

Trade-off between Investor's Short- and Long-term Goals

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Abstract. The latest studies and financial literature are analysed to determine the factors, which influence long-term shareholder value maximisation, which is ultimately the goal of the investor and the corporation itself. Content analysis has showed that the key to return sustainability is high quality of corporate governance, ethics and social responsibility, as well as plausible capital budgeting policy. Moreover, the road to long-term shareholder return sustainability is often "paved" by innovations. Based on the findings, the authors propose the model which helps to create an optimal portfolio with the aim to achieve the highest shareholder value in the long term by managing the risks associated with the above-mentioned factors.

Keywords: shareholder value, investor's goal, stakeholder theory, corporate governance, ethics, capital budgeting.

I. INTRODUCTION

When searching for the compromise between his or her long- and short-term goals, an investor always faces a dilemma of whether to receive benefit immediately in the form of dividend payout or invest these funds to get a higher return in future.

High immediate benefits, such as short-term corporate profit maximisation (which drives stock price), can be achieved by various means: manipulating accounting figures, cutting R&D investments, saving on employees' safety or on waste treatment technologies. The problem, however, is seen in sustainability of these returns and whether long-term investment return can be maximised.

The answer to the question about a corporate goal usually is profit maximisation, or better – shareholder value maximisation. Some speak about the stakeholder theory, which targets to satisfy all interested parties related to the company: investors, employees, customers, suppliers, and environment.

Jack Welch, former CEO of General Electric, for more than 25 years has been a proponent of shareholder value importance, but now is questioning the consequences of investor wealth maximisation by companies [17]. There appear more and more academic works, which criticize the dogmatic theory that the ultimate goal of a company should be shareholder value maximisation. The highest credit is given to the agency problem, when managers are engaged in short-term thinking and demonstrating unethical behaviour in order to achieve company's maximum market capitalisation, not thinking about long-term goals.

It is evident that companies are created to benefit their owners to provide them with a maximum return. It is interesting that Jim Collins not directly touching upon a social aspect shows that those companies, which provide long-term

returns, are acting with the vision to satisfy social needs, to help people solve the problem but not to earn as much as possible [4].

More and more investors are becoming socially responsible by limiting their investment universes to the companies, which care about the environment, employees, and customers. Majority of them believe that only this type of investment can provide sustainable long-term returns. Stock indices based on socially responsible investing (SRI) criteria are being created: FTSE4Good, DJ Sustainability World Index, SSE Sustainability Index etc. The criteria include corporate governance factors, ethical behaviour of the company towards stakeholders, environmental care.

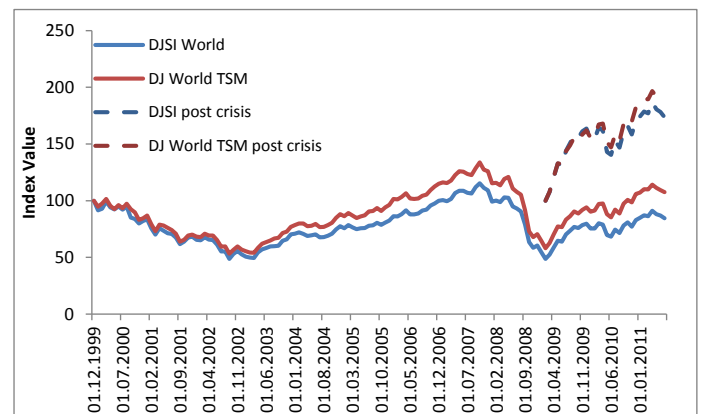


Fig. 1. Comparison of performance of DJ World Total Stock Market Index (DJ World TSM) and DJ Sustainability World Index (DJ SI World)

The chart shows DJ World Total Stock Market Index in comparison with the same index with the sustainability filter. Back to the beginning of the 2000s, sustainability factors were evidently not taken into account, and the annual performance difference was rather significant. And though the sustainability index still loses to the total market index in the post-crisis period, the annual difference in performances is not so substantial: 0.59% versus 2.08% for the total period. We conclude that there appears a special class of investors, which invest exclusively in corporate social responsibility (CSR) compliant companies. Besides, we hypothesize that companies, which manage their strategic development sustainably, are able to deliver higher performance.

Taking into account emergence of new trends on the markets, we try to find out of what is understood under shareholder value maximisation in the latest academic publications and how much attention is paid to the social aspect.

The present research aims to crystallise those factors that significantly influence shareholder value using qualitative analysis for that. We employ content analysis tools such as word frequencies and joint frequencies to find the most important themes within shareholder value or investor return issues.

The following hypotheses have been stated prior to the research:

Hypothesis I: Shareholder value maximisation is the major goal of a company imposed by the investors.

Hypothesis II: Shareholder value is a long-term concept.

Hypothesis III: Shareholder value maximisation in isolation cannot provide the highest sustainable return for investors.

Hypothesis IV: Accountability, corporate governance and capital budgeting are the major factors, which can sustain maximum shareholder return in the long term.

Besides, the approach to shareholder value creation and maximisation in the most widely used academic books is analysed in the article.

Based on the obtained study results and on the well-known Markowitz efficient market portfolio, we have created the shareholder's goal model trying to compromise investor's short- (not sustainable) and long-term (sustainable) goals.

II. RESEARCH METHODOLOGY

Literature analysis with the help of content analysis is mainly employed in the course of the present research. To understand the determinants of the long-term shareholder value and the factors, which succeed in shareholder value sustainability, we stick to the two strategies of the qualitative analysis:

1. Departure from the theory, when there are certain assumptions stated and 'hunches' about critical factors and relationships. This is done when considering the essence of investor's long- and short-term goals in academic literature;
2. Departure from the observations, when inspection of the data results in explanation. This approach is used in an attempt to discover the factors, which have the major influence on shareholder value in the long term.

Initial data for qualitative content analysis are extracted mainly from the most popular academic books on the corporate finance and investment management, as well as abstracts of the published scientific papers in the Business Source Complete EBSCO database, the world's definitive scholarly business database, providing searchable cited references for more than 1,300 journals. For word frequency and joint frequency analyses we have used 27 papers published after the financial year 2000. The papers for analysis have been selected based on the criterion if there was mentioned 'shareholder value maximisation' or related concepts. The criterion for the secondary filtering of the relevant papers was based on the fact if the authors mentioned any factor influencing a shareholder value. A vast majority of the analysed papers were based on the empirical research.

To determine the major constituents of the sustainable corporate development and long-term shareholder value creation, the authors have employed two text statistical software programs *TextStat* and *Hamlet II*, which also helped to analyze the relationships between the factors influencing the longevity of the company.

The obtained results have created a foundation, on which it is possible to develop a shareholder's goal model.

III. SHAREHOLDER VALUE AND INVESTOR'S GOALS – ACADEMIC LITERATURE REVIEW

A majority of books on corporate finance and investment management define an investor's goal as dividend payments and stock price appreciation, which can be either absolute return or outperformance of the relative benchmark. However, these notions seem to be rather simple and not covering the complexity of the shareholder's intentions. Moreover, they are also short-term related notions.

A majority of authors speak about shareholder's value maximisation. James van Horn puts profit maximisation, which is often regarded as one of the proper corporate objectives, in contrast to the value creation [10]. He says that there are certain shortcomings connected with earnings per share (EPS) maximisation:

1. Duration of expected returns is not included;
2. Accounting figures are subject to manipulation;
3. Risk/uncertainty of the future earnings;
4. High EPS does not mean high dividend payments.

Horn scarcely mentions social responsibility, which should be cared about when companies strive to achieve maximum shareholder return.

Glen Arnold also discusses the uselessness of EPS and accounting rate of return (ARR), when finding a solution about the ultimate goal of investor and corporation. He pays more attention exactly to a value creation aspect discussing that the most important key elements of value creation are: amount of capital invested, actual rate of return on capital, required rate of return on capital and planning horizon. It is worth noting that the author does not mention clearly the corporate ethics, agency problem, accountability, CSR [1].

The book published in 2009 by Frank Fabozzi and Pamela Peterson provides arguments to prove the uselessness of the accounting profit in the owner's wealth maximisation process and focus the attention on recently developed tools for measuring the shareholder value: economic and market value-added. The authors do not neglect agency problem discussing the costs of agency relationship and the ways to motivate managers to create the shareholder value in the long term. Manipulation with accounting data and social responsibility of the operating entity are also mentioned in this context [8].

Pierre Vernimmen associates the shareholder value with various important issues: capital structure decision, dividend policy, various shareholder value creation measures. The truth, he appeals to, is that the only strategy able to create the value for the investor is implemented only in the case when the shareholder's equity increases by more than the

amount of reinvested earnings. Though he mentions an agency problem but does not go much into details [18].

The following scheme briefly summarizes the main concepts associated with the shareholder value creation, which unanimously was admitted to be an ultimate investor's long-term goal.

Shareholder Value			
Measurement of Shareholder's Value: <ul style="list-style-type: none"> • EVA, • TSR, • MVA; • ROCE; • EPS; • ARR. 	Corporate Governance: <ul style="list-style-type: none"> • Agency problem; • Transparency. 	Corporate Ethics: <ul style="list-style-type: none"> • Accountability; • CSR; • Earnings Quality 	Capital Budgeting: <ul style="list-style-type: none"> • Dividend policy; • Capital Structure.

Fig. 2. Main concepts related to the shareholder value reflected in the business literature and academic books

IV. SHAREHOLDER VALUE AND INVESTOR'S GOALS – ANALYSIS AND REVIEW OF CONTEMPORARY RESEARCH

Review of Relevant Literature

A string of events on financial markets forced shareholders to consider sustainability of return on investment and turned attention to such problems as agency cost, social responsibility, and accountability.

Enron was worth only 30 bn USD at its peak market value of 70 bn USD, when manipulating with off-balance sheet items [11]. Sino-Forest, Chinese timberland operator, according to Muddy Waters Research, should cost below 1 USD, while company's market capitalisation at time, when the report was published, was 3.2 bn USD and stock price was 18.2 USD [19]. Zijin Mining, Chinese gold miner, was trying to keep silent about the devastating accident on one of his mines and was attempting to give bribes to journalists covering this issue [20]. These are just several examples of the unethical behaviour of the corporations to achieve higher returns, which definitely had a huge negative impact on the investing returns. Just recently investors in many countries started to think not only about the ethics but also about the risks connected with it and its influence on the long-term value creation.

Hart and Milstein speak about the attitude of the companies towards the need to become sustainable which is often viewed as an additional regulation, liability and additional costs as a result [9]. The researchers offer strategies that would make the company sustainable simultaneously increasing the shareholder value, calling it "creation of sustainable value by the firm". Four strategies offered by the authors are the following: 1. Pollution prevention (cost and risk reduction as a payoff); 2. Product stewardship (reputation and legitimacy as a payoff); 3. Sustainability vision, meeting unmet needs (growth trajectory as a payoff); 4. Clean technology (innovation and repositioning as a payoff).

CSR was viewed as a potential contributor to the shareholder value also by professors Martin, Petty and Wallace [15]. Their argumentation is that the reciprocal

commitment of the firm and its stakeholders can provide some basis for the long-term success. They also speak about the return from investments in CSR, which should be at least 100%. However, it is not clear what the time range is for the payoff. Another moment worth mentioning is that not often the investments in social aspects can be received in a material form. Often these are intangible benefits.

Another aspect, which is crucial for the shareholder value and which has been the only determinant (besides operating profitability naturally) of its creation until recently, is capital budgeting policy and all ratios connected with it: return on capital, cost of capital, capital structure, dividend policy – ratios which directly influence main shareholder value measures: economic value added (EVA), market value added (MVA), total shareholder return (TSR), return on capital employed (ROCE) etc. Capital budgeting policy and cost of capital minimisation are mentioned as a basis in the academic textbooks and research.

It is also worth mentioning that for more than several decades there is an ongoing debate regarding whose interests need to be satisfied: shareholders or stakeholders. The proponents of the shareholder theory argue that the main goal of the company should be firm value increase, stock price growth and, thus, maximisation of the shareholder wealth [14, 16]. However, this approach is criticised for encouraging management short-termism, which can turn into unethical behaviour. Proponents of the stakeholder theory believe that the economic profits of the company should be distributed among all stakeholders [2, 12, 13]. But again this seem to be a short-term approach as distributing the profits at one moment would hurt investment in research and development (R&D) and, thus, will not benefit society in the long term [5]. Another weak point of stakeholder theory is a constant change of the stakeholder, which means that one can receive benefit and exit relationship with the company, while another can have losses as the company was unprofitable at another time.

The compromise between these two conflicting theories can be found in the long term. According to Danielson et al., the shareholder theory is more apparent as a corporate and investor's goal, but the management should be dedicated to the long-term view, which means they should invest in all positive net present value projects regardless of whether these decisions will cause immediate increase in stock price [6]. Compensation incentives should be defined for managers accordingly.

In 1997 McKinsey conducted a study of the relationship among shareholder value creation, labour productivity and employment growth of 2700 companies across 20 countries [3]. The research results showed that focus on boosting the shareholder value also increases labour productivity and offers more employment opportunities in the long term.

Content Analysis Results

The research starts with the overall review of the themes covered in the selected publications on shareholder value creation sustainability and factors influencing it.

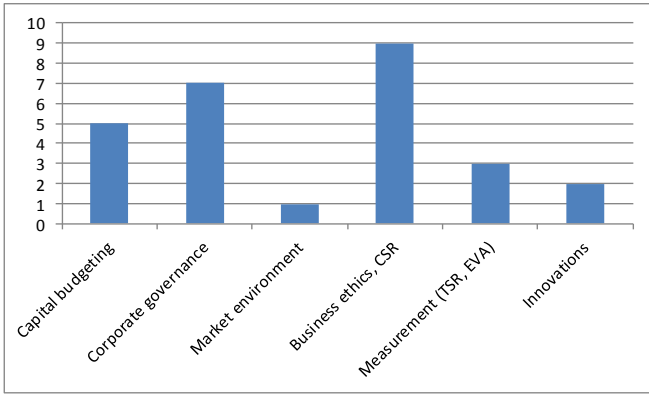


Fig.3. Number of studies emphasizing factors to maximize shareholder return in the long term

The chart above (Fig. 3) provides the analysis of the research topics (not older than 2000, extracted from EBSCO database) on the factors that have significant impact on shareholder returns maximisation and sustainability. Overall 6 major topics deserved major attention in the scientific articles:

1. Capital budgeting (dividend policy, capital structure, weighted average cost of capital (WACC), required rate of return);
2. Corporate governance (agency theory);
3. Market environment (industry regulations);
4. Business ethics and corporate social responsibility (accountability, earnings quality, stakeholder theory);
5. Shareholder return measurement (TSR, EVA, Cash return on investment);
6. Innovations as return driver (R&D investments, intangibles)

With the help of *TextStat* software, the authors of the article have also conducted the content analysis based on word frequencies. All words selected for the analysis have been split into 5 major groups.

The division into groups is based on the results obtained during the analysis of the business literature and the published scientific papers. The groups of words were dedicated to: corporate governance, capital budgeting, social responsibility and ethics, innovations and the rest were related to the shareholder value notion and its measurement.

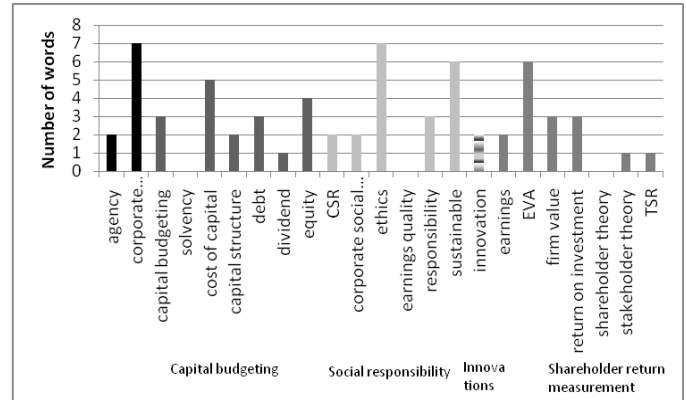


Fig.4. Frequency of words describing the major factors influencing the shareholder value

The chart includes those notions, which according to the primary analysis, are the most frequent in the analyzed text. As the chart shows, the most important concepts appear to be corporate governance and ethics. However, overall the word group related to the capital budgeting in the end turned out to be most frequently referred to.

Hamlet II software allows us to conduct also a thorough joint frequency analysis, which makes it possible to group words and concepts into hierarchical clusters and follow the most frequently appearing collocations (see Fig. 5). This type of analysis confirms previous research results as it builds a hierarchy based on the concepts related to the shareholder value in the long term.

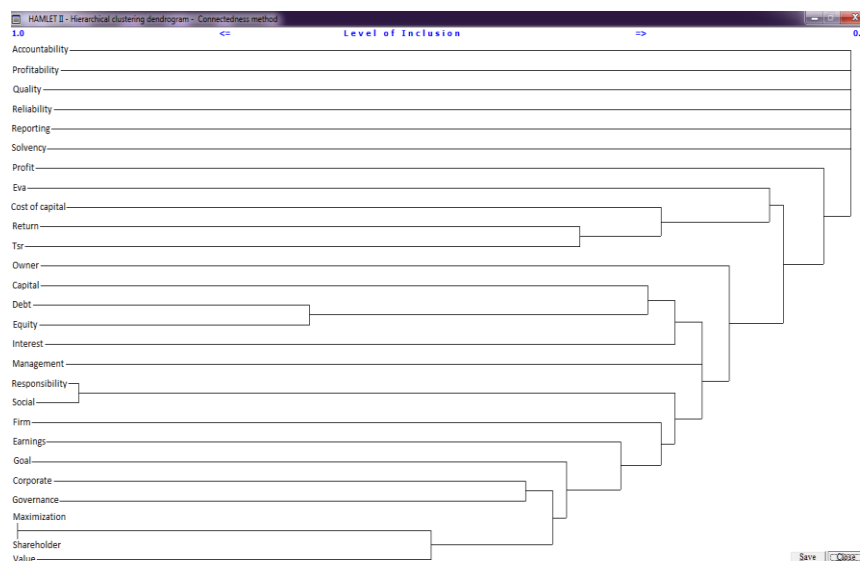


Fig.5. Hierarchical clustering dendrogram (Hamlet II) on most important concepts related to the shareholder value

One can clearly see the groups related to capital budgeting and to measuring the shareholder value. Another large group includes the notions connected to the social responsibility, corporate governance and ethics (see Fig. 6). Capital budgeting and social concepts obviously form another larger group, which has a direct impact on the shareholder value.

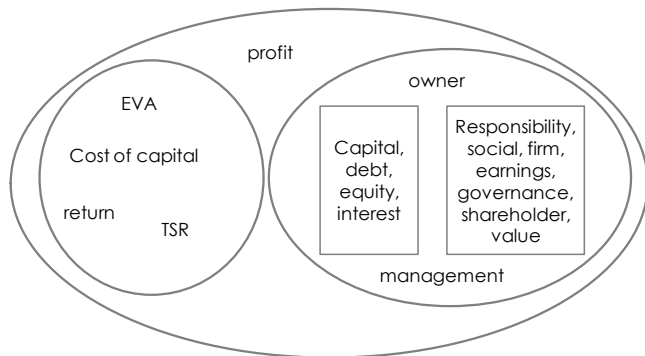


Fig.6. Main relationship between concepts discovered with the help of Hamlet II/ (magnification of Fig.5)

The authors of the article have tried to compare the frequency of usage of 'stakeholder' and 'shareholder' theories, which are mentioned one and zero times respectively. Definitely, it is not possible to make a conclusion that in this type of text the stakeholder theory is more important than the shareholder theory as the 'shareholder value' notion in the analyzed text is used more than 20 times. Besides, a 'stakeholder' separately is mentioned just 10 times, while obviously a 'shareholder' significantly more.

Looking at the shareholder value in the context of its sustainability a particular attention has been devoted to the frequency of the related words. 'Long-term' has been used 3 times, 'sustainable' – 7 times and 'sustainability' – 2 times, which points that the long-term approach of shareholder value creation is one of the key to the authors of the selected scientific papers.

To sum up the research of theoretical academic literature and of the scientific papers, which are usually more dynamic and able to capture the latest trends on financial markets, it is possible to conclude that there are several factors that can help to sustain the shareholder value. This complements the commonly accepted factor, which is capital budgeting, directly influencing cost of capital. Company compliance with business ethics rules and the quality of corporate governance should be definitely considered, when evaluating the company's ability to create a maximum long-term value for its owners. The authors of the article advise that also the company's innovativeness has to be considered as it often becomes a value driver and determines firm's longevity and ability to achieve above average returns in the long term.

V. HYPOTHETICAL SUSTAINABLE SHAREHOLDER VALUE MODEL

Based on the results of the present study, the authors propose the model of the long-term shareholder value maximisation, which resembles Markowitz portfolio theory.

Efficient frontier and Markowitz efficient portfolio are applied to the best possible choice of security selection on the stock market. The concept of capital allocation line, which is associated with the efficient frontier, describes the combinations of expected return and standard deviation (risk) of return available to an investor from combining optimal portfolio of risky asset and risk free asset [7].

The chart represents the portfolios with the highest level of returns at a given level of risk called an efficient frontier. Investor cannot diversify further to increase the expected level of return without accepting a greater risk. When introducing risk-free asset, the investor's best choice would be the tangent risk-free asset line to the efficient frontier of diversified portfolios.

Our hypothetical model is also based on maximising return at a given level of risk. On y axis instead of the expected return there should be the shareholder return or shareholder value, which can be measured as TSR or EVA or ROCE etc. (which was one of the five groups connected with shareholder value creation mentioned above). X axis as in case of the efficient frontier represents risk as well. However, the risk is defined not as a standard deviation. The risk in this case covers 4 spheres, which according to the study have the largest influence on the shareholder value in the long term.

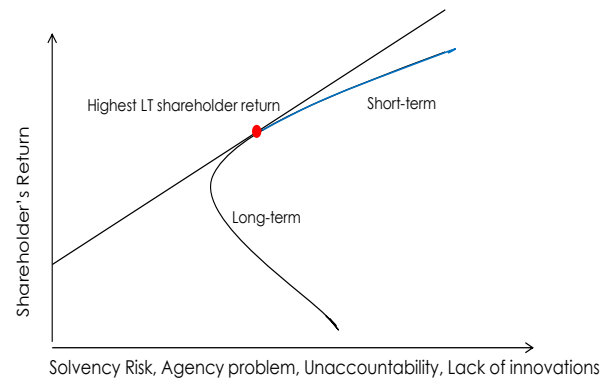


Fig.7. Hypothetical sustainable shareholder value maximisation model

Risk in the hypothetical model is defined as solvency risk (capital budgeting), agency problem (corporate governance), unaccountability (ethics, social responsibility), lack of innovations.

The risk-free asset line determines the tangency point, where the highest long-term return on a unit of risk can be achieved. It is worth paying attention to the line marked in blue, which provides a concept of the short term. In case the company carries significant risks such as cutting R&D budget, cheating with accounting figures, high short-term return can be achieved, as it should artificially inflate the

earnings, but obviously this strategy is not sustainable. When considering long-term performance, one sees that the higher the risks are, the weaker sustainability of the long-term return is, the lower the performance is, which can reach zero and become negative if the risks are very high. For example, in the short term the company may borrow funds to reduce its tax payment, thus increasing profit. But in the long term, the company may go bankrupt as the debt burden grows. If the company reduces investments in R&D, it will enjoy an immediate profit but may lose its competitiveness on the market.

VI. CONCLUSIONS AND RECOMMENDATIONS

The objective of the study, to find a compromise between investors' short- and long-term goals, has been achieved by creating a model, which provides a concept of long-term shareholder value. All the hypotheses stated in the introduction of the present research have been proved with the help of qualitative analysis of the academic literature, as well as contemporary scientific research papers.

Indeed, according to our findings, the majority of researchers sticks to the shareholder theory, not stakeholder theory, and considers that the ultimate corporate goal is shareholder value maximisation (Hypothesis I). Though some emphasize its long-term context, others neglect the fact that a corporate goal, which is shareholder value generation, can be achieved solely in the long-term period, when company's management has low incentives to act unethically to achieve a short-term result. The analysis of the contemporary scientific papers and articles has reassured that there should be a long-term focus when speaking about the shareholder value creation (Hypothesis II).

In order to detect the factors, which influence shareholder value sustainability, the authors have conducted the content analysis of the academic literature, as well as of scientific articles published in EBSCO not earlier than 2000. The analysis of the academic literature has shown that the basis of shareholder value is formed by the capital budgeting policy, stock performance, and operating profitability. Several references to the agency theory and social responsibility have also been provided.

The analyzed research papers, in contrast, focused exactly on the corporate governance, business ethics, and social responsibility. Of course, there were also articles about capital budgeting and shareholder value measurement tools. Innovations deserve special attention as in both sources they have been mentioned as long-term value drivers because only innovative enterprises can deliver superior performance in the long term. It has proved the Hypothesis III and partly also Hypothesis IV, which mentioned 3 factors influencing the shareholder value – corporate governance, capital budgeting and accountability. The research results have proved that also innovations have a certain weight in the long-term shareholder value creation, that is why this factor has been included as well.

Summing up the results, the authors of the article were able to develop a long-term shareholder value maximisation model, resembling Markowitz efficient frontier and capital allocation line. The hypothetical model allows understanding where the

maximum long-term shareholder value can be achieved and which risks can be minimized when investing in a particular company. Risk on x-axis shows the risks of poor corporate governance – agency problem, unaccountability, lack of innovations and also solvency risk. Should these risks increase in the short-term, investors could be able to earn higher returns as profit is maximized at the expense of reduced R&D budget, for example. In the long term, the increased risks can lead to zero and often a negative shareholder value.

It needs to be stated that this research is the initial stage of developing the hypothetical model, which needs to be looked at from different angles and requires proof for its accuracy, which should come from both academic and practical sides. One of the next steps of the present research continuation could be searching for evidence that companies themselves consider the shareholder value as an ultimate long-term goal.

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Jūlija Bistрова, Natalja Lāce. Kompromiss starp investora īstermiņa un ilgtermiņa mērķiem

Investīciju sabiedrībā ļoti aktīvi tiek apspriests jautājums par to, kuras intereses primāri jāņem vērā: uzņēmuma akcionāru vai visu ieinteresēto pušu. Vēl viena dilemma, ar ko sastopas katrs investors, ir ieguldījumu atdeves maksimizēšanā īstermiņā un ilgtermiņā, kas bieži vien ir pretrunā: vai nu saņemt dividendes uzreiz vai arī sekmēt to reinvestēšanu un vēlāk saņemt augstāko ienesīgumu. Pētījuma autori mēģina atrast kompromisu šīm dilemmām, analizējot pasaulē populārāko finanšu akadēmisko literatūru, kā arī modernus pētījumus par ilgtermiņa akcionāru vērtības maksimizēšanu, kas ir investoru un uzņēmumu galvenais mērķis. Publikācijas analīzei tika ņemti no datu bāzes *Business Research Complete*, kas ir piedāvāta EBSCO ietvaros. Teksta analīzei tika izmantota teksta statistikas programmatūra *Hamlet II*, ar kuras palīdzību tika analizētas anotācijas 27 publikācijām. Veicot teksta analīzi, tika noskaidrots, ka pamatfaktori, kas palīdz sasniegt augsta ienesīguma ilgtspējību ir augstās kvalitātes korporatīvā pārvaldība, uzņēmuma ētiskie principi un sociālā atbildība, kā arī prātīga kapitāla pārvaldīšana uzņēmumā. Turklāt, tika noskaidrots, ka ļoti bieži ilgtermiņa augsto akcionāro vērtību sekmē uzņēmuma spēja radīt inovācijas, kas sniedz augsto pievienoto vērtību. Pamatojoties uz pētījuma rezultātiem, autori piedāvā modeli, kas palīdz veikt optimālo portfeļa izvēli ar mērķi sasniegt augstāko akcionāru vērtību ilgtermiņā, ņemot vērā riskus, kas ir saistīti ar augstākminētiem faktoriem. Riski, galvenokārt, ir sekojošie: aģentu problēma, inovāciju trūkums, bankrota risks, zems atbildības līmenis.

Юлия Быстрова, Наталья Ляце. В поисках компромисса между краткосрочными и долгосрочными целями инвестора

В кругу инвесторов всё чаще обсуждается вопрос о том, чьи интересы следует брать во внимание в первую очередь: владельцев предприятия или всех заинтересованных сторон. Ещё одна широко обсуждаемая дилемма, с которой сталкивается каждый инвестор, касается максимизации отдачи капитала в краткосрочной и долгосрочной перспективе, что часто противоречит друг другу: или получить дивиденды сразу, или способствовать их реинвестированию с целью получить более высокую долгосрочную доходность. Авторы исследования пробуют найти компромисс для решения этих противоречий. С этой целью авторы используют качественный анализ наиболее часто используемой мировой академической финансовой литературы, а также исследования на тему максимизации отдачи капитала в долгосрочной перспективе, что является первичной целью инвесторов и предприятия. Текстовый анализ главным образом проводился на основе публикаций из базы данных *Business Research Complete*, которая является частью EBSCO. Для полного текстового анализа использовалась программа *Hamlet II*, с помощью которой были проанализированы 27 аннотаций к публикациям. В процессе исследования выяснилось, что основные факторы, с помощью которых можно достичь долгосрочности высокой доходности, это: высококачественное корпоративное управление, этические принципы предприятия и социальная ответственность, а также разумное управление капиталом на предприятии. К тому же было выяснено, что часто долгосрочность высокой доходности определяется также способностью предприятия быть новатором. На основании результатов исследования авторы предлагают модель, которая способствует выбору оптимального портфеля с наиболее высокой долгосрочной доходностью при определённых рисках, которые связаны с вышеупомянутыми факторами. Авторы выделяют следующие риски: проблема агента, нехватка инноваций, риск банкротства, низкий уровень ответственности.