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"SHORT-TERMISM"

AND SOME SIGNIFICANT CHALLENGES TO THE CAPITAL MARKETS

BY

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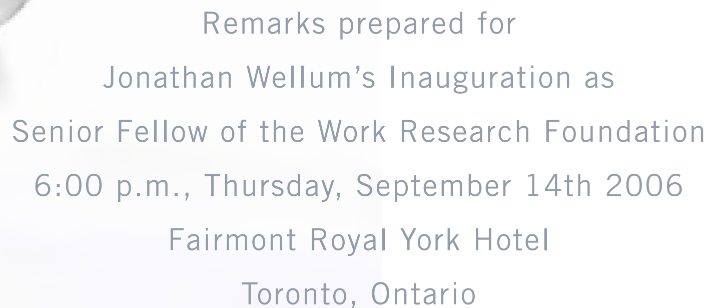

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ABSTRACT:

"Short-termism" in how we manage our money, our capital markets, and social policy holds long-term consequences for the viability of the Canadian economy and for the next generation of Canadians. Jonathan Wellum offers his analysis of "short-termism" and the serious problems this approach is leading to in each of these spheres of life. Wellum proposes an alternative that he thinks will lead to growth and human flourishing over the long term.

Jonathan Wellum has a distinguished career in the financial industry, holding various positions including his present role as the Chief Investment Officer and Portfolio Manager with AIC Limited.

I. "Short-Termism"

The plans of the diligent lead to profit as surely as haste leads to poverty

-- Proverbs 21:5

A. The Issue

In 2003, the former U.S. Securities and Exchange Commission (SEC) Chairman William H. Donaldson called upon business leaders at a corporate governance forum "to manage the business for long-term results and to get away from the attitude that you're managing the business out of a strait jacket that has been put upon you to create earnings per share on a regular basis." He further encouraged these leaders to "present to investors exactly how you are going to manage that business."[1] Expanding on his concern at the 2005 CFA Institute annual conference, Donaldson cited "short-termism" as a critical issue facing the financial industry and the broader capital markets.

Similar concern has also been noted by numerous corporate executives. In research conducted by the Business Roundtable Institute for Corporate Ethics, chief executive officers (CEOs) at many of the largest U.S. corporations were asked to identify the most pressing ethical issues facing the business community. "Effective company management in the context of today's short-term investor expectations" was among the most cited concerns.[2]

In a recent survey of more than 400 financial executives, 80 percent of the respondents suggested that they would be prepared to reduce discretionary spending on critical long term areas such as research and development, advertising, maintenance, and hiring in order to meet short-term earnings targets. An astounding 50 percent plus said they would delay new projects, even when it meant the long-term sacrificing of value creation.[3] These results confirm what we already know: that short-termism is a major issue that goes beyond companies' simply using accounting actions to meet quarterly earnings expectations! It affects real actions -- long-term actions -- such as asset sales, cuts in research and development, the foregoing of strategic, long-term investments, the contortion of corporate structures, executive management compensation schemes and other issues which I will briefly discuss and outline as areas worthy of more research and discussion, given their long-term impact on the capital markets.

Despite the fact that management's number-one objective should be the creation of long-term

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shareholder value, it is increasingly obvious that some management teams are managing their businesses more to meet short-term earning expectations or, worse, for short-term personal gain at the expense of other stakeholders.

Short-termism should not be confused with the notion of responding quickly to new market information which is critical for the survival of businesses and for market efficiency. When we use the term short-termism, we are referring to:

> the **excessive** focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to strategy, fundamentals, and conventional approaches to long-term value creation. An excessive short-term focus combined with insufficient regard for long-term strategy can tip the balance in value-destructive ways for market participants, undermine the market's credibility, and discourage long-term value creation and investment. Such short-term strategies are often based on accounting-driven metrics that are not fully reflective of the complexities of corporate management and investment.[4]

The bottom line is that the obsession with short-term results by an increasing number of investors, money management firms, and corporate managers in aggregate can lead to many unintended consequences. Some of these are reduced long-term value, decreased market efficiency, lowered investment returns, weaker corporate governance, and increased risk of corporate malfeasance.

B. The Reason

Over the past several decades the preoccupation with short-term results over long-term impact seems to have intensified. If it is happening in the capital markets we can expect to see this in other areas of social life as well. Anyone who has followed the debates on family, education, and government social and fiscal policy can draw the conclusion that "short-termism" – that is, the pursuit of immediate gratification at the expense of long-term thinking – has seeped into all aspects of our culture and not just into the capital markets. What is going on? Why have we become so short-sighted? Do we not know that optimizing decisions requires that they be placed within the context of their long-term impact? Is it because we simply do not care about the long-term anymore? Have we adopted economist John Maynard Keynes's tongue-in-cheek view concerning the long-term when he said, "in the long-run we are all dead"?[5]

With some thoughtful reflection our short-termism should not come as a surprise to us. Just take the fact that nearly one million introductory economics textbooks are sold annually in the U.S., and all the best-selling texts use the "positive-normative" disclaimer purporting to be value-free, and presenting an intellectual framework that simply tries to describe how self-interested economic agents act completely abstracted from any normative ethics or moral authority.[6] But do we actually believe that economics is value free and individuals are free to act as autonomous, self-interested, economic agents? If we do, why are we surprised when some managers of businesses and financial assets act in total self-interest, subordinating the needs of other market participants and the broader institutions of the culture to themselves?

Let's go further and ask another question. Should we expect people to think long-term and make self sacrificing decisions that are truly intergenerational when in both the moral and philosophical realms there is very little consensus left in Western countries over the proper foundation for moral behaviour, moral authority, our theory of knowledge, and, ultimately, one's purpose for even existing? We live in a culture that has the audacity

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to tell us that truth does not even exist (despite the self-refuting nature of that statement), and if truth did exist we could never know it anyway. Some refer to this as postmodernism. It is important to point out that although the nature of truth has been debated throughout the centuries, postmodernism has turned this debate on its head. While most arguments throughout history have focused on rival claims to truth, postmodernism rejects the very notion of truth as fixed, universal, objective, or absolute. As a result, we find ourselves in the midst of a culture without moral authority – as Stephen Carter calls it a "culture of disbelief."[7]

But as many astute thinkers and observers of history have pointed out, a culture that does not and cannot make moral judgements, has jettisoned its willingness to discern truth, and has no agreed answer to the question of the purpose of life, is surely living under the shadow of nihilism – that there is no ultimate meaning, and that ultimate reality (i.e. moral standards) is nothing more than what individuals determine it to be! Has this become the ultimate foundation for our short-termism? I believe so! And I am not alone. In a recent book, George Weigel indirectly quotes Christopher Dawson and summarizes the issue in bold terms: "A secular society that has no end beyond its own satisfaction is a monstrosity – a cancerous growth which will ultimately destroy itself."[8] Os Guinness underscores the foregoing when he says, "the trouble is that, as modern people, we have too much to live with and too little to live for. For most of us, in the midst of material plenty, we have spiritual poverty."[9]

Let me ask one more question which deals with the same issue. Why are we surprised by our short-termism when we are surrounded by an instant credit, mass consumption culture in which delayed gratification is ridiculed and mocked as outdated and irrelevant? Our mass media demonstrate this with their hackneyed slogans such as "What happens in Vegas stays in Vegas" and "Just Do It." Given that we (and our children) are inundated with such self-gratifying babble, why should we be surprised that individuals, families, businesses, and governments find it hard – indeed very difficult – to make long-term intergenerational decisions? When the highest ideals we have are personal peace and prosperity,[10] why should individuals make long-term sacrifices?

Meaning and purpose beyond ourselves and the current generation which are prerequisites for long-term thinking do not emanate from our economic system or our capital markets. Our markets are a mere mechanism and not a source of meaning. I understand that many religious and ethical systems make truth claims and have established moral systems. However, there is little debate in the critical literature that western capitalist economics is rooted in Judeo-Christian morality and its truth claims. While some in our culture may debate what I have just said, there is little debate over the commandments "You shall not steal" or "You shall not lie" or over the golden rule "Do unto others," particularly when it comes to corporate governance or the management of our assets by others. Our friends at *Enron* and *Worldcom* would have been far better off if they had stayed on-side of these out-of date standards. Purpose and meaning must be rooted in that which is above the physical and ultimately must find its rest in a personal Creator. A "faithless" or disbelieving culture will over time become increasingly short-term in its views, attitudes, and actions since the most important question eventually becomes: What's in it for me? Or, as the apostle Paul's quoting from the Old Testament prophet Isaiah so eloquently summarized secular thinking, "Let us eat and drink, for tomorrow we die" (1 Corinthians 15:32b).

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II. "Short-Termism" and Some Challenges to the Capital Markets

A. Demographics

> ***Sons are a heritage from the Lord, children a reward from him. Like arrows in the hands of a warrior are sons born in one's youth. Blessed is the man whose quiver is full of them* – Psalm 127:3-5**

i. The human resource shortfall: Where have all the children gone?

As a famous Arnold Toynbee quote puts it: "Civilizations die from suicide, not murder." A look at Canada's social indicators over the past three decades raises a question concerning where Canada is headed. Our lavish social welfare system, which rewards passivity and hampers creativity, coupled with our low birth rates and the adoption of secularism, have collectively created a situation where many Canadians have bought into the gospel of short-termism. *Clearly, the design flaw of the secular, social welfare state is that it is utterly dependent on a faith-based society birthrate to keep it afloat!*

As investment professionals, we need to step back for a moment and ask a simple question. What is Canada's greatest and most valuable resource? Is it our vast forests, our massive and highly desirable oil sands, our enormous fresh water reservoir, our manufacturing and assembly plants, our educational institutions, or, even, our form of government handed down by our forebears? No.

I would argue that none of these comes close to unearthing our greatest resource. Our greatest resource is the next generation . . . Canada's children.

The tragedy of our secular, short-term-driven culture is that our greatest long-term resource has been devalued so much that we have created our own scarcity of children! This result is not unique to Canada. It can be seen in most of the Western democracies and beyond, including Russia, China, and India. As a result, throughout much of the world we are committing a form of demographic suicide that has the potential to completely undermine our way of life and our economic system. I would argue that the failure to create a human future in the most elemental sense, by creating a successor generation, is surely tied to a collapse of faith and spiritual vitality and the ultimate display of our short-termism. But a society that treats its children as disposable and unnecessary commodities, trading them in for the

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ability to consume more and live more comfortably, is surely ripe for an economic correction. Let's take a few moments to look at some facts.

ii. Global aging of the world's population

The world is aging all across the globe, especially in western Europe, Japan, and to a lesser extent in the United States. This triad is vitally important to the capital markets because this is where the vast majority of the world's wealth is created and held. Falling birthrates, coupled with the lengthening of life spans, are causing populations to age rapidly.

Consider the following shocking facts concerning just western Europe and Japan:

1. Eighteen European countries along with Russia and Japan are now reporting negative natural increase (more deaths than birth);
2. No western European countries have a replacement-level birthrate. The replacement level is 2.1 children per woman; as of 2004, Germany's birthrate was 1.3, Italy's 1.2, Spain's 1.1, and France's 1.7 (the higher French rate is due to Muslim immigration);
3. Note that the difference between a replacement-level birthrate (2.1) and a birthrate of 1.5 or 1.4 is the difference between a stable population over time and a population that decreases by one third as each generation passes;
4. Germany is on a path to losing the equivalent of the population of the former East Germany by 2050;
5. In 2050, given current trends, 42 percent of Italians will be over sixty years of age, and almost 60 percent of the Italian people will have no brothers, sisters, cousins, aunts, or uncles;
6. Europe's retired population will increase by 55 percent in the next twenty-five years, while its working population will shrink by 8 percent leading to the impending bankruptcy of their social welfare, health care, and pension systems;[11]
7. During the next twenty years, the financial wealth of Japanese households will stop growing and begin to decline, leaving them $8 trillion USD less wealthy than they would have been if historical growth rates had persisted. Wealth in Japan will not only decline in the aggregate, but also for the average Japanese household that will be no wealthier in 2024 than it was in 1997;
8. The continual improvement in living standards the Japanese have enjoyed during the past half century will come to an end; and
9. By 2024, more than a third of the population in Japan will be over the age of 65. Savings rates will fall drastically, exacerbated further by the fact that younger Japanese people are saving far less then their elders did. Within twenty years, the savings rate in Japan will likely go negative. For a country that has exported excess savings abroad this will prove to be a major issue for the global economy.[12]

The bottom line is that the aging of the world's population, and the implications of this profound demographic shift, is emerging as the major social, political, and economic issue that must be tackled as soon as possible in order to at least minimize the impact it will have on the global capital markets. I would argue that solutions to this immense challenge go far beyond simple "technical fixes" to immigration, for the simple reason that

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most of our western democracies will be competing for the same qualified immigrants in the future. Rearranging the furniture on the Titanic is not the solution. We must come to grips with the enormity of the demographic, "short-termism" reality now!

iii. Selected implications of demographic change[13]

Let me take just a few moments to list just a few areas that will be "impacted" by the severe aging of the world's population, and underscore why this requires more research given its importance:

Economic growth
Within the next 10 years many countries will begin to see negative economic growth. This will be at a time when global debt levels are at record highs.

Economic prosperity – GDP per capita
Without increasing levels of productivity growth and increased returns on assets many countries will see decreasing levels of economic prosperity – that is, GDP on a per capita basis.

Labour supply

- There will be pressure to continue to raise retirement age across countries;
- Increased pressure on female labour force participation;
- Increased competition for immigrants will intensify; and
- We will see more movement of jobs rather than people with outsourcing and off-shoring.

Inflation
The dramatic aging of the world's population will be strongly deflationary. This will have major impacts on the capital markets and financial institutions. Given the massive global debt and entitlement programs, any sort of deflation could be disastrous.

Fiscal policy and expenditures
There will be significant pressure to completely overhaul major entitlements among countries with aging populations and developed social welfare systems. Given the aging of populations, the fiscal policies of the past are simply not sustainable, and pension promises as they currently stand cannot be met in many cases. In some cases this will probably lead to social upheaval and a further increase in the divide between the lower and upper classes.

Real estate markets
Over time, an aging and shrinking population in many regions will put downward pressure on real estate values. Who will buy those monster Muskoka properties twenty years from now?

Equity values and bond values
Any contraction of savings will put downward pressure on equity values and bid up the cost of debt. To date, pension funds and insurance companies have been large buyers of long-term bonds keeping interest rates at a very low level. Over time this demand should slow and indeed fall leading to higher interest rates, lower bond prices, and lower equity values.

Health spending
Clearly, health care spending will continue to increase dramatically putting a major drain on resources in countries that do not begin to adapt to the demographic changes quickly by overhauling their public policies.

The impact of the aging of the world's population and the impending savings contraction, coupled with the need to radically overhaul national entitlement programs, will have profound and lasting effects on the capital markets over the next ten to thirty years. More research in this area is essential in order to help shape public policies and prepare the global economies for the consequences. This is no time for short-termism

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which refuses to admit that an "aging storm" is fast approaching. It's up to us whether this is "a tropical depression" or "a category-five hurricane!"

B. Goodness, virtue, and "long-termism" underpin our GDP

***Lazy hands make a man poor, but diligent hands bring wealth* – Proverbs 10:4**

i. Values and the GDP

Economics is really a metaphysical science rather than a mathematical one, in which the spiritual values and attitudes are more important than physical assets, and the morality and virtue of the populace are as foundational as the money supply:

> Products, after all, are the assembly of qualities, and their value derives directly from the innate character and ideals of those who create them and the workmanship of those who produce them. Things are, in their final analysis, the expression of thoughts. Quality products derive from quality thoughts, shoddy products from shoddy thoughts.[14]

If this is true, like an individual business or a specific product or service, an economy is the sum of the spiritual and mental qualities of its people. Economic output will only be as strong as the values of the society. Without the refining influence of moral standards such as honesty, trust, integrity, and loyalty, the marketplace will quickly deteriorate. A society – particularly, a free market society that does not have strong values – will end up producing less and less of value. A nation whose values are in decline will eventually witness a decline in its economy. Can economic strength be cultivated in the soil of spiritual poverty and short-termism?

As Warren Brookes so eloquently penned over two decades ago:

> (I)t is not an accident that capitalism rose to world economic leadership only as a byproduct of the spread of Judeo-Christian spiritual values and laws; and to the extent that these values dissipate in hedonistic, amoral humanism, (may I add, "short-termism?") capitalism itself will decline.[15]

Have we already entered an economic decline driven by our short-termism seen increasingly in the very composition of our GDP? St. Augustine said "moral character is assessed not by what a man knows but by what he loves."[16] In our productive and efficient capitalist economies, what we love is reflected in what we produce! Looking at what we produce can be an excellent barometer on the health and long-term wealth of our culture. If we simply rely on economists and how they measure our economic output we could miss the obvious. Economists measure the size of an economy simply by giving us a gross tally of all the products and services bought and sold within an economy over a specific period of time. But as we saw with our economic textbooks, our friendly economists are purportedly "value neutral" and make no real distinctions between expenditures that build long-term value and those that feed an increasingly secular culture. Surely we can agree that money expended building up our infrastructure (roads, bridges, and electrical grid), or spent on home repairs are far more valuable than money spent to "redistribute wealth" at Casino Rama, to feed online pornographic addictions, or to provide medical services that take the life of an unborn child!

Since the GDP records every monetary transaction as positive, the costs of social decay and natural disasters are tallied as economic progress. Crime adds billions of dollars to the GDP. From the sale of locks and security systems to increased police protection and property damage repairs, GDP has expanded over the past several decades as

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a result of the increasing costs of prisons, social work, drug abuse, and psychological counseling. Divorce adds billions of dollars through not only legal and real estate fees but also by way of the debt burden families must take on, in many cases to establish second households. Hurricanes that force governments to go further into debt to help rebuild devastated areas are measured as a boon to the economy despite the weakening of the country's balance sheet.

The GDP ignores the massive non-market economy of household and community. This includes child care in the home, elder care, other home-based tasks, and volunteer work in the community. Anything where money is not changing hands is not included. But as the non-market economy has declined over the years, this has been portrayed as economic advance – which could not be further from the truth in most cases. GDP treats the depletion of natural resources as income but forgets to adjust for the reduction in value of the actual resource that generates the income. Will Alberta with all it's current wealth actually be wealthier in fifty years? This will depend on Albertans' reinvesting the profits from the oil industry into other areas to diversify their "concentration risk" or, in other words, to think long-term and make intergenerational investments.

The current GDP measure ignores the problem of spending more and more and living not only on "your own" borrowed capital but on capital borrowed from foreigners! Much of the recent rise in our GDP has been built on the back of high levels of personal debt used to finance in many cases not long-term assets (capital assets) but high levels of personal consumption (which represents over 70% of the GDP) on everything from trips, leasing cars people cannot afford to buy, excessive wardrobes, entertainment, dining out, among others. The problem is heightened since in the United States much of this is financed by borrowing abroad.

ii. The need for a better long-term measure of wealth

I suggest that some of us take the time to come up with a better gauge for economic progress that acknowledges the shortcomings of our current measure, that seeks to come up with a measure that places greater emphasis on the components of GDP that measure long-term capital investments, and that better reflects the state of the country's balance sheet and the ethics and virtue of its population. Any new measure simply cannot be solely focused on the spending side of the equation. Can you imagine investing in a business that calculated its success and prosperity the way economists calculate our GDP?

Investments in research and development, technology, basic infrastructure, education, health care, and faith-based institutions – just to name a few – should be more highly valued than expenditures to fund what I believe to be our culture's social pathology! Social indicators show that Canadians are spending a larger and larger portion of their assets on electronic entertainment, gambling, pornography, entertainment, and sports. But is our short-term infatuation with these things adding to private and public virtue, and making us a more productive and visionary culture? We may be willing to purchase the largest home we can finance with every conceivable gimmick, but if we are having fewer and fewer children to fill them what will be the long-term result? Our measure of wealth must be revisited!

Think for a moment of the once powerful Ontario economy. We can't even make it through the summer without importing energy from our American neighbours. Why? We have in our short-termism not been prepared to make the proper investments in our electrical infrastructure! It's been easier for our provincial government in invest in casinos throughout the province which now account for more than 5% of the provincial revenue

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than to ensure a stable energy base to power our critical manufacturing businesses. Where will this short-termism ultimately lead? As an investment professional I fear it can only lead to ultimate social decay.

C. Capital allocation and stewardship

***Dishonest money dwindles away, but he who gathers money little by little makes it grow* – Proverbs 13:11**

i. Corporations and short-termism

Unfortunately the effects of short-termism are alive and well within parts of the corporate world. While there is a large number of business people who do view themselves as long-term stewards of the next generation's wealth, the pressure to think and act based on short-term results has increased. We need to challenge our entrepreneurs to view their gifts and positions as callings and look beyond their own short-term circumstances. We need to encourage more and more business people to use their God-given talents and resources to be fruitful and bring added value into the world so that they leave behind a lasting and valuable legacy.

Some of the areas that reflect a short-term preoccupation in our corporate board rooms include governance areas such as:

1. The high levels of executive compensation, particularly when they are not tied to the long-term success of the business. How much is enough? Where is the attitude of partnership with the providers of capital?
2. Stock option backdating – which is simply a form of theft against the other shareholders. Any issuance of stock should only be made when the business receives as much in value as it gives;
3. The willingness of management to forego long-term investments in the business in order to make short-term earnings forecasts. This is a breach of stewardship against the long-term shareholders. All capital allocation decisions should be based upon the long-term economics of the business and never driven by accounting considerations; and
4. In Canada, "the trustification" of a large portion of our businesses. Given the tax arbitrage that is currently available, many executives have morphed their corporate structure simply to placate short-term investors focused on a short-term increase in the share price of the stock. Many businesses that have been converted into an income trust structure should not be "trusted" and over time will not produce much income!

Each one of these areas is worthy of further research and work in order to help shape public policy and apply pressure on the boards of company's to protect the long-term interests of all stakeholders, including the ultimate owners of the business – the long-term shareholders.

ii. Money managers, derivatives, and the "casino-ization" of the exchanges

The growth of professional money managers and the massive amounts of financial assets they manage make them an important group to understand. The behaviour of money managers has an important influence on the capital markets, and it ultimately impacts many decisions made in the corporate board rooms of our country. As the CFA Institute has pointed out, our money managers are in many cases investing based on shorter and shorter time horizons. Clearly some of this shortening of time horizons comes from an investing public that views the capital markets as an extension of the gaming industry and seem to have investing time horizons that cannot even span

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three months! Jim Cramer's *Mad Money* program on CNBC seems to have captured the spirit of our times!

There are several key areas that require further research and understanding in order to better understand and help formulate policy in both the public and private sectors in the interest of the long-term investor and the economy at large:

1. **Money managers and the rise of the hedge funds**

Short-termism and hedge funds more often than not go hand in hand. Most people are aware that hedge funds have grown dramatically over the past fifteen years. Assets have grown from US $58 billion in 1991 to approximately US $1.5 trillion at the end of June 2006. There are few businesses that are more volatile and market-sensitive than the hedge fund business. When the markets are good, hedge fund managers can take up to 10% of the assets they manage and when times are bad they will drop back to approximately a 1% return on their assets. This volatility is due to the fact that most of their money is earned through performance fees. What are the performance fees? They can vary anywhere from 20% to 50% of the yearly performance, often above a threshold level of return. The incentives are clearly short-term, which serves to heighten the short-term nature of the investment decisions!

Given the size of the hedge fund industry and the short-term nature of their investing, it is estimated that they now account for about one-third of the total trading volume. When one considers that a third of the trading on the global capital markets is due to hedge funds one must consider the long-term impacts on the capital markets of such short-term players. In his recent book, *Hedge Hogging*, Barton Biggs makes the following statement:

> Hedge funds and their managers have the career expectancy of rock stars. A fund whose performance elevates it into the top 20 of all funds based upon assets under management has less than a 50% chance of remaining in the top 20 for three years. The average life of a fund, like that of a National Football League running back, is only four years. Each year about 1,000 hedge funds close because of indifferent performance and the inability to get to critical mass. In fact, in 2004, a thousand new hedge funds were formed and about a thousand closed down, not with a bang but a whimper.[17]

Paying some of our brightest minds, graduating from some of our top MBA programs, to speculate on financial assets in order to either earn obscene amounts of money or close down and leave town is not a good long-term strategy for our society. Recently we have witnessed a large number of corporate reorganizations and asset sales that have been precipitated by hedge fund managers' pressuring weak management teams. Two examples include *Wendy's* spinning off *Tim Hortons*, and the income trust conversion of one of Canada's leading oil services company, *Precision Drilling*. Both these situations arose due to hedge fund managers' focusing on a quick pop in share value and not necessarily what is in the interests of the long-term shareholders. Yes – investment managers have a fiduciary obligation to make sure management teams maximize shareholder value, but this maximization of value should not be at the expense of the long-term shareholder.

Fairfax Financial Holdings, a Toronto-based insurance holding company, recently filed a statement of claim for US $6 billion in compensatory damages from a number of defendants, mostly hedge funds, for stock market manipulation. A quick reading of this statement of claim highlights some of the potential problems we could be increasingly dealing with when a large, mostly unregulated industry with significant size

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is run by our best and brightest hedonists placed in positions of importance that can land them up to 50% of the annual performance of a fund! The claims made by *Fairfax*, still to be proven in court, are nothing short of shocking. (These claims include various forms of personal and corporate intimidation along with the support of erroneous research reports to drive down the share price and provide profits for short positions). If only a quarter of what is alleged is true, we have a handful of hedge funds operating in a manner more consistent with the mafia than with capital market participants. Those of us in the financial industry who make our livings based upon the notions of right and wrong realize the seriousness of these allegations and wonder where this will lead. If we cannot believe in the integrity and honesty of market participants to play fairly we will all be poorer over time.

2. The massive growth of derivatives and the casino-ization of the exchanges

Two other major challenges facing the capital markets are the massive growth in derivatives and the privatization of our securities exchanges.

While the cash markets have been growing at approximately 8% to 10 % per year, the options and derivatives markets have been growing in excess of three times this level, or at approximately 25% per year for more than a decade. Leaders from the former Federal Reserve Chairman Allan Greenspan to Warren Buffett have sounded the alarm on the size of the global derivative market. Buffett actually referred to them as “financial weapons of mass destruction” in one of his recent annual reports. The size of the market, the leverage that is used, and the accounting for them are all areas of controversy and added risk to the capital markets.

The use and size of the derivatives market has gone well beyond any economic purpose, and more properly reflects the size and interest of speculators to trade these financial instruments simply for the purposes of short-term profits and not for the hedging of business risks. A couple of quick statistics will underscore these comments. The notional amount of interest rate and currency swaps at year end in 1987 totalled US $895 billion. By 2005 year end this total had grown to more than US $213,194 billion – an annual compound growth rate of more than 44%! The total notional value of derivative trades in 2005 topped more than US $1,175 trillion while the total value equity trades globally was US $50.4 trillion, on a total base for global financial assets of approximately US $140 trillion![18]

Given the foregoing environment, where many of the market participants are characterized by short-term greed and act as speculators in paper rather than as long-term providers of capital to businesses, we should be concerned about the long-term implications of privatizing our securities exchanges. If exchanges are now to be run solely for profit, and their revenue is generated by trading volume, then the ultimate goal of the world’s exchanges will be to increase the velocity of transactions. If more and more of the trades are conducted by short-term hedge funds, and more and more of the financial instruments are derivatives abstracted from the real economy and global commerce, where is all this headed? Is this actually good for the capital markets? Have we not, as Charlie Munger at the *Berkshire Hathaway* 2004 annual meeting mused, converted the NYSE into the world largest casino? In a culture where gambling is one of the biggest moral problems of our time, are we allowing our capital markets in the name of efficiency to become hostage to speculators who are really not much different than the poor folks who frequent Vegas, severing the dignity of work from the hope of financial gain, offering the hope of riches without due labour, and reward without dignity?

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Conclusion

Short-termism in our capital markets left unchecked is a cancerous growth. Short-termism will continue to weaken the long-term creativity and efficiency of our markets to allocate capital to the most efficient businesses – businesses making long-term investments and producing goods and services that add value to the broader culture without undermining private or public virtue. I have raised a number of significant challenges facing the capital markets over the next ten years and beyond. It is ultimately up to those of us who view the capital markets as a trust that must be protected for future generations to respond to these issues.

Over the next couple of years as Senior Research Fellow at the Work Research Foundation, I intend to pursue several of the issues raised in this paper, and shed some light on what I believe to be the evidences of decay in our culture and economy and ways in which we can try to move beyond our short-termism.

Here's what I mean . . .

I believe that we need to build around what some might call "general revelation" or self-evident truth, and seriously work out the implications for economic life. For example, most people believe that we should be honest, even if they do not hold themselves to that standard from time to time. Where does this come from? Where do we anchor our view of ethics? Why is ethics taught in the business faculties and not in the sociology or philosophy departments of our universities? We need to recover some notion of "public virtue" in a postmodern society where we are told "anything goes." How do we talk about virtue, ethics, and values which are so critical to our way of life and the maintenance of our social structures including the capital markets, when we live in the backdrop of a secular and pluralistic culture which implies that any talk of transcendent realities and morals is out of bounds?

Another issue I will be pursuing relates to our measures of economic progress. As discussed, GDP measures pure economic activity, but not all economic activity has long-term compounding value. What sort of measurements should we develop that could reorient our attention away from short-termism and toward long-termism? In investment parlance, what is really just maintenance capital spending, and what capital are we spending that will really grow the true wealth and size of the economy on a per capita and intergenerational basis? How can we minimize investments in areas that can hurt private and public virtue and undermine enterprise and creativity? Can thinking long-term make economic sense as well as social and spiritual sense? I realize that some of these issues will touch on controversial subjects for some, and, hence, on subjects that in many people prefer to avoid, but the folks at the Work Research Foundation have asked me to pursue these questions for the good of us all.

It is also important that we learn from our successes. For all the flaws in our system, some of which I have touched on tonight, there is still much to commend in our system. In our global

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context we do well to identify and champion that which has led to so much prosperity. Economic freedom goes together with every other kind of freedom. Using any comparative standard, Canada is a remarkably free society. But we cannot take our freedom for granted, and we must work hard to maintain the conditions that will support free institutions and the integrity of our capital markets in the future.

The answers to the questions we raise are not to be found in a stylish five-point policy plan that some government can pass. They go much deeper and involve the ethos and culture that affect how all of our institutions operate. Replacing a short-term myopia with a long term vision requires us to honestly address these issues, beginning with admitting that they even exist.

I want to thank you all for sharing this important event with me and the Work Research Foundation. We do not have all the answers. Yet, what excites me most about serving as a Senior Fellow is that together we can seek answers to some of the bigger and broader questions facing our capital markets – answers that will also impact the broader Canadian culture and its social welfare.

Notes

[1] "The New Environment in Corporate Governance: Taking Stock and Looking Ahead," Business Roundtable Forum on Corporate Governance (10 September 2003).
[2] "Mapping the Terrain" survey, Business Roundtable Institute for Corporate Ethics (2004). At www.corporate-ethics.org.
[3] John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "The Economic Implications of Corporate Financial Reporting," *Journal of Accounting and Economics,* vol. 40 (2005): 3-73.
[4] "Breaking the Short-Term Cycle," CFA Centre for Financial Market Integrity/Business Roundtable Institute for Corporate Ethics (September 2005).
[5] Barton Biggs, *Hedge Hogging* (Hoboken, New Jersey: Wiley, 2006) p. 292.
[6] John E. Stapleford, "Christian Ethics and the Teaching of Introductory Economics," *Journal of Markets & Morality*, vol. 3, number 1 (Spring 2000)
[7] Stephen L. Carter, *The Culture of Disbelief: How American Law and Politics Trivialize Religious Devotion* (New York: Basic Books, 1993).
[8] George Weigel, *The Cube and the Cathedral* (New York: Basic Books, 2005) p. 54-55.
[9] Os Guinness, *Entrepreneurs of Life* (Colorado Springs: Navpress, 2001) p. 16.
[10] Francis A. Schaeffer summarized our culture as a culture whose highest ideals have become personal peace and prosperity at all costs not understanding that Christian faith is necessary to keep these ideals over the long-term.
[11] George Weigel, *The Cube and the Cathedral* (New York: Basic Books, 2005) p. 21-22. The first six facts are taken from this section.
[12] "The Economic Impact of an Aging Japan" The McKinsey Quarterly (May 2005). Points 7-9 are taken from this article.
[13] "Why Demographics Matter? And How?" Credit Suisse – Fixed Income Research (July 18, 2006)
[14] Warren T. Brookes, *The Economy in Mind* (New York: Universe Books, 1982) p. 203.
[15] Ibid, 213. The parenthetical note is mine.
[16] Henry Chadwick, *Augustine: A Very Short Introduction* (Oxford: Oxford University Press, 2001), p. 54.
[17] Barton Biggs, *Hedge Hogging* (Hoboken, New Jersey: Wiley, 2006) p. 50.
[18] Source: Bank for International Settlement (www.bis.org) and World Federation of Exchanges (www.world-exchanges.org)

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