

How Much Can You Trust?

Prof. Dr. Iris Bohnet

Kennedy School of Government
Harvard University

7th International Sustainability Leadership Symposium, 31 August 2006

Trust and the Financial Sector

On my flight from Boston to Zürich, I read in the *Tagesanzeiger*:

“Ein Banker bringt es auf den Punkt: ‘Überall kann man flicken. Nur nicht in der Finanzbranche. Wenn hier deine Glaubwürdigkeit verletzt ist, bist du erledigt.’”

“...If you lose your credibility, you are destroyed.”

Is the focus on the short term
a response to the problem of trust?

Trust and "Short-Termism"

Centre for Financial Market Integrity (2006):

"... the short-termism mindset among certain investors is correlated with an overall loss of trust in corporate leaders. Those investors who have become distrustful of business leadership and its commitment to long-term value creation may have opted to seek short-term profits instead of long-term growth in value."

Trust and the Focus on Quarterly Earnings

- Frequent information increases investor **control**.
- Hitting earnings benchmarks (earnings same quarter last year and/or analyst consensus estimate) builds **credibility** with the market.
 - Earnings guidance: Can management accurately predict its future?
 - Can management make the necessary adjustments to hit earnings targets?

But the price is: sacrifice in economic value.

Is a focus on the short term
a necessary “evil” to build trust –
or why is it so hard
to focus on the long term?

Why is there a focus on the short term in the financial sector?

- Economics:
Principal-agent relationships → Incentives
- Psychology:
Complex decisions → "Bounded awareness"

Video clip

Please count the number of passes between the white players.

Bounded Awareness

- If your environment (instructions, incentives, information, complexity...) focuses your attention on x , you are more likely to miss y .
 - Short-term versus long-term
 - Simple metrics (earnings per share) versus more complex information on corporate strategy and performance

Game: How much do you trust?

- You receive CHF 100. You can keep it for yourself or pass any fraction to another, anonymous person (your agent).
- Any amount you pass along will be multiplied by a factor k determined by your agent's effort.
- Your agent can either keep the resulting amount or return any fraction of it to you.

Example: If you pass CHF 100 to another person and $k=3$, she will receive CHF 300 and can return between CHF 0 and CHF 300 to you.

Trust

- Game “represents” situation between investors and managers up to the mid-1980s:
Hardly any material incentives for agent to reward the trust the principal placed in her.
- Change in the mid-1980s: *Alignment of incentives.*
 - E.g. fraction of CEO pay tied to stock price increased from 1% in 1985 to 60% in 2005.
(Legg Mason Capital Management 2006 for largest publicly traded U.S. companies)

New Game

- Same game as before but
for any CHF 1 returned, your agent receives CHF $1+x$.
- Trustworthiness is rewarded –
but all depends on where reward comes from.
→ Based on short-term or long-term
performance measures?

How to change the game of trust?

Incentives

- *Managers:* Long-term pay for performance and disclosure.
 - Def. of “long-term” varies by industry but based on multi-year performance (e.g., Coca-Cola: 3 years; current median CEO tenure of Fortune 500 companies is 5 years).
 - Executives and directors are required to hold meaningful amount of equity in company.

How to change the game of trust?

Incentives

- *Analysts and asset managers:* Long-term pay for performance and disclosure.

Incentive disclosures are severely lacking in the managed funds industry.

- *Investors (institutional):* Competition and choice for beneficiaries.

Competition is severely lacking among institutional investors (e.g., pension funds).

How to change the game of trust? “Bounded awareness”

- *Managers:*
Shift the focus to long-term value creation, provide more meaningful information and avoid over-simplification.
 - Make easily available information less salient: More frequent communication about company strategy and long-term value drivers but less frequent reporting of simple “numbers:” shift from quarterly to annual earnings guidance or eliminate guidance.
 - Do not only report measures of central tendency (such as consensus earnings estimates) but also report measures of variation.

How to change the game of trust?

"Bounded awareness"

- *Analysts and asset managers:* Focus on long-term measures and "dissent."

Base analysis on long-term rather than short-term models, dissent from analyst consensus estimate.

- *Investors (individual and institutional):* Focus on long-term performance.

"Become owners:" hold longer, trade less.

(Annual turnover rate for shares of NYSE-listed companies more than 100 percent in 2005).

Lessons: “Long-termism” and Trust

- **Change and disclose incentives** of all agents (managers, analysts, institutional investors), **increase principals’ choices.**
- **Change focus** of all agents and principals by providing/requesting different information.