be convinced of the merits of engaging in forward-looking tasks and initiatives. In contrast, if intended were high and actual were low, a choice-architecture intervention might help to restore the balance in board meetings.



Pathways to Long-Termism

Approaches

01

Reorient Compensation Schemes (1/2)

The typical response to shifting towards more long-term orientation is aligned with the standard economic assumption that effort increases monotonically with pay.* Overall, this has led companies to develop long-term incentive plans (LTIPs) by employing longer time periods for measuring corporate and managerial performance and paying incentive-based awards.

Long-Term Incentive Plans have two primary objectives*



Align the interests of executives and shareholders to minimize both the associated agency risks



Recruit, retain and motivate executives to ultimately maximize their effort and achieve high performance

* Adapted from: Crossman, A., Gore, J., and Pepper, A. (2011).

Pathways to Long-Termism

Approaches



01

Reorient Compensation Schemes (2/2)

It is important to note that some concerns regarding LTIPs have risen the question as to whether these compensation schemes are the most effective and efficient means to achieving long-term behaviours by CEOs and their company.* Therefore, when developing LTIPs, companies should consider the following factors:

Executives are risk averse

Context:

Executives are significantly affected by risk aversion. Moreover, complexity increases perceived risk. Therefore, typically complex LTIPs discourage executives from desired long-term behaviours and may even lead them to demand a premium for riskier forms of compensation.

Things to consider:

Implement simple yet challenging performance metrics.

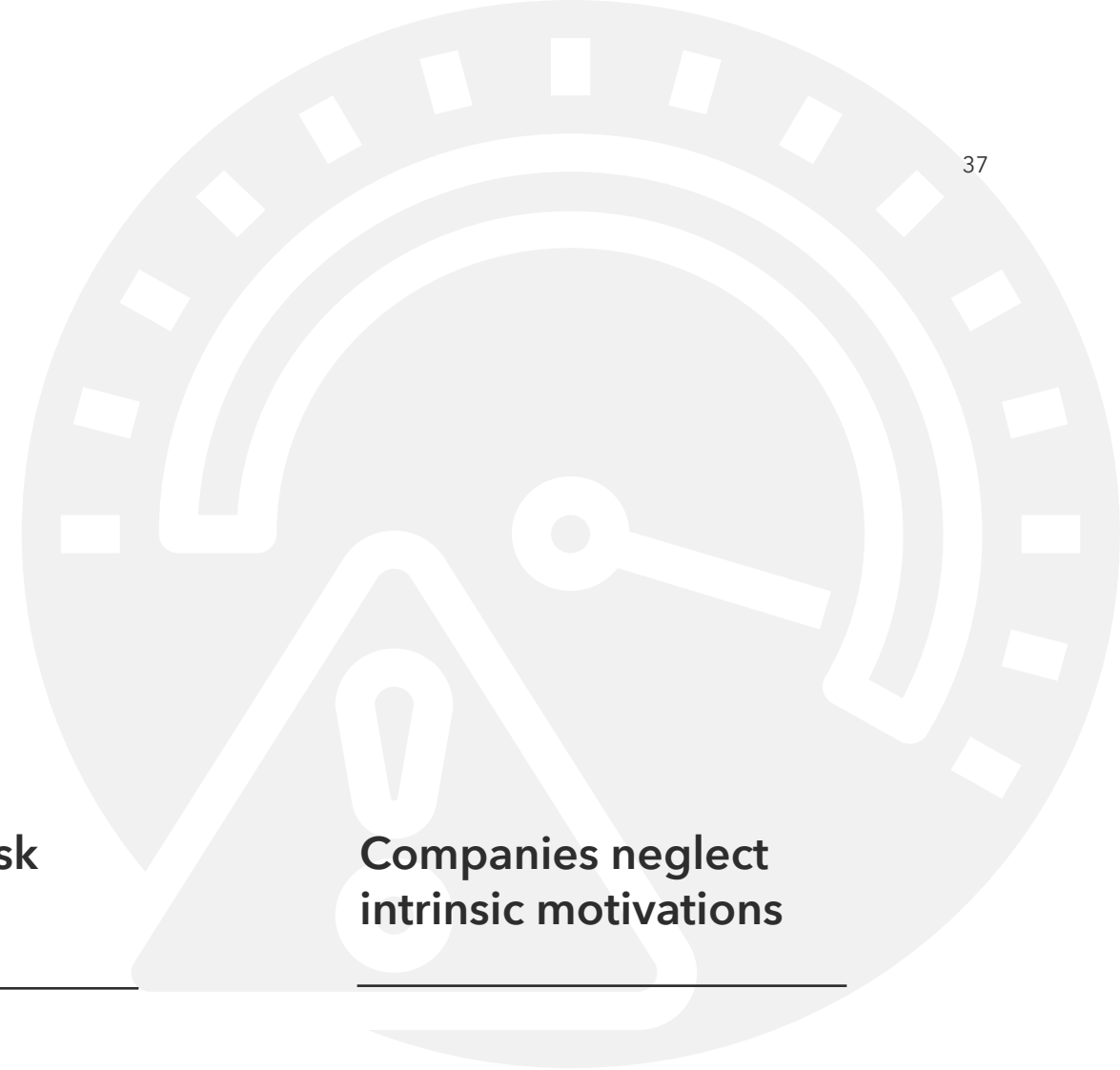
Companies neglect intrinsic motivations

Context:

Companies often focus on aligning the interests of executives and shareholders, while neglecting to retain and motivate executives. This leads to a myopic focus on the interests of shareholders and extrinsic rewards crowding out intrinsic motivation.

Things to consider:

Be mindful of the fact that intrinsic and extrinsic motivations are independent.



* Adapted from: Pepper, A. (2016).

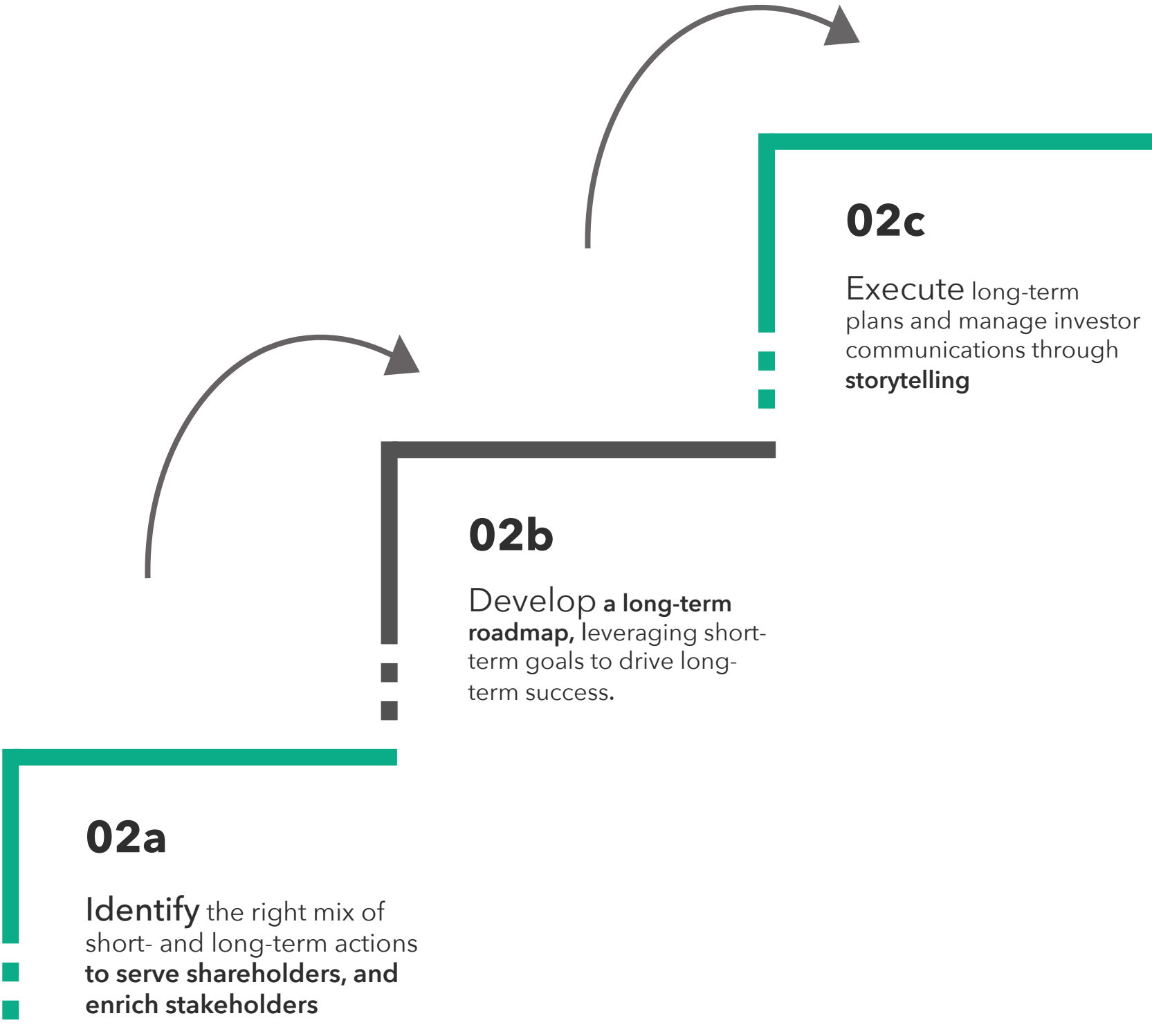
Pathways to Long-Termism

Approaches

02 Avoid a Trade-Off Mindset

"Most organizations operate as if they are opposing ideas that need to be traded-off because time is a relevant constraint."
- Jennifer Riel

In theory, companies can and should be able to balance both short-term and long-term goals; CEOs must avoid a trade-off mindset and seek to deliver on immediate goals in a way that also builds towards a sustainable future.



Pathways to Long-Termism

Approaches

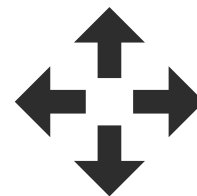
02a

Serve Stakeholders, Enrich Shareholders

Current Context - Unfortunately, the relatively recent obsession with capital markets and stock prices have led companies to define long-termism in these terms. If value creation is maximized by combining the resources of both employees and shareholders, why does value distribution favor the latter?

What needs to happen?

“There is an ethical aspect to long-termism - companies should exist to create great jobs and sell great products, and it is important to keep in mind that the stock price is not a key feature of either of those two things.” - Jennifer Riel



Shift Away From The Standard Agency Model

Hold the health of the enterprise at the core, rather than the short-term targets of shareholders



Serve All Stakeholders

This practice is essential to maximizing corporate value



Maximize ROI

ROI was in fact 8 times greater after 10 years for firms that recognize that no company can survive without a full complement of stakeholders

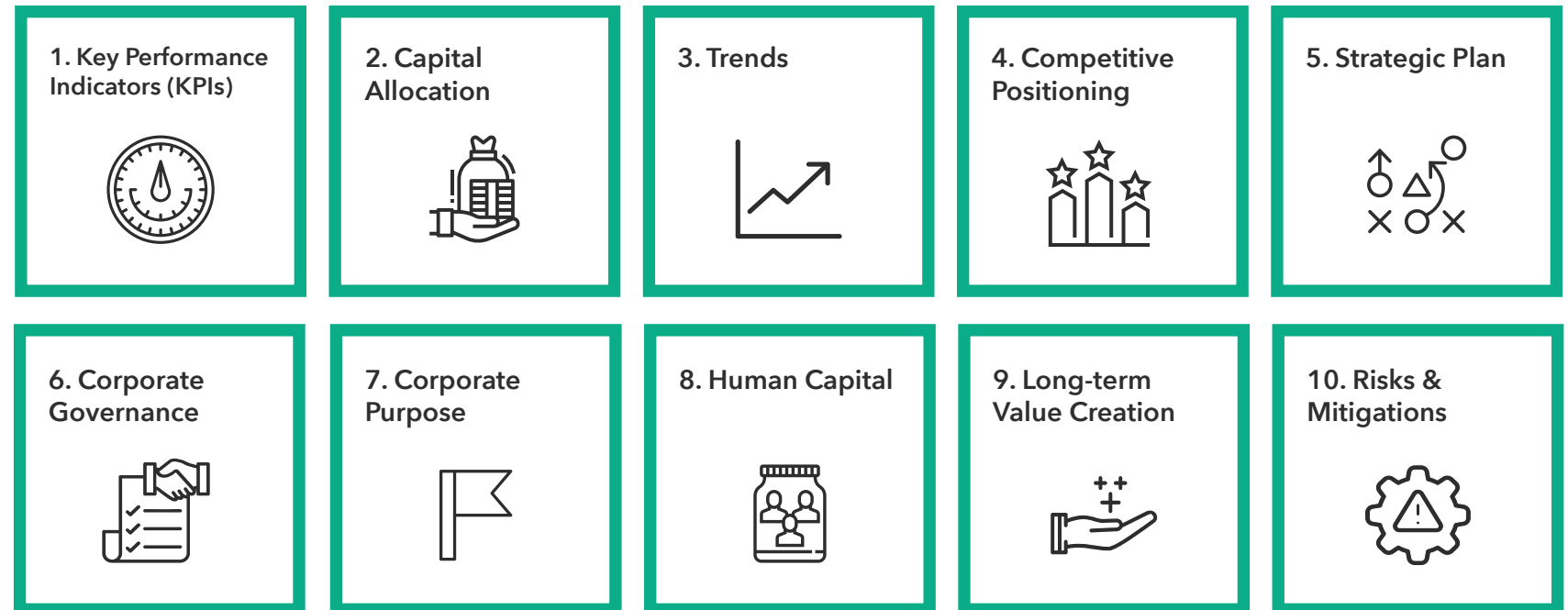
Pathways to Long-Termism

Approaches

02b

Develop a Long-Term Roadmap (1/2)

The key component to avoiding a trade-off mindset is to have a long-term roadmap that is defined by 10 key factors summarized as follows:



Source: Babcock, A., He, A., and Tellez, V. (2019).

Source: Sakis Kotsantonis, Christina Rehnberg, George Serafeim, Brian Tomlinson, and Bronagh Ward, The Economic Significance of Long-term Plans (London: KKS Advisors; New York: CECP, November 2018).

Approaches

02b Develop a Long-Term Roadmap (2/2)

It is important to note that the first five factors in particular, should define both short- and long term metrics, actions and goals.

1. Key Performance Indicators (KPIs)



Develop a mix of short-, medium- and long-term financial and operational KPIs. Not only will this allow investors to track progress toward long-term objectives, but it will also create a dialogue across the executive team regarding progress.

4. Competitive Positioning



Determine the company's short-, medium- and long-term value drivers and actions linked to the company's key milestones.

2. Capital Allocation



Create a framework underlying the company's long-term allocation strategy, highlighting the metrics around this plan. Develop a commitment plan to help the executive team envision and navigate possible setbacks that could trigger short-termism.

5. Strategic Plan



Articulate the company's detailed execution plan that defines the short-, medium- and long-term actions that management plans to take to achieve their long-term objectives. The plan should address the possible trade-offs that may arise between short-medium and long-term objectives and develop strategies to resolve them.

3. Trends



Highlight trends including both projections of the future market place and sources of competitive advantage, as well as those that affect people and operations. Assess the risks and opportunities associated with these trends.

Source: Babcock, A., He, A., and Tellez, V. (2019).

Source: Sakis Kotsantonis, Christina Rehnberg, George Serafeim, Brian Tomlinson, and Bronagh Ward, The Economic Significance of Long-term Plans (London: KKS Advisors; New York: CECP, November 2018).

Pathways to Long-Termism

Approaches

02c Storytelling (1/2)

CEOs need to be 'storytellers' to be able to successfully focus on the long-term. They need to be able to answer "What's the consistent story for where the company is trying to go in the long term, and how does this quarter fit in with that story?"

A long-term approach attracts long-term investors. Intrinsic (long-term) investors say that they favor companies with executive teams that confidently choose how, what and when to communicate about their business - more disclosure is viewed positively.

Clear communication of the long-term approach will enable companies to build a long-term investor base. Overall, this will reduce a company's cost of equity, encourage greater fixed investment, and is ultimately associated with higher returns.



Pathways to Long-Termism

Approaches

02c Storytelling (2/2)

There are two components to a CEO's story:

01 Technical Factors

These include the performance metrics that are in-year revenue and profit KPIs.

Examples: financial and operating metrics.

02 Health Metrics

These include metrics that talk to the future direction of the company, encapsulating both momentum and current position. They indicate the future goals of the company, but also serve as interim measures that indicate if the company is headed in the right direction.

Examples: long-term market share and share of revenue from newly launched products.

Case Example

Microsoft. *"Microsoft makes a distinction between their 'performance metrics' and 'power metrics'. The latter are about future-year performance. They are leading indicators of future success and are more about usage and customer love or satisfaction."**

- Satya Nadella, CEO of Microsoft

Note

CEOs and executives must ensure that the long-term and its context are part of every investor engagement, especially when talking about short-term results in quarterly meetings.

Start with the long-term as the wide lens, then zoom in on the details as needed. Doing so will serve as a reference point for investors when making decisions.

Adapted from London, S., Useem, M., & Zempel, R. (2018, June).
* Source: Nadella, S. (2018).

Pathways to Long-Termism

Approaches



03 Restructure Quarterly Meetings

This approach applies specifically to optimizing the design of public shareholder meetings.

Approach

Behavioural Implications

01 Remind investors of the company's long-term strategy and progress before diving into the short-term results.

Providing this reminder serves as a reference point for investor decision making, as they are nudged towards more long-term thinking and will place quarterly performance in this context.

In fact, investors said that doing so made the quarterly earnings calls more helpful.

02 Include annotations on materials that are distributed prior to the meeting, that highlight the intuition behind the metrics and values presented. Anticipate and address investors' possible concerns regarding quarterly metrics early on, or prior to the meeting.

Reduces the uncertainty investors may have around a company's quarterly performance, and increases the confidence investors have in the information being presented.

This will enable them to focus more on asking the right questions that address and ultimately encourage long-term investment behaviour.



Looking Forward

While the motion against short-termism has gained a lot of traction in recent years, what will the next few years have in store for companies? In particular, how should we expect to see long-term behaviours of companies evolve? What approaches will companies tend to adopt?

Varying Industries: This playbook focused on analyzing company-level drivers of short-termism to develop approaches that companies can take to be more long-term oriented. However, future research could focus on the extent to which short-termism differs between companies across different industries and if company level drivers need to differ across them.

International Businesses: How do planning time horizons and activities differ across different geographies? Do these variations lead to significant differences in performance across geographies?

The World of AI: There was a 60% increase in investment in AI in 2017 over 2016 by corporate executives, yet only 3% of business leaders plan to invest significantly more in re-skilling in the next 3 years.* However, with the pace of technological change, people will have to continuously update their skills.

The Aspen Institute notes that, “contrary to conventional wisdom, distinctly human talents will be in higher demand in the age of AI. Strategy, creativity, empathy, and judgement, will be more important and high-performance teams will increasingly blend human talents and diversity with smart machines in new, dynamic and innovative ways”.*

Despite more than 50% of jobs in the US needing more high-level creativity, 47% requiring more complex reasoning, and 36% needing more socio-emotional skills, according to Accenture’s 2018 study, there has been a decline in employee training – from 2.5 weeks of training per year in 1979 to only 20% of workers receiving any skills training by 2011.*

Noting these trends, future research could look at where and how business leaders should invest to support their long-term vision in the face of an era where humans and intelligent technology will collaborate. Further, how can AI be leveraged as a golden opportunity to start unwinding short-term activities and decisions in corporations, and foster a shift towards being more long-term to allow corporations to thrive in this next technological revolution?***

* Source: Shook, E., & Knickrehm, M. (2018, July).

* Source: Shook, E., & Knickrehm, M. (2018, Jan).

** Source: Padró, M. (2018, Nov 9).

Appendix A

Corporate Horizon Index Methodology

Index	Hypothesis	Measurement Approach
1. Investment	Long-term firms will invest more and more consistently than short-term firms	Ratio of capital expenditures to depreciation
2. Earnings Quality	Long-term firms will generate earnings that reflect cash flow, not accounting decisions	Accruals as a share of revenue
3. Margin Growth	Short-term firms are more likely to grow margins unsustainably in order to hit near-term targets	Difference between earnings growth and revenue growth
4. Quarterly Management	Short-term firms will do whatever they can to hit short-term targets, whereas long-term firms are willing to miss them if needed	Incidence of beating EPS targets by less than 2 cents and incidence of missing EPS targets by less than 2 cents
5. Earnings-per-Share Growth	Long-term firms are less likely to over-index on EPS rather than true earnings and act to boost EPS (e.g. with buy-backs)	Difference between EPS growth and true earnings growth

The Corporate Horizon Index (CHI) is based on patterns of investment, growth, earnings quality, and earnings management captured in five variables, with data drawn from McKinsey's Corporate Performance Analytics database. The index provides the first statistical evidence that shows that a long-term approach can lead to superior performance for revenue and earnings, investment, market capitalization, and job creation.*

* Source: Barton, D., Manyika, J., Koller, T., Palter, R., Zoffer, J., & Godsall, J. (2017, February).

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