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Why you've got to put your portfolio on the move

We analyzed hundreds of companies, worldwide, across a decade-long business cycle. The conclusion? Winners change their business mix, year after year. Laggards sit still.

by Sandra Andersen, Chris Bradley, Sri Swaminathan, and Andy West

Every CEO will ask, at least once, "Which business should this company be in?" But the best know it can't be a one-time question. They keep asking, and change their answer over time. These CEOs put their company's portfolio of businesses on the move—and outperformance tends to follow. The reverse largely holds true as well. CEOs who rarely ask the question end up with a static portfolio, and serially underperform. Why? Because the market moves on and their company doesn't. That's why sitting still is often the worst choice you can make.

We know, because we've measured. Specifically, we analyzed detailed financial results of more than 1,000 of the world's prominent public companies between 2007 and 2017, through a long cycle of downturn, recovery, and growth. Our research makes the clear business case for dynamic portfolio management. What's more, it points to principles that can keep you grounded during uncertain times and carry you into whatever comes next. Five takeaways in particular emerged from what the history shows:

1. *Keep the portfolio moving.* There is an optimal rate to rotate the industries you operate in—a Goldilocks pace that the best performers meet consistently. Leading companies tend to rotate their portfolios steadily, not wildly, and avoid keeping them fixed in place.

2. *Move with the market, changing lanes if you have to.* Headwinds and tailwinds matter a lot. The best companies identify where the winds are shifting and deploy resources aggressively where they predict the value creation to be.

3. *Use transactions to speed your way.* Mergers, acquisitions, and, not least, divestitures are generally essential to realize value creation. High performers account for an outsize share of merger and acquisition (M&A) transaction value and conduct programmatic M&A.[1]

[1] Programmatic M&A is realized when a company makes roughly two or more small or midsize deals in a year, with a meaningful target market capitalization acquired over a ten-year period (the median of the total market capitalization acquired across all deals is 15 percent). See Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com.

4. *Focus acquisitions at the perimeter of your portfolio.* How far from your core industry should you aim M&A? Statistically, we found the odds were best when companies used M&A to accelerate a move toward new opportunities in existing but secondary businesses (that is, outside, but not too far outside, of their core sectors).

5. *Go harder when you are in a tough spot.* How you stack up against your competitors affects how hard you need to pull on these levers. We found that companies in the lowest quintile of performance did better when they pulled even harder.

These lessons proved themselves in good times and in bad—and they're also harder to apply than they sound. If you feel like the call to shift your portfolio sounds challenging, especially given economic conditions, we hear you. Decision-making biases conspire toward inertia. Be assured, though, that we've heard far more CEOs and investors complain, after the fact, about shifting too little or too late than about the opposite. Get moving; the data is with you if you do.

The business case for portfolio change

Chances are, you've read plenty already about corporate portfolio management: conceptual, static reviews that seek to plot your business on some kind of matrix. Empirics, if included at all, are generally snapshot-in-time comparisons of different portfolio archetypes. While the literature can be helpful as an academic matter, it almost never addresses the *business case* of why portfolio change improves performance, or how to go through the difficult task of actually shifting your business mix.

So it was with business realities in mind that we analyzed reams of reported data. We sought out the links between changes in companies' portfolios and actual performance results. (The research was not as easy as it may sound, given the many ways companies report their segments and the many times they reclassify their businesses.) Critically, we sought conclusions that could be borne out through the long term, holding true across market cycles. Five principles proved most compelling.

1. Keep the portfolio rotating

How much should business portfolios change? Our research revealed a Goldilocks rate: portfolio rotation that's not too low, nor too high, but just right to produce outperformance. When we drilled down on a controlled subset of our studied companies, we found that about half of them kept their portfolios mostly static, refreshing them by fewer than ten percentage points over our studied ten-year period. In other words, their portfolio mix at the end of the period was similar to what it had been at the start. This group barely moved the needle in average annual excess total returns to shareholders (TRS). Another group, comprising about a quarter of the companies, were rapid churners, refreshing their portfolios by more than 30 percentage points over the decade; they actually produced slightly negative excess annual TRS (Exhibit 1).

The remaining 23 percent of the companies we studied registered a refresh rate between 10 and 30 percent. This last group consisted of the Goldilocks companies, and they delivered results that were *just right*—outperforming the others in excess TRS by, on average, 5.2 percent per annum. For a hypothetical company with $10 billion in

Exhibit 1

An optimal refresh rate keeps a portfolio moving at a steady clip.

Total returns to shareholders, average excess performance, 2007–17 (n = 209), %

[1] The refresh rate is calculated as the sum of the absolute differences in a company's % share of revenues by industry, divided by 2.

revenues, a Goldilocks rate of portfolio rotation would mean moving between $1 billion and $3 billion over ten years. One high performer we studied, today a global logistics company, had operated substantial depositary-credit and retail-banking businesses through the first decade of the 2000s. Indeed, those business units accounted for more than 15 percent of total company revenue in 2007. But between 2007 and 2017, the firm exited banking and determinedly expanded its presence in supply-chain logistics and parcel and e-commerce delivery instead—areas that each grew to represent about 50 percent of its sales by 2017. It added up to a refresh rate of 16 percent, which put the company in the sweet spot that marks TRS high performers. The company's decided pivot toward more value-creating business models helped to transform economic profit performance and to generate above-industry shareholder returns for the longer run.

2. Move with the market, changing lanes if you have to

When firms examine their performance, they rarely disaggregate between being lucky and being good. How much of their results derive from operating in a high-value-creating industry? How much derives from taking steps to get there? When times are good, stories of management prowess abound. When times are tougher, industry challenges dominate the discussion. We created a baseline of industry momentum to consider how a starting portfolio would have evolved had each constituent part performed in line with its pure-play peers. This allowed us to measure whether changes within a portfolio either sped up or slowed down performance. The sum of a company's moves for each of its business units represents total portfolio momentum (Exhibit 2).

When we examined the impact of portfolio momentum on a select portion of our broader data set, we found that the one-third of firms that had begun the period with positive industry momentum did very well, with annual excess TRS of 4.4 percent; they had started in the fast lane and remained there. The others went one of two ways. The companies that had started in the slow lane and moved into the fast lane—for example, a life-sciences conglomerate that shifted more capital to testing and treatment—reached the end of the ten years in reasonable shape, with excess TRS growth of

1.7 percent per year. But the companies that began in a slow-growing industry and stayed there struggled in comparison; they delivered a negative average excess TRS over the measured period.

Of course, picking the fast lane is easy in hindsight. The best companies plumb market insights to forecast which industries and markets are likely to thrive, and actively configure their portfolios to take advantage of those projected tailwinds. It takes courage to move early—but if you're not early, you'll probably be too late. Take one company we know, now a leading provider worldwide of financial research and analytics. In 2007, 40 percent of its revenues came, collectively, from its publishing and education businesses; its financial-research arm contributed about one-third of the company's top line, and its data and analytics businesses accounted for the rest. Seeing the challenges ahead for the publishing industry as a whole, the company sold its publishing and education businesses to private-equity investors and doubled down on financial research and analytics. By 2017, slightly more than half of its revenues were derived from financial research, and its financial-data-solutions business reached about 50 percent of the top line.

These moves were indeed ahead of the tide. Between 2007 and 2017, the average economic profit of companies involved in information provision increased by a massive $1.4 billion, while those involved in publishing *declined* by $73 million. The industry impact of veering out of the slow lane of publishing and into the fast lane of financial data helped contribute $400 million of the $850 million in economic profit "lift" that the company as a whole enjoyed over that period.

Exhibit 2

Move with the market, and change lanes if you have to.

Portfolio momentum—illustrated example

	Industry momentum, 2007–17 Average change in economic profit, $ million		Company's portfolio exposure Proportion of revenue, %				Company's portfolio momentum Expected change in economic profit, $ million
			2007	2017			
Business unit A	1,000	×	27	52	+25	=	250
Business unit B	100	×	33	48	+15	=	15
Business unit C	–80	×	40	0	–40	=	32
Total							297

3. Use transactions to speed your way

Mergers, acquisitions, and divestitures are typically essential to make a strategy work; you have to do deals to position your company for value creation. In fact, related research shows that the performance for companies using largely organic-only strategies has continued to deteriorate over the past ten years. Companies relying on organic growth, on average, decidedly underperformed their peers in TRS.

But M&A isn't just a matter of "doing deals"; there are different approaches to M&A and, we've found, they tend to produce different outcomes. *Programmatic M&A*, as we've noted, is realized when a company makes roughly two or more small or midsize deals in a year, acquiring a meaningful total market capitalization over a ten-year period (the median is 15 percent of total market cap acquired across all deals). In the *large-deal* approach, regardless of how many deals a company does, if an individual deal is larger than 30 percent of the acquiring company's market capitalization, we believe most of its portfolio story is told by this one large bet. *Selective M&A* involves doing deals, but the value of those deals fails to add up to a meaningful proportion of a company's market capitalization at the end of a ten-year period. And in the *organic* approach, a company makes one deal or fewer every three years, and the cumulative value of the deals is less than 2 percent of the acquirer's market capitalization.

When we looked at the companies that were operating at the Goldilocks refresh rate of between 10 and 30 percent over ten years, it was clear that programmatic M&A was the optimal path. The firms in our sample that used programmatic M&A delivered average excess TRS of 6.2 percent per year. We found similar outperformance when it came to the best way to change lanes. Of the companies that used transactions to move into high-growth industries, those that relied on a programmatic approach averaged 3.7 percent in annual excess TRS, compared with –0.5 percent for companies that attempted this using selective M&A, and 1.2 percent for companies using the large-deal approach.

That makes sense. A steady stream of deals gives a company access to the latest market intelligence and improves its transaction and integration capabilities. While deals won't succeed all of the time (nothing does), doing them as part of your regular business cadence enforces portfolio-management discipline, helps your team get smarter about industry levers and trends, and fosters investor confidence in your approach. By contrast, companies that do large deals often consider M&A "done" for several years while they integrate—which typically results in getting "dug in" even deeper in their core business, as well as taking M&A off the table as a vehicle to move their portfolio. In the meantime, the world moves on, continues to evolve, and opportunities are often missed.

To avoid that trap, a global industrial company pursued a programmatic approach as it aligned its portfolio with industry tailwinds between 2008 and 2017. Over that period, the company made more than 50 transactions, posting a refresh rate of 29 percent. Importantly, as part of its dealmaking rigor, it divested numerous businesses in which it lacked a competitive advantage. Its discipline paid off. The company's excess TRS versus that of its peers over the same period was an impressive 9 percent.

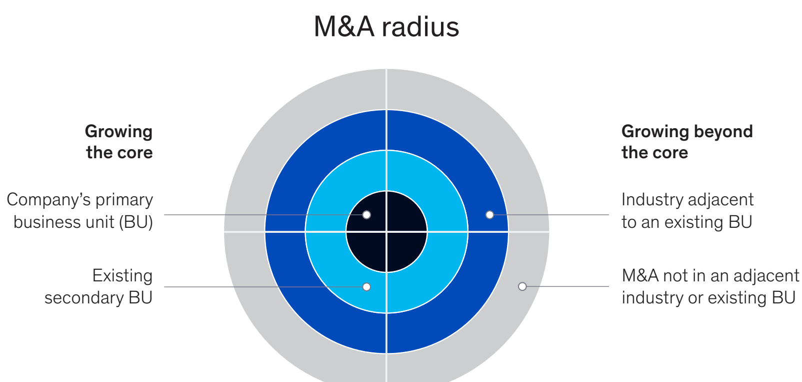
4. Focus acquisitions at the perimeter of your portfolio

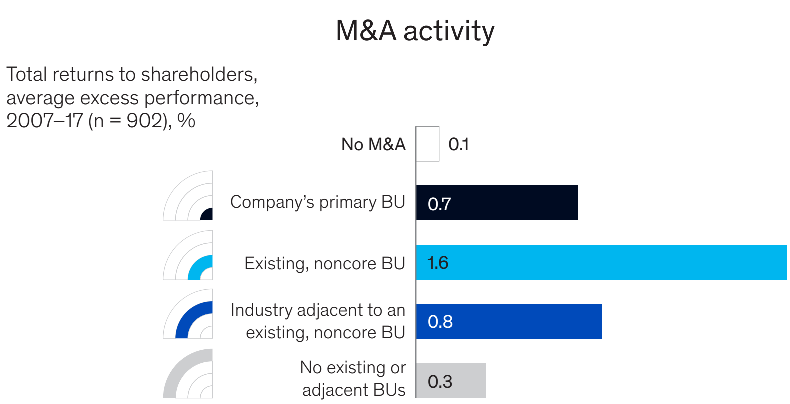
How far from your core should you aim your M&A? We call that distance the "transaction radius." Think of it, metaphorically, as seeking out targets progressively further afield, starting with the core of your existing business, with concentric circles extending outward. As a practical matter, we parsed the companies in our 2007–17 data set and assigned their acquisitions into one of four categories: adding to its primary industry segment; adding to an existing, secondary industry segment; buying into a segment adjacent to an existing business; or stepping out into an unrelated industry. We hypothesized that there was an optimal transaction radius from the core where winning players expanded—not too far, and not too close, to your core.

The results broadly confirmed the hypothesis (Exhibit 3). Companies that made acquisitions to shore up existing but secondary businesses registered the best results, returning an average of 1.6 percent in excess annual TRS. That said, a company's existing industry context turned out to be critical. Those that started in well-performing industries did best pursuing M&A within their core industries—not surprising, given they had little reason to shift out of their fast lane. Conversely, those that needed to change lanes got the biggest boost when they aimed further from their core.

Exhibit 3

Top performers tend to aim their M&A outside the core—but not too outside.





High performers recognize that getting to value creation can be a multistep dance. Consider one multinational chemicals company. At the start of our study period, the firm was primarily a basic chemicals company, a sector in which larger US- and Middle East–based competitors had far greater scale. The company recognized that specialty chemicals, and nutrition in particular—where it already had a small footprint—could move it into a faster growth lane. Over a decade, it made multiple acquisitions to extend its presence in the nutrition business, building upon its position in a more value-creating sector. In parallel, it exited businesses such as rubber, fertilizers, and energy, raising some $1.6 billion from its divestments. Those moves enabled the company to deliver more than 6 percent annual excess TRS.

5. Go harder when you are in a tough spot

How much do these takeaways change depending on where a company is relative to its competitors? Should you make more aggressive portfolio moves when you've fallen behind? Our analysis suggests that you should. For example, laggards do better when they step on the reallocation and M&A gas. That may seem counterintuitive, at least as far as deals are concerned. Conventional wisdom holds that companies must "earn the right" to participate in M&A—master their own businesses before they strike out to acquire others. And in fact, underperforming firms do hesitate to become buyers, and if they do make an acquisition, it tends to be a small one. After all, how likely is it that an underperformer can buy its way into growth? Why would you lean into a failing business unit by adding M&A to the mix?

Unfortunately, when you have a declining business, focusing on performance improvement alone, and ignoring your portfolio, does little for your odds of sharply turning things around. According to our analysis, the worse your starting point, the more urgent it becomes to shift to a faster track. For companies that find themselves in the bottom quintile of economic profit performance, making gentle portfolio shifts is a poor strategy. We found that it was precisely these underperformers that benefited the most from more aggressive reallocation and higher-intensity M&A. And step-out M&A, which is usually higher risk than acquisitions closer to the core, is a better option than modest portfolio shifts when the companies that do them are at the back of the pack.

Going harder paid off in spades for one of the world's largest packaging companies. In 2009, after several years of sluggish performance, the company, then much smaller, surprised industry observers by pulling off an ambitious acquisition of a multinational conglomerate's packaging unit (which the conglomerate, too, was right to divest, as the noncore line had become an ill fit). For the acquirer, however, the acquisition fit like Cinderella's slipper. It boosted the firm's growth and margin trajectory and led to a decade of outstanding shareholder returns. It was also a "bet the company" moment. Indeed, without the conviction to go hard on portfolio changes, the smaller company may well have become a takeover target itself.

A story of 'from–to'

The metrics on portfolio change speak volumes, across five distinct dimensions. But take away the numbers, and the core principles remain: move toward value creation in a systematic way. Don't overdo it with drastic action, unless you're cornered. Most importantly, don't sit still. Statistically, that's the worst choice you can make.

Yet too many organizations still incline toward inertia. The failure to move can be confounding; we and others have been calling attention to biases such as loss aversion and anchoring for years, and elevating the social side of strategy.[2] Companies that manage their portfolios more actively earn higher returns, with less variance, and are less likely to be acquired or go bankrupt. CEOs who undermanage their portfolios are more likely to be fired. Nonetheless, as our research shows, around half of sampled companies continue to barely change their business portfolios *at all*. What will it take, at long last, to get portfolios moving?

"Courage," Winston Churchill observed, "is rightly esteemed the first of human qualities," and when it comes to taking your organization from a laggard to a lion, courage is what you need to get started. Even with the force of data behind you, moving a portfolio in the right direction takes conviction and time, the will to push yourself and your team out of the bunker, and the determination to build a system that enforces change. There are proven practices to help you get moving:

- *Shift the default.* Whether we admit it or not, we fall in love with what we have. Daniel Kahneman famously tested the power of an "endowment effect" with the example of coffee mugs: participants who were given one refused to sell unless they received a price that was double what they would be willing to pay for it. (Dan Ariely found the spread rose to 14 times for premium basketball tickets.) To break out, approach portfolio management as private-equity firms do, with the knowledge that most businesses must be sold or put on the block eventually. Having the conversation about "why are we entitled to own this asset" instead of "should we sell it" can also help shift perspective in a way that generates a healthy and balanced debate. Even if these ideas only rarely become reality, shifting the default spurs a healthy, refreshing look at assets and does not presume that ownership is a given. That helps to make portfolio change the default plan, and not feel like the occasional one-off.

- *Drive conviction.* Your company's settings should at all times be fixed on value creation—not on treading water. Yet too often, swimming in place is the path of least resistance. When there is a difference of opinions about which actions are required, for example, leadership typically agrees to wait a bit longer; surely, a turnaround is right around the bend. Delay such as this can undermine the decisiveness you need: A growth opportunity is emerging, particularly at the perimeter of your operations? Go out and capture it; that's what your company should be programmed to do. One of your existing businesses continues to sputter? It's not working in your organization—sell it. It's unrealistic to expect your company to be a leader in every sector it's in. That's why one energy company established the rule that its corporate-planning team must identify 3 to 5 percent of the company's assets for potential disposal every year. Another Fortune 100 company even requires the leaders of each business unit

[2] See Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, January 2011, McKinsey.com; Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 2010, McKinsey.com; and Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.

to regularly nominate the three highest-potential divestiture candidates under their charge. That helps build conviction, organization-wide, that the mission is grow or go.

- *Build a blueprint.* Our businesses are wired, and our managers are incentivized, to think month to month and quarter to quarter. It's a fact of corporate life; we have numbers to make and investors to whom we need to present. In practice, this means that companies typically underweight long-term considerations, and overreact to short-term concerns. It means, too, that when companies do make a deal, they can often be "reactive"—a quick response to a temporary condition. It is quite a different matter to start with a quantified vision of how many deals you want to make and hew to a program to make that happen. Companies that succeed in making portfolio change a part of their DNA spell out a vision for their optimal portfolio, and create a detailed M&A blueprint to establish a baseline of the company's market position, ambitions, and gaps, as well as boundary conditions (such as types or sizes of deals) that will focus the scope of their deal search. Progress toward the target portfolio is reviewed by the planning committee regularly, ideally quarterly, to ensure that transactions are purposeful and not opportunistic. Top performers are relentless capital reallocators. They assign their current businesses to the categories "grow," "maintain," or "dispose"—and have clearly differentiated rules for how much capital goes to each.

- *Develop a machine.* Portfolio optimization requires a holistic perspective and an integrated process, and resource allocation and corporate planning should become systematized. When M&A is conducted, programmatic acquirers, we found, are twice as likely as peers to estimate revenue and cost synergies at various stages of the dealmaking process, and 1.4 times more likely than peers to have designated clear owners for each stage. Sophisticated dealmakers manage their dealmaking operations as core business operations. For example, they conduct due diligence and integration planning at the same time—holding discussions early in the deal process about how to get under the hood of deal value, and reimagine the opportunities that the acquired company could unleash once the deal is closed. They also have an integration plan, head count, and budget in place before the acquisition is closed, and get moving to fill in any gaps on personnel or tools so that integration can begin immediately at closing. That comes from considering corporate planning in a comprehensive way, and from developing M&A as an enduring capability—not as an occasional event.

Distinctive companies relentlessly manage their business portfolios, continually moving into new opportunities for value creation and systematically divesting business units that underperform. While not every moment is a moment for disruption, nor every sector or company ripe for M&A, the pervasive dearth of portfolio activity highlighted by our research suggests that too many companies and leaders are keeping their heads too far down. Pulling up means regularly reappraising your portfolio—and then committing to move. Precisely because everyone is competing at once, staying in place leads, almost axiomatically, to falling behind. Q

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