How to escape the short-term trap

Markets may expect solid performance over the short term, but they also value sustained performance over the long term. How can companies manage both time frames?

Ian Davis

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Companies around the world increasingly complain that financial markets focus on quarterly results and give little credit to longer-term value creation strategies, particularly those that depress today's profits.

Such claims must be challenged. They are not only contradicted by empirical evidence but also do nothing to improve corporate performance and investor returns. If anything, they undermine confidence and trust in markets.

Whatever the cause of the misconception, management teams should take the lead in correcting it. They need to make clear to their boards and to the capital markets the importance to long-term value creation of both the short-term *performance* of a business and its underlying *health*—that is, its ability to sustain and improve performance year after year after year. They also may need to manage their companies differently.

There is undoubtedly a noisy segment of analysts and traders fixated on next quarter's earnings. It's only natural that analyst and investor conversations will focus on the latest quarterly results, because they contain a significant amount of objective and reliable information about long-term performance. Also, they are news, and that moves markets. But many management teams, apparently believing that *all* market participants behave this way, don't attend to the longer-term health of their companies.

Short-term commitments are important, of course, and only by delivering on them will management build confidence in longer-term strategies. But the health of a company is crucial not just to its customers, suppliers, and employees but to its investors as well. It's crucial to turning the company's growth prospects, capabilities, relationships, and assets into future cash flows. Contrary to conventional wisdom, markets recognize this.

An examination of share prices demonstrates that expectations of future performance are the main driver of shareholder returns. In almost all industry sectors and almost all stock exchanges, up to 80 percent of a share's market value can be explained only by cash flow expectations beyond the next three years. These longer-term expectations are in turn driven by judgments on growth and—a lesson relearned after the dot-com bust—on long-term profitability. For example, cash flows in the global semiconductor industry need to grow at more than 10 percent a year during the next ten years to justify current market valuations. In retailing and consumer packaged goods, that growth rate is between 3 and 6 percent. In electric utilities, it is around 2 percent.

Future expectations clearly drive the stock price of individual companies too, thus explaining the often widely differing P/E or market-to-book ratios of companies with similar reported earnings. In the pharmaceutical sector, for example, the market ascribes significant value to a healthy drug pipeline even though it will not affect short-term earnings.

Even in the private equity sector, renowned for its focus on short-term operational improvements, health matters. Most private equity companies look to realize their investments in a five-year time frame. But they must still have a credible proposition for future earnings and cash flow growth to underpin a sale or IPO.

What makes a healthy company?

There are several generic components of a healthy company—a robust and credible strategy; productive, well-maintained assets; innovative products, services, and processes; a fine reputation with customers, regulators, governments, and other stakeholders; and the ability to attract, retain, and develop high-performing talent.

Thinking about health, as opposed to short-term performance, helps management teams understand how to look after companies today in a way that will ensure that they remain strong in the future. It focuses the mind on what must be done today to deliver the outcome of long-term performance. Companies are not focusing enough on managing the health of their businesses.

One major European company, for example, pulled off an impressive turnaround in short-term financial performance. But to its dismay, its financial success was accompanied by a fall in customer service levels and by a huge increase in staff turnover. The share price soared initially but then fell back. The company's

management complained that the financial markets didn't understand what it had achieved. But the problem was that the markets did: short-term success at the expense of health.

Such behavior is widespread. In one recent survey,[1] a majority of managers said that they would forgo an investment that offered a decent return on capital if it meant missing quarterly earnings expectations. In another, more than 80 percent of the executives responding said that they would cut expenditure on R&D and marketing to ensure that they hit quarterly earnings targets—even if they believed that the cuts were destroying value over the long term.

Beyond the misperception of what financial markets want, a number of factors contribute to management's short-term focus. Recent tough economic conditions have concentrated the collective minds of many companies on pure survival. The fact that 10 of the largest 15 bankruptcies have occurred since 2001 is a strong deterrent when it comes to business building and its inherent risk.

Regulatory and legal reforms have also been major contributors to "short-termism." Management teams have struggled to cope with a wealth of new regulations, many of which focus on the reporting of historical financial results. The same is true of board directors, who have been distracted from their role as stewards of a company's health. So despite an average 50 percent increase in the time commitments required of directors, many boards don't have the time to understand the kind of strategic trade-offs needed to get the appropriate balance between short-term performance and long-term health. A recent McKinsey survey of over 1,000 directors around the world found that more than half admitted to having only a "limited" understanding of where the company's long-term objectives would position it in five to ten years. The good news is that our respondents told us that they are now eager to devote more time to these issues.

Managing multiple time horizons

There is also a much older reason that management tends to be overly focused on the short term: it is very hard to manage both time frames. It is hard to build the resilience and organizational capacity not only to deliver but also to sustain performance. Three things can help.

First, a company's strategy should consist of a portfolio of initiatives that consciously embraces different time horizons. Companies do, of course, have different business units with distinct strategies. But few strategies direct a company in a way that will enable it to adapt to events and capitalize on opportunities as they arise. Some initiatives in the portfolio will influence short-term performance. Others will create options for the future—the development of new products or services, entry into new markets, or the restructuring of processes or value chains. A key management challenge is to design and select those initiatives and options to ensure, on a risk-adjusted basis, that the company's underlying health remains strong.

Second, companies need organizational processes to support a focus on both performance and health. Companies with a long-term-value orientation are always relentless about setting short-term-performance commitments and delivering on them. But such companies also define what they are doing to ensure their health and how they will measure their efforts to do so. Reckitt Benckiser, the leading household-cleaning-products business, emphasizes innovation as the key to its long-term strategy and specifically measures the proportion of sales coming from new products.

Different companies will identify the health and performance metrics—product development, customer satisfaction, or the retention of talent—appropriate to their industry or situation. But executives should insist on a balance of metrics that cover all areas of the business while grabbing every opportunity to talk about these metrics, both internally and to analysts and investors.

Career tracks and incentives—money, recognition, promotion—should reflect the time required to deliver on longer-term goals; the current trend of rotating people in roles every two or three years isn't necessarily good for corporate health. Moreover, companies ought to be mindful of the different leadership qualities needed to manage for performance and health. Corporate health typically requires new skills, not necessarily the reinforcement of the capabilities and leadership traits that worked in the past.

Third, companies need to change the nature of their dialogue with key stakeholders, particularly the capital markets and employees. That means first identifying investors who will support a company's strategy and then attracting them. There is no point, for example, talking about the company's health to court arbitrageurs or hedge fund managers looking for the next bid.

A management team should then spend serious time with analysts, explaining its views on the outlook for the industry and on how the company's strategic stance will create a source of sustainable advantage. Management will also need to highlight the metrics it has developed to track the company's performance and health. Just

talking vaguely about shareholder value without a time frame or without addressing the specifics of the business is not meaningful.

Companies might also be wise to separate discussions about quarterly results from those that focus on strategic development, as BP has done recently. And they should ensure that analysts spend time with operational managers. When it comes to forming judgments about sustained performance, the caliber of these managers is often the crucial factor.

Communicating with employees is just as important. The complaint that "we don't know what is going on" often reflects an emphasis on communicating results rather than long-term intent. It is no coincidence that a hallmark of great, enduring companies is that they make their future leadership generations feel involved in their long-term development.

The current focus on short-term performance is understandable given the recent economic and regulatory environment. Survival and the avoidance of risk have been of primary concern. But the focus is nevertheless unbalanced. Financial markets, as well as employees and all other stakeholders, place a real value on a company's future. Corporate managements and boards should square up to the challenge of managing for performance *and* health. And they should communicate loud and clear that this is exactly what they are doing.

About the Authors

Ian Davis is McKinsey's worldwide managing director. This is an expanded version of an article published in the *Financial Times* on April 11, 2005.