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The City and Capitalism for the Long Term

The Tomorrow's Value Lecture given by

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Capitalism has never been a rigid framework but one that has continually evolved. The 17th century ushered in the first joint-stock company. In the 18th century, the global insurance market was born right here in London. In the 19th century, we formalised the rules for stock exchanges.

Now, in the 21st century, capitalism has to take another evolutionary leap to adapt to rapidly changing conditions in the global economy. Today, capitalism is under considerable pressure, brought on largely by an excess of short-term thinking. I meet with CEOs every day, and I am struck by the contrast between the expectations most Western corporate leaders face compared to their counterparts in emerging countries. Most chief executives of public companies in the West feel relentless pressure — from the markets, shareholders and sometimes their own boards — to deliver short-term results. It is very difficult for them to plan long-term investments, even with timeframes as limited as three or five years. Many Asian CEOs, conversely, enjoy conditions much more conducive to long-term horizons, thanks to governments' efforts to foster steady economic development and to a higher preponderance of family-owned businesses eager to build enduring enterprises.

For capitalism to thrive, it urgently needs reform in three areas: shifting from a narrow focus on shareholders to a broader community of stakeholders; adopting an owner-based governance model aimed at building companies with high longevity; and moving from quarterly measures of performance to much longer timeframes.

Why is this the moment to rethink how capitalism works? I believe that centuries from now, people will look back on the next few decades as one of the most significant periods in human history. That is because several huge waves of change are transforming the world economy. The biggest and most significant is the rise of emerging markets. Three billion people in Asia and Africa will rise into the middle class by 2030 — a population of new consumers on a scale we have never seen before. To put that in perspective, the Industrial Revolution had 1/1,000th the scale in terms of how fast it happened and the number of people it affected.

The second big shift involves technology. Technological innovation is moving at least three times faster than management can respond, causing both positive and negative disruptions on a massive scale and in almost every industry. Companies unable to adapt are sideswiped by more nimble rivals. We can see this effect in businesses' shrinking lifespans. In the mid-1930s, the average S&P 500 company could expect to exist 90 years; today, that average is 18 years. The disruption is not limited to the corporate world: communication technology is affecting every institution on the planet, from governments to religious groups. And while it is producing great gains for societies over all, it also exacts costs. The troubling phenomenon of economic growth without job creation is in large part due to technological innovation, and it has profound consequences for societies.

Growing resource constraints are another significant new challenge. Those three billion people moving into the middle class will want to buy cars and phones and refrigerators, but they first need food, energy and water. I do not take the Malthusian view that we will run out of resources, as we have proven our ability to adopt technology to satisfy our expanding needs. However, we are beginning to reach the limits of human ingenuity to sufficiently increase supplies of core

resources such as food and water. In 2009, McKinsey worked with the World Bank, the International Finance Corporation and six companies that are big water users, including Coca Cola and Nestlé, to estimate water supply and demand up to the year 2030. What we discovered is that if we stay on the current trajectory of usage, and even accounting for technological innovation, demand for water will exceed supply by 40% within two decades. Since water does not follow political boundaries, shortages will have far-reaching implications. For example, I think we are going to see rising tensions between countries as societies increasingly tap rivers to fuel economic expansion. Similar conflicts may occur in the Himalayas.

Demographics is yet another issue that is putting pressure on capitalism. The global population is aging. In Asia, there were 10 workers for every retiree in 2000; by 2050, that ratio will drop to three workers per retiree. Similar aging patterns can be seen around the world, forcing increased spending on healthcare and social security.

When we consider these vast new forces and challenges, why should we assume that capitalism as it exists today is fit to address them? I think we have to challenge the current design, because the system is also failing large parts of society. The warning signs are already before us. For one, trust in business in the West has been on a steep decline that accelerated after the financial crisis, reaching record lows. In 1966, when Gallup first started polling the American public on this issue, that trust stood at 55%. In 2012, it was down to 21%. While the financial industry has the biggest reputation problem, business leaders in general need to be concerned. Interestingly, in many parts of Asia, trust in business has gone up and is now as high as 65%; in Brazil, it reached 70% at some points over the past four years.

Another warning sign is the rise in income inequality. In 1970, the top 1% of the

population in the OECD countries earned about 7% of the income. By 2009, that top percentile had doubled its share, to 14%. Meanwhile, the bottom 10% slid from having 4% of total income to 3%. The disparity is greatest in the U.S., U.K. and Italy, but it is growing almost everywhere. Escalation in income inequality amps up pressure on the system, making people wonder if capitalism is fair and creates opportunities for all. The aspect of this issue I find most worrying is unemployment, and particularly youth unemployment. About 75 million young people are unemployed around the world. In the U.K., 21% of youth between the ages of 16 and 24 do not have jobs today, and that does not include people who have stopped looking for work. If you consider those who are not working in their chosen professions, the number rises even higher. Things look even more grim in France and Spain, the latter of which has a staggering 56% youth unemployment. Businesses argue this is the government's problem or the education system's problem to solve, but I think we are all in for a troubling surprise if we fail to realise our shared responsibility.

So capitalism's problems are daunting, no doubt. But there are things we can do to improve it. I would suggest three areas in particular on which we should focus. The first is our definition of who constitute stakeholders in a given business. For the past four decades, the conventional view, articulated by Milton Friedman in an influential 1970 article1, has been that "the business of business is business." He argued that the social responsibility of businesses is increasing profits and innovation, not doing good in the community. This mandate, essentially limited to shareholders, was rooted partly in concerns that large conglomerates were not creating value for their owners. I believe today this view is completely wrong-headed, because we will not be able to increase shareholder value if we do not create benefits for all stakeholders, including local communities, governments and social organisations. I think Adam Smith would have disagreed with Friedman,

since in his first book The Theory of Moral Sentiments, he wrote about entrepreneurs' duty to take care of the societies in which they operate.

Business needs a community's licence to operate within it, and it will only get this licence if its operations benefit that community. However, it is important to note that paying attention to a larger set of stakeholders is not just an issue of corporate social responsibility, but is good for business profitability. Take Coca-Cola: it used to use three litres of water to make one litre of Coke. Naturally, this was a challenging proposition for its operations in areas of India, China and western United States that suffer from water scarcity. In response, the company has set up a program to reduce its water usage and has cut its consumption from three litres to two. Coca-Cola is doing this both because it is a valuable environmental measure and because it is good for its bottom line.

Many other companies have realised that benefiting local communities benefits them as well, creating symbiotic relationships. Rio Tinto has a big passion for education in Africa. The company chose that particular cause because it needs educated people to operate its machinery and drive its trucks, and the local schools were unable to supply them in sufficient numbers. Or consider what Paul Polman, CEO of Unilever, has been trying to do since 2010. He set out on a pretty outrageous mission: to double revenues while cutting Unilever's carbon footprint in half. The company's successful work on sustainable agriculture suggests Polman's aspiration may not be so far-fetched. As business leaders, we have to jettison the idea that shareholder value is all that matters. The question is: how do you measure the value created for other stakeholders? On that, we have much work to do

The second area of reform is around owner-based governance. Boards today, particularly in widely held public companies, are doing a fairly poor job of serving

their employers. First of all, boards spend far too little of their time on non-fiduciary issues. Surveys by executive-search firms have found that between 75% and 80% of directors' time is spent on protecting the company from financial risk. How much attention is devoted to longterm planning and strategic issues? Spencer Stuart surveyed a range of public company boards and found that only 4% had a long-term strategy committee. Public companies also need more of their directors' time. My colleague Conor Kehoe has compared the amount of time non-executive directors who sit on the boards of both publicly listed companies and private-equity companies spend on those respective duties. He discovered that they devote double or triple the amount of time to private equity-related firms than they do to public companies: 54 days a year versus 12 to 20 days. It is difficult to provide a lot of input if you are not taking the time.

A broader problem is that form has overtaken function in the boardrooms of many large corporations. There are plenty of rules and regulations, checklists and hoop-jumping, but these do not necessarily translate into potent actions. There are countless examples of boards that look phenomenal from the standpoint of size, meeting frequency, the directors' experience. What we need is for boards to adopt more of the mindsets of owners. The phrase 'ownerbased governance' comes to me from Jorge Lemann, one of the owners of Anheuser Busch and Burger King, and a very successful Brazilian entrepreneur. He said that the ideal governance structure is a publicly held company with a long-term minority shareholder, such as a family or a pension fund. This combines the benefit of transparency and access to capital with a stabilising influence (the minority long-term investor) who will insist on a long strategic timeframe, countering the pressure from some investors to zigzag when the quarterly performance fails to meet some benchmark.

The final issue we have to address, one that is intrinsically linked to the other two, is the need to shift from a focus on quarterly performance to longer-term

timeframes. This is absolutely vital for any company that wants to be around more than 18 years — you have to invest for the future. When you make your asset and investment decisions with a shortterm view, you get lower returns, as seen by comparing the investment results of private firms against those of their public peers. Partly because they focus on short horizons, public companies shy away from those longer-term but more lucrative investments, and end up investing at a quarter of the rate of their private counterparts2.
The proof of short-term thinking is all around us. Western CEOs spend a lot of their time and energy on managing the expectations of their shareholders and boards around quarterly results. This focus on short-term targets limits their ability — and willingness — to plan for the long term. Surveys indicate that 55% of CFOs will reject an investment with a positive net present value if making it means missing next quarter's consensus earnings3 — and that is a sample size of approximately 400 people. Lots of other research shows similar myopia. Private companies that go public invest 2.8 times less after their IPOs4. Stock prices of public companies regularly have a discount rate that is five- to ten percentage-points too high applied to them, based on future earnings and dividends achieved5.

These patterns have huge consequences on company performance and on returns for investors over time. They also have a dramatic impact on economies at large. The McKinsey Global Institute estimates that global annual spending on long-term investment was about $11.7 trillion in 2010. To get moderate economic growth on the order of 2% to 2.5%, that spending should be $18.8 trillion by 2020. At the current rate, however, we are likely to be about $7 trillion short. In all the discussions about economic troubles in Europe and elsewhere, we often ignore the role of private-sector investment, even as corporations in Europe and the U.S. sit on the sidelines with huge amounts of cash on their balance sheets.

Things look very different in the emerging world. When we compared Western multinationals' rate of investment to that of their developing-market peers, we found the latter had double the investment rate of their Western counterparts. In general, the attitudes toward investment timeframes differ strikingly between the developed and developing world. I will never forget the first meeting I had with Korean President Lee Myung-bak shortly after he took office about five years ago. We were helping him to develop a long-term vision for the country, and I asked him what timeframe he wanted to consider. He answered, "Sixty years." "There must be a translation issue," I said. "You mean six years, right?" He answered, "No, 60. I am a little short-term in my thinking." He went on to say, "We like to think about economic development in terms of generations, and as a leader, I should be judged a hundred years from now on what I was able to do in my time."

Contrast that with the mentality of most political leaders in the West. The long-term shifts I described create unprecedented challenges far into the future, yet Western governments are exceedingly short-term in their planning. It is very difficult to be a successful politician today and have a 10-year strategy. Electoral cycles encourage politicians to look at one- or two-year horizons in order to satisfy voters' immediate concerns. This is a tough problem to address, as electoral systems are enforced by constitutions and laws aimed at protecting democracy. It will not be easy to do away with quarterly capitalism. SEC rules demand transparency, and most companies feel they have to give quarterly guidance to satisfy the markets. In addition, the value chain of savers, institutional investors, asset managers and companies has become much more complicated over the past 40 years. There are many more layers between an institutional investor and the company in which it invests, and we are seeing new behaviours at each point in the chain. In general, the investor base has grown more activist, with the average duration of stock holding dropping from seven years to seven months6. Since the shift from defined-benefit pension plans to defined-contribution plans began, for

example, savers' portfolios have seen increasing churn as individuals tend to be more erratic in their investing than institutions.

That said, asset managers are also churning their accounts more: typical asset managers will turn over 75% of their investments each year7. Institutions actually own more overall stock — they hold 73% of the top 1,000 companies today versus 47% in 19738 — yet they play more passive roles in these investments than they used to9. They also provide shorter mandates to fund managers. The Canada Pension Plan Investment Board likes to say, "In our view, a quarter is not a quarter, it is 25 years," yet the CPPIB had evaluated many of its asset managers on a much shorter-term basis. I am not laying the blame at the feet of activist traders, but rather the combined shortterm mentality of the current market system. If we want to reform capitalism, we must make it a group effort supported throughout the value chain. When Paul Polman at Unilever tried to do away with quarterly earnings, he learned an immediate hard truth: it is easier to lose investors than it is to find them, but he is fine now as he attracted more long-term investors.

While making capitalism more long-term is itself a long-term project, there are two fronts on which we should act right now. Most important is for institutional investors to rally to the cause. One way they can do this is to publish goals for the average portfolio investment horizon, then measure performance based on those goals. Some have already acted: GIC, the Singapore sovereign wealth fund publishes 20-year performance targets and links part of its staff compensation to those benchmarks. The CPPIB in Canada has started to highlight 10-year performance in its annual reports and is shifting its external fund manager compensation to a five-plus-year model. Along with longer-term targets, institutional investors need to become more active on boards. The 'buy side' is going to play a key role because of a simple tenet I remember from my time in banking: he or she who owns the 'buy side' determines the 'sell side'.

The other critical area we should address is fostering a longer-term focus for boards, which in turn will help CEOs plan for more distant futures. The average tenure of a CEO has dropped from 10 years to six and, in some industries, it is three years. It is very hard for a CEO with a brief tenure expectancy to think about investing in places like China, because he or she knows the benefits will not materialise until their successor's successor's time. If you run an agri-food business, will you invest in a product with a lifecycle of 13 years? The boards can help by pushing for those longer-term investments. Regulation can, too. I believe we should get rid of quarterly earnings altogether. Corporate performance is much more transparent now than it used to be, making quarterly earnings an anachronism.

The problems with capitalism will only get worse if we do not actively work to reform it. The new global forces will affect all parts of society, and all parts must collaborate on preparing to face them. But our predicament is similar to that of frogs boiling in a pot of water: the change is happening too slowly for us to realise how big a danger we face.

Still, I am an optimist. I believe capitalism remains the best way to take billions of people to a higher standard of living. Our challenge is to stop spending so much time worrying about today and focus on tomorrow. One of my Chinese clients put it well when he said of the 21st century: "I think it will be a wonderful century for humanity, if we get through the first 30 years."

1 New York Times Magazine, 13 September 1970
2 Asker, Farre-Mensa, Ljungqvist "Comparing the Investment Behaviour of Public and Private Firms"
3 Graham, Harvey, Rajgopal "Value destruction and Financial Reporting decisions"
4 Asker, Farre-Mensa, Ljungqvist "Comparing the Investment Behaviour of Public and Private Firms"
5 Davies, Haldane "Short Long"
6 NYSE reporting, McKinsey analysis
7 Simfund database, McKinsey analysis
8 Conference Board (US based lobbying organisation)
9 CEM Benchmarking (boutique institutional investor research firm)