McKinsey&Company

Leading for the long term

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Successful CEOs combine winning strategies with compelling stories and constructive engagement with shareholders.

In this episode of the *McKinsey Podcast*, McKinsey senior partner Rodney Zemmel and Mike Useem, a professor at the Wharton School of the University of Pennsylvania, talk with McKinsey Publishing's Simon London about how senior executives can run companies for the long term while also managing demands for short-term performance.

Podcast transcript

Simon London: Hello, and welcome to this edition of the *McKinsey Podcast*, with me, Simon London. We often hear that today's CEOs face almost irresistible pressure to maximize short-term results. Where this pressure comes from is a matter of hot debate. But what we do know for sure is that building a business for the long term is a tough management challenge. My guests today are Mike Useem, who is a professor at the Wharton School of Business, and Rodney Zemmel, who is a senior partner in McKinsey's New York office. They are among the coauthors of a new book titled, *Go Long: Why Long-Term Thinking is Your Best Short-Term Strategy* (Wharton Digital Press, May 2018.) The meat of the book is a series of case studies and conversations that lay out the very practical steps taken by some leading CEOs to resist short-term pressures and set their organizations on a path to long-term success.

Rodney, Mike, thanks very much for being here today.

Mike Useem: Thank you.

Rodney Zemmel: Thank you. Happy to be here.

Simon London: We're here to talk about managing for the long term. But let's start with short-termism. To be the devil's advocate, Rodney, is it really a problem?

Rodney Zemmel: It's certainly not a new problem. You can find newspaper articles from the 1920s, and even earlier, talking about the perils of short-termism, the rise of short-termism, and so on. That said, we do think there's good evidence that we're experiencing more of a short-termism epidemic than we have for a long time.

Eighty-seven percent of executives and directors in our surveys feel the most performance pressure over a two-year time horizon rather than a longer time horizon. And 99 percent—and in some more recent analyses, 100 percent—of earnings for the S&P 500 are spent on dividends, on buybacks. Certainly more companies, more directors, and more investors are feeling the pressure for short-termism than they have in the recent past.

Simon London: And dividends and buybacks matter because?

Rodney Zemmel: It's a sign of companies not having the confidence to invest in the long term and instead handing the cash right back to their shareholders now. There's nothing wrong with giving cash to shareholders. That's what you're supposed to do if you're a company. But the idea that you would give all your current cash back to shareholders rather than investing in the long term obviously creates some doubts.

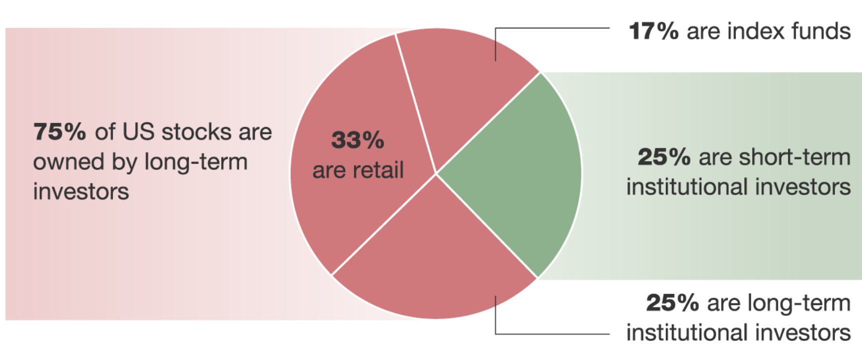
Simon London: To what extent is this about public markets? David Rubenstein points out in the introduction to the book that the number of US–listed companies has halved, I think he says, over the last 20 years. There are certainly more companies appear to be retreating from public markets. Is this a public-market phenomenon?

Rodney Zemmel: It's a really complicated issue. I end up feeling that it's a bit like one of those Agatha Christie novels where everyone's pointing the finger at everybody else as the culprit. Executives and many boards will tell you it's the public markets, it's the sell-side analysts, who are looking for news and who are asking questions about this quarter's profits. It's short-term traders, it's day traders, or, even worse, it's activist investors. And it's the markets that are putting on the pressure that gets hard for companies to stand up to.

What the investors will say is, "We actually would value companies that are able to better articulate their long-term strategy, and better articulate their long-term capital allocation." If you look at investor behavior, it's hard to say that, for most investors, they really are looking to favor the short term over the long term. The reality is if you use a discounted-cash-flow method, 70 to 90 percent of the value of most companies is beyond a three-year time horizon. Most investors realize that.

The other reality is that if you look at who owns stocks in the US, 75 percent is still owned by what we would classify as long-term investors (exhibit). That's either index funds, retail investors

Long-term investors own 75 percent of US stocks.



Source: Marshall E. Blume and Donald B. Keim, *Institutional investors and stock market liquidity: Trends and relationships*, Wharton School working paper; Thomson Reuters; McKinsey analysis who aren't day traders, or value funds. While I'm sure the investing community has a role to play in this, and the [decline in the] number of companies in public markets is really compelling, it seems that there's a bit more to it than just blaming the markets.

Mike Useem: Rodney's reference to the fact that three-quarters of equity assets are there for the long run—either in an index fund or just the orphans and the widows, as they're sometimes called, the individual stockholder—this says that the issues and how to grapple with them, in our view, come down to what happens in the boardroom and the executive suite.

Simon London: There's this wonderful Jack Welch quote in the book which boils down to "Anybody can run a company for the short term, and anybody can run a company for the long term, but the hard part about management is getting the balance right."

Rodney Zemmel: That is why we wrote the book, *Go Long*. We found a lot of research, some from McKinsey, some from elsewhere, on the value of being a long-term investor and why it's better for companies to focus on the long term. But the actual practical guide to how management teams and CEOs should do it, doesn't exist. I don't know that we've written it, but the book certainly explores CEOs who've made those decisions, how they did it, and hopefully has some useful lessons for people thinking about that trade-off.

Simon London: One of the things that jumps out at me in the case studies in the book is that the CEOs had to buy themselves the strategic flexibility to invest for the long term by sometimes doing some quite painful things in the short term. For example, Ford [in 2006] was a turnaround situation. [Ford CEO] Alan Mulally had to cut a lot of costs and lay off employees. But he did it with growth in mind. It wasn't an asset-stripping exercise or just running the company for cash. There was a long-term objective behind it.

Mike Useem: To pick up on that, our method of thinking about how to transcend this seeming problem—of a lot of pressures for short term but companies want to build for the long term—is to go to people who have managed to get the short and the long. There aren't a whole lot, but there are enough to compose a primer.

Alan Mulally was recruited by William Ford, executive chair of the Ford board, a couple years before the financial crisis of '08, '09. Even though it was the lull before the storm, he quickly realized that Ford was going to post a $17 billion loss the following year. Remember, this is even before the financial crisis took everybody down. So, he set forward a strategy to solve the immediate challenge: How are we going to pay the bills with a $17 billion loss? Ford secured a credit line for $23 billion and pushed its engineers to bring out better cars that would sell better. In the short term, the company did take some significant losses, but all wrapped around a strategy for recovering and getting through whatever might lie ahead.

Rodney Zemmel: What I think is interesting when you compare and contrast the different stories that we covered in the book is there were some dramatic turnaround stories. The Ford story may be the most dramatic. But there is a very nice quote from Sir George Buckley [former CEO] at 3M, who said, "The core of every business is dying."

He turned around 3M by refocusing and sustaining investments in R&D. What I thought was very interesting was his point of view that it's not just about managing through a crisis. Every business has a dying core because that's the old heart of the business. The only way you're ever going to be able to grow the business is by making sure you have the balance right between how you manage the decline or the stability of the core and what you do in new areas.

Mike Useem: George Buckley, who was thinking four, five, six years out, said, "We've got to structurally, through policies and practices, get our engineers and scientists focused on bringing out new products." You can beat the table to make it happen—and he did, of course. But he also had to find cash to make it happen. He made some very tough decisions. He sold off a big pharmaceutical arm, took costs out of other operations. It was very painful in the short run, but vital for the long term.

Simon London: He reengineered a very, very complicated supply chain, didn't he?

Mike Useem: He did.

"You can't just say, 'I'm going to do it.' You have to make a case for it. That's the essence of strategic thinking."

Simon London: I suppose that's what I was getting at: managing for the long term is not about being soft. The executives profiled in the book did some pretty tough things to create flexibility and generate cash to give themselves the room to maneuver.

Rodney Zemmel: I think that's a critical point. This is not about being soft, and this is not a book on corporate social responsibility. There are other very good books on that topic. Let's take the Larry Merlo story at CVS, for example. When he and his team made the decision to stop selling cigarettes, not only was that decision extremely well syndicated, extremely well thought through, extremely well managed from all the operational details. But also, they did it at a time when the company was performing well. He'd earned the right to be able to take that sort of decision. Maybe in a similar vein, Paul Polman at Unilever, when they came under pressure from 3G, he was able to defend the company by making the case that his focus on a sustainable company was not a soft decision that was about prioritizing social responsibility ahead of the successful and profitable growth of the company, but actually making the case that it was both, and that it was not a trade-off.

Mike Useem: That phrase "making a case" is one of the themes that came out of our discussions. I wouldn't have guessed this going in, but it's totally evident in talking with people who'd done it—like George Buckley at 3M, Alan Mulally at Ford, and Paul Polman at Unilever—they have to make the case to themselves. They have to think strategically. They had to look four or five years out. "What can go right? How is the industry changing?" Then they had to put those thoughts into a compelling account. They had to convince equity analysts, they had to convince the "buy side," the big investors themselves.

Equally, they had to convince their own people and the board of directors. What is, I think, especially striking was Polman's emphasis on, in maybe a half-dozen very specific ways, arguing to his board, talking with his investors, and to his customers as well, about what he was going to do, as he then began to move Unilever out of profitable but, in some cases, unhealthy food products. You can't just say, "I'm going to do it." You have to make a case for it. That's the essence of strategic thinking, and then articulating why we're on this path, and why this strategy's going to work.

Simon London: One of the things that jumped out at me is that many of the CEOs in the book are great storytellers. That ability to construct a narrative—in many cases reaching back into the history of the company. Paul Polman, for example, taking the whole board of directors up to Port Sunlight in the northwest of England, because that was Unilever's start, in a way. The company had a great tradition of looking after its workforce and thinking about a multi-stakeholder approach to its business.

Alan Mulally, though he didn't come from the car industry, reached back into the history of the Ford Motor Company, as well. Meaning-making as a leadership trait really comes out here.

Mike Useem: And that's a great phrase.

Rodney Zemmel: That notion of storytelling is interesting. I wouldn't have thought of it until you asked the question, but when we were talking to Larry Fink from BlackRock for the book, he had the observation that he and his firm want to hear the stories from CEOs.

They don't just want to hear, "How was this quarter?" And, "What's going to be up, what's going to be down next quarter?" But also "What's the consistent story for where the company is trying to go in the long term, and how does this quarter fit in with that story?"

Obviously it has to be a nonfiction story, not a fiction story. But this idea of CEOs as storytellers to be able to successfully focus on the long term—it's exactly right.

Mike Useem: By the way, I think there are two pieces to that storytelling so it does make meaning. The technical features of the argument are important. What's it going to cost us, for example, at CVS, if we take tobacco off the shelves? Larry Merlo, CEO, did estimate it's going to cost at least $2 billion if he did that. That's the content-driven technical argument.

The second half of the story is the noncognitive elements. The history we're a part of. Or the emotions that come to mind when we think about saving many, many lives because they're not getting tobacco when they walk out of our store.

Or taking your board to the place where the company was created. Or, in the case of Medtronic, the equipment maker, they often bring in patients who are alive today because they use a pacemaker used by Medtronic. The storytelling is both cognitive and emotional. You have to go for the head and the heart.

> “We interviewed a number of board directors, as well as chief executives. There was a common message from them around wishing they had more metrics for the long-term strategy.”

Simon London: The other storytelling element that a lot of the CEOs deployed was a metric. It was a meaningful metric. It encapsulated what they were trying to do, and they stuck to it.

Rodney Zemmel: All of these executives have many metrics. If you’re looking to be able to chart a course for the long term, you need to have metrics that cover both performance and also health. Performance would be the typical near-term financial and operating metrics.

Health might be things that give you an indication of whether you are on track against the strategy. It doesn’t mean they’re softer numbers. They can still be hard numbers, like longer-term market share or like percentage of revenues that come from newly launched products, which was one of George Buckley’s metrics. You’ve got metrics that are talking to the future direction of the company, that are giving you momentum, as well as current position.

This topic of metrics is one we heard from board members as well. We interviewed a number of board directors, as well as chief executives, for the book. There was a common message from them around wishing they had, and valuing when they had them, more metrics for the long-term strategy.

Simon London: Maybe they are momentum metrics. You have to deliver on the earnings per share, in the current quarter, or the current year. But the emphasis placed on market share by Ivan Seidenberg [former CEO of Verizon] seemed to say, “OK, we’re delivering today, but you also have to look at the momentum—are we winning in the market?”

Or Sir George Buckley, with the new product vitality index, I think he called it. How much of our revenue is coming from products that are less than five years old? That’s the momentum of the business.

Mike Useem: Simon, this issue of momentum is really important in looking at the long run, say, three to five years out. We know we want to get there, but we do need interim measures, or interim signs, that we’re going in the right direction. Call that momentum.

Rodney Zemmel: This is particularly true when making the right long-term move might make you go backward in some areas in the short term. To be able to justify that, I think you had better have your longer-term metrics ready to be able to make the countervailing story.

Maybe it ties back to your earlier question around: Is the market to blame, and how much should CEOs listen to the market when they’re making these moves? I think what we’d say—

and I'd be interested to see if you agree with this, Mike—is that CEOs should not overly listen to the market in the short term.

If you believe 75 percent of your stock is held by long-term investors, that still means there's a lot of stock held by short-term investors who can create a lot of movement in the short term. But if what you're doing is the right thing, then the long term will win out overall. So it is about being courageous and, in some cases, being patient.

Mike Useem: For the book, we did sit down and talk with the chief executive at Vanguard and the chief executive of BlackRock.

Both of them, and others in that investment world who preside over trillions of dollars of assets, much of it indexed or much of it very permanently invested, all said, "Look, we're in this business together. We're here for the long run. We're indexed." Chief executives should remind themselves that the Vanguards, the BlackRocks, and the State Streets are natural allies in helping you think four or five years out.

Simon London: Yes, because by definition, the [index funds] can't sell. In fact, there's a lovely quote in the book: "We may be passive investors but that doesn't mean that we're passive owners."

Rodney Zemmel: Yes. There's a very interesting debate around the effect that passive funds are having on long-term focus. There's one school of thought that says, "Look, because the passive funds are, by definition, passive, share of voice in the market is going to go more and more to asset managers who are moving money actively, which is going to create more short-termism."

The other school of thought says, "Actually, this is a real opportunity for the passive funds." If you go back into recent history, you'd say passive funds had three choices for how they could differentiate [in the asset-management sector]. They could differentiate either on their fee structure, they could differentiate on their service offering, or they could differentiate by being better stewards of your assets.

You could argue that the basis of competition on the first two of those, price and service, is so narrow now, that competition really becomes about being a better steward of your assets. I think this is why you see so many of index funds, or at least the big three index firms, focusing more and more on stewardship and governance.

Mike Useem: The flip side of that is that if three-quarters of the shares out there are held by the long-term investors, if you're a top executive, a chief financial officer, and a director of investor relations, why not go and actually meet with them? Build a relationship with them?

That gets us then to a chapter we wrote on the power of the board to help as well. We reference, in particular, a person named Maggie Wilderotter who, serving on the Hewlett Packard Enterprise board said, "Thinking strategically about the world we're in, we may end up with an activist investor or two, and we've got to be prepared to work with that kind of an investor if they do come along."

Maggie Wilderotter pressed the company to become more savvy about looking at itself as an activist investor would. And then maybe to make a few changes to help solve problems before they are brought to their attention by an activist. I think the board of directors has a particular role to play in working with top management with the equity market.

Simon London: What's your take on the role of the board, Rodney?

Rodney Zemmel: We have the view, and our interviewees had the view, whether it was the chief executives or the board directors, that there's a greater role for the board to play than they commonly do. In particular, and this may sound trite, the board has to really understand how the company makes money.

A surprising number of CEOs will say, "Not everybody on the board really understands how the company makes money now and how the company will make money in the future." If that basic understanding isn't there, it's pretty hard to have a meaningful conversation about the long term.

If that basic *is* there, then the board really can play a role in shaping the direction around long-term strategy. Most boards will say they don't want to be presented with a fully baked answer on this topic, they want to be part of the discussion. It is one of the places a board can add value.

But it needs to be a real conversation that has with it both the performance and the health metrics. You end up laying out a road map that includes a set of markers against which you can then measure the quarterly conversations that you're inevitably going to have to have.

Almost all boards, if you ask them what they'd like to spend more time on, this is almost always at or near the top of the list. By the way, if you ask chief executives what they would like to spend more time on with their boards, this is also usually at or near the top of the list. There aren't many topics where the boards and the CEOs would both like to spend more time.

Simon London: The obvious question is why isn't it happening?

Rodney Zemmel: First of all, I think it is the pressures of the day to day. It is quite hard for board chairs and lead directors to be able to say, "Look, let's timebox the discussion on the day-to-day matters, and let's make sure we've got an agenda that really is driven by the long term rather than by the short term."

Second of all, boards may simply just need to spend more time. We did an analysis of time spent by board members of public companies versus private companies. What we found is the public company boards are, on average, bigger and, on average, spend less time—in fact, it was half the time that some private boards spend.

The reality is these are difficult topics that are hard to get through if you're going to spend three or four hours a year on them. It may just require board directors just to be able to dig in a little deeper with management, to be able to add value on these topics.

Simon London: Is there something boards should be doing around CEO compensation?

Mike Useem: It's a really important issue in that sometimes we are what we eat, or we do what we're paid to do. If compensation is primarily leveraged around this year's performance, predictably, there's going to be a lot of focus on this year. Having said that, and having looked at data going back to the early '80s on the compensation of the top eight people of 40 of America's largest industrial firms, there has been a remarkable sea change in how individuals are paid at the top.

There's a movement away from fixed compensation. That's good. Much more variable. That's good. The variability depends on the performance, especially total shareholder return to the company. But most important, two-thirds of the compensation now for the top eight people depends on multiyear, essentially stock-based compensation.

Some of that is two-year, some of that is three-year. I will say that's not a terribly long run, but it's unequivocally twice or three times longer than one year! In some compensation plans now stock options vest after five years, actually. So boards are, increasingly, putting that long-term plan, or that long-term thinking, into actually how executives are paid.

Rodney Zemmel: I think that's very well said, Mike. It's clear there isn't a silver bullet. I think everybody would agree that EPS [earnings per share] metrics alone are bad metrics [on which to base executive compensation] because they're eminently gameable. But almost nobody still does that. It's probably just as clear that a five-year long-term metric alone is also a bad metric.

Mike Useem: Totally.

Rodney Zemmel: And it's going to require an intelligent conversation and a real understanding of the company's context, and of what time frame actually makes sense, for the company to be able to get to a good answer.

Simon London: What does all this mean for private companies? We focused very much here on publicly listed companies.

Rodney Zemmel: That's a good question. So much of the economy now is owned by private-equity owners. It's easy to stereotype private equity as being short-term owners. They might only hold a company for three years, five years, maybe seven years at the outside for most of them. However, we have a couple of observations. First of all, even the shorter of those time periods is longer than the average holding period of public-market stocks.

In addition, as any private-equity leader will tell you, if you're owning a company, intending to own it for five years, you're going to sell it to someone who also will intend to own it for at least five years. So you have to have at least a ten-year plan for that company. Being able to have a ten-year plan, plus or minus, away from the pressures of the public markets with quarterly reporting, can be a very beneficial thing. Now, does that mean all private-equity companies automatically act with the best long-term interests in mind? No, of course it doesn't. But I think it also means it's grossly unfair to characterize private equity as a more short-term form of ownership.

Simon London: That raises the bigger point about ownership structure. Who owns the equity, the attitude that they bring to the table, and how you, as a management team, engage with them can be a form of competitive advantage. This can be true even for public companies right? Courting long-term owners. Really getting under the hood with them so that you understand jointly the strategy. Investor relations isn't something that is passive, answering questions from equity analysts and that kind of thing. Or it doesn't need to be that.

Mike Useem: On investor relations, we've witnessed, without quite appreciating it, a quiet revolution on how that particular function has morphed from giving information to the equity market when questions are asked to a much more proactive and quote unquote, "strategically driven agenda."

The typical investor-relations director will report to the chief financial officer. But the director of investor relations is also in touch with all kinds of parts of the firm, with the top talent people, often very actively working with the nonexecutive directors as well, to not just be a source of questions that come from the market but also take a role in helping the company work with the market to the company's advantage.

On a prior project, I was involved in talking with directors of investor relations and chief financial officers. They often would talk about how vital it is to bring in investors that fit their profile for the kind of strategy they're pursuing. What's happened in recent years, at many of the larger firms, is that that investor-relations job has been professionalized and disciplined around what we're talking about.

Rodney Zemmel: We can have a long debate as to what extent companies really are able to choose their investors. Of course they can't in a technical sense, but there are three things they can do that we think have a very significant influence on the investors they end up with.

First of all, arguably the most important decision is which investors to spend time with. Are you spending your time with people who are the long-termers and who are the fundamental owners versus the short-termers?

Are you spending your time with people who you feel have a reason and an interest in understanding your stock and understanding your story versus the people who are more the in and out? Even more specifically, are you spending your time on the buy side versus the sell side? The sell side, of course, will always want to meet you and will always want to be able to write a story. But the value of time spent with them versus time spent with the buy side has to be weighted very carefully.

Simon London: And the buy side is the owning institutions, right?

Rodney Zemmel: Yes.

Simon London: As opposed to the intermediaries, the investment banks, and so on.

Rodney Zemmel: Yes—the analysts who are writing research reports and so on. The second choice is then what you choose to talk about. You have to talk about performance and you have to give financial information. But how much do you choose to talk about strategy and direction?

When you read investor presentations from different companies there is a huge variation in the extent to which they talk about the long-term strategy in a specific way, rather than just one general introduction slide.

Then the third choice is what you do on guidance. Certainly there are many chief executives or chief financial officers who would like to wave a magic wand and make the obligation to give guidance go away. I don't think we see that happening wholesale. But we would probably say the company shouldn't be giving quarterly guidance. They need to give quarterly results, but quarter-to-quarter guidance may well be a step too far, in terms of creating a straitjacket for yourself on short-term focus.

Mike Useem: To anchor this in some of the accounts we offered up in the book, Paul Polman, CEO at Unilever, when he embarked on the remake of the company along the lines we earlier described, one thing he pretty quickly decided to do was to stop offering quarterly guidance.

Simon London: I think that's all we have time for today. Thank you very much, Mike Useem and Rodney Zemmel, for being with us. And thanks to you, our listeners. If you want to buy the book *Go Long*: *Why Long-Term Thinking is Your Best Short-Term Strategy*, look for it in all the places that you buy your books. □

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