THE LONG RUN

McKinsey's **DOMINIC BARTON** tells Brunswick's **KEVIN HELLIKER** how long-term investing gives companies a competitive edge

DOMINIC BARTON RUNS SIX MARATHONS or half-marathons a year, a regimen that requires constant training. At least four days a week he logs six or seven miles, despite traveling about 270 days a year. Within a few minutes of departing a plane, he likes to don his sneakers and hit the pavement, finding that it re-energizes him. He's not pursuing athletic prizes. Research, Barton knows, shows that runners tend to live on average three years longer than non-runners.

As Managing Partner of McKinsey, Barton stands out as an authority on long-term benefits. He is lead author on a 2017 McKinsey Global Institute research paper showing that companies that are managed for the long term post extraordinary growth in earnings, revenue and market value. That conclusion emerged from his study of the performance of 615 non-finance companies from 2001 to 2015. On average, long-term companies in the study increased revenue by 47 percent more than others in their industry group, and earnings by 36 percent more.

The research put meat on the bones of an argument many business leaders have been advancing for years. "Finally, Evidence That Managing for the Long Term Pays Off," read the headline on a *Harvard Business Review* article about Barton's study.

Of course, it isn't for lack of such evidence that many executives manage for the current quarter. Their financial incentives often are based on meeting short-term goals. Their job security may be based on that too, in a climate where analysts and investors apply pressure on companies to match or exceed Wall Street's quarterly earnings expectations. So Barton has no illusions that McKinsey's research will induce an immediate, massive change in corporate behavior. He knows that chief executives generally aren't proud of decisions to cut research and development spending in order to satisfy the Street's demands of the moment.

But the stakes are too high to stop pushing for reform. Managing for the short term has played at least an indirect role in rising income inequality, rising populism, rising unemployment and growing distrust in business, Barton believes. Calling for "a shift from what I call quarterly capitalism to what might be referred to as long-term capitalism," Barton said in a 2011 *HBR* article that "we can reform capitalism, or we can let capitalism be reformed for us, through political measures and the pressures of an angry public."

As a consulting firm, of course, McKinsey doesn't generally advise clients how to maximize profits during the current quarter. Instead, the firm analyzes deeper, longer-term questions. That emphasis prompts some critics to suggest that Barton's arguments and research in favor of managing for the long term may be self-serving. But his views are mirrored by industry titans from Warren Buffett to Lord Jacob Rothschild.

ILLUSTRATION: LINCOLN AGNEW / PHOTOGRAPH: MARATHON-PHOTOS.COM


harmony
DOMINIC
4391
#FASTISBEAUTIFUL
Implenia

For their study, Barton and his co-authors devised an index of five quantitative indicators to identify long-term from short-term management strategies or orientations, relative to their industry peers. The indicators include how much investment a company makes, whether it utilizes accounting decisions to boost earnings, whether it repurchases shares to increase earnings per share and sustainability of margin growth (that is, cost-cutting), and whether it engages in "quarterly targeting."

Of the 615 companies Barton and his co-authors examined, only 164, or about 27 percent, engaged in what he calls long-term capitalism. But he expresses hope. "People are listening and momentum is building," said Barton. In a phone call from Lisbon, Barton discussed with the *Review* his thoughts and research on long-term capitalism.

Among the volumes of research that McKinsey publishes – for that matter among investment research published anywhere – does your recent long-term capital study stand out?

We don't rank our research. But this is a tremendously important topic for all our clients, and a strong contribution to investment research. There was a lot of existing research that focused on one or two key markers of short-termism, but this work takes a holistic view.

Can your study have much impact? Or is it getting lost amid the din of an extraordinary global news cycle?

It has generated a useful discussion within our firm, with pension funds, asset managers and our clients, as well as with people in the outside community – for example, Larry Summers. And we're still fielding follow-ups from academics and researchers who want to work with us to advance this research. But this is just a start. We plan to expand our research scope beyond the US and toward deeper drivers of short-termism.

What was the view of Larry Summers (former Harvard president, World Bank chief economist and US Treasury Secretary)?

[Laughs.] What Larry was saying, which I think is a good argument, is that there are some CEOs who are not good long-term players, and they shouldn't be in there for the long term. His analogy was there are some golfers that are very good at hitting long shots. As he said, if Larry Summers tried to do it, he would flip over backward just given his body type.

87

PERCENT OF EXECUTIVES AND DIRECTORS FEEL MOST PRESSURED TO DEMONSTRATE STRONG FINANCIAL PERFORMANCE WITHIN TWO YEARS OR LESS

Source: "Rising to the challenge of short-termism." FCLT Global, September 2016

We're not arguing that you shouldn't have any short-term focus. If you don't think about the short term, you're not going to survive in the long term.

But the short-term player is problematic. If you're a short-term player, there's a way that you can game the system. If you get a company to cut its R&D significantly, the cash flow implications of that would be very significant – you could pop the share price very quickly and the impact of that pop wouldn't be felt for four or five years. By then, the short-term activist could have taken their money and run.

You see the effect of the short-term investor in the average holdings of stock in the New York Stock Exchange. The proportion of shares that are traded almost on a second-by-second basis has gone way up, while multi-year holdings have declined.

If you go back to the origins of the philosophy of capitalism, Adam Smith talked about a much longer term, inclusive approach. But it seems to me that we've kind of lost our way – for the last 30 years or so, going back to the seventies.

One criticism of your study is that while it showed an association between long-term corporate behaviors and better outcomes, it didn't prove causation. How serious a limitation is that?

We were very upfront about what our study did and did not accomplish, and it did not establish causation. But we did identify a few thought-provoking indicators that can be used to differentiate between short- and long-term companies. We found that they had a striking relationship to outperformance when we used them to classify companies, but this conclusion stops well short of causation. Very possibly you can't prove causation. But that doesn't mean there's not a link. This isn't 100 percent proof, but we think it is pretty compelling evidence.

In the 14-year period you studied, why was the long-term advantage most pronounced after the recession?

The outperformance of long-term companies reflects the benefits of investments that they made at a time – 2007 to 2009 – when other companies were decreasing investment. Many companies were worried in the crisis and decreased R&D spending. By contrast, the long-term ones held it steady or increased, thus widening the performance gap.

In your 2011 paper, you mention a measure at some French companies that gives two votes per share to shares held longer than a year. Are any companies elsewhere adopting such a measure?
Yes, Aflac, Carlisle, J.M. Smucker, Quaker Chemical, Synovus. But SEC rules make it difficult for an existing public company to change voting structure. There's a good article on that, called "Tenure Voting and the US Public Company" in *The Business Lawyer*, Spring 2017.

In a 2011 article, you cite populism as a possible consequence of short-term corporate behavior. Did you foresee Brexit and Trump? Did corporate short-termism play a role in either one?
I did not foresee Brexit/Trump, but I did worry about populism and the backlash that we might see. Short-termism had an indirect impact in that the same things that drive corporate short-termism are driving a disconnect between society and CEOs. For example, an excessive focus on earnings instead of taking care of your employees. That is creating a disconnect between "elites" and society. Trust in CEOs has fallen precipitously lately – now hovering just above the level of trust in government.

In its work with public companies, does McKinsey meet resistance in shifting from short- to long-term thinking, investment and behavior?
It varies from company to company, but people recognize the value in focusing on the long term. Most pressure for short-term results comes from some investors – particularly activists – and boards. What we found interesting was all the short-term pressure that was felt from boards – the boards are obviously feeling pressure from asset managers and they, in turn, are putting a lot of pressure on CEOs.

Boards are spending a lot of time on performance issues rather than on the quality of the talent pool, innovation rates, the trust we have with the communities that we're operating in, our brand strength. Changing their focus is a critical first step before tackling external factors.

What are the external factors?
The market itself is sometimes the most important short-term player and CEOs are getting a lot of pressure from the market. Within that, it's a lot of the smallest investors that have the loudest voices. Clearly activists are one group. But there are also asset managers who need to deliver results on an annual basis or they're going to lose mandates from some of the long-term investors. It's my view that only about 5 percent of the so-called long-term funds are actually long term. You've got quite a lot of pension funds that incentivize their asset managers on an annual basis. That's not very long term.

So the key part of this is getting long-term investors, particularly the pension funds, the sovereign wealth funds, to really focus more on the long term.

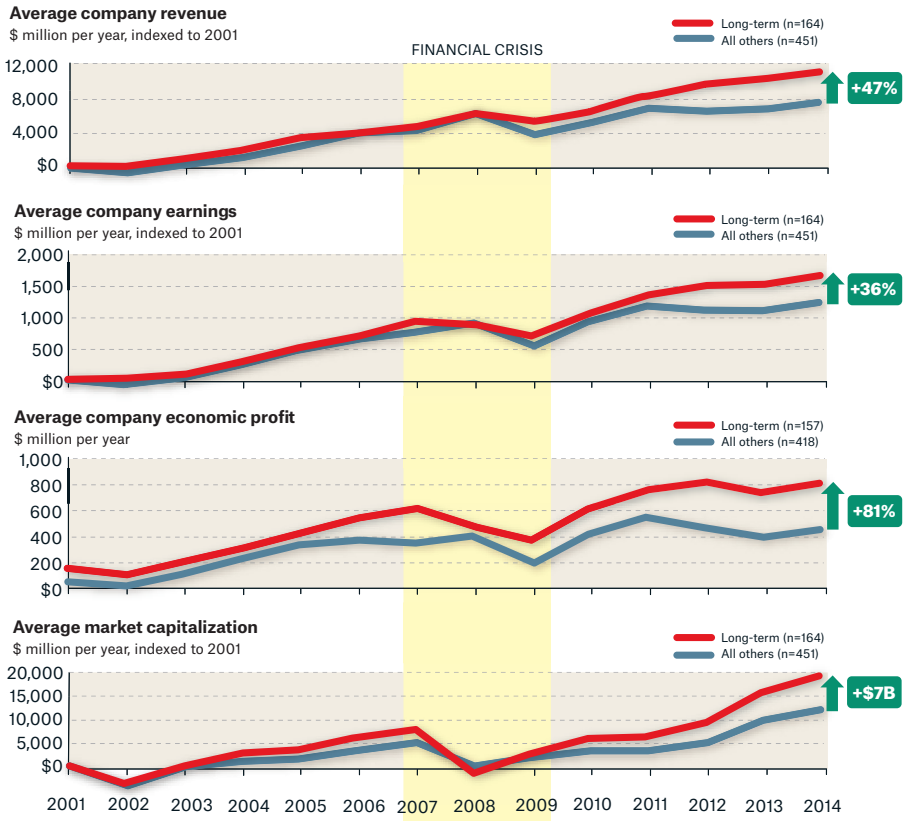
Are you seeing progress?
Yes. You see it in some US funds. You see it in some of the European, the Dutch pension funds. GIC in Singapore I think is a leading example, also the Canada Pension Plan, and some Australian and Norwegians funds.

In these cases, pension funds behave with a much longer timeframe than a typical asset manager does. It's invaluable the role modeling that these players are doing.

But it's not easy. Larry Fink, for example, is trying to drive this at BlackRock, through the letters

LONG-TERM COMPANIES exhibit stronger fundamentals and performance

Over 14 years, long-term companies show a big boost to their bottom lines



Source: McKinsey Corporate Performance Analytics; S&P capital IQ; McKinsey Global Institute Analysis

Long- and short-term companies suffer from the same market pressures, yet rebound very differently. While both suffered similarly in the market crash of 2008, for instance, the long-term companies surveyed retained their investments and actually regained market value faster than their short-term counterparts.

CHARTS: PETER HOEY

he's been sending to CEOs, saying, "What is your long-term strategy? What are the parameters or metrics that you're aiming for?" But as Larry Fink says himself, some corporates will turn around and say, "It would be great if some people within BlackRock read those letters as well."

Another example is Mark Wiseman, when he was at Canada Pension Plan. He was the one who pushed me in, saying, "My quarter is not three months. It's 25 years."

But he also said there were some people within his organization who didn't behave that way. He gave me the example of Tim Hortons, the Canadian coffee-and-donuts player that he enjoyed focusing on. He joined an analysts' call just to listen in. At the time, Horton's biggest strategic issue was how they were going to expand into the US. And yet he heard his own analyst on that call challenging the CEO on why the coffee-to-hash-brown cross sales last week dropped from the week before.

Can government help encourage more long-term investing?

Governments in general are coming to see that those who have more long-term money are going to have the advantage. So how do you attract more of that, or encourage more of that capital to be formed? The British government has an initiative they're calling the Patient Capital Review. Canada is also looking for ways to get more long-term money into the system. There may be some regulatory things we could be doing to encourage this. I would be excited if there were some regulatory shifts toward incentives for people to hold capital for a longer period. Governments could also step up infrastructure investments.

DOMINIC BARTON

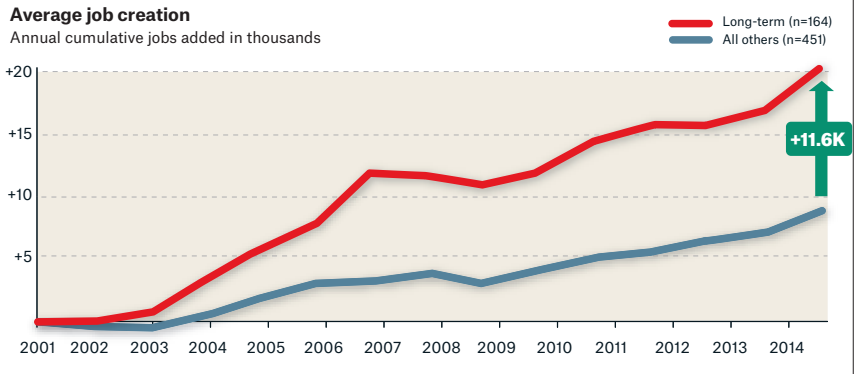
The Global Managing Partner of McKinsey, Dominic Barton leads the firm's focus on the future of capitalism and the role business leadership can play in long-term social and economic value. He served as McKinsey's Chairman in Asia from 2004 to 2009.

McKINSEY & CO. is a global advisory firm comprising 1,500 partners, more than 16,000 consultants and nearly 2,000 research and information professionals.

For its survey, McKinsey identified 164 companies engaged in long-term planning, out of a field of 615. The results of those 164 companies were then compared to the rest of the pack. Long-term companies outperformed the others in most cases, including the area of job creation, shown below.

LONG-TERM COMPANIES contribute more to employment and economic output

Over 11,000 more jobs were created each year by long-term businesses surveyed



Source: McKinsey Corporate Performance Analytics; S&P Capital IQ; McKinsey Global Institute Analysis

Is there a political component to this issue? Is either the left or the right more concerned about the costs of short-termism?

I think it's apolitical in terms of left or right. The left is probably more concerned with inclusive capitalism, right? What are companies doing in the community in which they're operating? Are they thinking about a broad enough group of stakeholders? But the right is doing that as well. In the US campaign, Hillary Clinton was talking about incentives for investors to hold their shares longer. And Trump was not saying, "That's a stupid idea."

What regulatory measures would you welcome?

Regulators have a very important role to play in re-focusing businesses and capitalism, in general, on the long term. For example, regulators could re-work "mark to market" rules [for establishing fair market value] so that valuations could vary by holding period; remove quarterly reporting requirements and taper capital gains taxes so that longer-term investments attract a lower tax rate. In Europe, they could scrap Solvency II for insurance companies, which incentivizes insurance companies (one of the largest categories of institutional investors) to act very short term.

What's your secret for staying fit on the road?

For me, traveling and exercise are two things that have to go together – because if I'm not exercising, well, I can't take it. [Laughs.] So my rule is, wherever I land I go for an hour run. If I can do it outside, it's all the better. I don't care if it's raining, because it acclimates me to the place really quickly. I don't want to come across like I'm some sort of athletic freak. I'm not. And I'm not fast. There are just some things I want to be tight on, because it helps me be alert. A mentor from way back told me something I choose to believe even though I doubt it is true, which is that one hour of running is like eight hours of sleep.

(Editor's note: Two days after this interview, Barton ran a half-marathon in Geneva in 1:49:05, placing in the top 40 percent of men aged 50-59. He also finished ahead of his two adult children.)

KEVIN HELLIKER is the Editor-in-Chief of the *Brunswick Review* and a former Pulitzer Prize-winning journalist for *The Wall Street Journal*.