FOCUSING CAPITAL
on the LONG TERM

STRAIGHT TALK FOR THE LONG TERM

An in-depth look at improving the investor-corporate dialogue

March 2015

Focusing Capital on the Long Term (FCLT) is an initiative for advancing practical actions to focus business and markets on the long term. It was founded by the Canada Pension Plan Investment Board and McKinsey & Company.

Contributors

Straight Talk for the Long Term is an output of the Focusing Capital on the Long Term (FCLT) initiative. Its development was led by **Lincoln Liburd** with support from **Tim Koller**, **Werner Rehm**, and **Robert Palter** of McKinsey & Company along with an FCLT working group comprised of delegates from the investor and corporate communities:

Richard Chenga-Reddy, Head of Regulatory Affairs, Standard Chartered

Adeline Diab, Head of Responsible Investment Integration, Aviva

Jon Duncan, Head of Sustainability Research and Engagement, Old Mutual

Robert Holl, Investment Analyst, Wellcome Trust

S. Padmanabhan, Executive Chairman, Tata Quality, Tata

Roger Seabrook, Vice President, Investor Relations, Unilever

Vasuki Shastry, Group Head of Public Affairs, Standard Chartered

Lex Suvanto, Managing Director, Financial Communications, Edelman

David Tien, Senior Portfolio Manager, Global Tactical Asset Allocation, Public Market Investments, Canada Pension Plan Investment Board

Allyson Tucker, Senior Investment Officer, Risk Management and Asset Allocation, Washington State Investment Board

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Introduction: why a longer-term dialogue matters

Short-term behavior is becoming the norm in today's capital markets. Rather than pursuing long-term strategies, many public companies dedicate significant resources to meeting quarterly earnings guidance and communicating their performance relative to this guidance.

This focus on short-term actions and communications seems counterproductive, considering that when experts deconstruct the value expectations embedded in share prices, 70% to 90% of a company's value is related to cash flows expected three or more years out.[1] Moreover, research shows that the current emphasis on short-term earnings targets leads to value-destroying behaviors. One survey found that 55% of CFOs would avoid undertaking an NPV-positive investment if it meant falling short of the quarter's consensus earnings per share. And 78% of executives said they would take actions to improve quarterly earnings at the expense of long-term value creation.[2] Companies that expressly seek to manage short-term earnings in order to narrowly beat consensus also underperform peers after two years.[3]

The investor-corporate dialogue can help counteract this short-term bias. We define "investor-corporate dialogue" as the flow of information and ideas between corporations and their current and future investors. A healthy dialogue can empower management to make strategic and operating decisions that build value for the long term.

Companies can start by changing the focus of their communications to investors, which currently tend to stress short-term performance and metrics. Partly in response to regulatory requirements, these communications have become increasingly complex over the years and focus mainly on historical results. The effect of this trend has been the growth of overwhelming amounts of data that often obfuscate the information that is critical for longer-term investors. When companies file 10Ks that are more than 700 pages long, how can investors understand a company's performance and future prospects?

Financial and performance disclosures tend to be written in confusing legalese that yields little insight into the company's value drivers or future potential. Rather than highlighting the most important recent developments, many corporate disclosures simply maintain the status quo. These disclosures rarely connect recent performance to long-term strategy and objectives. Instead, opportunities and risks are expressed in generic terms such as "increased competition" or "changes in commodity prices". At this level of abstraction, it can be difficult for investors to discern what differentiates a company (or a company's businesses) from others in its industry, and what that differentiated value proposition says about its future prospects.

Some companies are reluctant to disclose their long-term strategy for fear that business and industry trends will not unfold as expected, leaving them accountable for plans they can no longer achieve. Others worry about violating fair-disclosure regulations. These are reasonable concerns. However, we believe that all corporate stakeholders stand to benefit from an investor-corporate dialogue that adequately considers long-term performance and health as well as short-term performance. A Harvard study suggests that effectively communicating long-term strategy and consistently using long-term terminology (such as the future and years) on earnings calls is correlated with a lower cost of capital, lower stock price volatility and a longer-term investor base.[4]

Companies that articulate a long-term strategy effectively tend to attract investors who are more willing to look beyond short-term under-performance. The challenge remains creating an environment in which corporations and investors both see the benefit of communicating long-term strategies without sacrificing the level of discipline and financial disclosure imposed by quarterly performance targets.

We have three primary recommendations for companies that seek to strike a better balance between short-term performance and long-term value creation:

1. **Build a compelling long-term strategy and communicate it to investors.**
2. **Measure long-term value creation and performance relative to a set of long-term metrics specific to the company's long-term strategy.**
3. **Report to and engage with investors regarding long-term value creation.**

This report seeks to provide actionable recommendations to investors and publicly traded corporations. To support our analysis, we have included examples of what we consider to be sound investor-corporate dialogue. We recognize that the companies we discuss may face significant challenges today and in the future. However, we believe that these concrete examples help to support the report's observations and should be viewed from the context of investor-corporate dialogue best practice.

A diverse group of institutional investors and corporates was brought together to collaborate on this piece and each may pursue the recommendations expressed to varying degrees. Within the context of their unique situations, we encourage organizations to evaluate, adapt and adopt recommendations, enhancing long-term value created for all stakeholders.

1 Building a compelling long-term strategy and communicating it to investors

The first step in shifting the investor-corporate dialogue is for companies to articulate where they are going, and how they intend to get there over the long term. Board directors should be included in the process of defining strategy so that they can appropriately support and challenge management over its execution.

Management must credibly explain to investors how its strategy creates long-term value and strengthens competitive advantage. Communications from management to investors regarding strategy should include enough evidence to substantiate the company's position and direction.

While companies may define their long-term visions and priorities, their strategies often lack the rigor and transparency that intrinsic long-term investors need. A 2011 *McKinsey Quarterly* article noted that of more than 2,000 executives, only 35% felt their company's strategy possessed more than three out of 10 elements of a winning business strategy.[5]

Beyond a traditional business strategy, a long-term strategy should be rooted in a detailed understanding of the industry and of the company's current competitive position and strengths. It should present a proprietary view on evolving industry trends and lay out strategic initiatives over the short, medium and long term. Strategy is not simply stating "growth through M&A" or "sales optimization." These are at best strategic priorities. A long-term strategy directly addresses uncertainty around sustained value creation, providing a detailed path forward and also includes clear metrics and examples to allow investors to evaluate performance and progress over time.

Certain initiatives are responding to the impacts of short-termism by beginning to influence a structural shift to longer-term thinking. Groups such as the International Integrated Reporting Council (IIRC) are helping companies shift their view to a more holistic, integrated set of value-creation drivers, including those drivers that underpin the long-term sustainability of an enterprise. The European Commission recently made it possible for companies to abandon quarterly reporting (the UK has since expedited this into practice). Sustainability indices (e.g., Dow Jones Sustainability Indices, MSCI Sustainability Index) have further legitimized discussions on ESG with the investment community, one component of long-term value creation. The Johannesburg Stock Exchange, as part of the Sustainable Stock Exchange, made it a requirement for listed companies to provide an integrated report, combining both financial and nonfinancial information in the same investor disclosure. Corporations such as Microsoft, PepsiCo, Prudential, and Clorox were early to adopt integrated reporting, and leading investors around the world, such as Aviva, BlackRock, and CPPIB, have embraced the importance of sustainability as a component of long-term value creation.

Embrace a longer-term mindset and adjust strategies accordingly

The core idea behind long-term sustainable value creation is that corporations need to have a strategy and a business model that considers all stakeholders in their ecosystem. The goal should be to create value for all stakeholders by growing the enterprise beyond a product or investment cycle and beyond a CEO's or director's tenure.

A review of typical product lifecycles across a variety of industries illustrates the importance of longer-term thinking.

- Average asset turnover across industries is about 10.6 years.[6]
- The average pharmaceutical drug takes 12 years to develop and typically has a product lifespan of about the same duration thereafter.
- A gas turbine takes five years to develop and has a 25-year life expectancy.

Defining what fraction of a company's value comes from activities taking place five, seven or 10 years out can help suggest an appropriate time horizon for the company's long-term strategy. Typically, more than 70% to 90% of a corporation's enterprise value is ascribed to activities that will take place more than three years in the future.[7] At a minimum, this implies a five-year timeframe — far longer than most companies assign to their strategies.

In a McKinsey and CPPIB global survey of more than 1,000 executives, 44% of business leaders said their company's management team currently uses a primary time horizon of less than three years for setting corporate strategy. The same business leaders acknowledged the importance of thinking longer term: 73% said the primary time horizon should be more than three years, and 11% said it should be more than seven years.[8]

Clearly, corporate leaders are aware that they should be thinking longer term. In practice, few seem to do so.

Increase communications of long-term strategy

In order to encourage investors to adopt a longer-term view of their investments, and ensure better alignment between current market value and future potential value, companies should release more details about their long-term strategy and value-creation potential.

Developing and communicating a rigorous long-term strategy can deliver additional benefits for both internal and external audiences, according to a recent survey of managers from 66 organizations belonging to the IIRC.

- 92% of respondents reported having improved their own understanding of how value was being created (and destroyed) within the organization.
- 79% found that business decision-making had improved.
- 68% reported a better understanding of risks and opportunities.
- 78% reported better collaboration between the board and management.[9]

In addition, the IIRC survey showed that more transparent financial reporting helped organizations develop stronger relationships with investors:

- 56% reported a positive benefit in relations with institutional investors, and 52% with analysts.
- 87% believed that investors better understood the organization's strategy.
- 79% believed that investors developed greater confidence in the long-term viability of the company's business models.[10]

In our discussions with institutional investors, experts on corporate strategy and CEOs of companies across various industries, we found broad agreement on 10 key elements that companies should include when formulating long-term strategies and communicating them to investors:

1. Express a **clear statement of purpose, mission, and vision**.
2. Explain how the company's business model creates long-term value by identifying **key value drivers** at the reporting unit level (e.g., business, sector, geography).
3. State **management's market view**, major trends impacting it, potential for growth, the business' relative positioning, and implicit assumptions underlying the view (e.g., macroeconomic factors).
4. Highlight sources of **competitive advantage** such as talent, access to resources, or other assets that enable the company to execute its strategy and win in the marketplace, clearly substantiated by fact.
5. Disclose **strategic goals** ultimately tied to drivers of value creation (e.g., returns on invested capital, organic revenue growth) in the context of current and future market trends, and in the company's competitive advantage.

6. Lay out a **detailed execution roadmap** that defines short-, medium-, and long-term actions linked to key milestones and strategic goals targeted at long-term value creation.
7. Provide **medium- and long-term metrics and targets** that indicate the company's ability to deliver on its strategy, including an explanation of how the selected metrics will be measured and tracked consistently (see Section 2).
8. Explain how **capital and noncapital investments**, including the mix of profit allocation, lead to sustained competitive advantage and the creation of long-term value.
9. Provide an overview of **risks** and their mitigation plans, inclusive of sustainability challenges.
10. Articulate how **executive and director compensation** tie to long-term value creation and strategic goals.

Managers and board members should develop a common understanding of these 10 elements. This will ensure that their long-term strategy has a well-articulated narrative and that they can monitor progress over time. Subject to constraints on sharing competitive information, corporations should also release information about each element to investors. The goal should be to explain the strategy and generate an on-going dialogue around it.

Investors increasingly demand this sort of information. In a 2013 survey, the Association of Certified Chartered Accountants, or ACCA, asked investors what types of information were most important to include in the narrative reporting section of an annual report. Key business risks topped the list (38%), followed by key growth opportunities (37%), longer-term business expectations (36%), changes to the competitive environment (29%), and drivers of future performance (27%).[11]

While our research did not result in the identification of one company effectively communicating all 10 elements of a long-term strategy, the following table shows how companies have publicly addressed particular elements in compelling ways:

Case Studies

Long-term strategy element	Company	Description
1. Clear statement of purpose, mission and vision	Electrolux World's second- largest appliance maker by units sold, with net sales of SEK 109.2 billion	Lays out clearly in one page the vision ("who we want to be"), mission ("what we want to achieve"), strategy ("how we want to do it"), and the values ("the base for our work") of the company. Electrolux defines its mission as four financial goals (operating margin, capital turnover rate, return on assets, average growth), which have remained mostly unchanged over the past few years.
2. How long-term value is created	NEDBANK One of South Africa's four largest banking groups by assets and deposits, with total assets of R 750 billion (FY2013)	Links how value is created in the business through three steps (i.e., what we do, flow of money, and value added), and gives detailed explanation and figures for each segment of its businesses (i.e., Lending, deposit-taking and funding activities, Transactional, advisory, trading, investment, insurance and other services, Operations, and Tax and other). The company has also dedicated a website to communicating their long-term strategy (**Fairshare 2030**).

Long-term strategy element	Company	Description
3. Management's market view	metso A supplier of technology and services to the mining, oil, and gas industries, operating in more than 50 countries, with €3.9 billion in net sales (FY2013)	Provides a table of Metso's key industries (mining, construction, oil, and gas) detailing the market drivers, market trends, short-term market outlook, organic growth potential, acquisition potential, share of orders received from the industry during the year, and service intensity.
4. Competitive advantage	Garanti Turkey's second-largest private bank, with consolidated assets of $107 billion (as of September 30, 2014)	Garanti's annual report dedicates a full page to highlighting its competitive advantages and supporting fact base. For example, one of its competitive advantages is being a single point of contact for all financial needs. The strength of this statement is substantiated by the following: • International banking operations in the Netherlands, Russia, and Romania since 1990s • Leader in bancassurance • 18% of all pension participants in Turkey choose Garanti • With TL 9.8 billion business volume, maintains its leading position in factoring • Leader in number of leasing contracts • Turkey's first asset-management company • Strong presence in capital markets with ~7.5% brokerage market share
5. Strategic goals	AMGEN® An American multinational biopharmaceutical company, with a presence in more than 75 countries and total revenue of $18.7 billion (FY2013)	At an investor day presentation in April 2011, Amgen outlined the company's long-term strategy and gave financial guidance for 2015, which was supported by a seven-point plan, including building one of their product franchises to $3–$4 billion of worldwide sales by 2015, an operating plan to drive margin improvement and a clear capital-allocation plan. The company then provided clear financial guidance for 2015: • Revenues of $16-$18 billion • Adjusted net income of $6-$7 billion • Adjusted earnings per share (EPS) of $7.25–$8.60, representing a compound annual growth rate of between 7 and 11 percent
6. Detailed execution roadmap	SIEMENS A German multinational conglomerate operating in more than 200 regions worldwide, with revenue of €72 billion (FY2014)	In 2014, Siemens published its new long-term strategy, Vision 2020, in a strategy report independent of its annual reports. It detailed three specific steps to implementation. The focus in the short term was to drive performance through re-tailoring structures and responsibilities. In the medium term, it was to strengthen core businesses through reallocation of resources. Finally in the long-term, it aspired to seize further growth opportunities in new fields.

Long-term strategy element	Company	Description
7. Medium- and long-term metrics and targets	Westpac Top 5–listed companies by market capitalization on the Australian Securities Exchange Limited, with global assets of A $677.5 billion (2013)	In 2012, Westpac defined 10 objectives aligned with their three sustainability strategies for 2013–17. In 2013 it introduced a scoreboard for these objectives that included the following for each objective: • what was done in 2013 • an objective (e.g., help our customers meet their financial goals in retirement) • a metric to measure (e.g., "Westpac Group customers with Westpac Group superannuation (%)") • 2013 actuals • 2014 and 2017 targets
8. Capital and non-capital investments	Sasol South African energy and chemicals company, one of the top 10 most-valuable companies listed on the Johannesburg Stock Exchange, with turnover of R 202.7 billion (FY2014)	Being a company in a resource-intensive industry and South Africa's second-biggest emitter of greenhouse gases, Sasol and its disclosures receive close review. Their annual report clearly defines the criteria that Sasol takes into account when allocating resources. The criteria cover six types of capital: natural, human, social and relationship, intellectual, manufactured, and finance. Resource allocation decisions are designed to minimize the negative impact of capital inputs while maximizing positive outcomes. The report gives a detailed explanation of each capital type and outcome (impact on the relevant capital stock), as well as activities conducted to minimize the negative impact for each type of capital.
9. Risks	Deutsche Telekom One of the world's leading integrated telecommunications companies, with 143 million mobile customers and revenue of €60.1 billion	Deutsche Telekom segments risks (classified as "Industry, competition and strategy", "Regulation", "Operational", "Brand, communication and reputation", "Litigation as well as anti-trust and consumer protection proceedings" and "Financial") by low, medium, and high risks, assessing them according to the probability of occurrence and potential impact. The company's annual report also provides the change in risk level compared to the prior year.
10. Executive and director compensation	Berkeley Group A British luxury house builder, with £1.4 billion revenue (FY2013) and voted Britain's Most Admired Company in 2011 across all industries	Berkeley Group developed a long-term incentive plan which extends to 2021. Under the incentive plan, the Executive Directors would receive up to 5 million shares in 2021 if the company were to meet its long-term strategic targets (see Section 2).

Some companies are uncomfortable sharing this level of detail with investors, fearing it may weaken their competitive positioning. Such concerns are valid, especially as it relates to information about the sources of competitive advantage. However, true competitive advantage is typically not easily replicated.

For example, Toyota allows other car manufacturers to examine its best-in-class assembly lines, because it would take years for others to master the underlying processes and technology. Walmart has made clear that its competitive advantages include procurement and supply-chain management. Given Walmart's scale and the fact that these competitive advantages are embedded in proprietary IT and distributed across thousands of employees, there is limited risk that a competitor will be able to duplicate them.

The transition to disclosing more information regarding long-term strategy is likely to be a gradual journey for each company, not an abrupt shift. There is no silver bullet in terms of the right level of detail to share. However, companies should recognize the trade-off between protecting a competitive advantage and attracting an investor base that can support the company's strategy over the long term.

Shire PLC is a specialty biopharmaceutical company that saw a dramatic increase in the long-term composition of its investor base following the adoption and release of a comprehensive, long-term strategy, according to a 2014 study in the *Journal for Applied Corporate Finance*. Shire developed a range of financial and nonfinancial KPIs, and created a balanced scorecard linked to executive compensation. While acknowledging the importance of environmental performance, it chose to focus more on ensuring the safety of its products and accelerating the drug-approval process globally. Shire's reporting also addresses access to medication and other issues related to the broader healthcare system.

In 2009 and 2010, Shire started disclosing information about its employee health-and-safety programs as well as its manufacturing and supply-chain quality management initiatives. The result has been a dramatic shift in Shire's investor base, to the point where the majority of its shareholders are now long-term investors. Shire also has a higher proportion of long-term investors relative to its competitors, according to the study.[12]

Practical next steps: developing and communicating a long-term strategy

Corporations

- ☐ Identify the three to five key value drivers of the company's long-term strategy. Organize in-depth discussions with the board, management, outside experts and key long-term investors to discuss latest trends and dynamics on each of these value drivers. Consider using stakeholder feedback to refine the strategy.
- ☐ Assess the current long-term plan against the 10 elements of successful long-term strategy. Focus on those that should be improved in the next iteration of strategy refinement. In consultation with the board, identify elements that are especially important for the industry or for the company.
- ☐ Assess current reporting against the 10 elements of successful long-term strategy. Identify elements that would benefit from more transparency or emphasis in communications. Ask key long-term investors to identify elements they would like to see improved.
- ☐ Integrate multiple periodic reports into a single report that provides a concise and coherent narrative of how the company creates long-term value. The narrative should cover the different areas of the business and the full range of financial and nonfinancial capital employed, along with its financial and nonfinancial impact.
- ☐ Institute an annual, if not more frequent, strategic assessment process that measures progress against one-year performance goals and five-year strategic goals.

Practical next steps (continued)

Investors

- ☐ Urge companies in your portfolio to adopt the corporate guidelines stated above in articulating their next strategy.
- ☐ On company earnings calls or at investor days, ask questions about strategy and long-term planning.
- ☐ Challenge corporate strategies based on 10 elements of compelling long-term strategies emphasizing principles of integrated thinking and reporting.

2 Measuring long-term value creation and performance relative to a set of long-term metrics specific to the company's long-term strategy

A well-articulated strategy must include metrics that allow companies and investors to track progress against strategic objectives and assess the company's ability to deliver value over an extended time horizon. Developing and integrating such metrics into company and investor decision-making and compensation structures is essential in order to migrate the investor-corporate dialogue toward a more balanced discussion about a company's short- and long-term prospects.

Many leading companies are already tracking various short-term metrics related to sustained value creation as part of their reporting, though often lack medium- and long-term indicators of value creation. These longer-term metrics should be rooted in the company's unique value proposition, and should measure how the company creates value over time. As part of the strategic development process, management and the board should develop a clear view on how metrics and targets should evolve over time. Management should set targets and communicate expectations and progress to investors.

Companies will need to find a balance between protecting sensitive information and providing transparency to investors in a way that allows them to track progress over time.

We do not attempt to present a comprehensive set of medium- and long-term metrics tailored to different industries or situations. Other experts have invested significant time and resources in doing so.[13] Companies should choose their own set of metrics and adapt them to their industry, strategy, and geography. We do aim to establish criteria to guide companies in developing metrics that will be tailored to their strategy and directly tied to their long-term value-creation potential.

We recommend that companies complement their chosen financial metrics by adopting medium- and long-term health metrics (e.g., commercial health, cost-structure health, asset health and organization health) that track long-term success. Health metrics continue to be important for companies and investors yet tend to get overlooked in the current focus on short-term performance.

There follows a series of steps companies can take to measure long-term value creation within their long-term strategy:[14]

Establish reporting units that reflect the company's model for value creation

Companies should identify reporting units at a level that provides sufficient detail to help investors understand the company's strategy and business model, track underlying performance, and elucidate each business unit's long-term value-creation potential.

For example, Johnson & Johnson reports on three primary business segments: consumer healthcare, medical devices, diagnostics, and pharmaceuticals. Each has its own strategy, sub-segments, and unique set of performance metrics. Philips provides a breakdown by business sectors (i.e., healthcare, consumer lifestyle, and lighting) and reports consistently against the same metrics that reveal underlying segment performance each quarter (e.g., sales growth, EBITA, adjusted EBITA, working capital, etc.).

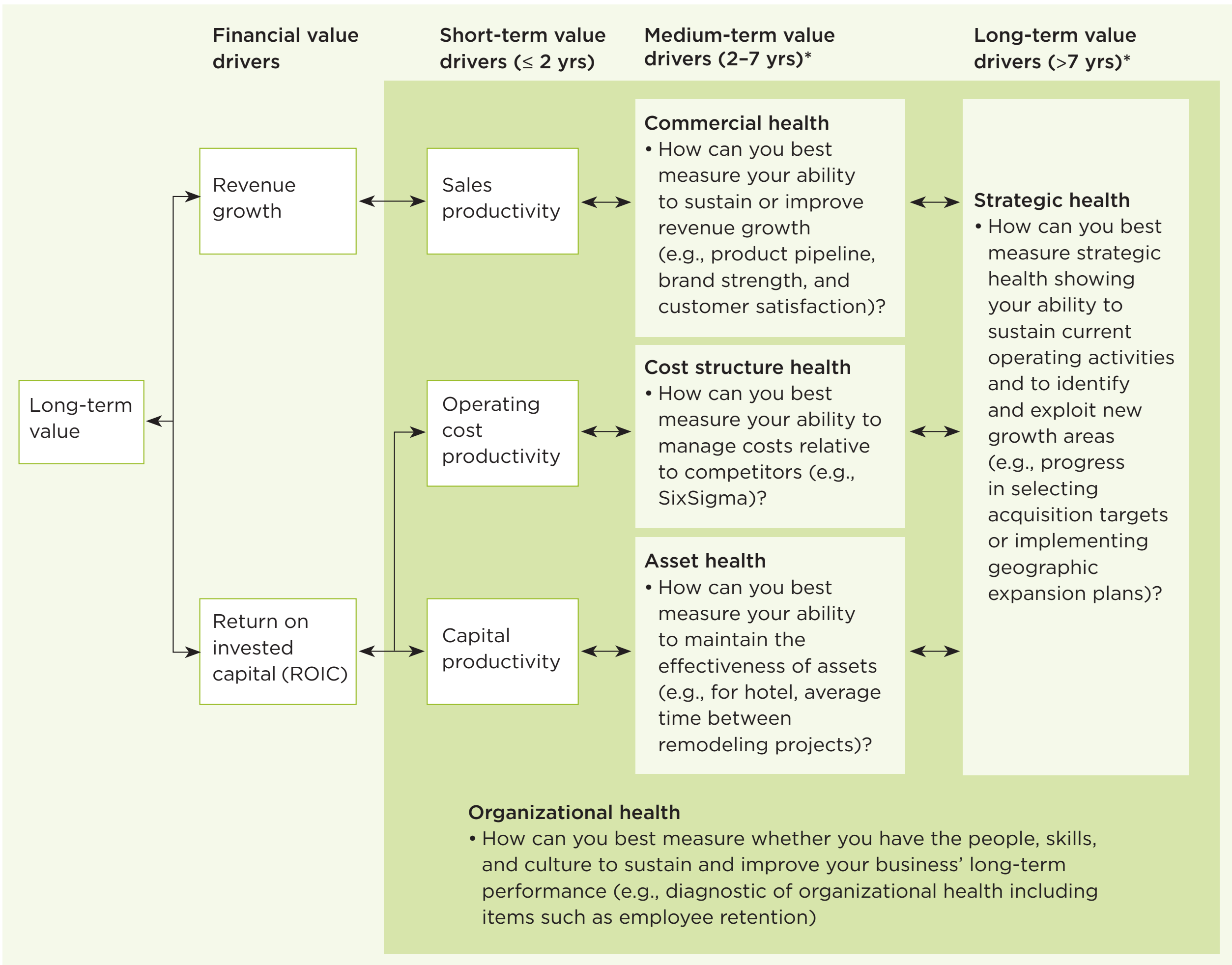
Best practices also include segmenting the business by geography. Unilever presents financial and operating metrics by product category (i.e., personal care, foods, refreshment, home care) and geography (i.e., Americas, Europe, Asia/Africa). The right level of granularity may differ from company to company. Ideal disclosure tracking performance may also vary from GAAP requirements. When that is the case, management should provide clear explanation as to why such disclosure is a better measure of performance and value creation.

Identify value drivers and metrics for each reporting unit

Investors should be able to understand and test key longer-term value drivers and metrics for each reporting unit to meaningfully assess how the company's strategy will increase return on capital over a sustained period.

Companies can build a value-creation tree (see exhibit below) for each of their reporting units to help identify longer-term value drivers tied to long-term revenue growth and ROIC. The exhibit below maps a series of questions for companies as they develop their own value trees:

Questions to ask while developing medium and long-term metrics



* Metrics measured today to forecast the performance in the medium and long term

Many companies focus on short-term profits at the expense of healthy revenue growth and increases in ROIC. Failing to achieve proper balance here can damage a company's health, hurt its performance and ultimately destroy value. In order to mitigate this costly risk, companies need to understand their longer-term value drivers and related metrics. The key is to grasp how each medium- and long-term value driver and related metric impacts organic revenue growth and ROIC. This in turn will drive EPS and value creation.

For companies engaging in measuring long-term value creation, sustainability can often be mistaken for a panacea. Over 70% of S&P 500 companies report on sustainability, one area of longer-term value drivers and metrics. Metrics related to environmental, social and governance (ESG) fall within the topic of sustainability and usually lack the practicality needed to support investor valuations. According to Generation Investment Management founder David Blood: “[M]ost ESG disclosure is not … conducive to mainstream use by investors, since these reports typically lack clear links with the company’s financial performance and long-term prospects for success.”[15]

As a first step in shifting investor behaviors and mindsets toward the long-term, corporations will need to continue to establish a closer and more explicit link between longer-term metrics and measurable financial impact.

Once key value drivers have been identified, companies can develop specific metrics to measure company health and longer-term performance. These longer term metrics should be directly linked to the drivers of future performance and allow management and investors to better track progress against strategic objectives.

Though not inclusive of all longer-term metrics, Toyota follows a strictly measured strategy tied to annual financial impact. Its current five-year plan requires 34% reduction in global CO_2 emissions from manufacturing compared to 2001 levels, as well as a 9% reduction in CO_2 emissions from transport compared to 2006 levels in Japan, and other targets in various regions of the world. It sets targets for fuel efficiency and total number of hybrid vehicles sold. The company is also reporting against these long-term targets. For FY2013, Toyota reported cost reductions of $10 million from reduced energy consumption, and $156 million in sales from recyclable goods and income from environment-related technologies. The company also reported $6.8 billion in benefit to consumers worldwide through reduction in gasoline consumption due to its transition to hybrid vehicles.[16]

Companies should select the metrics that are most relevant to their business. Choices include financial, organizational, operational, marketplace, or network metrics. We strongly recommend that companies provide several years of past data for each metric.

Medium-term health metrics help measure value two to seven years out. These metrics include:

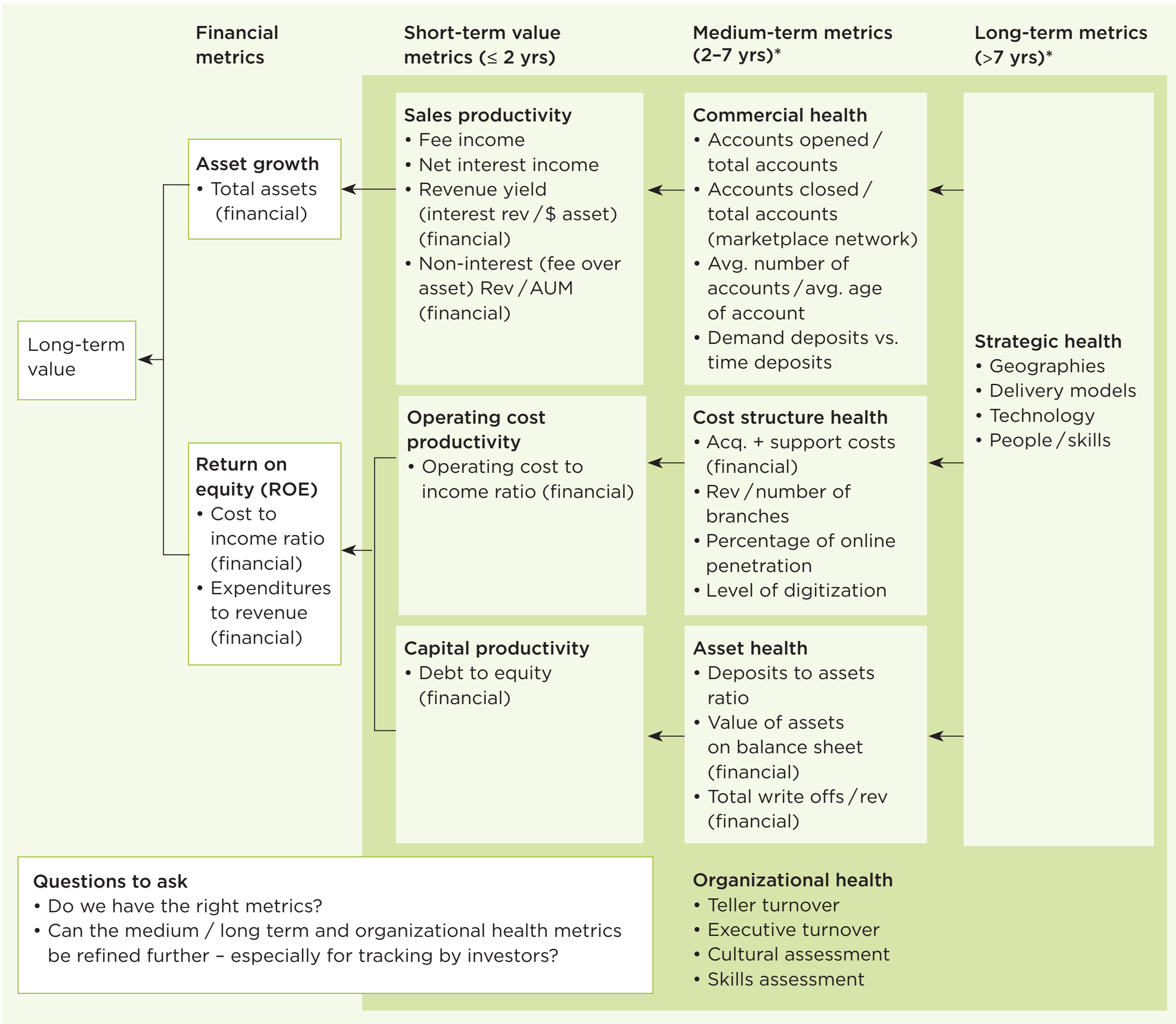
- **Commercial health**, which tracks a company’s ability to sustain or improve organic revenue growth (e.g., product pipeline, brand strength, and customer satisfaction). Commercial health metrics vary widely by industry. For example, a pharmaceutical company may tend to prioritize R&D, while an online retailer may put more emphasis on customer satisfaction and brand strength. Metrics should emphasize sustainable value creation and organic growth as opposed to, for example, simply cutting costs to increase profits.
- **Cost-structure health**, which measures ability to manage costs relative to competitors (e.g., assessments of Six Sigma programs)
- **Asset health**, which measures ability to develop and maintain the effectiveness of assets. For a hotel property, asset health could be measured by average time between remodeling projects. This metric should also reveal whether a company has the requisite asset flexibility to pursue attractive investment opportunities.

Long-term strategic health metrics evaluate a company’s ability to sustain its current operating activities, for example by assessing threats that could make its current business less profitable. These metrics are also designed to help companies identify and exploit new growth areas seven or more years out. In cases where strategic health is hard to quantify, qualitative milestones may be used instead of metrics. In the case of Microsoft, a long-term strategic health metric could evaluate its ability to enter the cloud market.

Organizational health metrics measure whether people, skills, and culture can sustain and improve the business’s long-term performance and deliver on its strategy. Employee retention is one example of an organizational health metric.

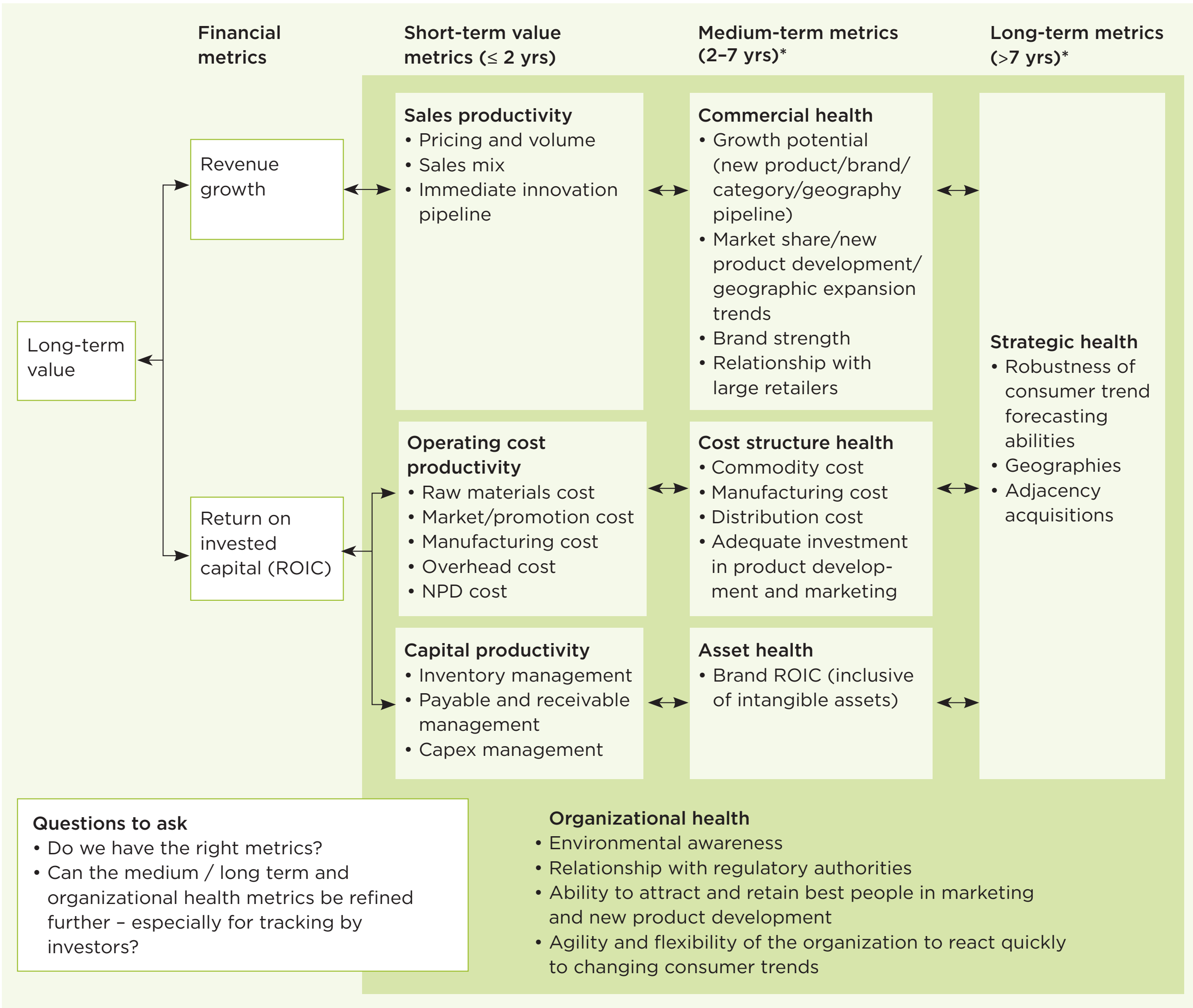
The right metrics will vary by industry, strategy, and geography. The next table provides two simplified value-tree examples, one for a retail bank and one for a consumer packaged-goods company.

Fundamental value driver tree for a simple retail bank



* Metrics measured today to forecast the performance in the medium and long term

Fundamental value driver tree for consumer packaged goods



* Metrics measured today to forecast the performance in the medium and long term

Simplicity is critical when choosing metrics to share with investors. In 2008, the *McKinsey Quarterly* interviewed Christopher Lafond, who was serving as the CFO of the research company Gartner. Lafond explained how the company identified longer-term metrics for investor consumption:[17]

> *"Like most companies, we have an enormous number of metrics we look at internally on a regular basis. But unless you're looking at the metrics every day, understanding the relationship of each metric to the final outcome can be really challenging. And our approach is that externally reported metrics need to be straightforward enough to attract investor attention and that the connection between the metrics and overall performance must be readily apparent."*

The goal is not to share more metrics, but to share the right ones. Companies should steer away from only providing short-term metrics (see Section 3). Instead they should invest more time and resources in sharing longer-term metrics and timelines. This will give investors a deeper understanding of the company's roadmap and long-term prospects. When done well, such actions can result in a more enduring investor base, giving management more flexibility to act and invest for the long term.

Set specific targets for the medium and long term

In order to build investor confidence in management's ability to deliver against the company's long-term strategy, it's important to set clear targets for medium- and long-term performance along with supporting assumptions.[18]

Companies like General Electric release target ranges for returns on capital. Humana provides long-term guidance on estimated membership in its health insurance plans. Gartner sets a range of long-term goals, including growth targets by business unit, margin-improvement targets, and capital-spending goals. Other companies, such as Westpac (see Section 1), set a range of possibilities for revenue growth under different scenarios defined by macroeconomic factors such as inflation or growth forecasts.

Although specific goals and targets vary by company and industry, they should align with the company's long-term strategy. For example, companies might consider adopting metrics based on three- or five-year rolling averages rather than the traditional year-over-year change.

Help investors understand company's value drivers, metrics and targets

Simply sharing long-term metrics and targets is not always enough. Investors must be convinced to use them. It is important to help investors understand why certain metrics and targets are better indicators of long-term performance than others.

Using the methodology described above, companies can develop tailored metrics and targets that speak to the underlying health and returns of their operations. For example, Whole Foods breaks out comparable same-store sales and ROIC by age of stores. This metric helps investors understand store performance over time. It also provides clarity on how the business will support prospects for long-term growth.

In 2014, Whole Foods reported weaker than expected revenue and profits in its first quarter, leading to a significant drop in its stock price. A closer look at the company's reported metrics tells a different story. While overall comparable-store sales growth had slowed, a breakdown by store age revealed that this decline was attributable to older stores, which comprise more than half of total stores and tend to have lower comparable-store sales.

At the time, 25% of Whole Foods stores were more than 15 years old. ROIC breakdown by store age showed that these older stores had a much higher ROIC. Better-informed investors would have been able to rely on these metrics to grasp the company's potential for continued healthy growth. In this case, investor focus on short-term performance and a poor understanding of longer-term metrics overwhelmed the market's ability to see the bigger picture.[19]

Report consistently

In addition to explaining how long-term metrics relate to value creation, companies should consistently report year-over-year performance as well as three or five-year rolling averages, whether good or bad. Management should also provide reasons for over- or under-performance and explain how ongoing performance levels impact long-term strategy.

Long-term investors continually update their forecasts for current and possible portfolio companies. Once companies disclose key metrics, investors need to be sure that the metrics will not be abandoned if the company is unable to deliver on them.

Companies who have continuously reported such metrics for several years gain investor trust. The front page of Berkshire Hathaway's annual report had become well known for reporting the annual change in its per-share book value versus the market performance of the S&P 500 since 1965. In March 2015, Berkshire adjusted this practice. Meanwhile, Gartner has identified two or three key metrics for each of its businesses, including research contract value, number of events, and gross contribution margin. Gartner believes that these metrics should stay consistent as long as its long-term strategy remains unchanged. The company reports on these metrics every quarter regardless of positive or negative news.[20]

In other cases, companies looking to introduce new metrics can provide more meaningful data by measuring performance over longer periods of time. For example, Tullow Oil, a multinational oil and gas exploration company currently facing difficulties in part related to a decline in global oil prices, reports performance over the past five years for each of its chosen metrics. Whenever a new item is introduced, the company recalculates the past five years of financial statements in order to make year by year comparisons feasible. In 2013, Tullow added two new corporate KPIs: contingent resource additions and revisions, and find costs. Consistent with its commitment to providing the past five years of results against any metric, Tullow provided performance figures against these two new metrics going back to 2009.[21]

Create appropriate long-term incentives for management

Companies and investors should translate longer-term objectives into measurable KPIs and embed these targets into their business processes. Performance against these KPIs and targets should define compensation and incentive packages, particularly for executive management and directors. This will help align their incentives to act in the long-term interests of the business and its stakeholders (particularly when aspects from organizational culture and values to the concerns of a broadened group of stakeholders are taken into account).

In 2011, the UK-based luxury house builder Berkeley Group developed a long-term incentive plan to help executive directors focus on generating long-term sustainable value for shareholders. Under the plan, executive directors would receive up to five million shares if the company met its long-term strategy target of returning £13 per share to shareholders by September 30, 2021.

Marks & Spencer, a UK-based international retailer, has developed a compensation framework to incentivize performance today and into the long term. The plan provides options and shares that vest over a three-year period subject to performance measured against EPS, ROCE, and revenue. Annual bonuses for executive directors are determined by their performance against the overall company's strategy (60% of potential bonus) and their performance against individual objectives for each director's respective business area (40% of potential bonus). Directors only receive their individual performance bonus when the joint corporate goals for profits before tax have been met.

Danish brewing giant Heineken embeds long-term sustainability KPIs into the performance assessments of its managers, who work in more than 70 countries. For example, supply-chain managers are given targets for reducing energy and water consumption in their breweries. Local logistics managers have specific targets relating to the CO2 emissions of distribution.

Practical next steps: measuring long-term value creation

Corporations

- ☐ Identify the key medium- and long-term value drivers and related metrics that support the company's long-term strategy and are linked to ROIC and organic growth in areas for each appropriate reporting unit (e.g., geography and business sector).
- ☐ Embed long-term metrics in the corporate strategy development process. Leverage insights from investors to periodically iterate on these metrics (e.g., five-year average ROIC, five-year average ROE, five-year average operating profit margin, FCF margin)
- ☐ Ensure that decision-making processes reflect long-term strategic goals (e.g., budget allocation, talent management, and succession planning) and adjust with time as the business evolves.
- ☐ Include long-term objectives and progress against objectives in CEO/board performance dashboards and cascade through organization.
- ☐ Include long-term objectives (with targets) in manager/director performance evaluations and tie to compensation.

Investors

- ☐ Include long-term value-creation metrics in valuation models and selection criteria for specific investments (e.g., five-year average ROIC, five-year average ROE, five-year average operating profit margin, FCF margin).
- ☐ Publish joint statement by institutional investors on the importance of medium- and long-term value creation metrics. Clearly state willingness to help support their development. Proactively engage corporations on those metrics.
- ☐ Target three to five corporations to assist in the development of medium- and long-term metrics.

3 Reporting to and engaging with investors

A well-developed strategy, supported by the right set of quantitative and qualitative metrics, can steer a business toward successful execution and value creation. By transparently reporting progress to investors in a way that fosters a long-term dialogue, companies can potentially reduce the volatility of their stock price along with their cost of capital.[22] Companies may also benefit from a changing of mindsets within investor-relations teams that aims to ensure the investor-relations team functions not as a transactional entity but as an entity bent on developing long-term relationships with long-term investors. The consequences of this can be far-reaching, helping to encourage a more strategically dynamic culture organization-wide. Fostering long-term dialogue is not solely the responsibility of companies. Long-term investors also have a substantial role to play in proactively engaging management and, where appropriate, directors.

As companies and investors look to increase the value derived from their interactions, they should consider how to enhance the content they share and the channels they leverage in order to focus on long-term value creation.

Companies and investors need to communicate clearly when performance has not met expectations. In the age of real-time media, controlling this message becomes increasingly important. Investors know that business is volatile, but they want to understand management's assessment of the situation as well as any possible risk-mitigating actions. Open discussions build long-term investor trust in management.

Take Progressive Insurance. In the third quarter of 2006, Progressive lowered its policy rates to encourage faster growth, making what then-CEO Glenn Renwick described as "an explicit trade-off of margin for longer-term customer growth." Renwick acknowledged that, "while we will never know the outcome of alternative decisions, we feel very good about the focus on customer growth."

When the strategy did not work out as planned, Renwick addressed the subject directly in the first two sentences of his letter to shareholders in the 2007 annual report: "Profitability and premium growth are both down and they directly reflect the pricing strategy we enacted." He stated that the particular strategic decision "did not produce the aggregate revenue growth we had hoped for."

Long-term investors look for this kind of candid assessment when deciding whether to invest in a management team.

Identify long-term investors

It is important for companies to identify long-term investors and create communications that meet their needs. While many types of portfolio managers and investors exist, they can be segmented into three groups based on the characteristics of how they manage their portfolios. The investor base typically consists of long-term investors, traders, and mechanical investors. Companies can segment their investment base by analyzing holding periods, investment portfolio concentrations, the number of professionals involved in investment decisions, average trading volumes, and the level of research required to trade. Results can be benchmarked against system-wide data (see exhibit below).

When long-term investors trade, they trade more per day in dollars than other investors.

Investor segment	Annual trading activity per segment, $ trillion	Annual trading activity per investor, $ billion	Annual trading activity per investor in segment per investment, $ million	Trading activity per investor in segment per investment per day,* $ million
Intrinsic	3	6	72	79–109
Trading-oriented	11	88	277	1
Mechanical	6	6	17	2

* Includes only days when investor traded.

Adapted from *McKinsey Quarterly*: Communicating with the Right Investors (Palter, Rehm & Shih), where the long-term investor segment is referred to as intrinsic.

While the underlying business and cash flow fundamentally drive performance, long-term investors drive long-term share price for a number of reasons. Long-term investors tend to be knowledgeable about the industry as well as the company's management and strategy. Typically, they spend meaningful amounts of time analyzing and modeling the company before meeting with management. Long-term investors tend to make calculated long-term decisions that show a focus on longer-term value creation rather than quarterly or annual EPS. Examples include extended holding periods and increases in position when short-term expectations push share prices downward; the ability to provide meaningful input to management, such as detailed market understanding and connection to resources; and the ability to influence other investors. For all these reasons, companies should keep long-term investors in mind as their key audience for communications including the company's story and metrics.

Of course, all investors need transparent information. Companies should define efficient protocols to handle in-bound calls and requests, embedding a screening process that is consistent with their segmentation. The goal is to ensure that all investors have access to information in ways consistent with the principles of fair disclosure. As part of this, companies should clearly define how management and directors will interact with shareholders and what information will be disclosed.

Rebalance investor engagement

Companies should modify investor-corporate interactions to place a greater focus on long-term value creation and adjust the content shared during interactions to better manage for both the short and long term. Four major interactions should be addressed immediately: one-on-ones or small group investor meetings, Investor Days, reporting statements, and earnings communications.

One-on-ones, or small group investor meetings, should be leveraged as an opportunity for management, and directors when appropriate, to focus time and resources on longer-term investors, ensuring the long-term strategy is fully understood.

Prioritizing one-on-one meetings with current and potential long-term investors is considered a best practice for investor relations. It is often most effective to focus on a targeted group of current and potential long-term investors that will most benefit from meaningful dialogue. Meetings with small groups of investors should be similarly targeted both in terms of people and time allocation. In these forums, management can focus the discussion on long-term strategy and corresponding performance assessments.

When appropriate, it may also make sense for board directors to engage with long-term investors to reinforce this long-term view. For example, it can be useful for investors to meet with the chairman or chair of the compensation committee for a discussion about how the company's long-term strategy is reflected in its retention and performance contracts with senior executives. Remuneration can serve as a launching pad but should not be the sole focus of a long-term dialogue.

These conversations can often be most effective when scheduled outside of the annual meeting cycle. To be more effective, it would make sense to arrange these meetings to take place around the middle of the fiscal year when investors and management are more likely to have capacity for open strategic discussions.

Gartner fosters a long-term investor base by being selective about how its executives spend time with investors. The head of investor relations is responsible for ensuring that the executives are meeting the right people. Gartner routinely denies one-on-one executive meetings with high-trading, high-turnover clients, even if requested by banks or brokers. This strategy has allowed Gartner to successfully shift its investor base toward low- and moderate-turnover investors.[23]

Unilever has built its long-term investor base by focusing on regular meetings between business heads and investors, rather than relying on quarterly earnings reports.[24] Additionally, Unilever's board chair travels to meet long-term investors for one-on-one meetings in key regions.

Investor Days are an excellent opportunity for companies to communicate a long-term strategy to investors. Investor Days vary in frequency. If a company is mature and following a clear, steady path, it may only need to hold an Investor Day every two or three years. However, an annual Investor Day can foster regular turnout and promote investor engagement.

Companies should conduct an annual Investor Day that provides a deep dive into company strategy. At a minimum, management should cover the 10 key dimensions of an effective long-term strategy (see Section 1). All of the company's major long-term investors should be invited. The company's presentations should be led by the senior management team, and offer clear articulation of the model for long-term value creation along with the steps to achieve it. Investors will greatly value hearing from leaders of reporting units and different businesses, and gain a deeper understanding of how the company works and is performing. If appropriate, a board director, preferably the board chair, should attend to validate that proper governance and incentives are in place to allow the company to deliver on the long-term strategy. Companies can identify and address key investor concerns by surveying investors six to 12 weeks before the Investor Day. A follow-up survey should be conducted soon after the event.

Covidien (a company acquired by Medtronic in January 2015) was a global healthcare products company and manufacturer of medical devices and supplies. At its Investor Days, senior management provided a thorough strategic overview that covered developed and emerging market dynamics, positioning, strategic focus, value-added offerings, and market opportunities. Covidien also included a financial overview and scheduled ample time for Q&A.

At Unilever's Investor Days, the chairman of the board is present and makes himself available to discuss governance topics. Westpac, the second-largest bank in Australia and New Zealand, allows investors to submit questions up to 10 days in advance of its Investor Days. This helps management understand investor concerns and respond appropriately.

Naturally, Investor Days should be leveraged to open a longer-term conversation with both the sell-side and buy-side. Companies can also consider hosting additional investor events to review specific aspects of the company's strategy and operations.

In addition to its annual Investor Day, Walmart invites key investors to visit one of its international operations every year in an effort to provide additional insight on the company's strategy and operations in that market.

Diageo, a multinational alcoholic beverages company based in the UK, held frequent Investor Days during which management reviews strategy for the full business. Diageo also holds shorter, region-specific sessions throughout the year to review regional strategy in more detail.

Reporting statements should be integrated and contain a section dedicated to sharing, at a minimum, the 10 key dimensions of a successful long-term strategy, along with a strategic update (see Section 1). These documents, along with other important company filings and public material, should be made easily accessible online.

Starting November 2015, European Union–listed companies will no longer be required to publish quarterly financial information as part of comprehensive changes to the EU's accounting framework. British regulators have already applied this change.

While the impact of this change remains to be seen, proponents argue that it will help organizations reduce short-termism, do away with preparation costs, and free up executive time. The goal is to reduce the amount of resources committed to backward-looking reporting. Companies will still be able to use press releases and additional filings to address intermittent but important developments.

Detractors argue that timely disclosures in volatile markets help level the playing field between minority investors and controlling shareholders, instilling greater financial discipline on companies and aligning them with global standards.

Europe is not the first region to move in this direction and it likely will not be the last. These initiatives underline the importance of getting annual reports and proxy statements right. If companies want to pursue long-term strategies, they need to start by ensuring that their financial and strategic communications are clear and readily accessible to investors.

Revamping the investor relations website can help. Most investor-relations sites are built using third-party templates that have limited scope for customized information or strategic messaging. Companies should revisit the editorial strategy for their IR websites to identify ways to deliver important messages and data. A quick review of investor-relations websites from companies like GE, Microsoft, Coca Cola, and AstraZeneca illustrates how a more thoughtful approach can make the content more engaging and relevant to short- and long-term investors alike.

Earnings communications can be used by companies to address long-term value creation as opposed to merely focusing on short-term target matching and valuation models, which have a tendency to strongly influence management and board behavior. Management should use the earnings Q&A as an opportunity to put short- and medium-term performance in the context of long-term strategy.

Earnings communications are typically couched in conventional formats that focus on retrospective, quantitative results. There are several ways to focus earnings communications on longer-term strategy. For example, the CEO section of the earnings script can be used to discuss strategy and explain how the quarter's results demonstrate progress against that strategy. This is particularly relevant for year-end results, which can recap progress made during the year. Similarly, the first-quarter earnings call speaks to the year ahead.

Consider this excerpt from Facebook's Q1 2014 call: "I'd like to run through our progress this quarter towards our three big Company goals: connecting everyone, understanding the world, and building the knowledge economy. Connecting everyone is about making the Internet services available to everyone in the world and allowing everyone to connect with the people and things that they care about. Our strategy for connecting everyone is based on two approaches. The first is about giving people new apps for sharing different kinds of content with different people. Today, our apps are at different stages of maturity. Our core Facebook app has an audience of over 1 billion people and has become an essential sharing infrastructure for the world. We are currently focused on building a great business around this and our continuing revenue growth on mobile this quarter shows our strong momentum here."

It can be very helpful to give investors more time to digest and analyze the data in advance of the earnings call.

Companies might consider releasing detailed tables and exhibits along with a prose overview well in advance of the actual earnings conference call, to provide investors more time to digest the information before diving into questions. To take things further, companies could release the full quarterly filing in advance, and perhaps hold the call the following day or soon after. If investors and analysts have enough time to review relevant data prior to the call, companies could omit the conventional prepared remarks that simply read through the tables, and instead provide more of a long-term narrative upfront and then quickly flow into Q&A.

Another useful tactic is to enable investors to ask questions online in advance of the call. Management can then answer questions that add limited value online and focus the live Q&A session around the questions that do matter. For example, Parametric Technology Corporation emails investors one week before the earnings call to solicit questions. Management then sends out a detailed memo to investors instead of reading a prepared script during the earnings call.

A small group of companies have concluded that earnings calls are not conducive to fostering a long-term investor base. Expeditors, a global logistics and freight-forwarding company, does not hold earnings calls at all, knowing that longer-term value will naturally come from those investors who make the time to meet with the company and are willing to thoroughly examine the company's written disclosure. As a result, Expeditors issues written statements around earnings that they believe respond to investor needs. Consuming these documents may take more time, but it enables management to spend time on what matters and to control their story.

There is increasing awareness that quarterly EPS guidance is not helpful in assessing the value of companies, and a growing number of companies are abandoning the practice. They include General Electric, which announced in December 2008 that it would no longer give annual or quarterly EPS guidance. One reason for the change is that long-term investors are less interested than shorter-term investors in whether a company "hits its numbers." Instead, long-term investors look beyond the next quarter and beyond EPS, which can be influenced not only by important value drivers such as growth and operating margins, but also by tangential items such as tax effects and share buybacks.

In addition, some important measures of value creation, such as capital intensity through depreciation, only indirectly affect EPS, so they are at best a proxy for true economic earnings.

Lastly, in the current environment, promising a bottom-line number for next quarter's earnings can raise questions about how a company will get there, given the prevailing economic uncertainty. The "how" becomes more important than the actual numbers. Companies should reduce short-term communications such as EPS guidance in favor of directing investors toward longer-term horizons. Several organizations, including Google and Unilever, have experimented with this idea to various degrees.

Google went public in August 2004. At the time of the IPO, Google's founders announced that they would not give traditional earnings guidance, but that they would discuss long-term trends in the business. This policy was broadly in line with the trend at the time to provide less quarterly guidance. While the decision not to provide financial guidance may have created increased volatility in the stock and analyst estimates, Google's policy gives the company the freedom to focus on long-term initiatives and communicate with investors based on what is important to the company's performance and future.

In May 2009, Unilever chose to discontinue its quarterly earnings guidance and replace it with a narrative description of how the company derives profit from the four pillars of its business model. This narrative includes a range of long-term metrics. The new approach helped Unilever control its long-term story while freeing management to think about longer-term issues and how current actions would position the company for success.

Unilever's stock fell more than 20 percent in the first few months following its decision to discontinue quarterly earnings guidance. By September 30, 2014, however, the share price had risen more than 90 percent and Unilever had outperformed the S&P 500 index by more than 20 percent.

Practical next steps: reporting and engaging

Corporations

- ☐ Perform investor segmentation to identify key long-term investors. Interview these investors to understand their concerns, needs, and interests. Interview potential long-term investors to understand why they are not invested.
- ☐ Adopt clear protocol for board members and executives to engage with long-term and short-term investors.
- ☐ Eliminate or reduce frequency of quarterly guidance and earnings calls.
- ☐ Adopt new engagement techniques with long-term shareholders (e.g., one-on-one and small-group meetings, online platforms, and revised investor call processes that focus discussion on long-term issues).

Investors

- ☐ Ask about long-term strategy, not only on one-on-ones but also in earnings calls and Investor Days.
- ☐ Develop and deliver outreach sessions to IR professionals that discuss investor segmentations.
- ☐ Provide longer-term feedback to five to 10 boards of key holdings.
- ☐ Commit to being more engaged in earnings calls and public interactions to bring counterweight to short-term-focused analysts and other communications.
- ☐ Institute formal investment or engagement platform to actively engage in two-way constructive dialogue with companies on factors of long-term value creation.

Conclusion

Investors and public corporations stand to benefit from an investor-corporate dialogue that considers long-term performance and health as well as short-term performance. In order for the dialogue to be value-additive, companies should develop and disclose compelling long-term strategies focused on sustainable value creation and report consistently against them. We recommend companies address the 10 key elements of long-term strategies. These elements range from a clear statement of purpose, mission, and vision, to a list of the company's competitive advantages (see Section 1). Additionally, any sound strategy should include metrics and targets by which to measure progress in the medium and long term.

Individual metrics vary across companies, industries, and geographies. However, common principles can be applied to build the right metrics for each business (see Section 2). While most companies track their short-term performance using well-defined financial and other metrics, many lack clarity around the longer-term.

In the medium term (two to seven years) companies need to track their commercial health, their cost structure health, and their asset health. Over the long term (seven-plus years), it becomes essential to measure strategic health, which we define as the ability to sustain current operating activities while identifying and exploiting new growth areas. It is no less important to measure organizational health, defined as the extent to which a company's people, skills, and culture can deliver long-term performance while delivering on its strategy.

Once a company has articulated its long-term strategy and identified the metrics and targets that will serve to evaluate that strategy over time, the stage is set for dialogue with investors. The dialogue requires ongoing reporting and active engagement with investors. Four major interactions should be focused on immediately: one-on-one meetings, Investor Days, reporting statements, and earnings communications (see Section 3).

Fostering long-term dialogue is not solely a corporate responsibility, however. Long-term investors have a substantial role to play in proactively engaging management and, where appropriate, directors as well.

Companies that articulate a compelling long-term strategy backed by measurable results are more likely to attract investors who look beyond quarterly earnings and focus on sustained value creation. Over time, corporations and investors should form relationships in which both parties see the benefit of communicating long-term plans without sacrificing the level of discipline and financial disclosure imposed by quarterly performance guidance.

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