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"SHORT-TERM PROFITS VS LONG-TERM PROFITABILITY"

by

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SHORT-TERM PROFITS VS LONG-TERM PROFITABILITY

When I was invited to address this group several months ago I was delighted to accept because I believe you are just the right people with whom to discuss a concern that has been building up in my mind over a number of years. I've had the opportunity to be a minor player in industrial America for a long time. More recently, I had a look at that world through the eyes of an investment counselor and even more recently, just the past few months, to take the macro view of a central banker. To me, the problem looks progressively more important. This concern is that I see our business and financial communities having a strong orientation toward short-term profits whereas I believe we need to be much more oriented toward long-term profitability.

As it turns out, I think the timing for addressing this problem is particularly fortuitous because we have just been through a major shock to our system and I think that gives us an opportunity to reassess ourselves and, perhaps, reorient as necessary. We are all concerned about what will be the eventual outcome of the events in the financial markets of the last several weeks. I for one am extremely optimistic that we are going to come out of it stronger than ever for two basic reasons. The first is that our financial system has demonstrated that it can stand up under an extreme amount of pressure. That's tremendously reassuring in view of the questions some people had in that respect. Our system is strong, flexible and durable. Much of what happened was totally unprecedented. Yet, our economy and our financial system are intact and strong today despite what has occurred in these past weeks. That's enormously reassuring. Secondly, and more fundamentally perhaps, the United States business community was already coming back strong before events in the stock market that began several weeks ago, and I see no reason why that momentum should be broken. Slowed for a while, perhaps, but not broken.

Over the past several years, there has been a great deal of concern that the United States was losing its competitive edge and was on the way to being a second class economic power. We all saw scare headlines in the media and thoughtful articles as well, about how the West is at last coming to the end of its vibrant era and is losing its will to keep pushing ahead. These claims were greatly overstated. They came in the midst of what is now a five year expansion and as we speak we are going into the sixth year with the economy in good shape despite the recent events in the markets. Industrial production is up strongly and the area of greatest concern, our export volume, has been growing at a real rate of 16 to 18 percent annually. Here again, there is every indication that this momentum has not been broken.

However, American business did realize that we were in trouble and that we had to respond. Respond we did. We have been deregulating, restructuring, merging, cost cutting, modernizing, automating and stressing high quality. Perhaps most important of all, management and labor have begun to try to understand each others' needs and to seek an accommodation that will be profitable to both of them and to our overall society. If the auto companies and the UAW can get together we all can.

All this holds a great deal of promise for the future, but there is yet another area that I believe needs to be addressed. That is the need to reorient our thinking to the long-term. We need to redefine success as generating consistent, dependable, sustainable, long-term profitability. I believe that this is inconsistent with an orientation toward maximizing every possible penny of earnings per share this quarter and next.

Of course, we all realize that there has been a great deal of that going on in the red hot bull market of the last few years. The stocks of publicly held companies have been on a rollercoaster. If a company could string together several good quarters selling used bluejeans - take that stock up! And up it went. It's PE soared. I might add, one slip and down it came just as fast. Alternately, if an industry was out of cycle, no matter what it's past record or future prospects, take it down. Give it a six PE. "Earnings momentum" has been the catchword, and if you have it you fly. And heaven help anyone who had an "earnings surprise," however slight. Sell it out! Take it down!

And, of course, there is that new phrase of the 80's: "put the company in play." For an investor who happened to own shares in a company newly identified in that way, it has been the ultimate delight, because a quick joyride was guaranteed. Conversely, for management, and often for the employee group, it was the ultimate nightmare. I have no doubt some here this morning could tell us something about that. All of the emphasis has been on profit right now. Big, quick, splashy, earnings per share. Our market has been into instant gratification.

And, the managements of most publicly held institutions had to respond. Explicitly or implicitly, consciously or unconsciously, enthusiastically or under duress, corporate strategies have been responding to this market demand. The big problem is, I would submit to you, that for the long-term - for most companies and most certainly for our nation's overall economy - this has been a losers game.

Now that is not to say that stock prices won't fluctuate. Of course they will. And it is not to say that some companies aren't stronger than others, and some managements more skillful. Of course they are. Nor is it to say that current profits are meaningless. That would be silly. If a company is profitless today, it won't be around for the long-term. And furthermore, it's our role in the economy to add value to goods and services at our jobs every day.

But what it is to say, is that we have a "Catch 22" here. In an attempt to maximize profits right now, we severely jeopardize our ability to maximize profitability over the long run.

This short term orientation shows through every day in the nuts and bolts realities of managing a company. If a company is to prosper over the long haul, it must invest itself in its line of products. It must invest in R&D, promotion and advertising, a high level of service. It must take chances on new products and stay with them when they start slowly. I was inspired by the Wall Street Journal article of September 29 about how DuPont stayed with Kevlar, its new wonder material. According to that story, it took DuPont 25 years and $700 million and it is still not a big winner. But it is a important product and will be a big winner.

If a company is to prosper over the long haul, it must look after its organization and its infrastructure. Training and maintenance have to be taken care of and cost cutting is a forever job. If a company is to prosper over the long haul it must look to its capital strength, maintaining a strong balance sheet and emphasizing cash flow and not merely reported earnings per share. I could go on and on about this but you know the litany and so does top management. The point is every one of these basics present an opportunity to cut corners and thereby raise current profits for a while and every one of them has to be taken care of carefully in order to ensure long-term profitability.

This is particularly true in the area of international trade, where we all know we have one of our major problems in the form of a huge trade deficit. I'm convinced that one of the underlying business reasons for this situation is that so many American companies are short-term oriented whereas our foreign competitors take a long-term view.

The United States is a huge and dynamic market and other countries know this, of course. In order to get into this market, they have been willing to pay a very large current cost of admission. They sent people to study us, they tried products out on us, and many of those products were expensive failures for a time. But they stayed with it, and they learned, and they got those products right. Furthermore, they priced them very aggressively and went for market share as opposed to those short-term profits. Now that they have that market share, I might add, they are not going to give it up very easily. All this was very costly to them in the short-term but it has begun to pay off in the long term.

With the important exception of a handful of major internationally oriented companies, our business community has not done that. We can and must do the same thing and our opportunity is vast. As a nation, we are not nearly aggressive enough as exporters. We export 5.5 percent of our Gross National Product. Germany, on the other hand, exports 25.8 percent, the United Kingdom 19.8 percent, and Japan 9.7 percent.

There are huge market opportunities out there for us just as there have been for our trading partners. There are at least three groups of markets. First, in the industrialized countries in 1986 we had a 91.6 billion dollar adverse balance of trade. We can cut deeply into this. In the emerging industrial countries there are big markets that are starting to open up and as time goes along, the third world (at varying rates of speed) surely will also open up. We need to get ahead of this by getting into those markets now. I'm satisfied that the United States can and will become a fearsome worldwide competitor. We have the managerial talent and the entrepreneurial drive that's required to be successful. What we need to do is be willing to accept the up front expense that it takes to get a long-term pay off.

So here's the challenge. Nothing less than to change financial-America and business-America's mind set. Change it away from its fixation on short-term profits toward long-term profitability. I would submit that right now is a perfect time to do that. In the aftermath of the recent financial shock you can just feel America beginning to rethink itself. Where are we? What are our strengths? What are our weaknesses? What can we do well? Where do we want to go and how do we want to get there? This is a problem largely of climate, of values, of perceptions, and understandings.

As America's business communicators, you are in an ideal spot to lead the way and to make a major contribution to your company and, indeed, to our country's economy. You know better than I how to guide public opinion but let me make a suggestion or two.

There are a number of publics out there that need to be addressed.

First of all, there is the general investing public. They have been fed a steady diet for a long time of "right now, this quarter, next quarter." It has been an exciting and easy concept to digest, but it is not adequate. The long-term may be a little less glamorous but it has to be seen for what it is - where the future lies. I urge you to start stressing that story. Second, you are in a particularly strategic place to address professional investors and security analysts. Aim your pitch at the long-term. I believe if they are given half a chance by their clients, who are the general investing public, they will be very responsive to this new orientation. Indeed, I think they would welcome relief from the short-term pressure. Third, the investment counsel community is an important subset of the professional financial world. There is a story here for the value investor, for the growth investor, and even for the contrarian. The only group who I do not believe will be interested are the professional short-term traders and the market timers but I don't think we need to worry too much about them in this context.

On a different level, we need to give much more attention to educating our young people in economic literacy. I've been delighted since I became a part of the Federal Reserve System to discover that the Fed is involved in many economic education programs at its various locations. But, unfortunately, there are very few such locations. This needs to be done everywhere and business and its communicators are perfect to take the lead in every community in the land.

Last but far from least, I think there is one more vastly under-exploited opportunity in the area of education. That lies in the fact that America's employees are also America's consumers and America's investors. As employees everyone has a clear and well understood interest in the long-term success of his or her organization. However, as investors the connection is not often made between what we want for our own companies and what we are looking for in placing our money. Many, many people still chase the hot stocks and the hot mutual funds, and many, many employee pension committees push their money managers to "go, go, go right now." If we can get them on board, if we can bridge the mental gap between our employee orientation and our investor orientation, I think that the battle will be half won.

The case can be made that history is largely determined by how societies respond to the key events and turning points that come along from time-to-time. It may be that these past several weeks have been one of those for our economy. While a lot of people have certainly been badly hurt and that is very regrettable, I believe that a lot of good can emerge from this episode. One way is for us to begin to work at changing the mind set that we have been talking about. The "Catch 22" of short-term profits vs long-term profitability is not terribly difficult to understand but it will take an enormous amount of work and time by many people to shift those gears. However, it can be done and communications is the way that it must be done. If this notion makes any sense to you, I hope that you will give it a bit of thought because one thing is certain and that is that you are in a key position to make a difference.