

Rappaport, Alfred – Saving Capitalism From Short-Termism

McGraw-Hill, 2011, [Business] Grade ★★ ★

In the popular debate there is a growing consensus that short-termism in financial markets is a big problem. Is this actually the case? – And if so, what can be done about it? Alfred Rappaport, one of the founding fathers of what's been dubbed the Shareholder Value Model and author of the trailblazing book *Creating Shareholder Value*, should be in a unique position to have a view on these topics. Rappaport's view is that there surely is short-termism in corporate and financial processes but that this – contrary to mainstream discourse – is not due to the Shareholder Value Model and the solution is actually to return to the roots and original intentions of this model.

Some of the arguments for the model are utilitarian: pooling of resources to the highest return on capital investments allocates a society's scarce resources to their most efficient use and thus is the mechanism by which economic growth is created; also, higher shareholder value means higher long term returns on securities which is sorely needed to give a decent living standard for retirees. The main argument however is in a way ethical. If you own something you are in lawful disposition of this property. The shareholders own the company so they should be in charge of it and decide on its purpose. Value is created by a company if it deploys capital into investments where the future incremental cash flow return on the investments are higher than the cost of capital of the funds needed to finance the investments. The value of the company, its shareholder value, equals the so called present value of all future free cash flows discounted by the cost of capital, net of net debt. The Shareholder Value Model simply states that it's a company's aim to maximize this net present value for the benefit of those who owns it. This is a model that looks at an eternal future. In contrast companies and investors are often trapped in a short-term rat race where the practice of maximizing quarterly earnings is sometimes dubbed as "creating shareholder value", making this perverted model very easy to dislike.

Rappaport in the two first chapters gives an historical résumé of short-termism and looks at the recent financial crisis through these glasses – finding myopic behavior on all accounts: the finance industry, regulators and government, corporations and home buyers. Next the author probes deeper into the reasons for this behavior when it comes to corporations and investors.

As many of the problems in Rappaport's opinion are caused by faulty incentives the second part of the book puts forward a number of solutions focusing on corporate managers and investment portfolio managers payment packages plus value creating practices in companies and in the investment process. The guiding principle for all this is a better alignment to the creation of long-term shareholder value as the concept was originally intended to be interpreted. The form and shape of the text follows a very natural pattern guiding the reader from start to finish line. This will obviously not convince the many vocal critics of (what they perceive as) "shareholder value".

Apart from a section on corporate financial reporting that I find a bit of a dead end I basically agree with the author and I also think the topic is vitally important. Despite this the book cannot really get my juices flowing. For anyone that has followed this debate the last 15 – 20 years there is nothing new and for a person of Rappaport's stature I also find the book rather shallow. To be fair the author states that the book is intended for a "broad audience": "*corporate executives, board members, institutional investors, and accounting standard-setters.*" They might not be specialists in this matter but it doesn't look like a group of people whose intelligence should be underestimated.

If you need a basic introduction to the topic, by all means read this book. However, although slightly dated, Rappaport's 1997 book *Creating Shareholder Value* still offers a more comprehensive picture and should be in every investor's bookshelf.

Mats Larsson, November 30, 2014