MARCH 2012
McKinsey Quarterly

STRATEGY PRACTICE

How to put your money where your strategy is

Stephen Hall, Dan Lovallo, and Reinier Musters

Most companies allocate the same resources to the same business units year after year. That makes it difficult to realize strategic goals and undermines performance. Here's how to overcome inertia.

Picture two global companies, each operating a range of different businesses. Company A allocates capital, talent, and research dollars consistently every year, making small changes but always following the same broad investment pattern. Company B continually evaluates the performance of business units, acquires and divests assets, and adjusts resource allocations based on each division's relative market opportunities. Over time, which company will be worth more?

If you guessed company B, you're right. In fact, our research suggests that after 15 years, it will be worth an average of 40 percent more than company A. We also found, though, that the vast majority of companies resemble company A. Therein lies a major disconnect between the aspirations of many corporate strategists to boldly jettison unattractive businesses or double down on exciting new opportunities, and the reality of how they invest capital, talent, and other scarce resources.

For the past two years, we've been systematically looking at corporate resource allocation patterns, their relationship to performance, and the implications for strategy. We found that while inertia reigns at most companies, in those where capital and other resources flow more readily from one business opportunity to another, returns to shareholders are higher and the risk of falling into bankruptcy or the hands of an acquirer lower.

We've also reviewed the causes of inertia (such as cognitive biases and politics) and identified a number of steps companies can take to overcome them. These include introducing new decision rules and processes to ensure that the allocation of resources is a top-of-mind issue for executives, and remaking the corporate center so it can provide more independent counsel to the CEO and other key decision makers.

We're not suggesting that executives act as investment portfolio managers. That implies a search for stand-alone returns at any cost rather than purposeful decisions that enhance a corporation's long-term value and strategic coherence. But given the prevalence of stasis today, most organizations are a long way from the head-long pursuit of disconnected opportunities. Rather, many leaders face a stark choice: shift resources among their businesses to realize strategic goals or run the risk that the market will do it for them. Which would you prefer?

Weighing the evidence

Every year for the past quarter century, US capital markets have issued about $85 billion of equity and $536 billion in associated corporate debt. During the same period, the amount of capital allocated or reallocated within multibusiness companies was approximately $640 billion annually—more than equity and corporate debt combined.[1] While most perceive markets as the primary means of directing capital and recycling assets across industries, companies with multiple businesses actually play a bigger role in allocating capital and other resources across a spectrum of economic opportunities.

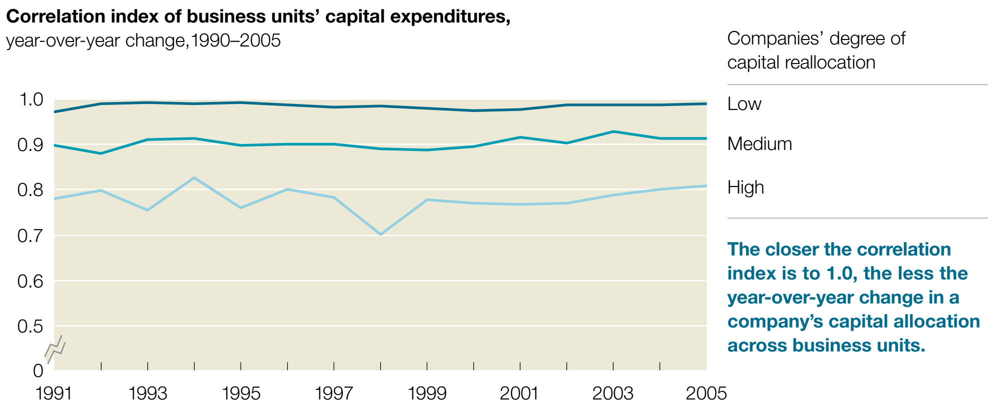
To understand how effectively corporations are moving their resources, we reviewed the performance of more than 1,600 US companies between 1990 and 2005.[2] The results were striking. For one-third of the

[1] See Ilan Guedj, Jennifer Huang, and Johan Sulaeman, "Internal capital allocation and firm performance," working paper for the International Symposium on Risk Management and Derivatives, October 2009 (revised in March 2010).

[2] We used Compustat data on 1,616 US-listed companies with operations in a minimum of two distinct four-digit Standard Industrial Classification (SIC) codes. Resource allocation is measured as 1 minus the minimum percentage of capital expenditure received by distinct business units over the 15-year period. This measure captures the relative amount of capital that can flow across a business over time; the rest of the money is "stuck." Similar results were found with more sophisticated measures that control for sales and asset growth.

Exhibit 1

Capital allocations were essentially fixed for roughly one-third of the business units in our sample.



businesses in our sample, the amount of capital received in a given year was almost exactly that received the year before—the mean correlation was 0.99. For the economy as a whole, the mean correlation across all industries was 0.92 (Exhibit 1).

In other words, the enormous amount of strategic planning in corporations seems to result, on the whole, in only modest resource shifts. Whether the relevant resource is capital expenditures, operating expenditures, or human capital, this finding is consistent across industries as diverse as mining and consumer packaged goods. Given the performance edge associated with higher levels of reallocation, such static behavior is almost certainly not sensible. Our research showed the following:

- Companies that reallocated more resources—the top third of our sample, shifting an average of 56 percent of capital across business units over the entire 15-year period—earned, on average, 30 percent higher total returns to shareholders (TRS) annually than companies in the bottom third of the sample. This result was surprisingly consistent across all sectors of the economy. It seems that when companies disproportionately invest in value-creating businesses, they generate a mutually reinforcing cycle of growth and further investment options (Exhibit 2).

- Consistent and incremental reallocation levels diminished the variance of returns over the long term.

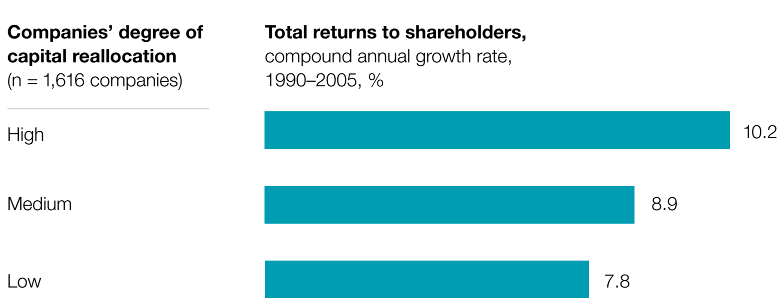
- A company in the top third of reallocators was, on average, 13 percent more likely to avoid acquisition or bankruptcy than low reallocators.

- Over an average six-year tenure, chief executives who reallocated less than their peers did in the first three years on the job were significantly more likely than their more active peers to be removed in years four through six. To paraphrase the philosopher Thomas Hobbes, tenure for static CEOs is likely to be nasty, brutish, and, above all, short.

We should note the importance of a long-term view: over time spans of less than three years, companies that reallocated higher levels of resources delivered lower shareholder returns than their more stable peers did. One explanation for this pattern could be risk aversion on the part of investors, who are initially cautious about major corporate capital shifts and then recognize value only once the results become visible. Another factor could be the deep interconnection of resource allocation choices with corporate strategy. The goal isn't to make dramatic changes every year but to reallocate resources consistently over the medium to long term in service of a clear corporate strategy. That provides the time necessary for new investments to flourish, for established businesses to maximize their potential, and for capital from declining investments to be redeployed effectively. Given the richness and complexity of the issues at play here, differences in the relationship between short- and long-term resource shifts and financial performance is likely to be a fruitful area for further research.

Exhibit 2

Companies with higher levels of capital reallocation experienced higher average shareholder returns.



Why companies get stuck

Why do so many companies undermine their strategic direction by allocating the same levels of resources to business units year after year? The reasons vary widely, from the very bad—companies operating on autopilot—to the more sensible. After all, sometimes it's wise to persist with previously chosen resource allocations, especially if there are no viable reallocation opportunities or if switching costs are too high. And companies in capital-intensive sectors, for example, often have to commit resources more than five years ahead of time to long-term programs, leaving less discretionary capital to play with.

For the most part, however, the failure to pursue a more active allocation agenda is a result of organizational inertia that has multiple causes. We'll focus here on cognitive biases and corporate politics, but regardless of source, inertia's gravitational pull is strong—and overcoming it is critical to creating an effective corporate strategy. As author and Kleiner Perkins Caufield & Byers partner Randy Komisar told us, "If corporations don't approach rebalancing as fiduciaries for long-term corporate value, their life span will decline as creative destruction gets the better of them."

Cognitive biases

Biases such as anchoring and loss aversion, which are deeply rooted in the workings of the human brain and have been much studied by behavioral economists, are major contributors to the inertia that prevents more active reallocation.[3] Anchoring refers to the tendency to use any number, even an irrelevant one, as an anchor for future choices. Judges asked to roll a pair of dice before making a simulated sentencing decision, for example, are influenced by the result of that roll, even though they deny they are.

Within a company, last year's budget allocation often serves as a ready, salient, and justifiable anchor during the planning process. We know this to be true in practice, and it's been reinforced for us recently as we've played a business game with several groups of senior executives. The game asked participants to allocate a capital budget across a fictitious company's businesses and provided players with identical growth and return projections for the relevant markets. Half of the group also received details of the previous year's capital allocation. Those *without* last year's capital budget all allocated resources in a range that optimized for the expected outlook in market growth and returns. The other half aligned capital far more closely with last year's pattern, which had little to do with the potential for future returns. And this was a game where the company was fictitious and no one's career was at risk!

[3] See Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," mckinseyquarterly.com, March 2010.

In reality, anchoring is reinforced by loss aversion: losses typically hurt us at least twice as much as equivalent gains give us pleasure. That reduces the appetite for taking risks and makes it painful for managers to give up resources.

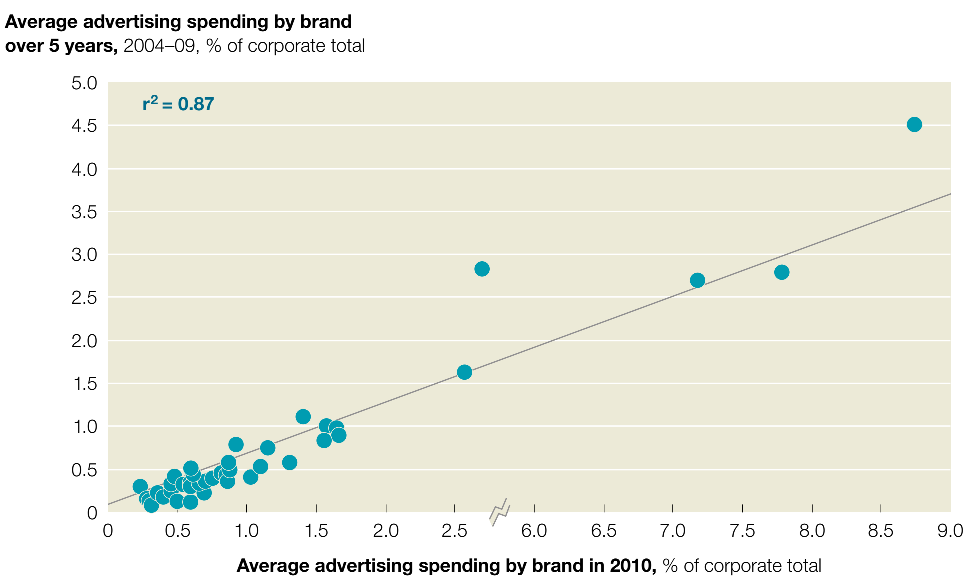
Corporate politics

A second major source of inertia is political. There's often a tight alignment between the interests of senior executives and those of their divisions or business units, whose ability to attract capital can significantly influence the personal credibility of a leader. Indeed, because executives are competing for resources, anyone who wins less than he or she did last year is invariably seen as weak. At the extreme, leaders of business units and divisions see themselves as playing for their own "teams" rather than for the corporation as a whole, making it challenging to reallocate resources significantly. Even if a reduction in resources to their division benefits the company as a whole, ambitious leaders are unlikely to agree without a fight. As one CEO told us: "If you're asking me to play Robin Hood, that's not going to work."

Exhibit 3

Inertia may affect the distribution of other scarce resources, such as advertising spending.

Correlation between each brand's 2010 advertising budget and its average advertising budget for previous 5 years at one consumer goods company (n = 40 brands)



r^2 is the measure of interdependence of 2 or more variables.

Overcoming inertia

Tempting as it is to believe that one's own company avoids these traps, our research suggests that's unlikely. Our experience also suggests, though, that taking steps such as those described below can materially improve a company's resource allocation and its connection to strategic priorities. These imperatives apply not just to capital but also to other scarce resources, such as talent, R&D dollars, and marketing expenditures (as shown in Exhibit 3, for advertising spending by one consumer goods company). All of these also are subject to the forces of inertia, which can undermine an organization's ability to achieve its strategic goals. Consider one company we know that prioritized expanding in China. It set an ambitious sales growth target for the country and planned to meet it by supplementing organic growth with a series of acquisitions. Yet it identified just three people to spearhead this strategic imperative—a small fraction of the number required, which is typical of the problems that arise when the link between corporate strategy and resource allocation is weak. Here are four ideas for doing better.

1. Have a target corporate portfolio.

There's a quote attributed to author Lewis Carroll: "If you don't know where you are going, any road will take you there." When it comes to developing an allocation agenda, it's helpful to have a target portfolio in mind. Most companies resist this, for understandable reasons: it requires a lot of conviction to describe planned portfolio changes in anything but the vaguest terms, and the right answers may change if the broader business environment turns out to be different from the expected one.

In our experience, though, a target portfolio need not be slavish or mechanistic and can be a powerful forcing device to move beyond generic strategy statements, such as "strengthen in Asian markets" or "continue to migrate from products to services." Identifying business opportunities where your company wants to increase its exposure can create a foundation for scrutinizing how it allocates capital, talent, and other resources.

Setting targets is just a starting point; companies also need mechanisms for revisiting and adjusting them over time. For example, Google holds a quarterly review process that examines the performance of all core product and engineering areas against three measures: what each area did in the previous 90 days and forecasts for the next 90 days, its medium-term financial trajectory, and its strategic positioning. And the company has ensured that it can allocate resources in an agile way by not having business units, which diminishes the impact of corporate politics.[4]

Evaluating reallocation performance relative to peers also can help companies set targets. From 1990 to 2009, for example, Honeywell reallocated about 25 percent of its capital as it shifted away from some existing business areas toward aerospace, air conditioning, and controls (for more on Honeywell's approach to resource allocation, see our interview with Andreas C. Kramvis, president and CEO of Honeywell Performance Materials and Technologies, in "Breaking strategic inertia: Tips from two leaders," on mckinseyquarterly.com). Honeywell's competitor Danaher, which was in similar businesses in 1990, moved 66 percent of its capital into new ones during the same period. Both companies achieved returns above the industry average in these years—TRS for Honeywell was 14 percent and for Danaher 25 percent. We're not suggesting that companies adopt a mind-set of "more is better, and if my competitor is making big moves, I should too." But differences in allocation levels among peer companies can serve as valuable clues about contrasting business approaches—clues that prompt questions yielding strategic insights.

2. Use all available resource reallocation tools.

Talking about resource allocation in broad terms oversimplifies the choices facing senior executives. In reality, allocation comprises four fundamental activities: seeding, nurturing, pruning, and harvesting. *Seeding* is entering new business areas, whether through an acquisition or an organic start-up investment. *Nurturing* involves building up an existing business through follow-on investments, including bolt-on acquisitions. *Pruning* takes resources away from an existing business, either by giving some of its annual capital allocation to others or by putting a portion of the business up for sale. Finally, *harvesting* is selling whole businesses that no longer fit a company's portfolio or undertaking equity spin-offs.

Our research found that there's little overall difference between the seeding and harvesting behavior of low and high reallocators. This should come as little surprise: seeding involves giving money to new business opportunities—something that's rarely resisted. And while harvesting is difficult, it most often occurs as a result of a business unit's sustained underperformance, which is difficult to ignore.

[4] For more, see James Manyika, "Google's CFO on growth, capital structure, and leadership," mckinseyquarterly.com, August 2011.

However, we found a 170 percent difference in activity levels between high and low reallocators when it came to the combination of nurturing and pruning existing businesses. Together, these two represent half of all corporate reallocation activity. Both are difficult because they often involve taking resources from one business unit and giving them to another. What's more, the better a company is at encouraging seeding, the more important nurturing and pruning become—nurturing to ensure the success of new initiatives and pruning to eliminate flowers that won't ever bloom.

Consider, for example, the efforts of Google CEO Larry Page, over the past 12 months, to cope with the flowering of ideas brought forth by the company's well-known "20 percent rule," which allows engineers to spend at least one-fifth of their time on personal projects and has resulted in products such as AdSense, Gmail, and Google News. These successes notwithstanding, the 20 percent rule also has yielded many peripheral projects, which Page has recently been pruning.[5]

3. Adopt simple rules to break the status quo.

Simple decision rules can help minimize political infighting because they change the burden of proof from the typical default allocation ("what we did last year") to one that makes it impossible to maintain the status quo. For example, a simple harvesting rule might involve putting a certain percentage of an organization's portfolio up for sale each year to maintain vibrancy and to cull dead wood.

When Lee Raymond was CEO of Exxon Mobil, he required the corporate-planning team to identify 3 to 5 percent of the company's assets for potential disposal every year. Exxon Mobil's divisions were allowed to retain assets placed in this group only if they could demonstrate a tangible and compelling turnaround program. In essence, the burden on the business units was to prove that an asset should be retained, rather than the other way around. The net effect was accelerated portfolio upgrading and healthy turnover in the face of executives' natural desire to hang on to underperforming assets. Another approach we've observed involves placing existing businesses into different categories—such as "grow," "maintain," and "dispose"—and then following clearly differentiated resource-investment rules for each. The purpose of having clear investment rules for each category of business is to remove as much politics as possible from the resource allocation process.

[5] See Claire Cain Miller, "In a quest for focus, Google purges small projects," nytimes.com, November 10, 2011.

Sometimes, the CEO may want a way to shift resources directly, in parallel with regular corporate processes. One natural-resources company, for example, gave its CEO sole discretion to allocate 5 percent of the company's capital outside of the traditional bottom-up annual capital allocation process. This provided an opportunity to move the organization more quickly toward what the CEO believed were exciting growth opportunities, without first having to go through a "pruning" fight with the company's executive-leadership committee.

Of course, the CEO and other senior leaders will need to reinforce discipline around such simple allocation rules; it's not easy to hold the line in the face of special pleading from less-favored businesses. Developing that level of clarity—not to mention the courage to fight tough battles that arise as a result—often requires support in the form of a strong corporate center or a strategic-planning group that's independent of competing business interests and can provide objective information (for more on the importance of the corporate center to resource reallocation, see "The power of an independent corporate center," on mckinseyquarterly.com).

4. Implement processes to mitigate inertia.

Systematic processes can strengthen allocation activities. One approach, explored in detail by our colleagues Sven Smit and Patrick Viguerie, is to create planning and management processes that generate a granular view of product and market opportunities.[6] The overwhelming tendency is for corporate leaders to allocate resources at a level that is too high—namely, by division or business unit. When senior management doesn't have a granular view, division leaders can use their information advantage to average out allocations within their domains.

Another approach is to revisit a company's businesses periodically and engage in a process similar to the due diligence conducted for investments. Executives at one energy conglomerate annually ask whether they would choose to invest in a business if they didn't already own it. If the answer is no, a discussion about whether and how to exit the business begins.

Executives can further strengthen allocation decisions by creating objectivity through re-anchoring—that is, giving the allocation an objective basis that is independent of both the numbers the business units

[6] See three publications by Mehrdad Baghai, Sven Smit, and S. Patrick Viguerie: "The granularity of growth," mckinseyquarterly.com, May 2007; *The Granularity of Growth: How to Identify the Sources of Growth and Drive Enduring Company Performance*, Hoboken, NJ: Wiley, 2008; and "Is your growth strategy flying blind?," *Harvard Business Review*, May 2009, Volume 87, Number 5, pp. 86–97.

provide and the previous year's allocation. There are numerous ways to create such independent, fact-based anchors, including deriving targets from market growth and market share data or leveraging benchmarking analysis of competitors. The goal is to create an objective way to ask business leaders this tough question: "If we were to triangulate between these different approaches, we would expect your investments and returns to lie within the following range. Why are your estimates so much higher (or lower)?"

Finally, it's worth noting that technology is enabling strategy process innovations that stir the pot through internal discussions and "crowdsourcing." For example, Rite-Solutions, a Rhode Island–based company that builds advanced software for the US Navy, defense contractors, and first responders, derives 20 percent of its revenue from businesses identified through a "stock exchange" where employees can propose and invest in new ideas (for more on this, see "The social side of strategy," on mckinseyquarterly.com).

Much of our advice for overcoming inertia within multibusiness companies assumes that a corporation's interests are not the same as the cumulative resource demands of the underlying divisions and businesses. As they say, turkeys do not vote for Christmas. Putting in place some combination of the targets, rules, and processes proposed here may require rethinking the role and inner workings of a company's strategic- and financial-planning teams. Although we recognize that this is not a trivial endeavor, the rewards make the effort worthwhile. A primary performance imperative for corporate-level executives should be to escape the tyranny of inertia and create more dynamic portfolios.

The authors would like to acknowledge the contributions of Michael Birshan, Marja Engel, Mladen Fruk, John Horn, Conor Kehoe, Devesh Mittal, Olivier Sibony, and Sven Smit to this article.

Stephen Hall is a director in McKinsey's London office, and **Reinier Musters** is an associate principal in the Amsterdam office. **Dan Lovallo** is a professor at the University of Sydney Business School, a senior research fellow at the Institute for Business Innovation at the University of California, Berkeley, and an adviser to McKinsey.