FOCUSING CAPITAL
on the LONG TERM

Short-termism: Insights from business leaders

Findings from a global survey of business leaders commissioned by McKinsey & Company and CPP Investment Board

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Executives and board members report that as a result of increasing pressure to produce short-term results, strategic decisions are harder to make.

The pressure on business leaders to deliver financial results in the short term has increased considerably since the economic crisis, according to a survey jointly commissioned by McKinsey & Company and Canada Pension Plan Investment Board (CPPIB)[1] on time horizons in executive decision making.[2] More than three-quarters (79 percent) of the respondents told us that the time frame in which they personally felt the most pressure to deliver financial results was two years or less. And while 73 percent said that their companies should look at least three years ahead in their strategic planning, only just over half said their management teams actually did so.

In this survey, we asked senior executives and board directors about the ways they balance short- and long-term priorities, the time frames they use to decide on strategy and investments, and the potential benefits from taking a longer-term approach to decisions.

We found that the respondents, all C-level executives or board members,[3] most often cited their own executive teams and boards (rather than investors, analysts, and others outside the company) as the greatest sources of pressure for short-term performance. They most frequently attributed the increase in this pressure to economic uncertainty. In addition, they said the pressure was affecting decisions on a range of actions – from undertaking M&A to managing externalities – that could

[1] McKinsey and CPPIB commissioned this survey as cofounders of Focusing Capital on the Long Term, a collaborative initiative developing practical tools and approaches to help institutional investors and corporate directors enhance long-term value creation. Further information is available at www.FCLT.org.

[2] The online survey, 'Looking toward the long term', ran from April 30 to May 10, 2013, and garnered responses from 1,038 executives representing the full range of industries and company sizes. Of these respondents, 722 identified themselves as C-level executives and answered questions in the context of that role, and 316 identified themselves as board directors and answered accordingly. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[3] At the beginning of the survey, we asked respondents to identify themselves as either C-level executives or board members at the company with which they are most familiar and to answer all the following questions in that role. Some respondents were both C-level executives and board members, and some were board members serving at multiple companies, but they answered the survey questions in their capacity in one of these two roles and for just one company.

benefit their companies in the long run. The largest share of respondents reported that the most helpful ways to reorient their companies toward a long-term view would be to create strategy-focused board committees and to ensure that boards spent most of their time on long-term issues. Encouragingly, these two actions were also the ones that business leaders said their companies could most easily implement today.

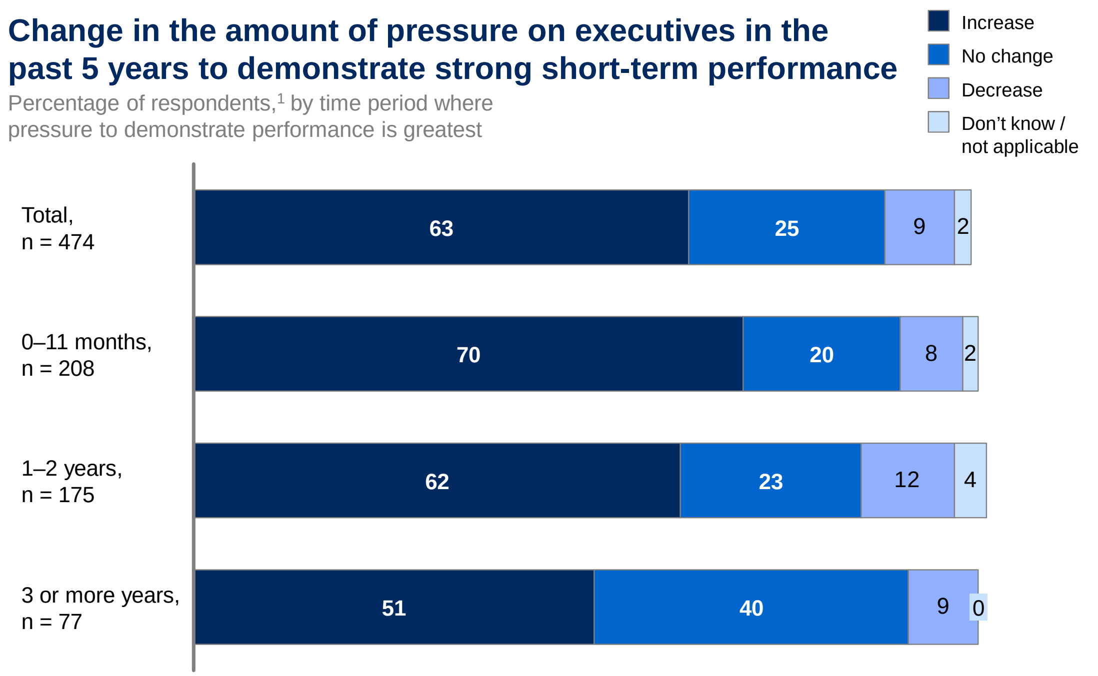
The pressure to perform

Nearly two-thirds (63 percent) of the respondents said that the pressure on their companies' senior executives to deliver short-term financial performance had increased over the past five years. And as we mentioned earlier, 79 percent said they felt the most pressure to produce results within two years or less. In both cases, those answering in their capacity as senior executives experienced the pressure most acutely: they were more likely than board members to report increased pressure and to say they felt it over shorter time horizons.

Across regions, respondents in European and North American companies were more likely (64 percent) than those in emerging markets (54 percent) to say that the pressure had increased since the financial crisis. Those who reported feeling pressure to demonstrate results faster were also likelier to say that the pressure had increased (Exhibit 1).

CEOs were more likely to report feeling an increase in short-term pressure over the last five years than board members (65 percent versus 57 percent, respectively). CEOs who reported that their companies had performed as well as or worse than their competitors over the previous five years were significantly more likely to report increased short-term pressure (74 percent). But a majority of CEOs whose companies had outperformed their competitors also reported such an increase (58 percent).

EXHIBIT 1



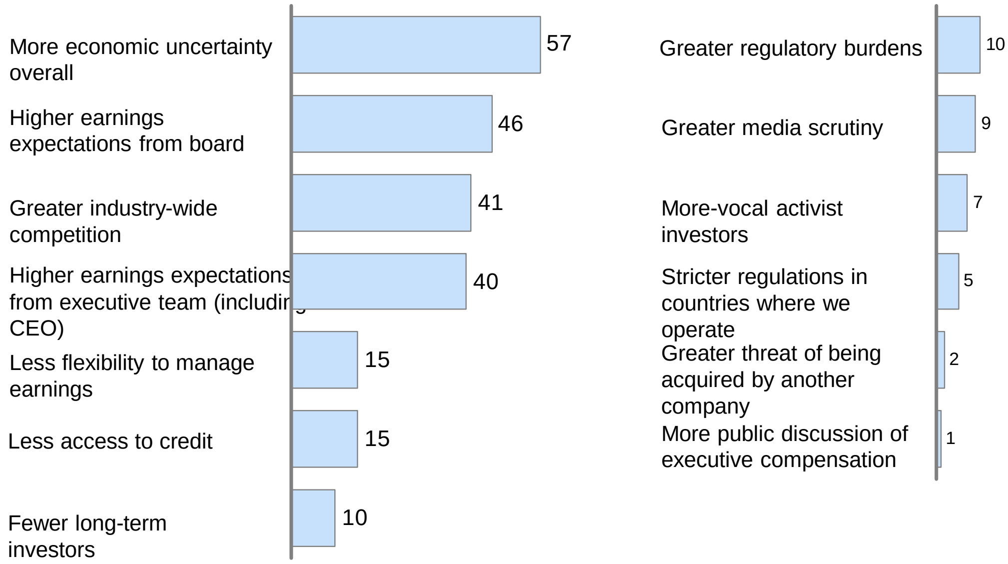
1 Figures may not add up to 100%, because of rounding.

When asked where the pressure came from, a majority of the respondents who said it had increased cited economic uncertainty as the primary reason (57 percent). They pointed less to investor-related issues, such as fewer long-term investors and more vocal activist ones (Exhibit 2). Among respondents at public companies, 46 percent cited higher earnings expectations from the executive team as an underlying cause, compared with 33 percent of respondents at private companies.

EXHIBIT 2

Most significant reasons in the past 5 years for increased pressure on executives to demonstrate strong short-term performance

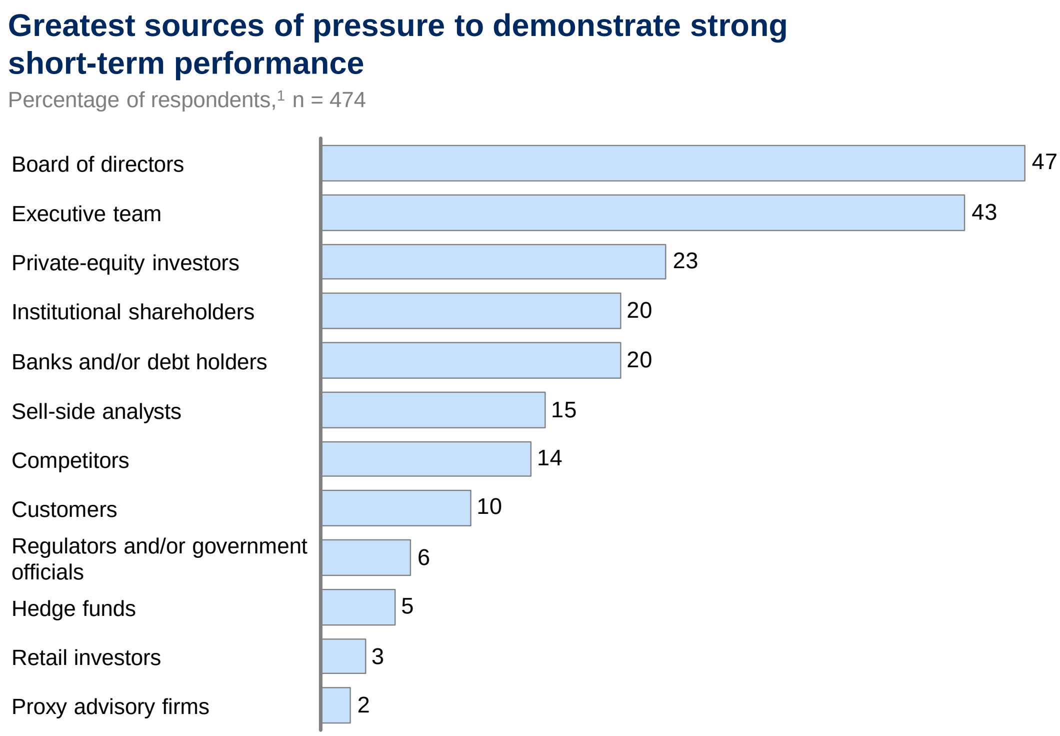
Percentage of respondents who say pressure to demonstrate performance has increased,[1] n = 311



1 Respondents who answered “other” or “don’t know” are not shown.

The greatest sources of pressure to demonstrate short-term results, respondents said, were the respondents themselves: board members and C-level executives (Exhibit 3). Surprisingly, board members were slightly more likely than executives to identify themselves as a source of increased short-term pressure. Respondents who reported that over 50 percent of the investor base had held their companies’ stock for more than two years were less likely to say that the board or sell-side analysts were the main source of the pressure. This finding implies that the boards of companies that are most under pressure from short-term-oriented investors and sell-side analysts probably are not doing enough to shield management from it.

EXHIBIT 3



1 Respondents who answered “other”, “none”, or “don’t know/not applicable” are not shown.

Timing strategic decisions

Survey respondents also provided insights into how increasing pressures for short-term performance influence the way business leaders approach strategy. Nearly half (44 percent) said that when their companies’ management teams conduct a formal review of strategy, the primary time horizon is no longer than two years (Exhibit 4). When asked what it *should* be, 73 percent said three or more.

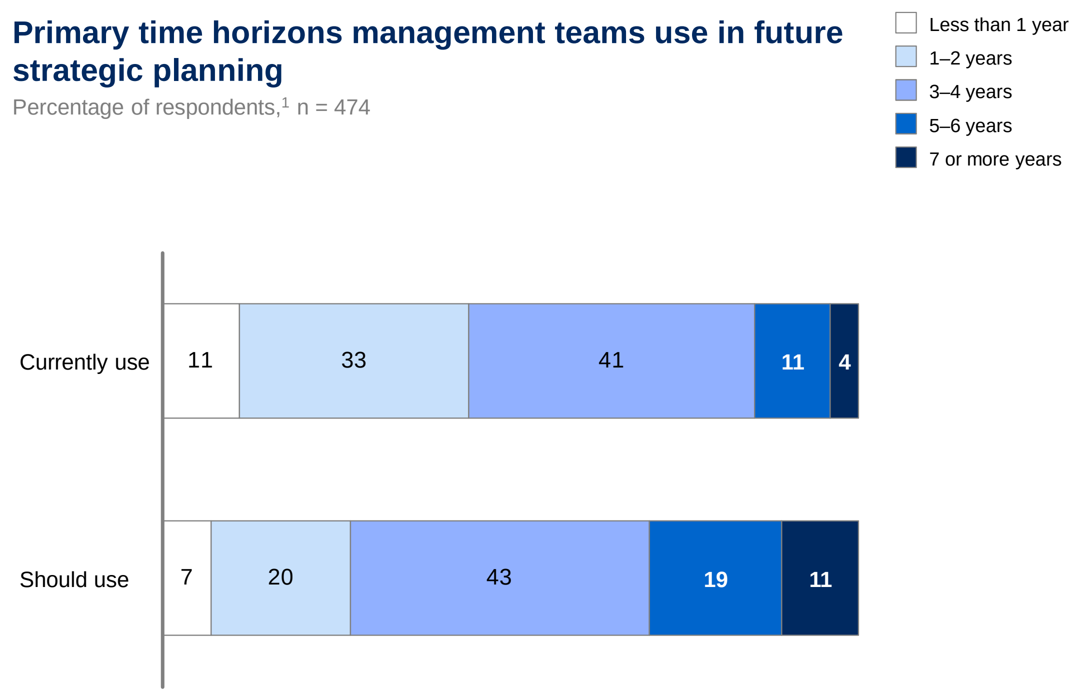
Responses varied among regions, however. More than 80 percent of North American and European respondents stated that a horizon of three years or more was ideal. Only 58 percent of respondents from emerging economies did.

Executives who reported that they spent more time with internal stakeholders (for instance, the board, the wider management team, or colleagues) were likelier to select three to four years as the optimal time period for strategic planning. Those who spent roughly equal amounts of time with internal stakeholders and external ones (for example, customers, regulators, competitors, nongovernmental organizations, industry bodies, investors, and sell-side analysts) were more likely to select five to six years.

EXHIBIT 4

Primary time horizons management teams use in future strategic planning

Percentage of respondents,[1] n = 474



1 Respondents who answered "don't know" are not shown.

In a hypothetical scenario, we asked respondents how much of their companies' quarterly earnings or revenue targets could be put at risk to pursue an investment with a positive net present value that would boost profits by 10 percent over the next three years. Confirming our suspicion that many companies have a short-term bias, a majority of the respondents said that their companies would not be willing to accept significantly lower quarterly earnings for this kind of investment. At public companies, responses varied by size: only 49 percent of the respondents at larger companies[4] and 35 percent at smaller ones[5] said they would be willing to miss earnings by up to 5 percent to pursue such a deal.

4 With annual revenues of at least $1 billion.

5 With annual revenues of less than $1 billion.

We also asked about several other business decisions and the extent to which a focus on short-term financials affects a company's willingness or ability to pursue investments with uncertain long-term outcomes, to manage earnings, and to look after risks and externalities. For earnings management, a majority of the respondents reported that the short-term focus has some effect on decision making. Forty-nine percent said that short-term pressures reduce their companies' willingness to pursue investments with less certain returns.

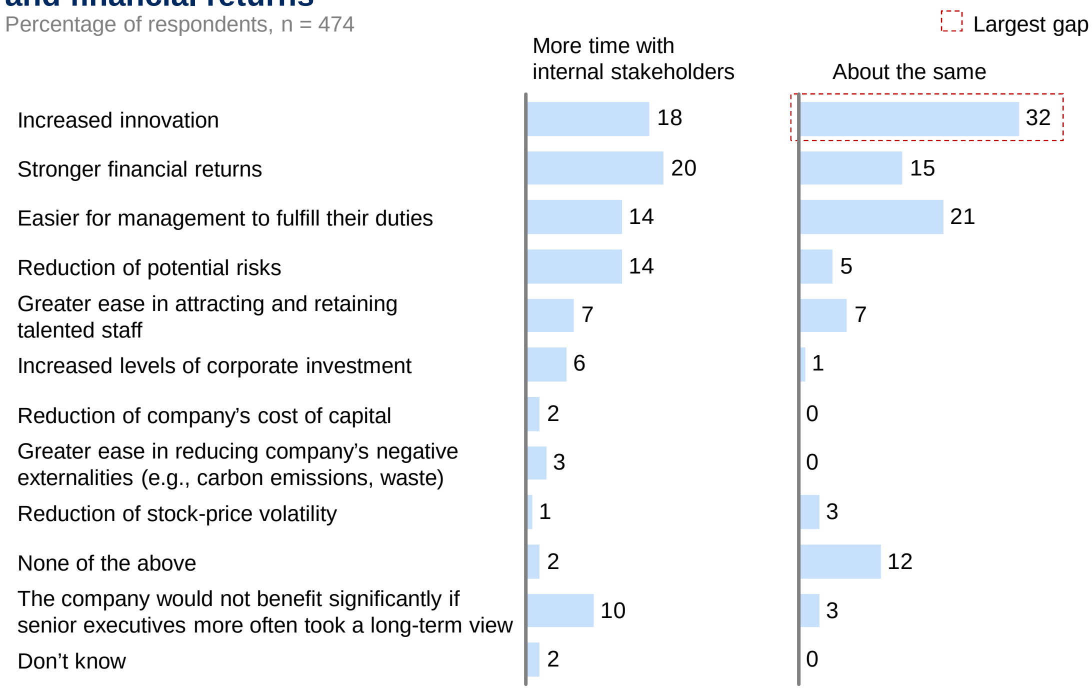
Impact on performance

Most respondents (86 percent) agreed that their companies would be well served if senior executives took a long-term approach to business decisions more often. As the top benefits, they said that it would increase innovation, strengthen financial returns, and help managers to perform their duties effectively. Just 9 percent said that their companies would not benefit significantly if executives took a long-term perspective.

Executives who reported spending more time with internal stakeholders were less likely to see the potential for increased innovation or reduced business risks than executives who balanced their time between internal and external stakeholders (Exhibit 5).

EXHIBIT 5

Respondents believe a longer-term focus would increase innovation and financial returns

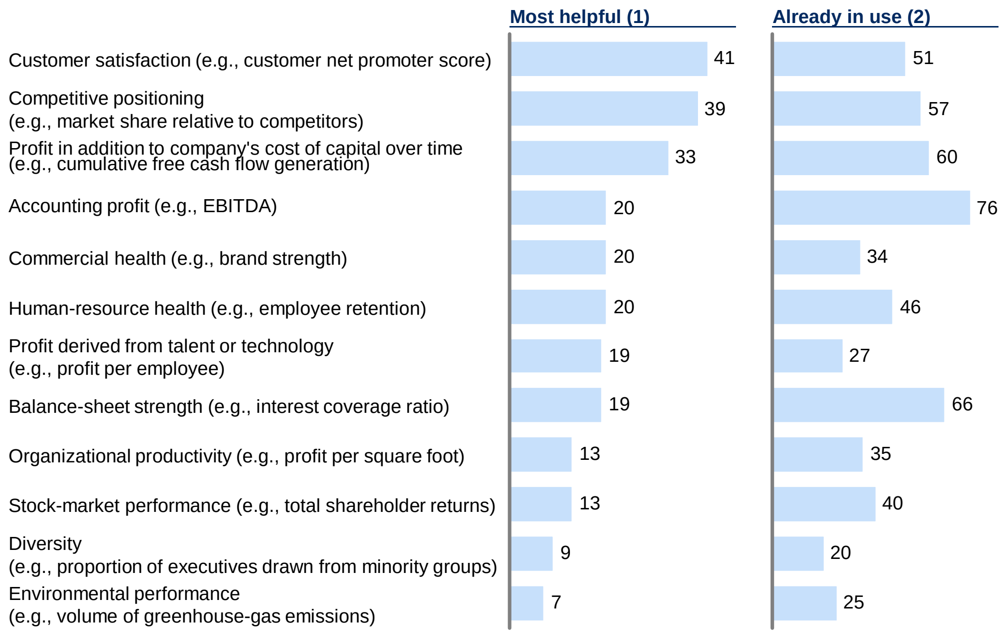


If companies did take a longer-term view in their decision making, directors and executives would need regular access to information notably different from what they now see. The largest share of respondents said that customer-satisfaction (41 percent) and competitive-positioning (39 percent) metrics would be most helpful in making long-term decisions. At the moment, however, business leaders rely more on financial metrics, such as accounting profits, balance-sheet strength, and company profits (Exhibit 6).

EXHIBIT 6

In order for senior executives and board members to shift to long-term thinking, companies need to provide them with different information

Percentage of respondents, n = 474

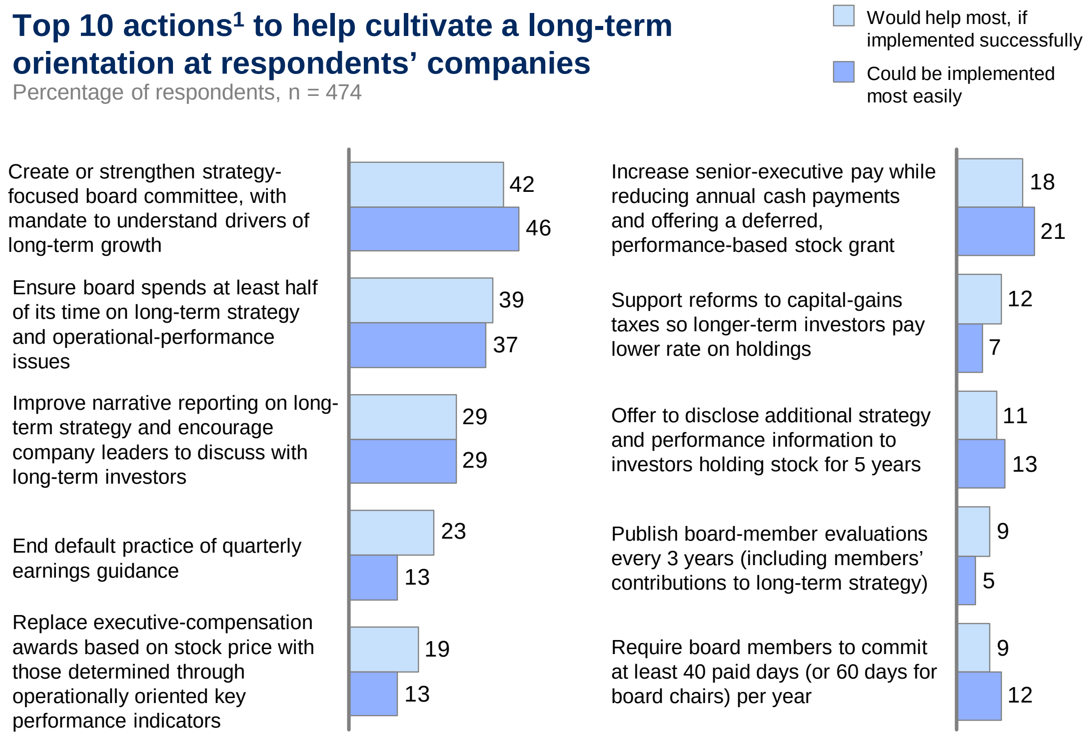


1 Figures may not add up to 100%, because of rounding.

Seeking solutions

Business leaders said that the actions most likely to help cultivate a longer-term orientation at their companies were developing a strategy-focused board committee, ensuring that the board spends at least half of its time on long-term issues, and improving narrative reporting on long-term strategy. Encouragingly, respondents said that these three would be the easiest to implement (Exhibit 7). Yet the fact that so many executives and board members have not yet taken them suggests that companies may not be giving enough thought to how they can reduce excessive short-term pressures.

EXHIBIT 7



1 Out of 14 choices.

Board members and senior executives expressed different opinions about potential solutions. For example, 51 percent of directors said it would be most helpful to spend at least half of their time on long-term strategy and health issues. (Indeed, in a recent survey of board directors,[6] respondents reported that just one-quarter of the decisions they make relate to long-term company matters.) In contrast, just 34 percent of C-level respondents thought that boards should spend more time on long-term issues, with the largest share (44 percent) saying that a strategy-focused board committee would help the most.

[6] See Chinta Bhagat, Martin Hirt, and Conor Kehoe, "Improving board governance: McKinsey Global Survey results," mckinsey.com, August 2013.