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Strategic short-termism: Implications for the management and acquisition of customer relationships☆

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ABSTRACT

We study a duopoly model of history-based price competition with switching costs and demonstrate how strategic history-based pricing induces the owners of the firms to implement managerial short-termism by delegating the pricing decisions to managers with a discount factor lower than that of the owners. Managerial short-termism is a strategic device whereby owners can soften price competition at the stage when customer relationships are established. The degree of short short-termism is shown to depend on the market structure, the intensity of competition and the magnitude of switching costs.

1. Introduction

During the past decades the marketing literature has highlighted the importance of strategies focusing on the acquisition and management of customer relationships (see for example, Dwyer et al., 1987). As exemplified by Venkatesan and Kumar (2004), Blattberg et al. (2009) or Stahl et al. (2012), this approach has emphasized the application of customer lifetime value (CLV) with associated business strategies to maximize the long-term profitability of customer relationships. As Reinartz et al. (2005) emphasize, this typically involves the balancing of resources between acquisition and retention of customers. It seems intuitive that managers operating with a short-term objective would pay insufficient attention to the long-term implications of customer policy and that managerial short-termism therefore would imply reduced profit margins and suboptimal customer lifetime value for the firms. In this study we show analytically that quite the opposite holds true: managerial short-termism promotes profit margins in oligopoly markets with switching costs. We characterize how delegation of pricing decisions to short-sighted managers serves as a strategic instrument to soften competition between firms in oligopoly markets.

In general, short-termism refers to the phenomenon of excessive discounting of future outcomes. In this study we consider the delegation of pricing decisions to short-sighted managers as a strategic instrument. The analysis is conducted within the framework of history-based (or behavior-based) price discrimination with switching costs.

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Due to the switching costs, firms have strong static and dynamic incentives to acquire customers because established customer relationships are a valuable asset generating benefits not only at present but also in the future. Firms can achieve higher market shares by targeting very competitive prices to consumers with whom they have not yet established a customer relationship. The implied tougher competition reduces current profits. To avoid such intensified competition, each firm can commit not to compete as fiercely by delegating the pricing decision to a manager who is more short-sighted than the owner, i.e., a manager with a discount factor lower than that of the owners of the firm.

Our analysis establishes analytically that for arbitrary *exogenously* given initial market shares, the subgame perfect equilibrium configuration is characterized by strategic delegation to myopic agents, i.e., price-setting managers paying less attention to the future than the firm owners. Myopia turns out to be optimal both with a two-period and an infinite horizon. Thus, strategic history-based pricing competition induces the owners of the firms to implement managerial short-termism.

We also extend our analysis to an environment where we *endogenize* the initial market shares and for that purpose we focus on price competition with differentiated products and a two-period horizon. Our main qualitative result is robust to such considerations: in equilibrium, pricing decisions are again delegated to managers operating with discount factors lower than those of the owners. The equilibrium managerial discount factor crucially depends on the parameters of the model - the magnitude of the switching costs, the market power in the initial period, and the discount factor of the owners. Overall, we establish that the degree of short-termism is determined by balancing the incentives to exploit market power in the initial period against the incentives to benefit from switching costs in the second period.

The banking industry and the mutual funds industry are representative examples of industries where switching costs play an important role. For example, Kiser (2002) and Shy (2002) present evidence of significant switching costs in deposit markets and Brunetti et al. (2016) characterize the determinants of switching costs. Kim et al. (2003) establish similar evidence regarding lending markets. Hortaçsu and Syverson (2004) emphasize the empirical significance of switching costs in the mutual funds industry.

A firm's commitment through a short-termist managerial contract is valuable because it raises prices of all firms in the market and thus raises the profit of the firm. A low managerial discount factor may be related to a high personal discount rate, impatience. In principle, firms could use sophisticated methods to elicit managerial discount factors during the job interview and screening process when recruiting mangers. In a field experiment (Burks et al., 2012; 2008; 2009) show that the discount factor can be elicited distinct from present-bias (Heidhues and Köszegi, 2010; Laibson et al., 2003) and that the two induce different economic behavior. Similar methods can clearly be used when selecting managers.

Alternatively, the firms can implement short-termism with managerial compensation contracts, which are renewed with a probability lower than the discount factor of these firms. A limited probability of managerial contract renewal corresponds to a limited average tenure for the managers in question. For example, Kaplan and Minton (2012) or Martin (2002) report evidence consistent with short-termism in that respect.

As the historical overview of Haldane and Davies (2011) makes clear, short-termism has been deemed a significant economic problem for a long time. Based on their survey of CEOs at Fortune-1000 firms, Poterba and Summers (1995) present a number of observations highly consistent with considerable short-termism in the decision making of the firms. They estimated firms to apply average discount rates at around 12 % to future cash flows, i.e. discount rates much higher than either equity holders' rate of return or the return on debt. Clearly, such a degree of short-termism would severely distort the selection of investment projects by implicating the rejection of positive-NPV projects and the substitution of valuable long duration projects with inferior front-loaded projects.

The academic debate has paid particular attention to managerial short-termism induced by the pressure from the investors and the capital market. This approach, exemplified by Stein (1989) or Narayanan (1985a,b), has emphasized the mechanism whereby professional managers manipulate short-term earnings at the expense of long-term earnings in order to boost stock prices and the inferences regarding managerial ability. Formally, in this type of models with asymmetric information, short-termism is the outcome of signal jamming by professional managers who give priority to short-term projects in an attempt to influence stock prices as well as inferences regarding managerial ability. The market is indeed able to rationally discount the short-term earnings inflation, but if the managers would not inflate the short-term earnings the market would infer the firm to have a lower value.[1] This type of short-termism has recently caused particular concern (see, for example, Kay, 2012 and Mayer, 2012) in the UK, where companies with dispersed ownership float a high proportion of their stock. In a recent study, Terry (2015) investigates short-termism induced by analyst earnings targets. He finds, using a non-parametric regression discontinuity design, that firms just meeting or beating analysts' earnings targets display discontinuously lower long-term investment growth, whereas managers just failing to meet such targets face lower compensation and abnormally low immediate stock returns. Terry's findings thus suggest a tradeoff between the short-term prospects of firms and their managers versus the level of their long-term investments. Contrary to this approach, in our model short-termism is a consequence of decisions by the owners, not the professional managers.

Short-termism generated by owners, and not by managers, is also a core feature of the model of Bolton and Scheinkman Xiong (2006) who show that short-term speculative returns render shareholders to prefer short-term gains at the expense of long-term value. Also, Thakor (2017) presents a screening model with asymmetric information about manage-

[1] Darrough (1987) argues that the shareholders could, within the context of such a model, design a compensation scheme to managers in order to prevent short-termism.