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Focusing Capital on the Long Term

by Dominic Barton and Mark Wiseman

Since the 2008 financial crisis and the onset of the Great Recession, a growing chorus of voices has urged the United States and other economies to move away from their focus on "quarterly capitalism" and toward a true long-term mind-set. This topic is routinely on the meeting agendas of the OECD, the World Economic Forum, the G30, and other international bodies. A host of solutions have been offered—from **"shared value"** to **"sustainable capitalism"** —that spell out in detail the societal benefits of such a shift in the way corporate executives lead and invest. Yet despite this proliferation of thoughtful frameworks, the shadow of short-termism has continued to advance—and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers.

The main source of the problem, we believe, is the continuing pressure on public companies from financial markets to maximize short-term results. And although some executives have managed to ignore this pressure, it's unrealistic to expect corporate leaders to do so over time without stronger support from investors themselves. A crucial breakthrough would occur if the major players in the market, particularly the big asset owners, joined the fight—something we believe is in the best interests of their constituents. In this article we lay out some practical approaches that large institutional investors can take to do this—many of which are already being applied by a handful of major asset owners.

The Intensifying Pressure for Short-Term Results

One of us (Dominic Barton) previously wrote about the need to "fight the tyranny of short-termism" (see **"Capitalism for the Long Term,"** HBR March 2011), and over the past few years both our organizations have been monitoring the debate on short-termism. Early in 2013 McKinsey and the Canada Pension Plan Investment Board (CPPIB) conducted a *McKinsey Quarterly* survey of more than 1,000 board members and C-suite executives around the world to assess their progress in taking a longer-term approach to running their companies. The results are stark:

- 63% of respondents said the pressure to generate strong short-term results had increased over the previous five years.
- 79% felt especially pressured to demonstrate strong financial performance over a period of just two years or less.
- 44% said they use a time horizon of less than three years in setting strategy.
- 73% said they *should* use a time horizon of more than three years.
- 86% declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.

What explains this persistent gap between knowing the right thing to do and actually doing it? In our survey, 46% of respondents said that the pressure to deliver strong short-term financial performance stemmed from their boards—they expected their companies to generate greater earnings in the near term. As for those board members, they made it clear that they were often just channeling increased short-term pressures from investors, including institutional shareholders.

That's why we have concluded that the single most realistic and effective way to move forward is to change the investment strategies and approaches of the players who form the cornerstone of our capitalist system: the big asset owners.

Practical Changes for Asset Owners

The world's largest asset owners include pension funds, insurance firms, sovereign wealth funds, and mutual funds (which collect individual investors' money directly or through products like 401(k) plans). They invest on behalf of long-term savers, taxpayers, and investors. In many cases their fiduciary responsibilities to their clients stretch over generations. Today they own 73% of the top 1,000 companies in the U.S., versus 47% in 1973. So they should have both the scale and the time horizon to focus capital on the long term.

But too many of these major players are not taking a long-term approach in public markets. They are failing to engage with corporate leaders to shape the company's long-range course. They are using short-term investment strategies designed to track closely with benchmark indexes like the MSCI World Index. And they are letting their investment consultants pick external asset managers who focus mostly on short-term returns. To put it bluntly, they are not acting like owners.

The result has been that asset managers with a short-term focus are increasingly setting prices in public markets. They take a narrow view of a stock's value that is unlikely to lead to efficient pricing and collectively leads to herd behavior, excess volatility, and bubbles. This, in turn, results in corporate boards and management making suboptimal decisions for creating long-term value. **Work** by Andrew Haldane and Richard Davies at the Bank of England has shown that stock prices in the United Kingdom and the United States have historically overdiscounted future returns by 5% to 10%. Avoiding that pressure is one reason why private equity firms buy publicly traded companies and take them private. Research, including an analysis by CPPIB, which one of us (Mark Wiseman) heads, indicates that over the long term (and after adjustment for leverage and other factors), investing in private equity rather than comparable public securities yields annual aggregate returns that are 1.5% to 2.0% higher, even after substantial fees and carried interest are paid to private equity firms. Hence, the underlying outperformance of the private companies is clearly higher still.

Dominic Barton is the global managing director of McKinsey & Company. **Mark Wiseman** is the president and CEO of the Canada Pension Plan Investment Board.