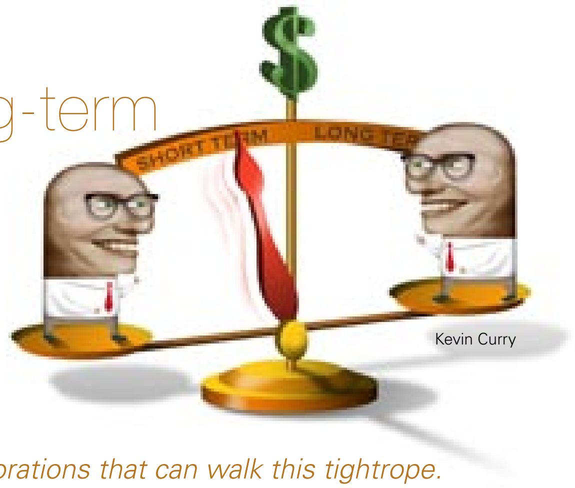
Balancing short- and long-term performance



Kevin Curry

**Janamitra Devan,
Anna Kristina Millan, and
Pranav Shirke**

The benefits are many for corporations that can walk this tightrope.

Many corporate leaders struggle to increase long-term shareholder value. This comes as no surprise, given an increasingly competitive environment in which financial markets often evaluate a company and its CEO by the most recent quarterly results. But the cost of neglecting long-term performance can be high in today's rapidly changing business world, where most companies either do not survive or are acquired.[1]

Our research into companies listed on the S&P 500 from 1984 to 2004 shows that some *do* achieve strong results in both the short and the long term. We identified 266 companies and grouped them in four quadrants: companies that recorded strong short- and long-term performance, those that performed poorly in the short term but well over time, others that were strong in the former but lackluster in the latter, and companies that were mediocre in both (exhibit).

We then examined how the companies in each quadrant performed along four dimensions: long-term total returns to shareholders (TRS), survival rates, the tenure of current CEOs, and the volatility of share prices reflected in the beta deviation from the industry average.

Clearly, the ability to balance short- and long-term performance pays off handsomely. On average, companies with strong overall performance beat companies in all the other quadrants on most measures. The average TRS of the top corporations was 9.4 percentage points higher than the average of companies with mediocre short- and long-term performance, and the survival rate of the former was substantially higher: 73 percent were still around in 2004—the end of the analysis period—as opposed to 57 percent of the companies with mediocre performance. Moreover, a CEO at the top performers remained in office almost three years longer, and those companies' stock prices were substantially less volatile.

Companies with robust long-term but lackluster short-term performance had survival rates almost equal to those of the top performers but scored lower on each of the other measures. Companies with strong short-term but weak long-term performance had marginally less volatile stocks than did companies with strong performance overall but were weaker on the other three measures.

Living up to investor expectations for any length of time is usually demanding. Our analysis showed that, of the high-performing companies in our sample, a few owed their success to a prolonged sweet spot for their products or services rather than to a deliberate attempt to achieve balance. The rest skillfully juggled current opportunities

EXHIBIT

The long and short of it

Companies' performance from 1984 to 2004 (for companies listed in S&P 500 in 1990)[1]

Long-term performance	Short-term performance: Low		Short-term performance: High	
High	Total returns to shareholders (TRS), %	15.6	TRS, %	18.5
	Survival rate, %	72	Survival rate, %	73
	Tenure of current CEO in years	4.5	Tenure of current CEO in years	7.7
	Beta deviation from industry average	0.05	Beta deviation from industry average	–0.01
	47 companies		*62 companies*	
Low	TRS, %	9.1	TRS, %	14.2
	Survival rate, %	57	Survival rate, %	64
	Tenure of current CEO in years	4.8	Tenure of current CEO in years	6.0
	Beta deviation from industry average	0.19	Beta deviation from industry average	–0.04
	81 companies		*76 companies*	

Methodology

- Short-term performance measured as average return on capital employed (ROCE) for all but financial companies, where it was measured as return on equity (ROE)
- Long-term performance measured as average 5-year compound annual growth rate (CAGR) in sales from 1984 to 2004; individual averages of companies were compared with respective industry averages
- Long-term TRS calculated as rolling monthly average of 5-year CAGR between Jan 1989 and Oct 2004
- Survival rate measured as ratio of surviving companies vs total number of companies
- CEO tenure represents average tenures of individuals who were CEOs when research was completed
- Beta deviation calculated as average of difference between beta for each company and its respective industry beta[2]

[1] For 266 companies listed in S&P 500 in 1990; excludes 167 companies that were acquired or dissolved during period analyzed and 67 companies considered marginal cases for falling within + or –5% margin of defining lines of quadrants.

[2] Beta is measure of asset's risk relative to market; a given stock's beta is >1.0 if, over time, it moves ahead of market and <1.0 if it moves behind market.

Source: Barra; Bloomberg; Hoovers; Standard & Poor's; Thomson; McKinsey analysis

with others providing for long-term growth. This approach was relatively painless for companies with large pools of capital to finance long-term options. The majority of corporations, however, balanced both objectives only by making difficult trade-offs with limited resources and in the face of unrelenting shareholder pressure for an immediate return on equity.

Even sweet spots turn sour over time, and overflowing pools of capital occasionally run low. Regardless of whether (and how) companies may be juggling short- and long-term performance today, those aiming for longevity need to balance trade-offs between current earnings and shareholder value over an extended period of time. How can these goals be achieved?

We found that many successful companies instilled a long-term mind-set. They tended to appoint CEOs who kept an eye on short-term operational performance, for example, while also constantly emphasizing innovation that could produce long-term growth. These companies also typically introduced dynamic strategic processes to evaluate growth initiatives on an ongoing basis, thus enabling management to be nimble when it decided to abandon, reorient, or accelerate them.[2] Successful companies also used financial incentives to attain both short- and long-term targets. While none of the levers, on its own, guaranteed success—a plethora of other factors was involved, such as managerial talent, organizational flexibility, and strong execution skills—they are a starting point.

Janamitra Devan and **Anna Kristina Millan** are consultants in McKinsey's Washington, DC, office, and **Pranav Shirke** is a consultant in the Singapore office.

[1] By 1998, the average estimated tenure of a company listed on the S&P 500 was ten years. If history is a guide, over the next quarter century no more than a third of today's major corporations will survive in an economically important way. See Richard N. Foster and Sarah Kaplan, "Creative destruction," *The McKinsey Quarterly*, 2001 Number 3, pp. 40–51 (www.mckinseyquarterly.com/links/15591).

[2] For a wide-ranging view of how to pick and manage the right set of long-term growth initiatives, see Lowell L. Bryan, "Just-in-time strategy for a turbulent world," *The McKinsey Quarterly*, 2002 special edition: Risk and resilience, pp. 16–27 (www.mckinseyquarterly.com/links/15592); and Lowell L. Bryan and Ron Hulme, "Managing for improved corporate performance," *The McKinsey Quarterly*, 2003 Number 3, pp. 94–105 (www.mckinseyquarterly.com/links/15593).