



Corporate long-term behaviors: How CEOs and boards drive sustained value creation

by Kevin Sneader, Sarah Keohane Williamson, Tim Koller, Victoria Potter, and Ariel Babcock

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FOCUSING CAPITAL
ON THE LONG TERM

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Foreword

Time and again, research has shown that companies create the most value when executives and directors concentrate on achieving superior long-term results rather than meeting short-term targets. Yet executives can find it difficult to resist focusing on the here and now when they face pressure from investors and boards to deliver strong near-term results. Our analysis of companies' performance also shows that behavior focused exclusively on the short term has grown more prevalent during the past several years. The COVID-19 pandemic has only placed further short-term demands on executives. In a recent survey, nearly half of executives said that the pandemic has compelled their companies to postpone or end some long-term growth projects.

The crisis has also hastened momentous developments in business (such as the uptake of digital technology) and society (such as efforts to build more equitable systems, correct injustices, and reskill workers for in-demand jobs) that have been in motion for some time. It has highlighted the perils of engineering operations, such as supply chains, for efficiency and cost-effectiveness without building in resilience.

Executives have begun responding to these new realities. Half of those who completed our recent survey say their companies have altered their long-term strategies because of the pandemic. We'd submit that companies perform better when they regularly revisit their strategies and their value propositions to stakeholders. We also believe the shifts caused by the pandemic have created a critical opportunity to reorient businesses toward the long term.

Although the advantages of maintaining a long-term orientation are clear, the practical aspects of managing for long-term performance are less well understood. FCLTGlobal and McKinsey have published joint studies revealing a few things that long-term companies *don't* do, such as invest modestly in R&D and use accounting methods to lift reported earnings. In this report, we build on that analysis to identify the behaviors that long-term companies consistently exhibit. We also propose actions that boards and executives can take to promote these behaviors.

These findings are derived from extensive research, which was led by Ariel Babcock, Tim Koller, and Victoria Potter, and supported by Travis Hinds, Ganesh Raj, Josh Rosenfield, and Luke Stidham. Jonathan Godsall, Bill Huyett, Conor Kehoe, Bruce Simpson, and Robert Uhlaner shared their expertise as members of the project's steering committee. We wish to thank these colleagues for their contributions, as well as many others whose insights shaped our thinking.

We hope that this report will help business executives realize the benefits of a long-term orientation, and policy makers to promote the adoption of a long-term focus. We invite you to send us your comments at CorporateHorizonsResearch@mckinsey.com.

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Executive summary

Ample evidence shows that companies create more value for investors when executives consistently make decisions and investments with long-term objectives in mind. Addressing the interests of all stakeholders also leads to better long-term performance. The future, it seems, should belong to managers who have a long-term orientation and accept the importance of treating various stakeholders fairly.

Nevertheless, our research shows that behavior focused on short-term benefits has risen in recent years. In a survey conducted for this report, executives say they continue to feel pressure from shareholders and directors to meet their near-term earnings targets at the expense of strategies designed for the long term. Managers say they believe their CEOs would redirect capital and other resources, such as talent, away from strategic initiatives just to meet short-term financial goals.

Executives may continue to focus on short-term results because adopting a long-term orientation can be challenging. While previous research has established that long-term companies perform better in the long run, it has not identified the management behaviors that enable them to do so. This report represents our attempt to fill this gap. In it, we show that long-term companies adhere to five behaviors, and we provide evidence that those behaviors work:

Investing sufficient capital and talent in large, risky initiatives to achieve a winning position. Many established businesses have developed an aversion to risky bets. Instead of playing to win, they play not to lose—and so they struggle to stay in front of competitors. Long-term companies identify strategic moves that will keep them ahead in the long run and commit ample resources to strategic initiatives such as product innovation, marketing and sales, and talent development.

Constructing a portfolio of strategic initiatives that delivers returns exceeding the cost of capital. Growth alone won't deliver value. Companies must devote resources to endeavors that produce returns in excess of the cost of capital. Not every investment that a company makes has to earn more than its cost of capital. But if the entire portfolio of strategic initiatives earns more than its aggregate cost of capital, then a company can expect to create value over the long term.

Dynamically allocating capital and talent—via divestitures, if need be—to businesses and initiatives that create the most value. Running a long-term company does not equate to maintaining the same business mix for extended time spans. Managing for the long term requires executives to monitor the company's standing and enter or exit businesses as the competitive landscape shifts (via acquisitions and divestitures, when necessary). Companies must also reallocate talent as frequently as they reallocate capital.

Generating value not only for shareholders but also for employees, customers, and other stakeholders. Long-term companies focus on improving outcomes for all their stakeholders, not just those who own shares in the business. They have good reasons to do so. Motivated employees get more done than disgruntled ones. Well-treated suppliers work together more collaboratively. Satisfied regulators are more likely to award operating licenses. While executives must consider trade-offs among the interests of their constituents every day, over the long term, the interests of shareholders and stakeholders converge.

Staying the long-term course by resisting the temptation to take actions that boost short-term profits. When temporary changes in fortune occur—dips in revenue, for example—maneuvers that boost short-term results take on a powerful appeal. Long-term companies resist three temptations: starving growth investments, cutting costs that could weaken the company's competitive position, and making ultimately uneconomic choices just to reduce the natural volatility in revenue and earnings.

To reorient companies toward long-term objectives, business leaders must adopt new behaviors and abandon unproductive ones while empowering managers to make decisions with long-term outcomes in mind. To help corporate directors and executives get started, we have identified a few things that they can do.

Boards of directors can help orient management toward the long-term in three ways:

- Ensuring that strategic investments are fully funded each year and have the appropriate talent assigned to them
- Evaluating the CEO on the quality and execution of the company's strategy, the company's culture, and the strength of the management team, not just on near-term financial performance
- Structuring executive compensation over longer time horizons—including time after executives leave the company

CEOs can reorient their companies by using their influence and authority in four ways:

- Personally ensuring that strategic initiatives are funded and staffed properly and protected from short-term earnings pressure
- Adapting the management system to encourage bold risk taking and to counter biased decision making
- Proactively identifying and engaging long-term oriented investors—and having the courage to ignore short-term shareholders and other members of the investment community
- Demonstrating the link between financial and nontraditional metrics to prevent short-term trade-offs

We believe that these management behaviors and tactics can benefit business leaders as well as investors across nearly every location and industry. Even with the benefit of this research, all companies will find managing for long-term performance a complex endeavor, one that would be informed by further research on topics such as the board behaviors and CEO traits that are conducive to long-term performance or executive-compensation structures that give CEOs strong incentives to adopt a long-term orientation. But executives should not take this complexity as reason to wait. The sooner they adopt long-term behaviors, the sooner they will achieve the performance gains that produce value for stakeholders over the long run.

01

Why long-term management behaviors matter



Facing pressure from customers, employees, governments, and other constituents, more CEOs have begun to consider how their companies can meet the needs of these stakeholders, protect the environment, and uphold their duty to create value for shareholders.¹

McKinsey, FCLTGlobal, and others, however, have found that the dilemma that some executives perceive—whether to focus on stakeholders or shareholders—has less bearing on corporate performance than another choice: whether to concentrate on creating long-term shareholder value or increasing the share price in the near term. Choosing to prioritize long-term value creation resolves much of the perceived conflict between stakeholders' interests and shareholders' interests, because these two sets of interests largely converge in the long run. Companies create long-term value for investors *only* when they satisfy customers, engage and motivate employees, and maintain good relations with communities and regulators across extended time horizons.

Research confirms that executives can serve both shareholders and other stakeholders best by cultivating a long-term orientation in their companies. This report is meant to help them do that. We surveyed more than 500 executives to identify the links between management behaviors and long-term business performance. We also conducted new empirical analysis of some drivers of long-term value creation, complementing our findings with those of other researchers. This approach enabled us to document behaviors of managers at long-term companies and make recommendations for boards of directors and CEOs on some of the most effective actions they can take to reorient their organization.

¹ "Statement on the purpose of a corporation," Business Roundtable, August 19, 2019, [businessroundtable.org](https://www.businessroundtable.org).

The recent rise in short-term behavior

Despite executives' growing appreciation of stakeholder capitalism, companies have in recent years exhibited greater efforts to lift share prices in the short term. In updating our Corporate Horizons Index, which measures short-term behavior in aggregate among large publicly traded US companies,² we discovered a statistically significant increase in short-term behavior from 2015 to 2019. A survey for this report³ revealed that three continuing concerns encourage executives to manage for short-term results: their shareholders, their boards, and their compensation structures.

Shareholders. Executives have long felt that shareholders demand continual increases in accounting profits and consistent achievement of quarterly earnings targets. But the investors who do demand such outcomes constitute the minority. Repeated studies show that a large majority of shareholders—who own some three-quarters of US stocks⁴—care little about short-term performance, preferring that executives focus on longer-term value creation.

Boards of directors. According to our survey, one reason why executives feel short-term pressure from boards is that boards spend the majority of their time on issues affecting the next one to three years. Another is that board directors know too little about the strategies and investment plans of the businesses they direct to provide effective long-term guidance to management.

² Dominic Barton, James Manyika, Tim Koller, Robert Palter, Jonathan Godsall, and Josh Zoffer, *Measuring the economic impact of short-termism*, McKinsey Global Institute, February 2017, McKinsey.com.

³ The online survey was in the field from June 20 to July 20, 2020, and garnered responses from 481 participants at or above director level from North American and European companies with annual revenues of \$250 million or more.

⁴ Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," January 30, 2017, McKinsey.com.

Executive compensation structures. Few companies tie executives' compensation to the company's long-term performance.⁵ On the contrary, compensation structures often give executives a strong incentive to prioritize short-term results.⁶

Balancing short-term pressure with long-term perspective

Executives undeniably face real pressure to focus on and deliver satisfactory short-term results. However, executives should weigh short-term demands against two other noteworthy considerations: the empirical evidence in favor of a long-term orientation and the long-term interests of investors and other stakeholders.

First, the evidence. Our previous report on managing for the long term, which looked at corporate performance from 2001 to 2014, established that companies that seek strong long-term results outperform companies that optimize their short-term results. That superior performance shows up in several measures. The revenue growth of long-term companies exceeded that of short-term companies while exhibiting less volatility. Long-term companies generated higher growth in both earnings and economic profit (profit minus the opportunity cost of invested capital). They also delivered greater total returns to shareholders, overcoming a more pronounced drop in market capitalization during the 2007–2009 financial crisis by rebounding more strongly after the crisis. Lastly, long-term companies created more jobs.⁷

⁵ Ric Marshall, "Out of Whack: US CEO Pay and Long-Term Investment Returns," MSCI, October 5, 2017, msci.com.

⁶ Alex Edmans, Vivian W. Fang, Katharina A. Lewellen, "Equity Vesting and Investment," *The Review of Financial Studies*, July 2017, Volume 30, Issue 7.

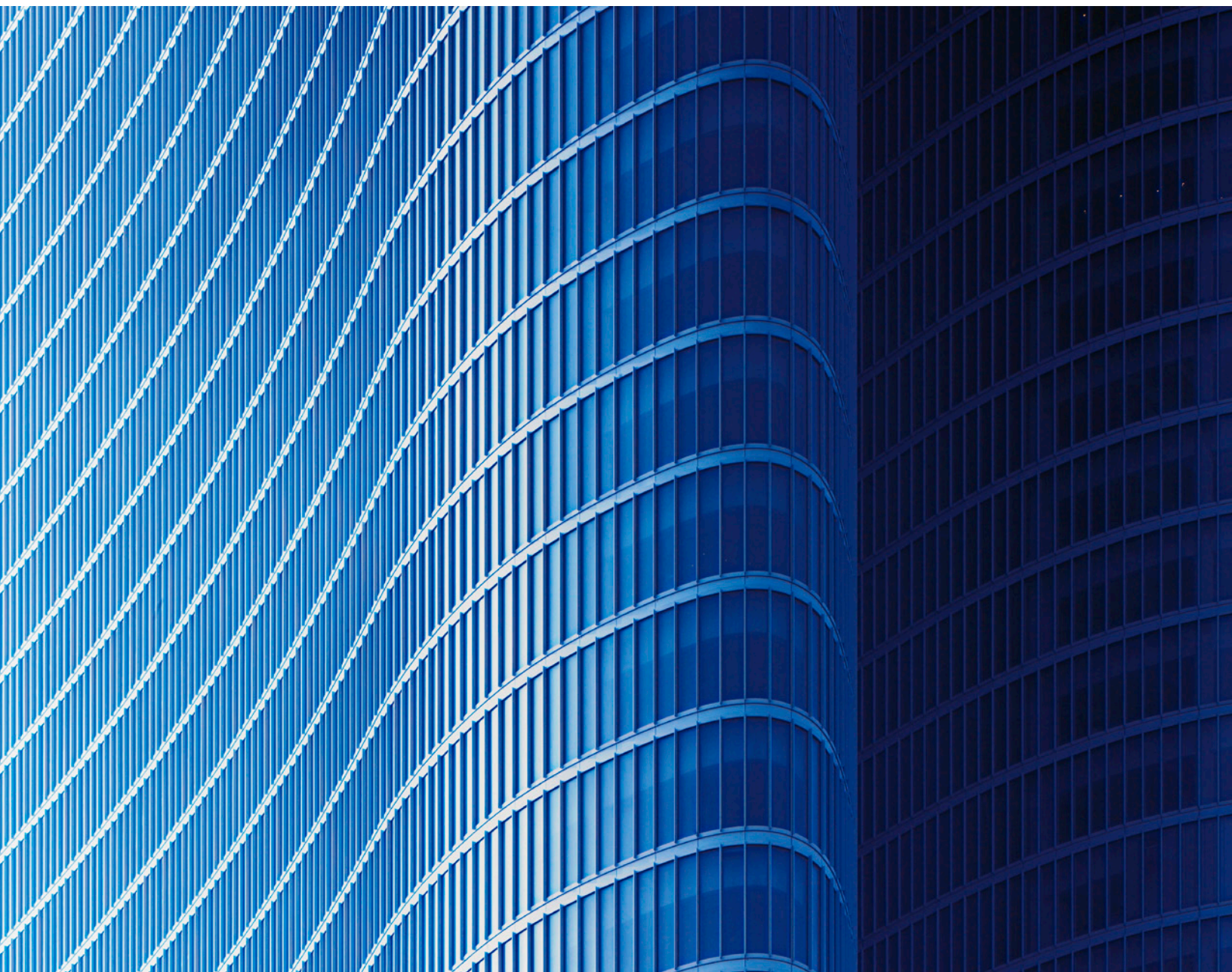
⁷ Dominic Barton, James Manyika, Tim Koller, Robert Palter, Jonathan Godsall, and Josh Zoffer, *Measuring the economic impact of short-termism*, McKinsey Global Institute, February 2017, McKinsey.com.

Sustained creation of shareholder value addresses a top concern of long-term investors, who, as we noted above, own most of the shares in US public companies. Other stakeholder groups also place long-term demands on companies and their leaders. Employees insist that CEOs provide not only fair pay and benefits, but also work environments where employees can uphold their values. Customers want to be assured that the goods and services they buy are produced in a manner aligned with their ethical beliefs. People who live near corporate offices and plants ask that business leaders treat surrounding communities with the same care and respect they would extend to the places they call home.

Executives who choose to prioritize long-term value creation over short-term profitability must then take on the responsibility of reorienting their companies toward long-term results. To do that, they will need to understand what management behaviors distinguish successful long-term companies from their peers, and what steps boards and CEOs can take to foster and reinforce a long-term orientation. The next chapter offers a closer look at those behaviors and their effects on long-term value.

02

The management behaviors that define long-term companies



Certain patterns of investment, growth, earnings quality, and earnings management distinguish long-term companies from other companies. They invest more and more consistently; they eschew the use of accruals and accounting methods to boost their reported earnings; and they focus more on revenue and other measures of financial performance that relate to value creation.⁸ Yet previous research has not identified the specific behaviors that management teams apply to maintain a long-term orientation.

This report results from our efforts to fill that gap. In addition to reviewing and synthesizing our own research and that of others in academia and the business world, we conducted a survey of executives and analyzed data on management and corporate performance. These techniques enabled us to uncover a set of five behaviors that executives at long-term companies consistently display.

Because companies' circumstances vary so much (for example, the competitive structure, growth rate, and level of innovation in their industry, and the legal and regulatory frameworks that govern business conduct), we have defined these five behaviors in general terms that will allow executives at particular companies to adapt and apply them to their situations. In this chapter, we offer a closer look at the five behaviors:

- investing sufficient capital and talent in large, risky initiatives to achieve a winning position
- constructing a portfolio of strategic initiatives that delivers returns exceeding the cost of capital
- dynamically allocating capital and talent—via divestitures, if need be—to businesses and initiatives that create the most value
- generating value not only for shareholders but also for employees, customers, and other stakeholders
- staying the long-term course by resisting the temptation to take actions that boost short-term profits

⁸ Dominic Barton, James Manyika, Tim Koller, Robert Palter, Jonathan Godsall, and Josh Zoffer, *Measuring the economic impact of short-termism*, McKinsey Global Institute, February 2017, McKinsey.com.

Investing sufficient capital and talent in large, risky initiatives to achieve a winning position

Many established businesses have developed an aversion to risky bets. Instead of playing to win, they play not to lose—and so they struggle to stay in front of more aggressive competitors or new disruptive entrants. Companies that are managed for long-term performance, on the other hand, identify the strategies they need to develop to stay ahead of trends in their industry. They also commit ample resources to strategic growth initiatives, such as product innovation, marketing and sales, talent development, and operational expansion, and to other initiatives, such as building supply-chain resilience, that protect them against competitive threats and systemic shocks, such as the COVID-19 pandemic.

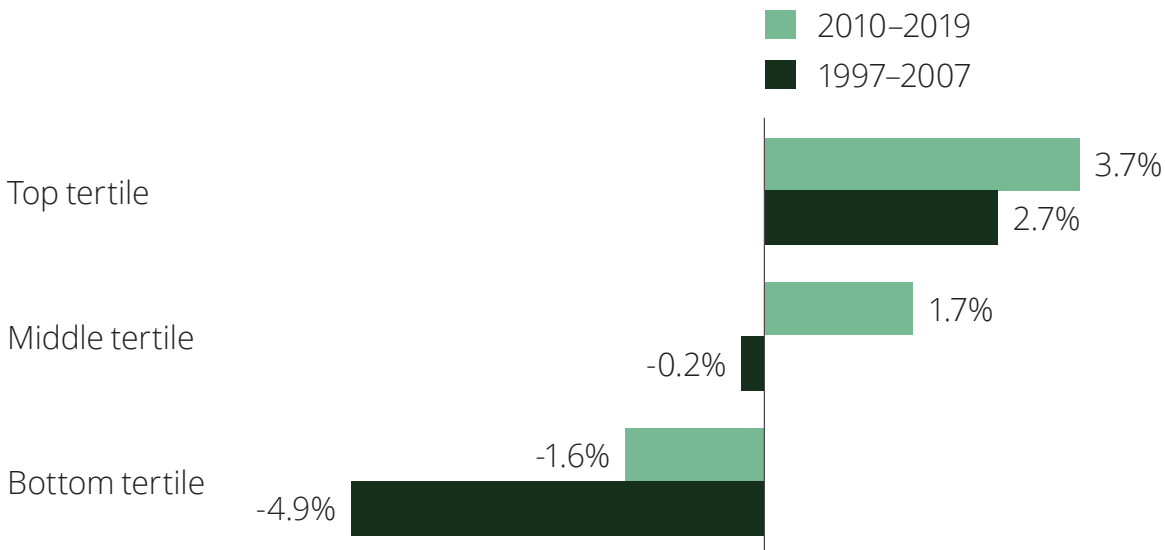
Amazon and Microsoft represent two such companies (see sidebar, “Microsoft’s big bet on cloud computing”). During the past 15 years, both invested large sums in their cloud-computing businesses. In 2019, those businesses generated revenues of \$35 billion and \$38 billion, respectively, far more than competitors that put less money and talent into their cloud-computing plays.

Sustained investments in strategic priorities matter for long-term performance because they lead to higher rates of revenue growth—and revenue growth is one of the most important drivers of long-term shareholder returns. Our research shows that companies in the top third for revenue growth for their industry generated total shareholder returns (TSR) that exceeded those of their bottom-third peers by six to eight percentage points per year (Exhibit 1). Over a 10-year period, the additional gains of top-third companies yielded shareholder returns that were 80 to 110 percent greater than those of the bottom-third companies.

EXHIBIT 1

Companies with higher levels of revenue growth create more shareholder value than peer companies do.

Annualized excess total shareholder returns, by tertile of revenue growth in industry, %



Respondents to our recent survey underscored the link between investment and growth. Executives who said their companies consistently support their long-term strategic priorities with the capital, talent, and sponsorship necessary for success were 87 percent more likely than their peers to report higher revenue growth.

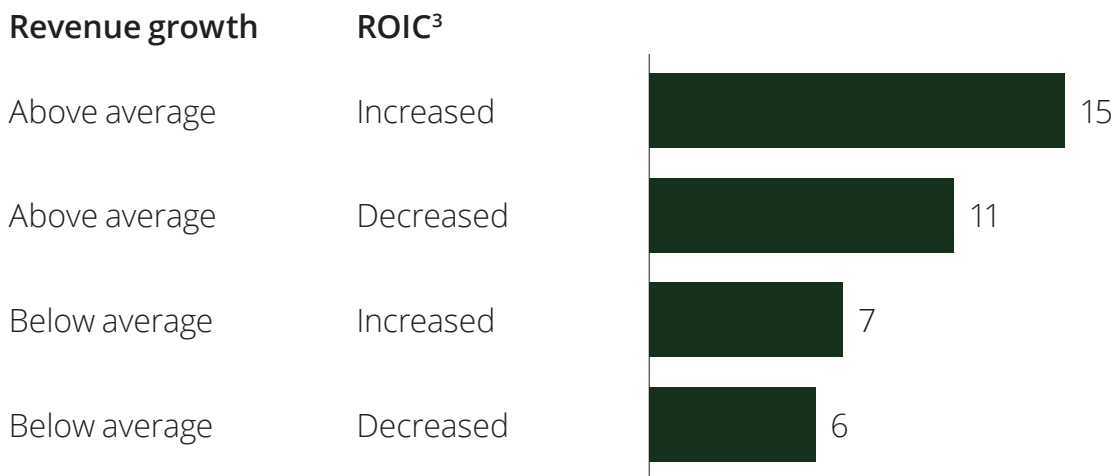
We've also shown that for companies with high returns on invested capital (ROIC), increasing revenue growth is more important for value creation than improving margins or further increasing ROIC. Small dips in margins and in ROIC are okay if they lead to higher long-term growth. According to McKinsey research on large, nonfinancial US companies with ten-year average ROIC of 20 percent or more, those companies that achieved above-average growth rates but decreases in ROIC from 1996 to 2005 delivered greater TSR than those companies that grew at a below-average rate while increasing ROIC (Exhibit 2).⁹

⁹ Bin Jiang and Tim Koller, "How to choose between growth and ROIC," September 1, 2007, McKinsey.com.

EXHIBIT 2

For companies with high returns on invested capital, growth generates more value than boosting returns further.

Total shareholder returns (TSR)¹ for companies with high returns on invested capital (ROIC),² 1996–2005, %



¹ Median of compound average TSR from 1996 to 2005 for each group of companies, adjusted for compound average 1996–2005 TSR of S&P 500 Index companies (6.9%).

² 78 companies with 10-year average ROIC $\geq 20\%$ and market capitalization $> \$2$ billion in 1995.

³ Excluding goodwill.

However, long-term managers cannot just shovel money into new initiatives: studies show no correlation between spending and long-term financial performance.¹⁰ To pay off, strategic initiatives also require commitments of talent and management attention. Given the significant risk and potential benefits of a company's priority investments, executive teams should assign their best managers to oversee them—and grant them the time and capacity they need to manage effectively. Executives, too, must spend their own time seeing strategic projects through execution, offering guidance on key decisions, and removing obstacles.

¹⁰ Eric Hannon, Sander Smits, and Florian Weig, "Brightening the black box of R&D," *McKinsey Quarterly*, April 1, 2015, McKinsey.com.

Most every company will have a minimum of five to seven strategic initiatives in various phases of development and with various risk-return profiles. Large companies could have many more. A consumer-packaged-goods company with a corporate strategy to move into healthy foods and into emerging markets, for example, might develop 20 new products and invest in five or six new countries. A medium-sized technology company, on the other hand, might make fewer strategic plays because it has fewer product lines.

Microsoft's big bet on cloud computing

When Microsoft entered the cloud-computing market in the early 2010s, it did so at great expense and considerable risk. The big play succeeded: the intelligent-cloud segment of Microsoft's business, which encompasses its Azure cloud platform and related services, generates 31 percent of its revenue and is growing more rapidly than any other segment.

Microsoft laid the foundation for its cloud-computing business with large investments in the development of platform-as-a-service offerings. The company turned to third-party providers for the necessary infrastructure supporting those offerings. But by 2014, it had become clear that customers preferred that cloud-computing providers deliver both platforms and infrastructure as services. After Satya Nadella became CEO, Microsoft greatly increased its investments in data centers, from \$2 billion to \$14 billion per year, to bolster its cloud-infrastructure offerings.

Besides these commitments of financial resources, Microsoft devoted considerable effort to redesigning its operations to support its cloud-computing business. Building cloud software requires different engineering approaches from those used to build on-premises software. Adopting agile principles (first in 2011 in Nadella's former division, servers and tools, and then more widely across the company) revitalized the company's culture, shortening its development cycles and allowing it to meet customers' needs better.

The cloud business has helped Microsoft create more value for its shareholders. In addition to generating around one-third of Microsoft's revenues, the cloud segment nearly doubled its share of the fast-expanding market for cloud services, from 10 percent in 2014 to 22 percent in 2019. Over the same period, Microsoft delivered total shareholder returns averaging 30.5 percent per year.

Constructing a portfolio of strategic initiatives that delivers returns exceeding the cost of capital

Growth alone won't deliver value. According to a fundamental principle of corporate finance, companies create long-term shareholder value only when their ROIC exceeds their cost of capital. Companies must therefore devote their resources to endeavors that produce returns in excess of the cost of capital over time. Otherwise, they can turn into large, complex enterprises that lack distinct advantages and end up destroying shareholder value.

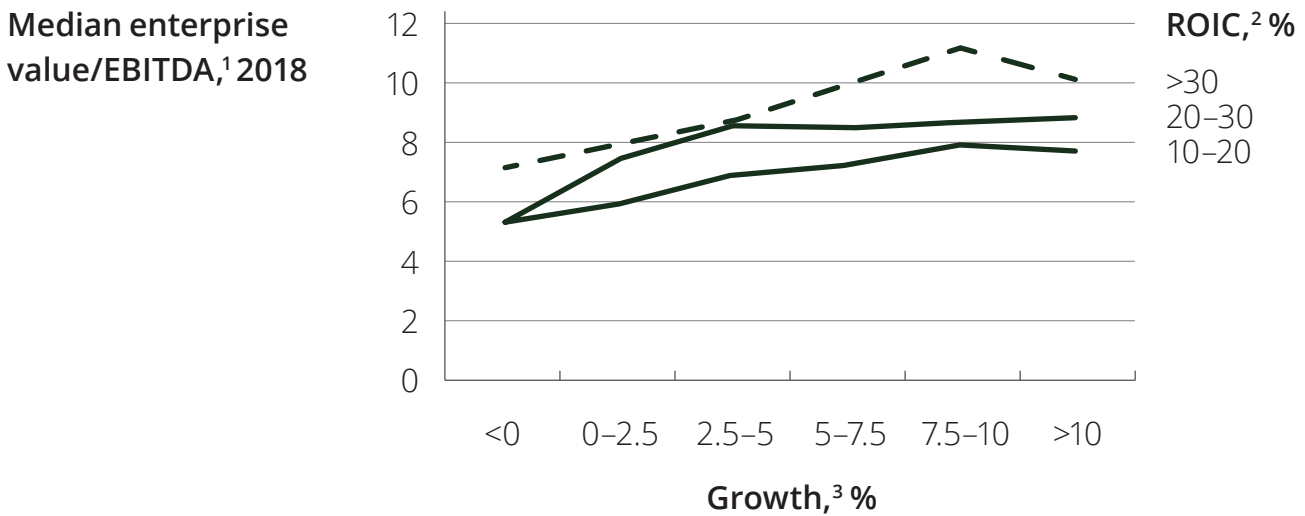
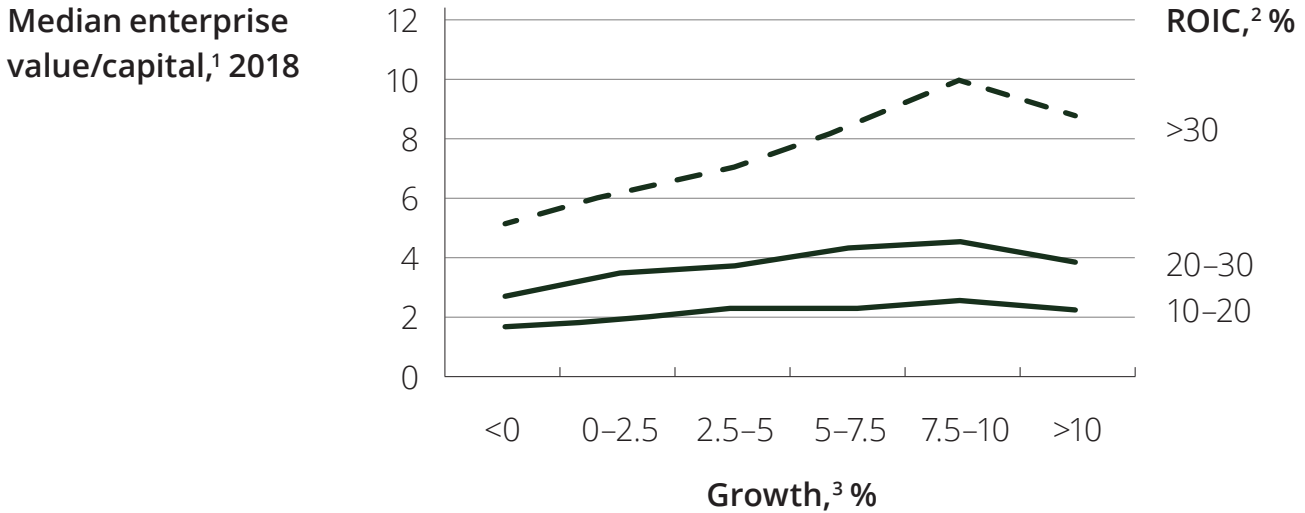
Not every investment that a company makes has to earn more than its cost of capital. Large companies can make multiple bets at a time, including some risky bets with the potential to yield high rewards. (If companies invest only in plays with a high chance of succeeding, they will miss out on important growth opportunities.) When they place bets with a wide-enough variety of return profiles, they can expect that their losing bets will be offset by successful ones. As long as the entire portfolio of investments earns more than its cost of capital, a company can create value over the long term.

Strong empirical evidence supports the pursuit of high ROIC. Among companies with similar growth rates, those with higher ROIC achieve higher valuation multiples. This pattern holds true across all levels of growth (Exhibit 3). Similarly, companies with higher ROIC also produce greater shareholder returns over the long term. Other McKinsey research indicates that for companies with low ROIC, lifting ROIC generates greater increases in total shareholder returns than increasing growth does (Exhibit 4).¹¹

¹¹ Bin Jiang and Tim Koller, "How to choose between growth and ROIC," September 1, 2007, McKinsey.com.

EXHIBIT 3

Companies that produce higher returns on invested capital achieve higher valuation multiples at all levels of growth.



¹ Capital = invested capital excluding goodwill; EBITDA = earnings before interest, tax, depreciation and amortization.

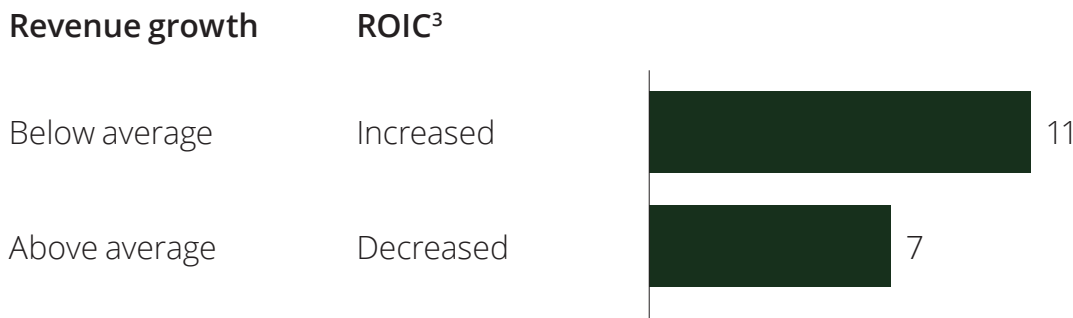
² Average return on invested capital excluding goodwill from 2016 to 2017.

³ Analyst consensus forecast of annual earnings growth from 2018 to 2020.

EXHIBIT 4

Companies with low returns on invested capital create more value by improving returns than by growing quickly.

Total shareholder returns (TSR)¹ for companies with low returns on invested capital (ROIC),² 1996–2005, %



¹ Median of compound average TSR from 1996 to 2005 for each group of companies, adjusted for compound average 1996–2005 TSR of S&P 500 Index companies (6.9%).

² 64 companies with 10-year average ROIC of 6–9% and market capitalization >\$2 billion in 1995.

³ Excluding goodwill.

Most companies will need to find a combination of growth and ROIC that works for them, given the conditions in their industry and the opportunities they face. Comparing two companies, US retail giant Costco and spirits maker Brown-Forman, shows the possibility of creating substantial long-term value in different ways. From 1996 to 2017, Costco’s after-tax operating profits grew by 11 percent per year, whereas Brown-Forman’s grew by 7 percent per year. Yet the two companies generated identical shareholder returns of 15 percent a year. Brown-Forman matched Costco on this count because its ROIC of 29 percent substantially exceeded Costco’s 13 percent.¹²

¹² Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, June 2020.

Although many executives will find it obvious that returns on invested capital matter for long-term value creation, large numbers of companies around the world still focus on growth. On the whole, growing larger has not made them more profitable. McKinsey research on Asian businesses illustrates this phenomenon. From 2005–07 to 2015–2017, companies in Asia accounted for more than half the global decrease in economic profits. One-third of Asia’s own drop in economic profit can be explained by the allocation of capital to value-destroying sectors (that is, sectors in which ROIC is less than the cost of capital). Compared with the rest of the world, Asia has a smaller share of companies that create economic value.¹³

¹³ Chris Bradley, Wonsik Choi, Jeongmin Seong, Ben Stretch, Oliver Tonby, Patti Wang, and Jonathan Woetzel, *The future of Asia: Decoding the value and performance of corporate Asia*, McKinsey Global Institute, May 2020, McKinsey.com.

Haier makes a multiyear push into advanced economies

When Zhang Ruimin took over an ailing Chinese refrigerator factory in 1984, few people would have predicted that the company would someday become one of the world's largest and most geographically diversified makers of household appliances. For several years in the mid- to late 1980s, Haier focused on delivering products good enough to command premium prices in China. The government's program of "reform and opening up" had gotten under way, and each year millions more Chinese earned enough to afford Haier's refrigerators.

Sales rose and so did Haier's margins. In 1991, Zhang decided to make a large investment in a new production facility, the Haier Industrial Park. The added capacity enabled Haier to keep up with skyrocketing demand as China's economy grew rapidly in the mid-1990s.

Zhang then set his sights overseas. Although Haier's scale had increased significantly, international sales accounted for just 3 percent of Haier's revenues. Zhang felt the company should spread out across the globe. He announced a goal the company called "three one-thirds," which called for one-third of the company's revenues to come from products made and sold domestically (in China), one-third from products made domestically and sold overseas, and one-third from products made and sold overseas.

Anticipating that Haier would struggle to win customers outside China, Zhang centered his expansion plan on investments in the company's brand and overseas R&D capacity. Haier first began marketing and selling its goods in advanced economies, such as Europe, Japan, and the United States, believing that brand strength in those sophisticated markets would give it credibility elsewhere. By 2004, 70 percent of Haier's overseas sales came from those three markets. Haier also invested significant amounts in R&D—around 5 to 7 percent of yearly revenues—for Zhang figured that designing products to match local demands would also help Haier in its new overseas markets. The company established eight design centers, including five outside China, by 2007.

Haier's bet on international markets has paid off for investors. Bolstered by the 2016 acquisition of GE's appliance business, the company held a 10.5 percent share of the global household appliance market in 2017. In addition, the company's TSR averaged 17.7 percent from 2009 to 2019.

Dynamically allocating capital and talent—via divestitures, if need be—to businesses and initiatives that create the most value

Running a long-term company does not mean maintaining the same business mix for indefinite lengths of time. Managing for the long term requires executives to monitor the company's holdings on a continuous basis and to enter or exit businesses as soon as they sense long-term shifts in the competitive landscape. This practice will involve making acquisitions and divestitures; sometimes, it even calls for shrinking the company. Executives must also make sure to reallocate talent to high-value initiatives frequently.

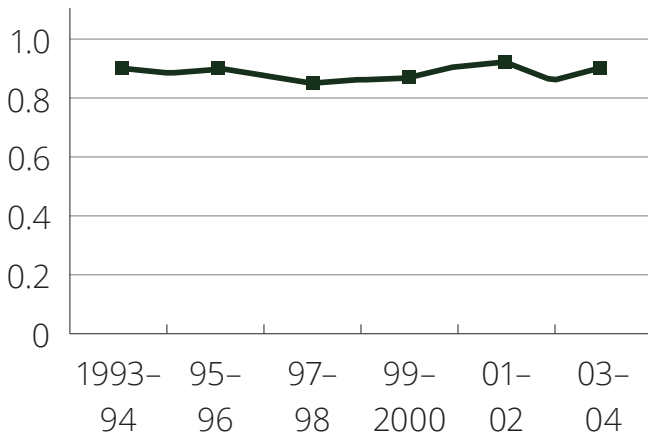
Dynamic resource reallocation confers a significant performance advantage: McKinsey research shows that companies that reallocate more of their resources earn higher shareholder returns than companies that let their resources stagnate. However, few companies actively reallocate capital and other resources: most budget their resources in much the same way from year to year, plus or minus only a small percent (Exhibit 5).¹⁴ Respondents to a recent executive survey articulated companies' tendency to not move capital around, with 45 percent saying that their companies tend to add to their R&D and capital-expenditure budgets rather than funding specific projects.

¹⁴ Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 1, 2012, McKinsey.com.

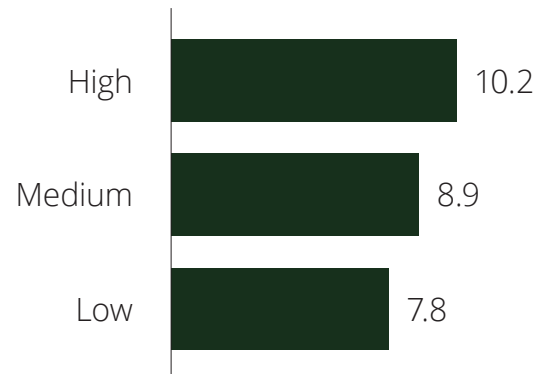
EXHIBIT 5

Most companies allocate the same amounts of capital to business units from year to year, but companies that reallocate more capital create more shareholder value.

Correlation index of business units' capital expenditures, year-over-year change, 1993–2004



Companies' degree of capital reallocation (n = 1,616) **Total returns to shareholders, compound annual growth rate, 1990–2005, %**



Survey research has uncovered other noteworthy findings. In our recent survey for this report, executives who said that their companies' investment processes focus on future projections, rather than past results, were 65 percent more likely than peers to have above-average organic revenue growth and 83 percent more likely to have above-average ROIC. Another survey measured the benefits of reallocating talent. It found that companies that rapidly reallocated talent were 2.2 times more likely to outperform their competitors on TSR than companies that reallocated talent at a slower clip.¹⁵

¹⁵ Mike Barriere, Miriam Owens, and Sarah Pobereskin, "Linking talent to value," *McKinsey Quarterly*, April 12, 2018, McKinsey.com.

Executives also benefit from looking beyond their companies and pursuing opportunities to acquire businesses when they believe that their companies would be the best owners for those businesses. Acquisitions, particularly very large ones, often don't create value, and they seldom generate more value than organic growth.¹⁶ But companies that have adopted a "programmatically" approach to M&A have been shown to outperform their peers. (Programmatically M&A involves making a series of small or medium transactions that are tightly aligned with a company's strategic objectives; those transactions help the company meet those objectives faster than it could with a purely organic approach.)¹⁷

By the same logic, executives should remain vigilant for signs that a business unit's performance has begun to slide or could soon decline due to long-term changes in its product area. When those signs appear, executives must move quickly to divest. Those who worry that investors will frown on divestitures should take heart: the stock market consistently reacts positively to both sales and spin-offs.¹⁸ In a recent McKinsey survey, 43 percent of respondents said they divested assets too late or didn't divest when they should have (Exhibit 6).¹⁹ (The reasons they cited for delay ranged from "waiting for business performance to improve" to "difficulty of replacing lost earnings.") Indeed, when it comes to resource reallocation, taking swift action in anticipation of long-term trends rarely backfires. Another McKinsey study of large corporations found that almost no companies reallocated resources so quickly that performance declined.²⁰

¹⁶ Marc Goedhart and Tim Koller, "The value premium of organic growth," January 19, 2017, McKinsey.com.

¹⁷ Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 12, 2019, McKinsey.com.

¹⁸ Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, June 2020.

¹⁹ Results are from a June 2020 survey of executives, board members, and corporate-development leaders at companies with revenues of more than \$1 billion (n = 128).

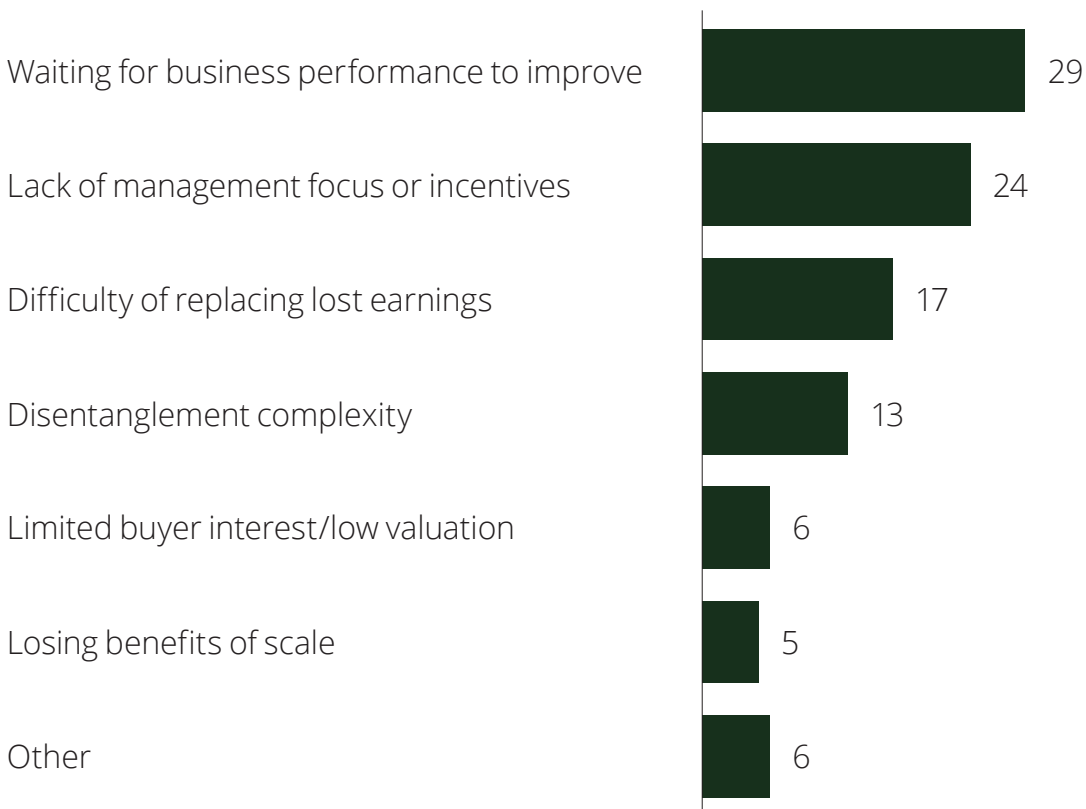
²⁰ Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 1, 2012, McKinsey.com.

EXHIBIT 6

Executives say their companies wait too long to divest.

43% of corporate-development executives said their companies divested assets too late or didn't divest when they should have¹

Reasons why companies waited too long to divest,¹ % of respondents



¹ Results are from a June 2020 survey of executives, board members, and corporate-development leaders at companies with revenues of more than \$1 billion (n = 128).

Walmart's long-term investments in digital lead to growth

When Walmart's leaders began considering in the early 2010s how best to harness both physical and digital assets, they recognized right away that such an endeavor would be neither quick nor easy. As Walmart CFO Brett Biggs told us in an interview, the board and executive team each spent a lot of time reviewing long-term shifts in the retail sector and debating the implications of a bigger bet on e-commerce. Although they anticipated that some investors would object to the short-term financial hit despite the potential long-term benefits, they chose to commit to a major omnichannel initiative.

The initiative began with the build-out of Walmart's traditional direct-to-home e-commerce platform. Executives also recognized the need to offer an even broader assortment of goods online, which meant building a marketplace business and adding sellers and new brands. Over time, the company's online presence expanded along with its store fleet, giving customers a seamless omnichannel shopping experience.

Since 2014, Walmart has invested more than \$5 billion per year in its e-commerce and omnichannel capabilities. The company reallocated capital to match its new approach to serving customers, increasing funding for supply-chain improvements, store transformations, and digital initiatives. Walmart also made strategic acquisitions, including Jet.com in the United States and a controlling stake in India's e-commerce giant, Flipkart. The strategy continues to evolve as Walmart adapts to changes in customer needs and the competitive landscape.

Walmart supported its growth in omnichannel by adding many engineers, designers, and other technology specialists to its workforce. The company recruited aggressively, bringing in a chief technology officer and other accomplished executives who could attract a new breed of tech talent. Walmart Labs, the technology division, now employs thousands of people—not at Walmart's Arkansas headquarters, but at a dedicated Silicon Valley hub.

Important, too, were executives' efforts to explain their strategy and demonstrate financial discipline to investors. As Biggs put it, "Being transparent allows [Walmart CEO Doug McMillon] to say to investors, 'Here is something we plan to do for a period. You might not like the short-term impact, but here's why you'll be happy at the other end.'" Biggs also said that maintaining operational discipline and financial strength have enabled Walmart to invest for the long term. "If you just cut costs, they come back later. By taking costs down systemically, we found billions of dollars. That gave us a cushion for some of our investments."

Walmart's omnichannel push has produced the kind of growth that generates long-term value for investors. During fiscal 2020, the company recorded global e-commerce sales of nearly \$37 billion, or around 7 percent of sales—almost \$12 billion more than the previous year.

Generating value not only for shareholders but also for employees, customers, and other stakeholders

Long-term companies focus on improving outcomes for all their stakeholders, not just those who own shares in the business. They have good reasons to do so: happy customers lift their revenues higher, motivated employees get more done than disgruntled ones, well-treated suppliers work together more collaboratively, and satisfied regulators are more likely to award operating licenses. Concern for the environment should also figure into management's long-term outlook. Environmental-efficiency initiatives can not only prevent fines but also add value by reducing costs over the long term.

Efforts like these typically belong to the category of environmental, social, and governance (ESG) programs—and they have been shown to yield benefits for shareholders. In a 2019 McKinsey survey, 57 percent of respondents said they believe ESG programs create long-term value, and 83 percent say they expect ESG programs to contribute more shareholder value than they do today. Respondents also said they would be willing to pay a 10 percent median premium for a company with a positive ESG record compared with a company with a negative ESG record.²¹

These responses don't mean that a company should undertake every ESG idea that comes along. Rather, executives should take stakeholders into account when making decisions by actively searching for and investing in initiatives that benefit both stakeholders and shareholders.

²¹ "The ESG premium: New perspectives on value and performance," February 12, 2020, McKinsey.com.

In doing so, executives should bear in mind that focusing on all stakeholders can create value in five ways:

- **Improving revenue growth.** Many of today's consumers want products that have positive environmental, social, and health impacts or at least cause minimal harm in these areas. When McKinsey surveyed consumers about automotive, buildings, electronics, and packaged goods, more than 70 percent said they would pay an additional 5 percent for a green product if it met the same performance standards as a nongreen alternative. On the other hand, one survey found that 47 percent of consumers who are disappointed with a brand's stance on a social issue stop buying; 17 percent never return.²²
- **Reducing costs.** Companies can find cost reductions that also benefit a range of stakeholders, such as local communities. Some beverage companies have cut spending by reducing water consumption (especially where water is scarce). Shifting to renewable energy has helped some retailers lower their costs. Packaging products with less material also reduces costs and eliminates waste.²³
- **Optimizing investment decisions.** Environmental factors can have profound effects on the risks and rewards associated with potential investments. Shrinking demand or rising environmental costs for some products might compel companies to avoid investments that may be "stranded" or obsolete in the future. Regulatory changes and taxes can add to energy costs. On the positive side, companies might invest in growth areas, like renewable energy or packaging technologies that avoid single-use plastics or eliminate plastic altogether.

²² Mehdi Miremadi, Christopher Musso, and Ulrich Weihe, "How much will consumers pay to go green?," October 1, 2012, McKinsey.com.

²³ W. J. Henisz, "The Costs and Benefits of Calculating the Net Present Value of Corporate Diplomacy," *Field Actions Science Reports*, Special Issue 14, 2016.

- **Improving employee productivity.** Recent studies have shown that positive social impact correlates with higher job satisfaction. A majority of workers considers a company's social and environmental commitments when deciding where to work,²⁴ and mission-driven companies have 40 percent higher employee-retention rates than their peers.²⁵ In our survey of executives, those who reported that their companies acknowledge long-term ESG risks said they have twice the chances of attracting talent as their peers do.
- **Reducing regulatory and legal interventions.** A strong stakeholder-value proposition can ease regulatory pressure and enable companies to achieve greater strategic freedom. In pharmaceuticals and healthcare, the profits at stake related to regulation can be around 25 to 30 percent. For banks, which operate with strict capital and consumer-protection requirements, profits at stake can be 50 to 60 percent. A strong ESG reputation can help companies win contracts: for a massive infrastructure project in Long Beach, California, selection was based in part on prior performance on sustainability.

According to one survey, more than 70 percent of asset managers worldwide are implementing or evaluating ESG considerations in their investment strategies.²⁶ Some investors and asset managers might approach ESG investing mechanically, purely on the basis of ESG metrics. Others will look at companies' actions related to all their stakeholders and consider how these will affect long-term performance—a comprehensive view that can also help executives think about ESG issues. In an interview, Walmart CFO Brett Biggs said that his company chooses to undertake some environmental projects with negligible financial returns if managers agree, after debate, that those projects will yield other significant benefits to stakeholders. Many of Walmart's other environmental initiatives offer positive net present value, and so, using a portfolio-level approach to managing risks and returns, the company can cover the costs of those that don't.

²⁴ "2016 Cone Communications Employee Engagement Study," Cone Communications, 2016, conecomm.com.

²⁵ Josh Bersin, "Becoming irresistible: A new model for employee engagement," *Deloitte Review*, January 27, 2015.

²⁶ "Smart Sustainability: 2020 global survey findings from asset owners," FTSE Russell, August 6, 2020, ftserussell.com.

Danone's efforts to create value for all its stakeholders

Danone, a global food company based in France, made news in mid-2020 when it became the first publicly-listed company to adopt the *entreprise à mission* (or mission-based enterprise) model under French law. But the company's history of looking after the interests of many different stakeholders, not just shareholders, goes back for decades. In 1972, Antoine Riboud, the company's cofounder, publicly stressed the need to consider the human side of business. As Danone CFO Cécile Cabanis told us in an interview, Riboud and other early leaders of the company accepted that "if we want to make a healthy society, we have to make a healthy company." Emmanuel Faber, who became CEO in 2014, has continued to pursue this vision.

Danone has reshaped its business portfolio in line with its mission of "bringing health through food to as many people as possible." From 1998 to 2006, Danone divested many of its businesses that make foods which it considers unhealthful. In 2007, it divested its highly profitable cookie business and used the proceeds to acquire Royal Numico, a nutrition and health company. The move aligned not only with Danone's values, but also with the interests of consumers and shareholders. At the time, Cabanis said, the market for nutritional products had begun to grow more strongly than the market for food products, especially in Asia, where Danone's footprint was small.

Cabanis also noted that Danone has overhauled its resource-allocation process, making allocation decisions more frequently and involving top executives. "Now we don't do budgets yearly, but we do a quarterly forecast and continue to add on an additional forecasting each time," said Cabanis. "The important thing is that you don't pre-book resources, but that you unlock resources based on the value of your decisions." Otherwise, she said, unsuccessful ventures can hold onto the resources they have been allocated.

Danone has also made extensive efforts to integrate financial and nontraditional metrics in its management systems and external reporting. According to Cabanis, all business units and product categories have three-year financial and sustainability goals. The finance team takes those goals into account when making decisions, even turning down projects that are expected to generate excessive carbon emissions. To bring sustainability factors and financial reporting closer together, Danone recently incorporated the cost of its carbon emissions into its reported earnings per share—a move that it hopes will prompt and inform discussions about investment decisions.

Staying the long-term course by resisting the temptation to take actions that boost short-term profits

Managing for the long term requires executives to adhere to the four behaviors described earlier, no matter what. That is easier said than done. When temporary changes in fortune occur—dips in revenue, for example—the corrective moves that let executives boost short-term results take on a powerful appeal. *Political turmoil in Russia is reducing our revenue. What if we decreased R&D investment in Southeast Asia in order to meet our yearly targets?*

Short-term moves to improve earnings seldom turn out well. In our survey, respondents who said executives at their companies try to meet short-term financial targets by taking actions that create no long-term value also said that their companies achieve worse financial outcomes than others. Respondents said these companies are half as likely as peers to realize more organic revenue growth, and 27 percent less likely to generate higher levels of ROIC.

Nevertheless, 70 percent of all survey respondents said their companies' executives would take actions that do not enhance long-term growth just to meet short-term financial goals. We focus below on three such actions that are dangerously tempting. Our advice: don't give in.

Starving growth investments due to short-term challenges, such as temporary earnings deviations from plans or poor performance in other parts of the company

Very few companies meet their short-term profit targets consistently over multiple years—too many elements are out of their control. Still, executives often feel pressured to meet short-term earnings targets, at all costs, often by slowing down and spending less on strategic initiatives to make up for the shortfall. Respondents to our survey said they believe their companies would cut long-term growth investments by 17 percent, on average, when faced with a 15-percent dip in

revenue—even though the survey specified that the dip resulted from external factors (such as currency fluctuations), would not imperil the company’s existence, and would not persist. Similarly, in a well-known survey of CFOs, 80 percent of respondents said they would reduce discretionary spending on potentially value-creating activities such as R&D and marketing to achieve short-term earnings targets. Nearly 40 percent said they would give discounts to customers to make purchases this quarter, rather the next, to meet quarterly earnings targets.²⁷

Evidence suggests, however, that such tactics seldom pay off in the long run. Our survey looked at the relationship, measured in terms of ROIC and revenue growth, between the tendency to cut investments and the likelihood of poor financial outcomes. Respondents who said their companies would not reduce growth investments when facing the 15 percent revenue dip also reported stronger financial performance. Their companies were 10 to 15 percent more likely to have higher organic revenue growth than their peers and 15 to 20 percent more likely to have higher ROIC. The lesson: rather than trying to please investors in the short term by sacrificing long-term value creation, executives should lay out their strategic plans and explain to investors that they are choosing not to depart from those plans just to hit short-term targets.

Improving earnings by cutting costs in areas essential to the company’s competitive position, such as customer service and R&D

CEOs sometimes set aggressive short-term performance targets to impress investors or their boards, then find that those targets can be met only by cutting back on customer experience, innovation, and other areas that define the company’s competitive position. In a recent survey, 30 percent of executives said their companies tend to reduce spending on customer service or product quality when facing short-term performance challenges. It’s an approach that will lead to lower performance in the long run.

²⁷ J. R. Graham, C. R. Harvey, and S. Rajgopal, “Value Destruction and Financial Reporting Decisions,” *Financial Analysts Journal* 62, Number 6 (2006): pp. 27–39. They found similar results in a 2011 updated survey (not published).

Numerous situations over the years have shown how quickly a company can surrender its position of strength through unwise short-term moves. In one case, a new retail-company executive announced ambitious earnings targets. To achieve them, the company cut spending on the front-line sales force through actions such as reducing the number of in-store workers, and curtailing training programs for those who remained. Customers took notice—and took their business elsewhere. The company’s stock price soon plummeted.

Another company, a leader in the high-tech industry, announced that it planned to invest in developing a new technology well ahead of its peers. It proceeded to invest only token amounts, while its competitors made much bigger investments and gained large shares of the new market. The first company never caught up. Finally, an example from the apparel business: seeking faster growth, a premium fashion company added lower-quality, lower-price product lines to its prestigious master brand. The new products sold briskly at first, but the company’s original customer base eventually decided that the brand had lost its luster. Sales dropped.

The outcomes of these choices look predictable in retrospect. Nevertheless, plenty of executives routinely make short-term cost-cutting decisions that blunt a company’s long-term competitive edge. (The COVID-19 pandemic provided a recent reminder of how these decisions can come back to haunt executives. Many companies experienced severe disruptions because they hadn’t invested enough in making their operations resilient.) Over time, such decisions not only don’t pay off; they cost companies a lot—and in more than just financial terms. Respondents to our survey who said their companies would reduce headcount if faced with a temporary revenue decline were more likely than peer companies to say they have trouble attracting talent.

Artificially reducing the natural volatility in revenue and earnings

A troublesome management belief holds that companies must consistently meet quarterly earnings guidance to keep investors happy. That might be true as far as short-term market commentators are concerned. But managers and investors who care about long-term value creation should know that companies ought to avoid reaching for short-term targets if doing so would damage their long-term prospects.

McKinsey research shows that companies with strong growth or ROIC earned shareholder returns exceeding their sectors' averages even when they inconsistently met consensus estimates for quarterly earnings. Similarly, research by FCLTGlobal and McKinsey finds that meeting (or even issuing) quarterly earnings guidance yields no valuation benefit.²⁸ In other words, executives shouldn't go out of their way to give earnings guidance—or to hit consensus estimates—because it makes little difference to the value that a company creates over the long term. Much more important are its fundamental value drivers: growth and returns on capital (Exhibit 7).²⁹

Another idea about earnings bedevils executives: that less volatile, or “smooth,” earnings growth somehow contributes to value creation. This conviction, too, lacks evidence. According to our research, plenty of companies with more volatile earnings growth in the short term generate high total shareholder returns in the long term, and plenty of low-volatility companies generate low shareholder returns. And although the median return of the low-volatility companies is higher, the statistical significance of the disparity vanished once we factored in growth and returns on capital (Exhibit 8).³⁰

²⁸ Ariel Babcock and Sarah Keohane Williamson, “Moving Beyond Quarterly Guidance: A Relic of the Past,” FCLTGlobal, October 23, 2017, FCLTglobal.org.

²⁹ Tim Koller, Rishi Raj, and Abhishek Saxena, “Avoiding the consensus-earnings trap,” January 1, 2013, McKinsey.com.

³⁰ Bin Jiang and Tim Koller, “The myth of smooth earnings,” February 1, 2011, McKinsey.com.

EXHIBIT 7

Strong growth and returns on invested capital matter more for value creation than meeting earnings estimates.

Median excess return compared with sector,¹ 2005–11, %

	High growth + high ROIC ³	High growth + low ROIC ³	Low growth + high ROIC ³	Low growth + low ROIC ³
Consistently beating²	4	3	0	-2
Inconsistent²	2	0	0	-3
Consistently missing²	0	-5	-5	-6

¹ Company's total returns to shareholders (TRS) minus median TRS of the sector. Sample size is 243 nonfinancial S&P 500 companies with December fiscal year-end.

² Difference between actual earnings per share and consensus estimate 30 days prior to earnings announcement. "Consistently beating" defined as beating expectations by >2% at least 4 out of 7 years, 2005–11. "Consistently missing" defined as missing expectations by >2% at least 4 out of 7 years. Companies consistently meeting expectations (by +/-2% at least 4 out of 7 years) are not shown due to small sample size.

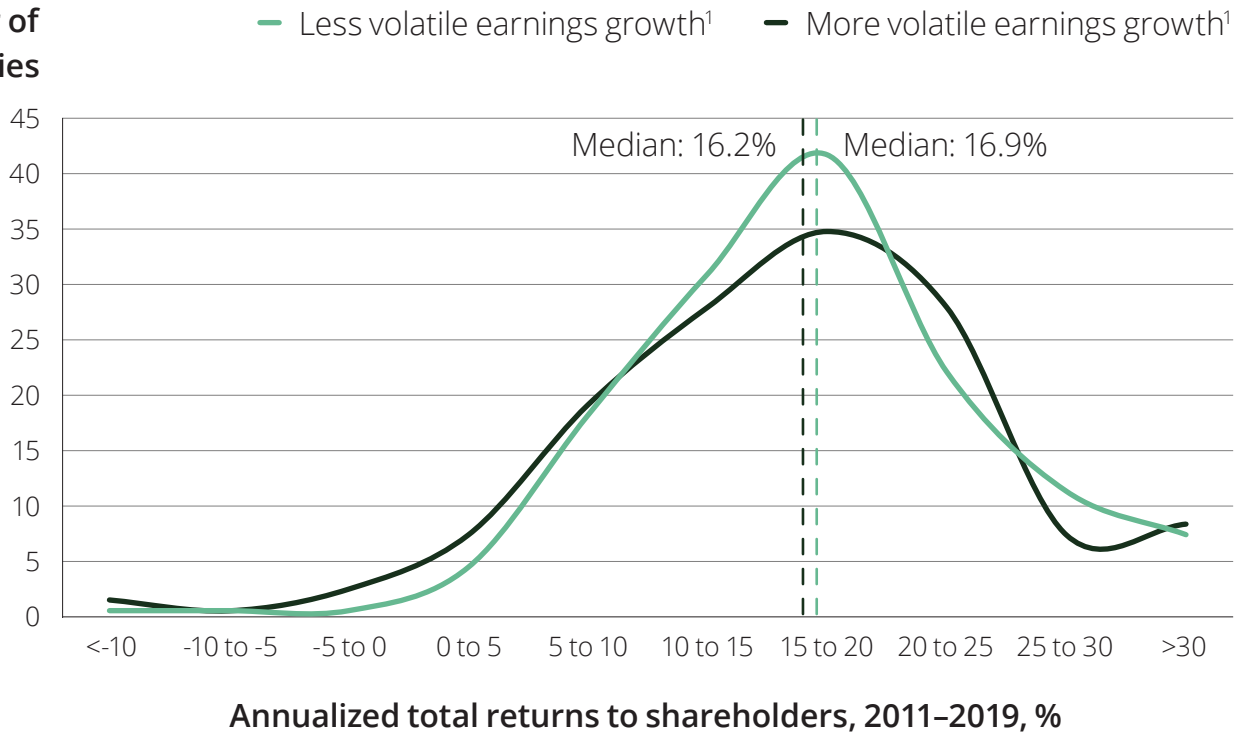
³ ROIC = return on invested capital (2005–11); growth = compound annual growth rate of revenue (2004–11). Companies categorized as high ROIC or high growth exceeded the absolute reference points of 15% for ROIC and 7% for growth or the median of the respective sector in the sample.

Source: Standard & Poor's Capital IQ; McKinsey analysis

EXHIBIT 8

Earnings volatility and value creation are not linked.

Number of companies



¹ Based on difference between each company's second-highest and second-lowest levels of growth during the 9-year period; 135 companies in each category.

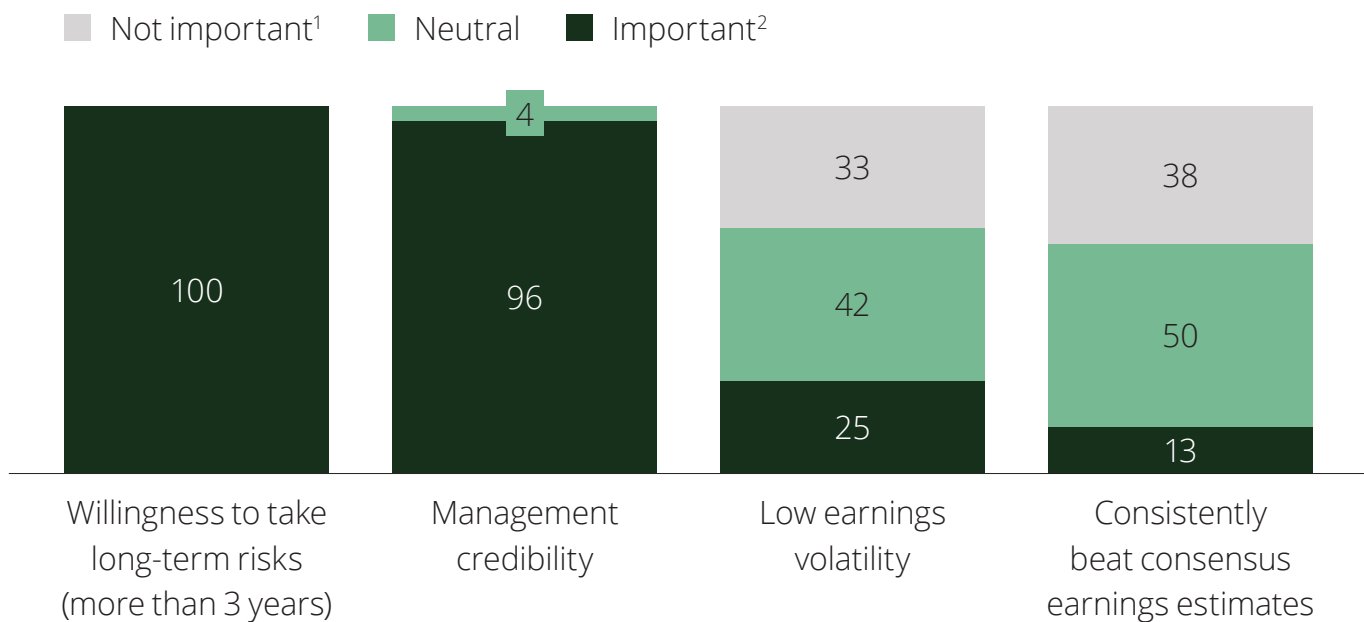
Finally, many executives misunderstand what matters to their most important shareholders: the executives believe that shareholders place great importance on short-term results and consistency. But a survey of long-term institutional investors by McKinsey and the Aspen Institute Business and Society Program found the opposite (Exhibit 9). When asked to rate the importance of various factors to their investment decisions, small minorities of these investors said they considered meeting consensus earnings forecasts and maintaining low earnings volatility important. Most or all said they considered management's credibility and willingness to take risks with the long view in mind important.³¹

³¹ Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," January 30, 2017, McKinsey.com.

EXHIBIT 9

Intrinsic investors focus on management credibility and willingness to take long-term risks.

Importance of factor when assessing a company as a potential investment, % of respondents



¹ Includes respondents who chose "not important" or "not important at all."

² Includes respondents who chose "important" or "very important."

Source: McKinsey and Aspen Institute panel of long-term investors, 2014

Best Buy's disciplined approach to strategic execution

When Hubert Joly became the CEO of Best Buy, a major US electronics retailer, in 2012, the company had suffered several years of declining sales and profits, in part because e-commerce businesses had undercut the prices offered at its brick-and-mortar stores. Rather than immediately searching for areas where Best Buy could cut costs, Joly spent his first week visiting stores. He wanted to hear from front-line workers about the in-store customer experience—something that could set Best Buy apart from e-commerce operations.

Informed by those conversations, and by careful study of the company's books, Joly and his team formulated a plan called "Renew Blue," which they announced just eight weeks after he had taken over as CEO. The plan called for working on five priorities: improving the in-store and online experience for customers, hiring and developing strong leaders and employees, working with vendors to create more value, increasing returns on invested capital, and sustaining Best Buy's positive impact on the world.

The executive team then set about reallocating the company's resources to those five priorities. Best Buy upped its investments in its e-commerce platform and delivery capabilities, so as to equal the online shopping experience offered by all-digital rivals. It formed partnerships with tech manufacturers like Apple and Google, placing their products in branded sections of Best Buy stores. Cooperating with vendors also helped improve Best Buy's ROIC, since the vendors paid for the build-out of their stores-within-stores.

To further enhance its customer experience, Best Buy boosted the pay of its front-line workers, with the aim of putting higher-caliber talent in customer-facing positions. Cutting headcount, Joly decided, would be a cost-saving move of last resort—and it would begin with executives and senior managers, whose contributions made less of an immediate difference to customers. Best Buy also resolved not to surrender sales to e-commerce vendors, with a guarantee that it would match any lower prices they offered.

Joly and his team kept investors apprised as they implemented the Renew Blue plan: they explained the new investments, the expected paybacks, and the progress they were seeing. The results soon became evident in Best Buy's financial performance. From 2014 to 2018, same-store sales rose each year and ROIC increased by more than 12 percentage points. Shareholders reaped the rewards: over the same period, Best Buy generated TSR of more than 9 percent per year.

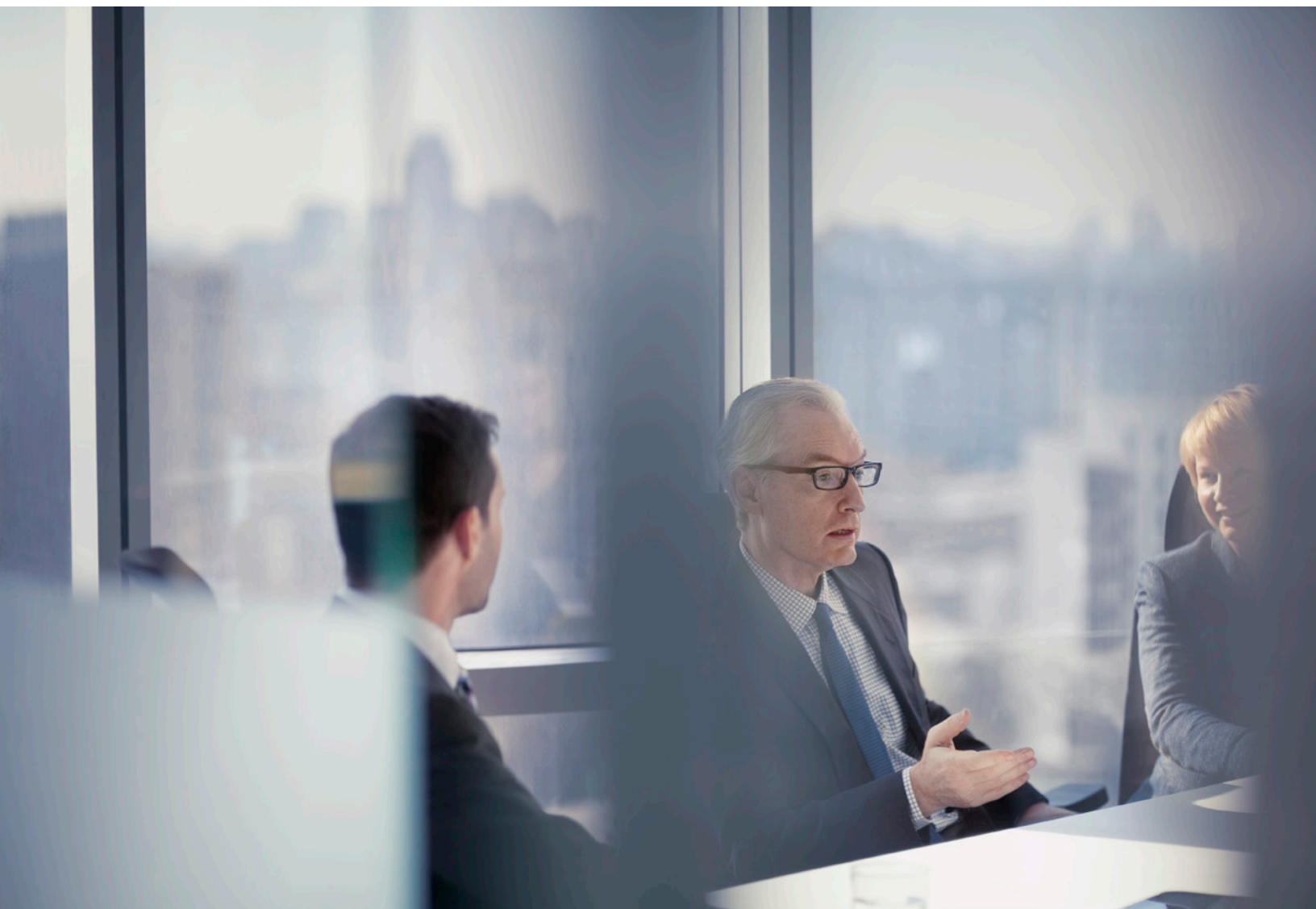
For more, see "Leading with purpose and humanity: A conversation with Hubert Joly," McKinsey Quarterly, June 18, 2020, McKinsey.com.



The five behaviors described here provide executives with a framework for aligning management's agenda with a corporate strategy and purpose focused on creating value for shareholders over the long term. In the following chapter, we outline actions that corporate directors and chief executives can take to promote these behaviors. The actions should make clear both how much the typical board and CEO will need to change their behaviors to achieve a long-term orientation and what changes are likely to be most helpful in the early stages.

03

How boards and
CEOs can orient
companies toward
the long term



Getting a company to manage for long-term performance requires considerable effort. As the previous chapter shows, CEOs and directors themselves must take up new behaviors, abandon old ones, and empower managers to make decisions with long-term outcomes in mind. While these behavioral changes will manifest themselves in the choices that executives make, they ultimately depend on a fundamental shift in mindset. In particular, business leaders must develop the conviction necessary to sustain a long-term orientation in spite of the pressure they get from some stakeholders to boost short-term performance.

Relieving short-term pressure on executives can powerfully enhance their ability to focus on the long term. In our survey, executives who said they feel less pressure to deliver short-term results were more likely to say that they adhere to long-term management behaviors. For example, when faced with temporary declines in revenue, they make smaller cuts to investments. These executives also report greater revenue growth, higher returns on invested capital, and an enhanced ability to attract top talent, relative to their peers.

To help business leaders develop a long-term orientation, we've identified a few things that boards and executives can do. The board has three tasks: ensuring that companies allocate enough resources to strategic initiatives, expanding their evaluation of CEOs to consider factors other than the company's financial performance, and aligning executives' compensation with the company's long-term results. CEOs can support and protect long-term strategic initiatives, formalize mechanisms to encourage risk taking and counter bias, engage long-term investors, and link financial metrics with nontraditional ones to prevent short-term trade-offs. In this chapter, we offer a closer look at each of these activities and make suggestions as to how boards and CEOs can carry them out.

The board's role in managing for the long term

The board of directors ordinarily has a well-established role: thinking about the future of a company, approving its strategy, reviewing its performance, and evaluating management. However, when it comes to determining that management makes decisions with the intention of creating long-term value, few boards spend adequate time assessing the strategies and investment plans of the businesses they direct. Below, we describe three ways in which boards can help management adopt a long-term orientation.

Ensuring that strategic investments are fully funded each year and have the appropriate talent assigned to them

Long-term success requires investing today in endeavors that will yield returns later on. Directors should make sure that management has grounded its strategy and mission in a deep understanding of how global trends will affect its businesses and what competitors are doing. Then, in their periodic reviews of the company's strategy and performance, directors should pay close attention not only to outcomes, but also to execution—specifically, whether the management team has launched strategic initiatives that will generate long-term value and followed through on them with adequate investments of capital and talent.

To formalize this practice, boards should ask management to report on the funding and progress of strategic initiatives and review that report for signs of effective strategic implementation. For a large company, such a report might document as many as 20 to 30 initiatives. That list will likely include a few initiatives sponsored by the corporate team, in addition to those driven by business units.

For each strategic initiative, the report should describe a business case, outline an action plan with clear milestones, and identify a delivery team of talented employees. It should also show that each initiative is fully funded and protected from short-term financial needs. To maintain accountability, the report should describe any action taken by management, such as deferring maintenance, to boost short-term results if the action might affect future performance.³²

We recognize that discussing the report with management will take up a substantial share of the board's time (not to mention the time that management will spend preparing it). But if directors want to adopt a long-term orientation and help management do the same, examining management's execution of strategy, not just the strategy itself, should become an integral part of the board's agenda. This may mean that the board will spend more time on its duties. It might take time away from other matters and use it on strategy and investment instead; long-term boards spend twice as much time on strategy as other boards do.³³ Or the board might assign the extra strategic work to a board committee.

The boards of companies owned by private-equity firms have set a high bar in this regard. One McKinsey survey found that private equity directors spend much more time on value creation than public-company directors. It also found that private-equity directors spend three times as many days on their roles as do their counterparts at public companies. Much of this additional time went into hands-on, informal interactions such as field visits and ad hoc meetings with executives.³⁴

³² These topics are derived from the book *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* by Martin Hirt, Sven Smit, and Chris Bradley (Hoboken, NJ: John Wiley & Sons, February 2018).

³³ "Toward a value-creating board," February 1, 2016, McKinsey.com.

³⁴ Viral Acharya, Conor Kehoe, and Michael Reyner, "The voice of experience: Public versus private equity," December 1, 2008, McKinsey.com.

Evaluating the CEO on the quality and execution of the company’s strategy, the company’s culture, and the strength of its management team, not just on near-term financial performance

Choosing and evaluating CEOs are two of the board’s most important responsibilities, but many boards don’t consider the full picture when assessing performance. For example, surveys indicate that most CEO evaluations focus on the company’s financial results.³⁵ This occurs in part because regulators in the US and some other countries have compelled boards to assess CEOs based on quantifiable performance indicators, as these tend to be less subjective than qualitative ones.

As we discussed earlier in this report, however, short-term financial results don’t necessarily provide insights into the long-term direction and likely success of the company. Moreover, the practice of evaluating CEOs based on a company’s financial performance appears to be counterproductive. Responses to our survey indicate that companies that evaluate executives mainly in terms of the company’s financial results—rather than on how they achieved those results—were 13 percent less likely to have revenue growth above peers.

Focusing on financials is problematic for another reason: executives can easily game their companies’ short-term results. Drawing up a broader set of assessment criteria can guard against that kind of obfuscation. Academic research suggests that performance evaluations that use *both* “hard” evaluation criteria, such as financial measures, and “soft” criteria, such as measures related to talent management or customer satisfaction, make it harder for managers to game their performance ratings.³⁶

³⁵ Melissa J. Anderson, “Boards Say Leadership Is a Key CEO Performance Metric,” *Agenda*, November 2, 2015, nadler-leadership-advisory.com.

³⁶ Alex Edmans, Mirko S. Heinle, Chong Huang, “The Real Costs of Financial Efficiency When Some Information Is Soft,” *Review of Finance*, October 2016, Volume 20, Issue 6, pp. 2,151–2,182.

While each board should align its CEO-evaluation criteria with factors particular to the company, it might start by developing those criteria in line with the following general questions:

- How successful have the CEO’s strategic decisions been over multiple years? What were the reasons for success or failure? Does the CEO acknowledge disappointments and learn from them?
- How well does the CEO execute the company’s strategy? Are critical strategic investments given adequate funding and the necessary staffing?
- Does the company’s culture encourage debate about important decisions? Are subordinates or underrepresented groups afraid to disagree with superiors, especially the CEO?
- How innovative is the company? Are managers and employees encouraged, formally and informally, to propose bold new ideas? Does it make investments in new product concepts or new markets that might come to overshadow existing offerings?
- What is the diversity and quality of the management team and how aligned is it with the company’s strategic direction?

Structuring executive compensation over longer time horizons—including time after executives leave the company

Executive compensation plans can give business leaders proper incentives to work on long-term value creation.³⁷ And while it has proven difficult to demonstrate a causal relationship between long-term executive pay and long-term performance,³⁸ adjusting some elements of executive pay structures appears to encourage long-term behaviors on the part of CEOs.

³⁷ FCLTGlobal is creating a unified view of how a company will create long-term value with the most relevant metrics. For more, please see Ariel Fromer Babcock, Allen He, and Victoria Tellez, “Driving the conversation: Long-term roadmaps for long-term success,” FCLTGlobal, February 21, 2019, fcltglobal.org.

³⁸ Ric Marshall, “Out of Whack: U.S. CEO Pay and Long-Term Investment Returns,” MSCI, October 5, 2017, msci.com.

One such element is the time horizon over which CEOs are compensated. Studies show that CEOs cut investments in R&D, advertising, and capital expenditures in years when significant portions of their equity are scheduled to vest.³⁹ Boards can counter this tendency by extending the vesting and holding periods for CEOs' equity awards. Other research shows that companies that give executives longer-duration pay structures experience less earnings manipulation, more growth opportunities, more long-term assets, greater R&D intensity, and better recent stock performance.⁴⁰

Some investors have pushed companies to adopt longer-term models for executive compensation. For example, Norway's Government Pension Fund Global, the largest equity holder in the world, proposed in 2017 that executives be barred from selling shares that were granted as compensation for at least five, and preferably ten, years after they leave the company.

The CEO's role in managing for the long term

CEOs and their top teams are ultimately responsible for creating a long-term orientation in companies, and CEOs can serve as role models for the rest of the management team when making big decisions. In addition, we see four areas in which CEOs can use their influence and authority to orient their companies toward long-term goals: by implementing strategic initiatives, promoting risk taking, engaging long-term shareholders, and reporting on both financial and nontraditional performance metrics.

³⁹ Alex Edmans, Vivian W. Fang, Katharina A. Lewellen, "Equity Vesting and Investment," *The Review of Financial Studies*, July 2017, Volume 30, Issue 7.

⁴⁰ Radhakrishnan Gopalan, Todd Milbourn, Fenghua Song, and Anjan V. Thakor, "Duration of Executive Compensation," *Journal of Finance*, December 2014, Volume 69, Issue 6.

Personally ensuring that strategic initiatives are funded and staffed properly and protected from short-term earnings pressure

To some readers, it might seem obvious that companies should allocate sufficient resources to strategic initiatives and prevent those resources from being reallocated for the sake of short-term earnings. According to our survey for this report, companies that devote adequate funding and staff to strategic priorities are 87 percent more likely to report revenue growth above peers than companies that deprive their strategic priorities of resources.

Yet it remains common for businesses not to fully support their strategic initiatives. In our survey, just 50 percent of respondents said they believe their companies' budgets consistently reflect their long-term strategic priorities. Another survey asked respondents whether their companies closely align spending on capital expenditures, R&D, and marketing and sales with their strategic priorities. Only 30 percent said yes.⁴¹

Experience suggests that CEOs must personally steward the allocation of resources in order to ensure that strategic projects not only receive full complements of funding and staffing but also retain those resources in periods of short-term pressure. The importance of the CEO's involvement is also evident from our survey results: companies whose CEOs ensure resources are allocated to critical growth areas are twice as likely to exhibit greater organic revenue growth than their peers.

Just as boards can promote long-term orientations by ensuring that companies allocate enough resources to strategic initiatives, so should CEOs focus on this task. In adopting the long view, many CEOs will find it necessary both to spend substantially more time on resource allocation than they do now and to look more carefully at resource-allocation decisions. A CEO should keep close tabs on the 20–30

⁴¹ "The finer points of linking resource allocation to value creation," March 29, 2017, McKinsey.com.

strategic initiatives with the greatest potential impact (which are not necessarily those that use the most resources) as well as spending by each business unit. This kind of vigilance is necessary to ensure that long-term projects, and long-term results, are on track.

At one large company with 60 business units spread across three divisions, the CEO and management team allocate resources to the three divisions and let the division heads apportion them among the business units. But because the company ties division heads' pay and promotion opportunities closely to short-term financial performance, division heads sometimes choose not to fully fund important initiatives. The CEO and management team could correct this by closely monitoring the allocation of resources to each of the 60 units and each unit's spending on strategic priorities.

Adapting the management system to encourage bold risk taking and to counter biased decision making

In 1979, Daniel Kahneman and Amos Tversky demonstrated that most people place greater weight on potential losses than potential gains when considering whether to take risks. They termed this tendency "loss aversion."⁴² Managers, too, are loss averse, and they bring this tendency to the investment decisions they make on behalf of their companies. In a 2012 study, McKinsey asked 1,500 corporate managers across the globe to consider a hypothetical investment with either a large return or a total loss. Even though the potential gain far exceeded the loss, the managers would only accept a very low chance of loss—far lower than the objectively risk-neutral chance.⁴³ Loss aversion causes managers and companies to shy away from high-risk, high-reward projects.

⁴² Imagine the opportunity to flip a coin on the condition that you will win \$200 if it comes up tails and lose \$100 if it comes up heads. Even though the expected value of the coin flip is positive ($200 \times 0.5 + -100 \times 0.5 = 50$), most people would decline to flip the coin because the threat of losing \$100 is more off-putting than the prospect of winning \$200 is appealing.

⁴³ Tim Koller, Dan Lovallo, and Zane Williams, "Overcoming a bias against risk," August 1, 2012, McKinsey.com.

Other research shows that organizations whose cultures discourage strong debate are more likely to exhibit decision-making biases, such as groupthink, that can lead to the misallocation of investment resources.⁴⁴ While certain techniques can help overcome these challenges, CEOs can also institute and enforce processes that counter biases and encourage people to express a diversity of views.

Since CEOs occupy an enterprise-wide vantage point, they can look at risks at the portfolio level and give others the information they need to do the same. Implementing a company-wide approach to resource allocation, one that highlights expected returns and risk in the aggregate, can help managers see that their portfolios can accommodate bets on relatively risky endeavors because some of those bets will pay off.

CEOs can also encourage executives and managers to take more risks by not penalizing them for taking on risky projects, even if those projects fail. CEOs can go further by identifying employees, of any rank or seniority, with an aptitude for identifying high-risk/high-reward opportunities and offering them rewards and recognition for helping companies invest in new sources of growth or profitability.

Another way that CEOs can improve corporate decision making is to promote vigorous debate. One study found that, for big-bet decisions, high-quality debate led to decisions that were 2.3 times more likely to be successful.⁴⁵ Many techniques, such as appointing a devil's advocate to challenge ideas or using secret ballots or games to elicit people's true opinions, can stimulate debate. Another is assembling diverse groups to consider new ideas. Research has shown that organizations that invest in diversity and inclusion are more likely to discover creative solutions to problems.⁴⁶

⁴⁴ For more, see Aaron De Smet, Tim Koller, and Dan Lovallo, "Bias busters: Getting both sides of the story," *McKinsey Quarterly*, September 4, 2019, McKinsey.com.

⁴⁵ "Decision making in the age of urgency," April 30, 2019, McKinsey.com.

⁴⁶ Kevin Dolan, Vivian Hunt, Sara Prince, and Sandra Sancier-Sultan, "Diversity still matters," *McKinsey Quarterly*, May 19, 2020, McKinsey.com.

Proactively identifying and engaging long-term oriented investors—and having the courage to ignore short-term shareholders and other members of the investment community

Long-term investors (including retail investors, index funds, and institutional investors) own around 75 percent of the shares in the typical large US-based company.⁴⁷ Yet their views tend to get drowned out by more vocal short-term investors, who demand frequent disclosures to inform their short-term trading strategies. CEOs and management teams seeking superior long-term performance can benefit from focusing on the interests of long-term investors and discounting the demands of short-term investors (and their representatives, who include many sell-side analysts).

In this regard, it helps CEOs to spend more time talking with long-term investors. These investors make decisions to buy or sell shares in line with their outlooks for a company's long-term growth and prospects, so they want companies to deploy their capital in a disciplined fashion, making smart long-term bets when they can and returning cash to shareholders when the company can't invest it profitably. They want companies to delight their customers, hire and retain productive employees, and avoid safety and environmental risk. They don't worry when companies "miss" consensus estimates. On the contrary, long-term investors view temporary price dips as opportunities to invest more, not as signs of failure.⁴⁸

Executives will find that it pays off to communicate more transparently with investors. Transparency builds trust with investors, especially long-term investors. It makes it easier for investors to understand the long-term outlook for the company. And it can give executives some leeway to implement long-term-oriented changes that investors might question, such as when Walmart elected to increase wages for hourly workers so that it could better compete for talent.

⁴⁷ Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," January 30, 2017, McKinsey.com.

⁴⁸ Ibid.

Communicating more transparently is a practice that some executives may resist: they might argue that too much transparency reduces their freedom to manage reported results. (One company reports the results of two business units, one very profitable and the other unprofitable, as though they are one unit, in order to mask their individual performance). Other CEOs and CFOs are concerned about divulging sensitive information to competitors. In our experience, however, a company's competitors, customers, and suppliers already know more than managers realize. Sophisticated investors rarely worry about this.

Many CEOs and CFOs feel they learn a lot from—and even enjoy—their conversations with long-term investors. Those conversations also help reassure executives that maintaining a long-term outlook, rather than chasing short-term results, best serves the company and its shareholders.

Demonstrating the link between financial and nontraditional metrics to prevent short-term trade-offs

We've made the case that creating long-term value for a wide range of stakeholders helps companies improve their shareholder returns. When companies' external reports make clear how these two outcomes are linked, they reinforce the importance of stakeholder value creation to people inside and outside the organization. Such reports discourage executives from making short-term compromises on stakeholder-value creation by enabling employees, customers, and other constituents to hold executives accountable. The reports also inform the many shareholders who see strong nontraditional performance as a function of corporate well-being, a sign of management savvy, or a bulwark against reputation and regulatory risk.

To enrich their dialogue with long-term shareholders and other stakeholders, executives ought to select, track, and report the nontraditional indicators that are most material to their company's long-term performance.⁴⁹ Some of these indicators, such as employee

⁴⁹ This is consistent with the approach taken by the Sustainability Accounting Standards Board (SASB) and endorsed by several large investors, including BlackRock.

satisfaction or diversity, will be considered broadly relevant to many companies. Others, such as water consumption, will matter a lot in certain industries and little in others. A well-designed reporting approach that relates financial metrics to nontraditional ones will help executives set strategy, make sound long-term decisions, avoid short-term temptations, and equip stakeholders to assess the value that a company creates.

04

The next frontier in long-term management



We believe that the long-term management behaviors described in this report can be applied by business leaders in nearly every industry and location. And while the recent increase in short-term behavior should concern long-term investors, savvy executives might find in this trend an opportunity to distinguish their businesses from the competition. By instituting long-term behaviors, they can help their companies create more value and deliver greater shareholder returns.

We also recognize there are limits to the research that this report summarizes, and that many topics in long-term management invite further study (some of which are summarized in the sidebar). Here, we focus on a particularly thorny dilemma: how to manage for the long term when the future of a company's industry is in question, whether because demand has gone into decline, or because the industry creates negative effects that society will not tolerate for much longer. Executives in these industries face special challenges, for which there are no easy, clear-cut solutions.

Some industries are becoming obsolete—they face a long-term decline in demand that is unlikely to reverse itself. For example, the rise of online retail has greatly reduced the amount of time that shoppers spend in malls and department stores. This trend is almost certain to continue. Creative mall owners might adjust to it by exploring alternative uses for their properties. Department stores, similarly, have been in decline for more than 20 years. For their executives, having a long-term orientation may mean closing stores that can't be saved and boosting sales in the surviving stores with fresh ideas for attracting consumers.

Other industries must recognize that they will experience difficulties over the long term because of the negative externalities that they create. Consider the future of the typical coal-mining company. While some stakeholders would prefer that coal companies slow production or close mines for the sake of the environment, such moves would harm other stakeholders. Investors would collect diminished returns. Employees would lose their jobs and have less money to spend with local businesses. Shortfalls in coal production could drive up the cost of electricity. And one coal company's decision to curb output might do little to help the environment, because another company could fill the production gap.

Companies in many industries face similar dilemmas: their operations harm stakeholders who aren't immediately involved with the company—but ending operations would have problematic effects on other stakeholders. The complex trade-offs involved in maximizing the welfare of all stakeholders make it difficult for executives to set forth ideal long-term plans. Nevertheless, business leaders have a responsibility to think about both the long-term outlook for their companies and their responsibilities to all stakeholders.

While we realize that these decisions are knotty, we hope that the ideas presented in this report will help leaders untangle some of the many complications they must confront. We also invite readers to use FCLTGlobal's forthcoming online tool for assessing a company's long-term orientation in relation to the broader business community. The tool, we hope, will help executives and board members identify the long-term management behaviors that will most benefit their company and its stakeholders. The need for companies to create long-term value is only becoming more urgent, and those that respond with conviction stand to gain a lasting competitive edge.

Areas for further research

We appreciate the complexity of managing for long-term performance. As directors and executives think about how their organizations will navigate an uncertain future, they will continue to encounter difficult questions. Researchers have begun to investigate some of these questions; others will require further study. Below, we outline a few of the questions that we hear most often:

- **Board orientation:** How do boards tackle issues related to diversity, social justice, the environment, and industry disruption to help orient their companies toward the long term? Which public-company boards exhibit a strong long-term orientation? What distinguishes them from the boards of other public companies of similar size? What lessons can be drawn from boards of companies with other ownership structures?
- **CEO evaluation.** What changes would let boards evaluate CEOs with a wider array of criteria, including nonfinancial performance metrics, such as employee composition and retention, and qualitative factors, such as the strength of the corporate culture? What legal and other barriers need to be overcome? Are there other companies that do this well?
- **Compensation.** How much does compensation influence CEOs' behavior? Which factors, such as culture, mission, compensation, or promotion opportunities, influence employees most strongly? How can boards balance the pay of executives and front-line workers? How can a board structure the CEO's compensation package so that the CEO prepares the company to thrive for years after he or she leaves the position?
- **Geographic variations.** How do the features of the business environments in particular locations affect short-term pressures and the time horizons of management? Do differences among the roles of boards (for example, the duty of boards in the Netherlands to prioritize companies' continued existence) or the inclinations of executives (for example, the tendency of some business leaders to maximize growth) affect the actions that companies might take to foster a long-term orientation? Are there noteworthy differences in short-term and long-term behaviors among regions or between emerging markets and developed ones?
- **Macroeconomic implications.** How do short-term corporate behaviors and long-term corporate behaviors affect growth, investment, productivity, employment, income and wealth distribution, sustainability, and other aspects of economic performance?

Corporate long-term behaviors: How CEOs
and boards drive sustained value creation

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