NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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THE ECONOMY AND THE FUTURE -- THE TYRANNY OF THE SHORT-RUN

An Address by

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The Commonwealth Club
San Francisco, California

November 21, 1980

One of history's most elementary -- and yet most easily ignored -- lessons is that human progress depends on economic progress. Democracy and personal liberty are sturdiest when they are buttressed by an economic system capable of meeting the material needs and aspirations of society's members. Conversely, the landmarks in human progress -- in the arts, science, government, or elsewhere -- have rarely been reached in societies in which the economy was unable to free most of its members from a daily obsession with subsistence needs. On the contrary, wherever the economy is feeble or stagnant for a prolonged period, where most people see their basic material needs as unfulfilled and the prospects for improvement as unlikely, the result is almost invariably either a dull fatalism or political upheaval, neither of which is likely to be favorable to liberty and freedom.

The United States is not immune from these principles. Our progress towards greater social and human well-being depends upon sustained economic growth and productivity. These, in turn, require that we encourage high levels of investment in the expansion and modernization of plant and equipment and in research and development. To stand still in terms of capital investment or the search for new technologies is to move backwards in terms of economic and social vitality.

Yet, for more than a decade and a half, instead of formulating policies that enhance the long-term strength of the American industrial system, we have milked it in order to enjoy short-term benefits -- both social and economic. Although American industry has proved vital and resilient enough to sustain both solid economic growth and greatly expanded government spending and wealth transfer for some period of time, its underlying strengths are being slowly eroded. We are today beginning to see the consequences of a philosophy which often assumes that economic growth is an impediment, rather than a precondition, to a stronger, more just and more humane nation.

For these reasons, restoring the vitality and stability of the American economy is the greatest challenge we face today. It will test the intelligence, competence, and unity of our Country. It will determine the quality of life for our children and our Nation's standing in world affairs. Historically, the strong performance of our economy has been our greatest social program. It has created opportunities for the disadvantaged to climb the ladder. It has provided the ability for immigrants to educate their children. It has enabled the middle class to gain the stability of home ownership and the security of pensions, and it has made it possible for government to fund both a strong national defense and a compassionate response to our human concerns. Without steady economic growth, there is no cushion to provide for our rising social expectations -- for the affirmative action, cleaner environment, safer workplace, and the other facets of a brighter future for our children and for ourselves. If, on the other hand, our economy is strong, I believe that America's finest days are still ahead.

I want to share with you today some thoughts concerning the strengths and weaknesses of our economic system. I believe that the most fundamental problem facing us is that we have lost our sense of the future -- we tend increasingly to focus on the short-run and to ignore the longer-range consequences of business and political decisions. It is that attitude which we must change if we are to realize the full potential of our Nation and our people.

The Role and Strength of the Economy

Of course, the phenomenal strength and wealth-generating capacity of our economy is no more than the sum of the strength and vigor of the individual businesses of which it is comprised. Traditionally, the power of American business has been an article of faith. A little over a decade ago, Servan-Schreiber wrote in the *American Challenge* that our business executives were in a class by themselves for their ability to build multi-national empires around the world. Now, only a decade later, we find that the competitiveness of American business seems somehow -- subtly, almost impreceptibly -- to have eroded.

Our economic record in the decade of the '70s was the second worst in this century -- inferior to all but the terrible 1930s.

The United States now has the highest percentage of obsolete plants, the lowest percentage of capital investment, and the lowest growth in productivity and savings of any major industrial society. In fact, over the last two decades, the United States has had the lowest domestic investment ratio of any major industrial country.

Predictably, these economic phenomena have had social and political consequences. When an economy turns sour, its malfunctioning robs us of our self-confidence. It creates distrust, people feel squeezed and cheated, and then begin to hunt for the villains and the oppressors. When we most need mutual trust and productive partnerships and cooperation between society's members to solve our problems, we find ourselves disunited. The consumer and the producer both feel squeezed, and both wrongly blame each other.

Moreover, those whose politics relate to only a single issue drown out the voices which counsel attention to the broader public interest. A democracy which is oriented towards an unaffordable egalitarian sharing of the national product will find it virtually impossible to impose the kind of discipline required to maintain government policies that will keep us on a reasonable economic course over time. Instead, pressures build for governmen to address the issue of the moment and not the fundamental problems regarding our growth and prosperity in the long term.

Of course, government is itself part of the problem. The cumulative effects of almost five decades of constantly accelerating reliance on government regulation to address social inequities and problems have taken a toll on business. Indeed, some in the business community argue that government regulation is the sole source of economic malaise. From this perspective, government -- despite the vigor of the private sector -- is seen as having succeeded in undermining the economy through overbearing regulation, tolerance of inflation, indifference to the cost of environmental and social programs, and a pervasive anti-business attitude.

Each of these accusations has a basis in fact. Whatever the political party in power, whatever the administration, the problems have continued. Yet, while there are many changes in regulatory philosophy which need to be implemented, a large part of the cause of today's economic problems would remain untouched. It is too simplistic to attribute all of our economic problems to government; indeed, that sort of reasoning is counter-productive; it absolves everyone else of responsibility. The causes are much more fundamental than government regulation -- or high energy costs or overpaid or lazy workers or poor tax policy, although these are all involved. Although part of the responsibility lies with forces outside the corporation, a significant share rests with the attitudes, preoccupations, and practices of many American managers, boards of directors, and shareholders.

Inflation and Private Economic Decisionmaking

The consequences of those attitudes, and their tendency to cluster around the short-term, are my theme today. I want to begin that analysis by touching on a crucial economy-wide factor in the erosion of our economic strength which fosters short-term thinking. While most people -- schooled by a decade of experience -- are familiar with the debilitating impact of inflation on the individual, its impact on the business community and the results of its operations are less commonly grasped.

Inflation has obviously had a major impact on our government, business sector and society. John Kenneth Galbraith put it most starkly when he said: "Nothing so weakens the government as persistent inflation." Lenin put it in terms of destroying a government through debauching the currency.

Inflation has made a shambles of the key corporate performance measure, reported profits. Traditional financial accounting has been providing misleading signals about the growth and health of company earnings. The ability to develop and market new products, to finance essential investment in new plant and equipment, and to pay dividends is not there -- even though traditional accounting methods say that it is.

As a result of an accounting requirement imposed by the Financial Accounting Standards Board, for the first time, in 1979, we have begun to have information which, individually and in the aggregate, gives us some sense of the impact of inflation on the corporate economy. The fact that the Financial Accounting Standards Board has been forced to come to grips with the impact of inflation on financial reporting is, in itself, an indicator that the problem is serious. While it would be wrong to consider the resulting data precise, it would be equally irresponsible to ignore it. In my view, the principles and methodologies reflected in its Statement No. 33 are sound -- and the best presently available.

What does this information tell us? The samplings which have been done to date indicate that <u>real</u> corporate income in 1979 was on the order of 60 percent of that reported on an historic cost basis; that the effective tax rate, rather than being 39 percent, was on the order of 53 percent; that dividend payout, which we tend to think of as averaging one-third of after-tax profits, is, in reality, two-thirds; and that return on assets, rather than averaging 17 percent, averages 8 percent. These figures mean that real corporate earnings are, in many instances, inadequate to cover dividend payments and that many companies are paying dividends out of capital -- in effect, liquidating, without the awareness of shareholders and most likely without the awareness even of management or boards of directors. What that, in turn, tells us is that many companies do not have the wherewithall to replace obsolete plants, let alone to expand, to modernize, to create jobs, and to invest in research and development -- all of which are essential if we are to remain competitive in world markets, and, even more importantly, to sustain a healthy, vigorous society. Corporate profits, rather than being obscene, are, in many if not most cases, inadequate.

This is a message that is beginning to be understood. Yet, despite widespread agreement that inflation is our most serious economic problem, the pain which its solution would entail has made it extremely resistant to being cured.

Nonetheless, even if inflation and the resulting distortions in corporate financial measures could be eliminated, that alone would not do the job necessary to revitalize the economy. Much of the crippling of our economic system which has occurred is the result of other private sector actions and decisions.

The Tyranny of the Short-Run

I want now to turn to an examination of the attitudes of some managers toward the future and the impact of those attitudes on the health of the economy. Let me begin by comparing the way in which government and business have traditionally addressed the future.

We often complain, particularly in an election year, about the time-frame within which elected government tends to function -- the time-frame between elections. It has always seemed to follow that the private sector had the advantage. It could plan and manage in a longer time-frame -- it was not subject to the vicissitudes of political life and the need to cater to political constituencies and deliver results in a two-year, or perhaps, at most, four-year period.

The consequences of elected government's short-range perspective are not difficult to understand. Politicians tend to prefer programs the benefits of which are available immediately, but the costs of which appear only at a later stage. They are less interested in public investments that have to be financed now but do not pay off adequately before the next election. Such programs increase the possibility that the opposition will win that election and that the voters will attribute the benefits to the new administration.

This may suggest that long-term planning is only possible in the private sector. But that is no longer the case. The planning time-frame -- the distance to the future -- within much of the business and investment communities has become at least as short. While shortsightedness is not a condition with which any of us can exist indefinitely, the business sector can least afford it, for it is the sole source of wealth creation within the American economy and the American society. What, then, has caused this shortsightedness?

In the first place, the behavior of much of corporate management is strongly influenced by performance measurements and rewards which are heavily focused on short-term results. The consequences can be far-reaching. They may deter capital investment, discourage research, and inhibit new product development and introduction and other so-called discretionary items which adversely impact current earnings. And, while these may be semi-discretionary on a year-to-year basis, they are not at all discretionary in relation to the long-term health and dynamics of the individual company and the economy as a whole. The management that is concerned about insuring this year's bonuses by inflating this year's earnings has little reason to accept several years of losses in order to introduce a new product or to break into a new market. Yet, our foreign competition is more than ready to make investment decisions that may not pay off for a decade.

These sorts of performance incentives also encourage generation of earnings through financial management as contrasted to competition in the marketplace, improvement of earnings by deferring maintenance and reducing advertising, or increased dividends to bolster the stock price. Similarly, these incentives push management to launch takeovers which, even if they make some financial sense, often do not deliver the economic promise or the synergy which is anticipated. And, where a corporation is comprised of a large number of diverse and far-removed components -- which deprives managers and directors of an ability to have a "feel" for each element -- there may be an even greater reliance on earnings figures as a measure of performance.

A European businessman advises us:

> "[I]f your goal is to build a business for the 1990's, you are probably willing to sacrifice some of the return on investment for the near term, even for five years. This is one of the reasons why foreign firms, primarily European companies, are willing, and are in a position, to pay a much higher multiple than most American companies. Most major European companies do this because they are willing to invest dollars now for the future, not for next year, but for the long run."

Akio Morita, Chairman of Sony, put the problem most succinctly:

> "The problem in the United States is management. Instead of meeting the challenge of a changing world, American business today is making small, short-term adjustments by cutting costs, by turning to the government for temporary relief. Success in trade is the result of patience and meticulous preparations with a long period of market preparation before the rewards are available."

But the problems do not begin and end with corporate management. The board of directors often plays a significant role in creating or exacerbating the problem. The board is a potential source of stability. It is a body that should be expected to provide longer-term perspective and continuity -- a body that should understand and balance the short-term pressures under which management finds itself with the need for a longer-term vision of the company and of the industry of which the company is a part. But directors, in many instances, aggravate the problem by focusing their assessment of corporate managerial performance on the short-term and rewarding management with incentive compensation, options and stock rights keyed to the short-term, while ignoring decisions which will have their effects only in the long-term. Thus, too often, boards, particularly those that do not have an adequate measure of independence from management, do not bring the type of longer perspective that may be lacking in corporate decisionmaking.

Short-term thinking pervades investor attitudes as well. Indeed, the traditional concept of the investor is becoming obsolete. The linkage between ownership and participation in the equity markets is -- to put it mildly -- strained. Increasingly, the so-called investor, whether individual or institutional, is nothing more than a short-term speculator in the income stream of the company.

Today, something on the order of three-quarters of corporate stock is bought and sold by professional portfolio managers of mutual funds, pension funds, and insurance companies.

These managers must do more than invest for the future. They are under pressure to produce the short-term results necessary to keep their jobs and to attract clients. It is easier to produce immediate results than to explain an investment strategy calculated to produce greater returns over a longer period. In the search for quick profits, they move in and out of large positions based on short-term results and with little regard for the strengths of the underlying enterprise. They tend to be opportunists rather than long-term investors in the individual businesses or industries. They are more likely to be attracted by aberations or short-term performance than by long-term growth potential. Security analysts, and brokers likewise, largely expect to profit by correctly guessing the short-term fluctuation of price-earnings multiples instead of long-term potential for growth. Moreover, the institutional investment practices of today stress modern portfolio theory and risk diversification. This sort of approach to investing entails little interest in management or in the exercise of the shareholders' rights.

This problem is compounded by emphasis on earnings-per-share and the price-earnings ratio. At one time, we were much more inclined to concentrate on book value -- a measure not nearly as volatile. In fact, earnings-per-share and price-earnings ratios did not come into vogue until the 1960s -- about the time that the investment and productivity measures I have been describing began to turn down. I would suggest that this was not coincidental.

I would also suggest that earnings-per-share is today an increasingly irrelevant measure. It tells one relatively little about managerial performance and the future of the company. I would hope and expect that we will develop an alternative measure. I would urge that we look at cash-flow-per-share as a potentially much more meaningful measure over time to reflect management performance and the future viability and potential of the company.

Steps Toward a Solution: Lengthening the Focus

If the analysis I have just presented is correct, what does it mean? Are we in a self-perpetuating downward cycle, with all the suction of a whirlpool, from which there is no escape? At minimum, the kind of short-term oriented cycle in which we find ourselves behaves as though tomorrow is forever. And, in fact, a series of tomorrows will create a forever -- a very predictable one -- and not a very desirable or promising one.

I do not believe, however, that the situation is irreversible by any means. We have enormous natural resources remaining in this Country. Granted, we import half of our petroleum needs, but the Germans and Japanese import almost all of theirs. We have an enormous domestic market resulting in economies of scale that should give us a competitive edge.

Defense spending is not as high a proportion of national income as it was two decades ago when the Country was enjoying robust economic health. We are still the world's most productive society, not just in gross aggregate terms, but also in terms of output per man-hour. We hold a commanding technological lead in important areas.

I want to close by suggesting several steps which would help us to capitalize on these strengths and to release our potential by refocusing our approach to economic decisionmaking.

First, curbing inflation must be our number one priority. Inflation must be contained despite the political and social costs of doing so. The sacrifices inherent in bringing inflation under control are much more visible and immediate than the devastating social dislocations which will inevitably follow if we tolerate its continuation.

Second, we have to reassess and limit the interventionist role of government in private sector decisionmaking. This is not an anti-government statement by any means, but one which recognizes that we need to achieve a balance. In recent years, government has moved from being a brake, and from providing conduct rules to assure an orderly society through regulatory guidelines, to a much more active and interventionist role in affecting conditions under which goods and services are produced and the physical characteristics of the output are determined.

The government, if it has not yet become the _de facto_ decision-maker in the production process, has certainly become a participant who cannot be ignored. But the intolerance of errors which government exhibits in its dealings with the private sector, coupled with the benefit of hindsight with which government is able to evaluate the private sector, leads to corporate risk aversion, rather than risk-taking. Government thus diminishes the private sector's sense of responsibility -- both in economic and ethical terms -- for its own conduct and for its own performance. While the mechanisms of regulatory reform are beyond the scope of my remarks today, the corrosive effects of regulation on business's sense of responsibility must be reversed.

Another priority must be to increase existing tax incentives to productive investment. This would provide structural changes that are needed for a more lasting improvement in productivity, and would help create a climate in which investments in all phases of technological innovation would be increased as a natural result of the entrepreneurial process. Tax policies should promote modernization; new plants equipment and technology; new research and development; and more rapid advancement of new industries. And, as we provide incentives for capital to be deployed and redeployed, we will cause the economy to be more responsive and to challenge those components that should be reduced or eliminated.

I would also urge strongly that Congress and the Internal Revenue Service revise the existing policy and allow the use of the LIFO method of valuing inventory for tax purposes even where it is not used for financial reporting purposes. In today's inflationary context, LIFO more closely approximates economic reality and is, in my judgment, the preferable method for both tax and financial reporting purposes in almost all cases. But, regardless, it is not constructive or healthy for inventory profits to be taxed, requiring companies to generate the amount equivalent to the tax merely to replace the inventory. Placing barriers in the path of the use of the LIFO method is the grossest way to encourage and then tax inflation.

Third, we need to return to a longer-term perspective in the evaluation of securities and investments. We need, in other words, to find a way to deal with the attitudes of equity investors or else to reduce the importance of equity investment.

Investor attitudes have an enormous amount of leverage. They are a linch-pin of the short-term cycle because of the importance of the equity marketplace as a measure of management performance and reward and as a source of financing. Perhaps we need to unlink the income stream speculator from ownership in American business. If so, this could be accomplished by providing greater tax incentives for long-term holdings and by increasing the tax burden on short-term profits -- including short-term trading by tax-exempt institutions.

Alternatively, perhaps we need to increase the role of debt so that equity financing is less important. The economies against which we compete most vigorously have much more highly leveraged debt-equity ratios than we have traditionally been comfortable with. A somewhat heavier debt-to-equity ratio would significantly reduce the importance of equity while still being much more conservative than, for example, Japan and Germany. Such a change could, nevertheless, have a significant impact in the relative roles of the securities industry, banking, the corporation, and the government. I am not sanguine that such a change in government-business relationships in this country would be compatible with our political philosophy. We must, however, explore whether we can encourage equity ownership to assume the responsibilities traditionally associated with it, or whether we should make the role of equity less important.

Finally, while government and investors have a role to play in revitalizing the economy, much of the responsibility must rest with the business community. Managements must assure that investment in future profitability is not sacrificed on the altar of quarterly earnings growth, and the board of directors must hold management accountable for doing so. When an enterprise fails to plan for, build and maintain its own long-term health, the blame for the consequences cannot be passed off to government regulatory or tax policies, or to investor attitudes, or the market's tendency to focus on short-term measures like earnings per share. Rather, willingness to pay the price today for the health and vitality of the enterprise tomorrow is the ultimate test of stewardship. If management and the board do not meet that challenge, they have failed.

To be responsible, the board must understand the company's plans to build its future, monitor their implementation on an ongoing basis, assure itself that current earnings are not being produced at the expense of the company's future either through inadequate investment in future development or through short-changing current expenses, and that executive compensation packages are appropriately balanced to reward long-term performance. If the board measures and rewards managerial performance skewed to short-term performance, it is encouraging management to short-change the corporate future and cannot absolve itself of responsibility for the consequences.

Conclusion

My theme today has been that we need to restore a time horizon in order to rebuild the vigor of our economic system. As we begin to recognize the need for a longer-term perspective and for greater latitude within which market forces are free to operate, we can again focus our creativity on how to achieve our economic and social goals.

I think we are beginning to awaken to our economic problems and needs, and what we must do to address them. We are also realizing our limitations; that we are not as omnipotent as we might at one time have believed. Yet, America's economy is still enormously potent -- the greatest in the world. I believe we are arriving at a vital consensus; that is, that the industry of this Country must be revitalized. That consensus, I believe, is the critical element in rebuilding our economy, reestablishing our economic position in the world, and, most importantly, in financing our social agenda.

In this undertaking, every sector has its responsibility to discharge, and neither time nor justification for focusing on what "others" should do. When Joseph Schumpeter wrote his very dispairing treatise in the early 1940s, he concluded by noting that he was not pessimistic:

> "The report that a given ship is sinking is not defeatist. Only the spirit in which this report is received can be defeatist: the crew can sit down and drink. But it can also rush to the pumps."

What we do not know today is what it will take to send us to the pumps. We do know that drink, however pleasant, is only a temporary solution.